Minutes of WG1 meeting on 26 March 2014

Summary

- HMRC no longer intends to introduce a general override to the accounts per Chapter 3 of the Condoc, i.e. a more explicit version of "fairly represents".
- HMRC has also determined that it should be possible to introduce specific rules to deal with most cases where some "interference" has affected the accounting presentation of a transaction or instrument in an unacceptable way so there should be no need for a general rule per Chapter 4 of the Condoc.
- A subset of WG1 will meet to discuss the scenarios that have been identified as requiring a specific rule and confirm the preferred approach to these scenarios.
- As regards the regime TAAR, HMRC welcomes suggestions as to how filters could be included in the legislation to make the target of the rule clearer but this cannot result in any dilution in the impact of the rule, particularly in light of the decisions above in relation to "fairly represents" and "interference".

Looking behind the accounts

Section 307 and "fairly represents"

HMRC noted that section 307 is trying to achieve a lot with not very many words and, consequently, the provision doesn't offer as much clarity as it could and should. The aim is to unpick the provision, establish its objectives and make it more explicit. There is no intention, as part of this, to extract and reproduce the rule aimed at providing a general override to accounting, i.e. the current HMRC interpretation of "fairly represents". There are still some issues with regard to 'looking behind the accounts' but these relate to more specific areas rather than the fundamental building blocks of regime. This decision has been driven by the representations made regarding the uncertainty that would be associated with such a rule and the fact that the anti-avoidance function of such a rule should be delivered by the regime TAAR. This leaves open the possibility that some difficulty might arise in the future where the accounts don't give the "right" answer in a specific scenario (this may be pro-taxpayer or pro-HMRC) and there is no avoidance involved – in other words, certainty may come at the cost of flexibility of interpretation in some cases.

The group noted that the position of the non-HMRC members in relation to section 307 and "fairly represents" is very much predicated on the understanding that, under the new regime, the starting point will be the profit and loss account and the existing section 322 and the debt buyback rules will be reformed. This is understood.

Chapter 4 of Condoc

The original proposal was there should be a rule to deal with situations where the presentation in the accounts of a particular transaction or instrument is influenced by another transaction or instrument. HMRC prepared a discussion paper on this, suggesting that there should be a general rule to allow the accounting to be unravelled. However, there is an alternative approach which would not involve a general rule with exceptions for situations where the interference is acceptable but instead would involve specific rules to deal with cases where the interference is a problem. HMRC agreed that any general rule would be likely to apply only in limited circumstances but, if an alternative approach is to be adopted, they need to be reasonably certain that it is possible to identify all situations where a specific rule is needed. A number of these situations were identified in the discussion paper and it seems that no one has identified any significant new areas that need to be considered. Therefore, HMRC has reached the conclusion that they are prepared to use specific rules rather than a general anti-interference rule. However, this means that the group now needs to deal with the specific issues.

Specific issues

The general proposition was that the LRDC rules should be applied as if any 'interference' arising from the accounting treatment of other instruments or transactions were not present, i.e. the rule should identify how the item would have been accounted for absent the interference and then the interfering item should be taxed appropriately in accordance with other rules (e.g. capital gains). The discussion to date has suggested that the disadvantages of a general rule outweigh the advantages. In very many cases, the interference is acceptable, e.g. hedge accounting, and there are a number of situations where a specific rule is needed. This should not leave much other than anti-avoidance situations, which should be covered by the regime TAAR anyway. The consequence of not having a general rule is that the taxpayer may be disadvantaged as there will be no provision for overriding the accounting in a non-avoidance scenario, but these situations will hopefully be rare.

The specific scenarios are as follows:

1) **Hedge accounting –** In general, the interference is acceptable for tax purposes. Focusing the regime on the amounts recorded in the profit and loss account P&L should deal with cashflow hedge accounting and other scenarios are already managed using the Disregard and EGLBAGL Regulations. The group agreed that they would be happy with this approach, i.e. retaining the Disregard Regs in some form.

2) **Capitalised interest –** The intention is essentially to retain the existing rule.

   With regard to debits and credits recorded in equity more generally, the thinking is that there will not be an equivalent to section 321, i.e. *prima facie* amounts recorded in equity will not be brought into account. It was noted that, in the context of compound instruments, this would mean that, where something is wholly accounted for as equity, it wouldn't be within the regime from the perspective of the issuer company. This is one of the consequences of following the P&L with no override but there should be limited situations where an instrument, which is wholly accounted for as equity, would be a loan relationship. It was suggested that while it may be rare in practice, there is still a question around group symmetry in particular where an item is recorded in equity in the issuer but amounts will arise in the profit and loss account of the lender – it would be wrong to have net taxation in respect of such instruments.

   It was suggested that there are two types of transactions, which will typically give rise to entries in equity: a) amounts arising from a transaction with the shareholder in its capacity as shareholder which do not constitute profits from a LRDC; and b) amounts in respect of instruments which are regarded as wholly equity instruments. With regard to the first, the new regime is focused on the profit and loss account so capital contributions and distributions will not be taxable (this is where section 321 has caused problems in the past). With regard to the second category, a special rule would be required and the current intention is not to introduce such a rule. Is this the right answer? It was noted that this may give rise to problems in practice, e.g. warrants would be equity instruments from the issuer's perspective but represent derivative contracts for the holder. Also perpetual loans may be accounted for as equity but constitute loan relationships for tax purposes. HMRC suggested that most of these situations should relate to regulatory capital type issues for banks and the preference would be to avoid cluttering the regime with provisions that could be included in specific rules for regulatory capital. However, this is not just about regulatory capital. It was suggested that it may be worth setting up a smaller sub-group to look at this in a bit more detail and deal with some of the difficult questions arising from this new approach.

3) **Recognition / Derecognition / Repos** – The key issue here is the difference between legal and accounting definitions. The current thinking is that the basic test of connection is legal for debtor relationships and derivative contracts and beneficial ownership for creditor relationships. There are a number of situations where the accounting test is different and it may be appropriate to follow the accounts, e.g. section 332 says that if a company ceases to be party to a loan but continues to bring amounts into account, tax should follow the accounts. It will also be necessary to consider

mortgages, charges and collateral. If collateral is provided in the form of loan relationships, the rules need to confirm whether the legal or accounting perspective is relevant. Is there a need to specify particular cases or could there be a general rule that applies whenever amounts continue to be recognised in the profit and loss account? This might depend on whether there is any possibility of creating double taxation. The point has been raised in the context of situations where two companies have the same asset or both partnership and partner recognise the same profits. There is a question as to whether section 332 goes too far and needs to be more limited. This will need further attention from the sub-group.

With regard to derecognition or non-recognition of something to which a company is legally a party, there is no firm view on how to manage such situations. There are three options: A) deal only with avoidance scenarios and rely on existing rules; B) deal only with avoidance scenarios and rely on the regime TAAR; or C) develop a new rule that deals with non-avoidance scenarios as well, e.g. double recognition of same profits. Further discussion is needed to arrive at the best answer from the perspective of complexity, certainty, etc. This discussion is related to the open question as to how section 307 should be amended (see below). It is likely to be easier to deal with the difficult scenarios if the basics are right.

With regard to the existing rules on derecognition, they have appear to have eliminated avoidance transactions in this area. However, it is possible that something else is needed to deal with non-avoidance situations. There are also cases of non-recognition which arise where someone else has failed to derecognise a loan – this is not derecognition within the meaning of the existing tax provisions. There is a question as to whether there needs to be a more general rule to deal with situations where accounting and legal treatments differ on which entity has the loan relationship. When the current derecognition rules were first published in draft, there was no purpose test but it was introduced following consultation to deal with situations like repos, etc. The problem with introducing a general rule is that it reopens that discussion.

HMRC noted that there seemed to be no strong preference for Option C. However, the situations noted above do arise, e.g. partnership and partner recognising the same income, and it was agreed that section 332 may go too far. There are cases where the operation of the rules as they stand could lead to double taxation. .

4) **Distributions in specie**

5) **Interference involving other parties –** The discussion paper concluded that this can't be dealt with satisfactorily.

There is clearly more work to do. It was agreed that arranging a subgroup would be a good idea. In particular, section 332 and the options for dealing with derecognition / non-recognition need further discussion as well as the point around compound instruments accounted for in equity. The general direction of travel is not to make unnecessary changes but consider whether it is possible to tweak the existing legislation in order to make some improvements.

"Amounts in accounts" / Section 307

Closely connected with the discussion around whether the test of connection should be legal or accounting is the question of whether there should be a provision at the beginning of the regime to define what is meant by "amounts in accounts". This may be generally obvious but there are always outliers where the answer is not obvious and it will be important to deal with this without going back to "fairly represents". The group needs to decide to what extent it would be worth saying something in the legislation or elsewhere.

If the starting point is "amounts" but it becomes necessary to split the credits and debits, e.g. in order to target a debit under s441, what rule facilitates this? This is not necessarily the same as dealing with "interference" but it does involve looking behind the face of amounts in accounts. If there is avoidance

and a main purpose can be identified, then the situation can be dealt with under regime TAAR but if there is no avoidance or it is not possible to demonstrate main purpose, there is a question as to it would be better to have statutory guidance on this. It is currently covered with some lack of clarity and this has resulted in differing views. Some believe that it is obvious; it will always be necessary to analyse the amounts in the P&L as they are aggregates. However, some bits of the regime refer to specific DRs (s441) or CRs (s322), and it can be difficult to identify the amounts targeted by these provisions. In the context of s441, it is possible to conceive of a situation where there is a net nil in the P&L but gross CRs and DRs. There shouldn't be any need for a rule on composite amounts as one can just drill down. However, if after the drill down there is still a net nil (e.g. due to interference) then a specific rule is needed.

The function of section 307 is to apply accounting concepts to tax. This process needs to be clearer and more explicit though the terms "debits" and "credits" will likely need to be retained as the terms are used throughout the legislation.

Regime TAAR

Target of the rule

In order to identify whether a result is in line with the purpose of the legislation and so whether or not the regime TAAR should apply, it is necessary to understand the purpose of the legislation. There is therefore a question as to whether there should be a statement of purpose at the beginning of the regime. It was noted that if section 307 is recast in a helpful way then a separate statement of purpose may not be required. It was also noted that any such statement is unlikely to be specific enough to be helpful. Most of the debate is likely to focus on the application of the detailed rules and it won't be possible to attach purpose statements to every provision in the code. The TAAR should aim to ensure that a taxpayer cannot escape or manipulate the rules inappropriately or fall within the rules inappropriately. There is a question as to how to include this in the legislation if the purpose of the underlying provisions is not explicit.

HMRC referred to a table provided by the non-HMRC members of the working group which looks at the policy objectives of the regime TAAR (as set out in the Condoc) and considers whether these are achieved by the strawman TAAR put forward by HMRC. The first point is that the strawman suggests a broad rule which is insufficiently targeted. HMRC noted that when anti-avoidance legislation is first introduced, it is generally amplified and illustrated in guidance and this would be the case here. However, this is not to say that there is no need to make sure that what is in the legislation is appropriate, and gives all of the direction that it can. The non-HMRC members of the group noted that the approach of including material in guidance does not give any real comfort in commercial planning and this is particularly the case here as the breadth of the rule means that it will not be possible to deal with all situations in guidance. In order to provide any element of certainty, given the status of HMRC guidance before the courts, there needs to be something in the legislation to explain the target of the rule. HMRC emphasised that it is not that they are not prepared to look at the legislative wording but it will not be possible to include everything in the legislation. The group acknowledge this but noted that this is not a reason not to look at wording.

Repeal of other anti-avoidance provisions

HMRC referred to a schedule provided by one member of the working group listing provisions which could potentially be repealed once the regime TAAR is introduced. They noted that they would not be in a position to go through the list at the meeting as they hadn't had enough time to review but they would pick this up again at a later meeting. However, HMRC emphasised that they are keen to identify those provisions which can be repealed. It won't be possible to make any decisions until the form of the regime TAAR is clearer, but they agreed that there is a degree of iteration and so it may be possible to frame the rule to ensure that it covers certain elements.

Policy objectives

With regard to the table listing the policy objectives of the regime TAAR, HMRC confirmed that they do not disagree with the list. It is a reasonable representation. The rule must be comprehensive and effective but should not impinge on commercial transactions more than necessary to achieve that.

- **Intended tax advantages –** The proposed definition of "tax advantage" does not do anything to exclude advantages that are intended under legislation. HMRC agreed with this and noted that this is also true of all other anti-avoidance legislation including s441. It was suggested, however, that it should be possible to be more specific here given the amount of thinking that has been done around what the regime should and shouldn't cover. There was a discussion at the last meeting regarding "the intentions of Parliament". This is a difficult concept to include in legislation and is probably not particularly helpful. There is a form of words associated with the GAAR, i.e. whether the results are consistent with the underlying principles and policy, which might help in some circumstances, e.g. debt restructuring once the rules have been amended. However, the extent to which this would be helpful in all cases is an open question as there are lots of pieces of legislation which are very mechanistic where it is difficult to discern any principles. In some circumstances, it may result in an equally difficult discussion regarding policy objectives as there would have been on the TAAR more generally.

- **Specific vs general – A question was raised whether,** if the regime TAAR needs to deal with "fairly represents" and "interference" situations, the drafting should focus on these situations and not every possible scenario? HMRC said the rule is intended to fill gaps; some of these gaps may be ones which might have been filled by "fairly represents", but not all, and the rule may need to deal with cases which cannot be envisaged now. The rule is intended to cover cases where the avoidance relates to the application of the basic framework (e.g. what is now covered by s455) but also points about the detailed rules (e.g. whether they are being applied or not applied inappropriately). There are certain identifiable scenarios that the TAAR needs to cover – it may be possible to articulate this to some extent in the wording of the legislation. It may be that some existing anti-avoidance rules could be replaced by the TAAR but, because the existing rule is specific in application or specifies a particular outcome, it may be preferable to retain the existing rule.

  The idea of the TAAR is that it should be broad – one test of whether the rule is successful is the extent to which new anti-avoidance rules are needed each year. The key point is that the rule should cover new scenarios that have not arisen in the past. However, it was suggested that it might be possible to articulate generic categories of avoidance, e.g. situations where there is some interference, and use this to inform how the rule is phrased. This is not to say that the legislation has to mention specific scenarios but it could refer to general principles. A number of avoidance provisions have been introduced in the last few years to deal with specific avoidance transactions; these might have been unnecessary if a general rule had existed. "Fairly represents" is still regarded by HMRC as providing a measure of protection in some cases (though not all agree with that). If s307 is being amended, HMRC will no longer have that protection and a replacement is needed. Therefore, it may not be possible or desirable to make the rule any more targeted.

  At one end there is a very broad rule with no filters at all and at other end there are very specific provisions to counteract a single scheme. It was suggested that, where HMRC has been most successful in countering avoidance activity, the legislation has fallen in the middle of this spectrum, e.g. derecognition, disguised interest. Generically, there are certain types of things that taxpayers do that cause problems – could the legislation describe the issues in general terms? It may not be easy but it might help to strike a balance between protection for HMRC and certainty for taxpayers. HMRC noted that this is not where they are at the moment but they are prepared to consider the possibility of inserting some wording to provide some comfort around what the TAAR is trying to do. However, this is very different to reversing the polarity and having to identify a series of triggers to engage the TAAR. It was suggested that there are lots of options in between the two extremes - one step would be to mirror wording used in the GAAR around the intentions of Parliament,; another option might be to provide some examples in a non-exhaustive list. HMRC noted that they are not necessarily averse to including some generic examples in the legislation but there is a question as to how helpful this would be.

- **Other filters** – HMRC was of the view that the proposal is not out of line with other TAARs – CGT, IP, Bank levy, etc. The non-HMRC members of the group noted that this is much broader. HMRC pointed out that a taxpayer should have to be doing something removed from normal commercial activity for the regime TAAR to apply. It was suggested that the problem is that companies often do undertake pretty esoteric steps in order to access a particular rule, e.g. with regard to FX management. It then comes back to whether or not it is appropriate for a particular taxpayer to access that rule. Requiring consideration of all steps in a commercial context is helpful but a general rule will provide little comfort. If someone does something to ensure that they fall within a particular rule, whether or not this is acceptable will depend on the facts and whether or not accessing the rule was a "main purpose". No one has come up with any additional wording that will help in this case. There is a question around the definition of "arrangements" – different rules use different definitions. There needs to be a clear signpost in the legislation to confirm that it is not one step in isolation. HMRC couldn't see any issue with this – case law makes clear the need to look at all the facts of a case in determining purpose.

Next steps

The HMRC view remains that they are prepared to look at a filter to exclude scenarios where the arrangements give rise to a result intended by the legislation. However, as regards to turning the proposal on its head and including a series of specific triggers, they are a long way from this. A key objective is to eliminate the need for continual release of new anti-avoidance provisions. This is the remit from the Minster. HMRC would welcome suggestions as to how the objective around not wanting to impinge unnecessarily on normal economic activity can be achieved, but this cannot be in a way that dilutes the impact of the rule, particularly in light of conclusions on "fairly represents".

The non-HMRC members of the group noted that they would like to walk through the list of policy objectives and confirm whether they are resolved or not resolved but met in guidance. Guidance would give only limited comfort as it would imply an element of discretion unless the guidance will have statutory or quasi-statutory status.

It was agreed that the regime TAAR would be on the agenda for the next meeting. It was also agreed that the next meeting on 16 April would be cancelled and the group would meet again on 30 April instead.