

Minutes of WG1 meeting on 21 July 2014

HMRC noted that the agenda for the meeting was to provide an update on FB2015 and review the draft clauses, which were circulated in advance of the meeting.

Finance Bill 2015

- Sections 307 and 308 (core of the regime) - legislation drafted and for discussion at the meeting.
- TAAR - instructions were sent to OPC last week and HMRC is expecting something before the next scheduled meeting.
- Looking behind the accounts - instructions were also sent to OPC last week. It is possible this will be ready for discussion at the next meeting but OPC has been asked to prioritise the TAAR drafting so this may need to be deferred to the following meeting. HMRC confirmed that the intention is to draft a basic rule (if an amount is recognised for accounting purposes, then it is subject to the LRDC regime) and then address any issues
- Foreign exchange (WG3) – instructions are due to go to OPC shortly.
- Partnerships (WG2) - revised material has been received from OPC and is being discussed but there is still more to do.
- Corporate rescue - two drafts of the proposed legislation have been shared with WG2 and there is also a further discussion paper from HMRC on this.
- Connected companies (primarily amendments to s352 regarding interest rate contracts and relaxing amortised cost to allow fair value hedging) and amendments related to accounting changes – HMRC is considering a draft and this will be shared following further discussions with OPC.
- Draft Regulations related to Change of Accounting Practice (“COAP”) and Disregard Regulations due out this year. The aim is to introduce these pre-2015 when new GAAP becomes mandatory. WG3 is specifically looking at the elections in Reg 4A and 6 (FV accounting) to give taxpayers longer to elect and make Reg 6 “elect in” rather than “elect out”. The changes to COAP are intended to deal with potential transitional issue on distressed debt / amend and extend transaction (ties in with WG2) and also permanent as equity instruments (to preserve existing treatment). There are also amendments to update the statutory references.

There is likely to be a lot more legislation released for discussion over next couple of months.

Timing

As regards timing, the election is in May so Parliament dissolves by the end of March. Therefore, the Budget will be in the earlier half of March though there is no date yet. Equally, there is no date yet for Autumn Statement or the publication of draft clauses. HMRC is not aware of any reason why the timing wouldn't be early December as usual. The pre-election Finance Bill will need to go through Parliament all at once after Budget and before the dissolution of Parliament so the time for tweaking / report stage amendments, etc is very limited / non-existent. It is not clear yet whether the LRDC changes will be included in the pre-election Finance Bill. The earlier Finance Bill is usually shorter than normal but it is also true that substantive measures can be included. This is a question for agreement between the Government and Opposition but discussions on this are not expected until March. For planning purposes, HMRC is assuming that these measures will not be sufficiently controversial to warrant objection so they will likely be included in the earlier Bill. If the LRDC amendments are not included in the pre-election Bill then, again on the basis that this is not politically sensitive, HMRC is assuming that they will be included in the later Bill in 2015. As a general point, the legislation needs to be in as good a shape as possible by December due to the limited time for changes thereafter.

The intention is still for commencement to be for periods beginning on or after 1 January 2016.

Draft legislation

Section 307 (and new section 306A)

Section s307, etc. currently seeks to do two things: 1) explain what it is that the regime applies to; and 2) explain how to arrive at the credits and debits that will be used to calculate the taxable amount.

As regards the second element, there are two (potentially) different directions based on the existing legislation: 1) follow the accounts, i.e. per s307(2); and 2) take the amounts that, when taken together, fairly represent the profit, etc., i.e. per s307(3). One of the potential problems with this approach is that it tries to do two different things in determining “the matters” and then arriving at the credits and debits. These can get mixed up leading to a lack of clarity / difficulty. There are potentially conflicting requirements in relation to credits and debts and where these point in different directions, it is not clear from the legislation what should happen.

Therefore, following discussions in WG1, HMRC has concluded that the second possibility should be eliminated and the regime should be firmly based on the credits and debits derived from the amounts in the accounts unless there is a specific departure in the legislation. There will be no general override. The changes proposed to the legislation are designed to effect these decisions. Therefore, the changes have two aims – 1) separate identification from computation; and 2) remove the “fairly represents” override. The group agreed these were the two aims of the amendments.

The new s306A(1) should be largely the same as the previous s307(3). The legislation still refers to all of “the matters” but there is now no reference to fairly represents.

The group raised a couple of potential reservations –

- 1) Section 307(1) has been omitted.
- 2) Also, it was suggested that the way s307 worked previously was that ss(2) identified all of the possible amounts and then these were subject to ss(3) which filtered the accounting data, e.g. if hedge accounting mixed up multiple items. However, the new draft pulls out ss(3) as a scoping provision; it is not clear that this was its previous function.

HMRC noted that the proposed omission of s307(1) is still open for discussion and OPC had raised this as a question as well. The same phrase is used in Pt 7 so this would also need to be omitted. It also appears in Pt 8 so there is a question as to the impact on IP and what difference the provision might make.

Arguably, it is misleading because the definition of a LRDC item does not operate by reference to the accounts. There is a question as to whether the provision is really doing something that would be lost. It was suggested that it serves as a useful reminder as regards the computational mechanics that the accounts are key. What is s307(1) delivering that s307(2) is not? The group accepted that if the reference to “fairly represents” is deleted then the issue may disappear.

The question was asked as to whether ss(1) helps to understand the reference to credits and debits in ss(2)? However, Parts 5 and 7 don't use “debts and credits” in terms of accounting but rather state that these are the things to be taken into account for tax purposes so they are adjusted from accounting terms. The legislation starts in s295 by stating that profits arising from LRs are chargeable and then it states that profits are to be calculated using the credits and debits given by this Part. Then s307(2) provides that the amounts to be brought into account *as credits and debits* are the amounts recognised in determining profits in accordance with GAAP. It is odd that the legislation uses accounting terms to describe something that is not an accounting item. However, the intention is to retain credits and debits as tax concepts as these are deeply embedded in the regime. When the legislation talks about items in the accounts it refers to “amounts”. These must then be converted into numbers in the tax calculation and now they become credits or debits. These might not tie exactly to “amounts” because of the effect of tax rules.

The conclusion was generally that s307(1) doesn't seem to be serving any particular function that would be lost if the provision was repealed but, on the other hand, the provision is not doing any harm and is in line with another Part albeit one operating in different way. HMRC is to consider the point again but there is no obvious reason to do one or the other.

There is an insertion into s307(2) in order to link back to “the matters” now listed in s306A(1) and ss(3) and ss(4) are omitted. The latter is just transplanted into s306A. As regards ss(3), the proposal involves removing the words "when taken together", "fairly represents" and "for the accounting period in question".

The question was asked as to whether "taken together" is doing something different from "fairly represents". There should be no need to consider individual loan relationships unless there is a specific reason in the legislation. It could be said that "taken together" reinforces this but arguably it is specific to “fairly represents” rather than creating a general rule. HMRC has taken the view that there is no need to introduce specific wording to achieve a position where there is nothing to stop one from considering loan relationships in aggregate; this arises naturally. This should be clear from s295 which refers to “profits arising from its loan relationships” and s306A also refers to loan relationships in the plural. HMRC asked the group whether they considered that something would be lost or changed if the phrase "taken together" was omitted and no one raised any concerns.

As regards the omission of “fairly represents” this has been debated in sufficient detail for HMRC to be happy this is the right answer.

With respect to the phrase "for the accounting period in question", there is a view that a function of s307(3) is to explain how amounts should be allocated to one accounting period rather than another. HMRC has taken the view that subsection (2), which refers to "for any period", should be sufficient and nothing further should be needed. However, it was suggested that this is a reference to a “period of account” rather than a tax “accounting period”. If there is no specific rule, then amounts should be time apportioned in accordance with the general rule in CTA 2010. There are other approaches in other parts of the Code, which state, for example, that time apportionment applies unless certain conditions are met. It was suggested that it might not be possible to derive a specific rule and in practice most taxpayers would time apportion anyway. However, in response to this, it was noted that there could be quite material mismatches in respect of FX if, for example, one company has a long period of account, the other has a short period and both are required to apply time apportionment. If the approach is to assume that a set of accounts is drawn up at a particular date then this may not be an issue. Arguably, this is what “fairly represents” provides anyway but it was suggested that this approach may only be taken if there is a potential issue and otherwise time apportionment would be used. It will be important to have something that allows for a simple approach where it works but also allows for a more complex approach if needed.

It was noted that s308 also refers to “period” but it is unclear whether this is a specific reference to an “accounting period” or a “period of account”. Section 307(3) used to refer to “credits and debits” and “accounting period” so this was clearly using tax language. On this basis, it was suggested that there would be a definite change in the legislation if “accounting period” was omitted. However, it was accepted that s307(2) and s308 may be sufficient to get to the right answer. The general view was that it should be possible to get the right answer based on the wording of s307(2) without specifying “accounting period” and HMRC can confirm in guidance that s307(2) clearly overrides s1172.

It was agreed that s307(5) probably fits better in s306A given that it is talking about expenses, which relates back to s307(4) and this has been moved in full to s306A.

It was noted that there may be a number of consequential amendments to eliminate references or amend to s306A(1) if relevant.

Section 308

The function of s308 is to link back to s307(2) as it explains what is meant by amounts recognised in determining profit or loss. Currently, it refers to amounts recognised in a specific list of statements but the proposal is to refer only to amounts recognised as an item of profit or loss. This is an attempt to ensure P&L only and is consistent with the terminology in new accounting standards. The preference would be to avoid references to specific statements as the terminology keeps changing.

There were two points of discussion on s308:

- Is “item of profit or loss” and “other comprehensive income” sufficiently well-defined and / or understood to be used here?
- Is there any potential confusion as a result of the reference to “accounts”?

The term “accounts” is also used in s309 and is not defined. HMRC noted that there shouldn't be any difficulty in using the term in the same way here. As regards the phrase "transferred to become", this is being used to avoid any theoretical argument that the item in OCI is different to the item in P&L.

Is there anything that could go wrong with regard to FX gains and losses? If an OCI item includes a FX gain or loss then it will be important to ensure that the FX rules apply when the amount comes out of OCI. For example, as regards exchange movements on overseas branch, which under IFRS do get recycled through P&L but under FRS 102 do not get recycled, these should not be brought into account under s328 in either case. This should work as intended as s308 will bring in the amounts under IFRS and s320A will bring in the amounts under FRS102 and then, in both cases, they will be specifically excluded under s328. It will be important to make it clear that the item retains the same character when it is recycled so it can be subject to specific rules.

Section 320A

There is a new s320A to provide for deemed recycling if not otherwise there. It was noted that there had been discussions about specific cases. However, the conclusion was that it should be simpler to provide for a general rule as there may be new cases. The provision is intended to be generally worded and act as a “backstop” to ensure the amounts are eventually brought into account. The thinking is that, in practice, it should be quite clear whether or not items will be recycled. It was noted that transitional rules generally are still to be considered.

It was noted that “item of profit or loss” is defined in both s308 and s320A. However, this does not seem to be a particular issue and, given importance, it seems easier to include in both provisions.

It is not clear how often the recycling rule will apply in practice. There is own credit risk, equity instruments and possibly overseas branches (though these will be scoped out in s328). As regards equity instruments, it was noted that there are occasionally boundary issues between liability and equity under IAS 32 so it makes sense to have general rule. The original intention was to define these cases but this has proven difficult and conceptually possible that other scenarios will arise. It is not clear whether the general wording is an issue. There is no obvious problem but it is quite a broad rule for what seems to be a few narrow situations so it will be important to be comfortable that this is the preferred route.

It was noted that consideration should be given to how the rules will work on intra-group transfers and migrations. If a liability is transferred intra-group, looks like the recycling gets triggered on novation rather than on disposal outside the group as the liability will cease to be recognised. If a company is exported then the amounts may never be recognised as there is a deemed disposal but the liability will not cease to be recognised. It was noted that group continuity should apply to cover the OCI amount but there is a question as how the rules will interact as the new provision triggers recognition of gain when the debt ceases to be recognised. In both cases, it may be possible to specify the consideration (carrying value adjusted for OCI and fair value respectively) but it's not clear whether this would achieve the objective.

It was noted that FS groups will want the ability to take a deduction on hybrid instruments over the life of instrument. If there is a liability to back regulatory capital and the company is paying interest then they will want to take deduction but they can't derecognise the liability so they can't get into s320A.

Next steps

HMRC to consider further the points made today, speak to OPC and issue updated draft legislation. The consequential changes will also be picked up.

The next meeting may be deferred until September due to holidays. Draft legislation for the regime TAAR should be available by then for discussion.