

Minutes of WG2 Meeting

10am – 12pm Monday 24 February 2014

HMRC, 100 Parliament Street (G57), London, SW1A 2BQ

Attendees

Ann Brennan (GE / BBA Rep)
David Boneham (CIOT / Deloitte)
Lara Okukenu (Deloitte)
Graham Williams (PwC)
Andrew Seagren (KPMG)
Catherine Linsey (ECI Partners)
Paul Baldwin (FTI Consulting)
Vincent Maguire (Clifford Chance)
Jonathan Richards (Ernst & Young)
Andrew Hastie (LBG)
Tom Cartwright (Pinsent Masons)
Graham Iversen (Slaughter and May & BVCA)
Adam Blakemore (Cadwalader)
Richard Milnes (Grant Thornton)
Lydia Challen (Allen & Overy / Law Society)
Kevin Cummings (BDO LLP)

(collectively the “group”)

Tony Sadler (HMRC) - **Chairman**
Judith Diamond (HMRC)
Richard Daniel (HMRC)
Liz Ward-Penny (HMRC)

(collectively “HMRC”)

Apologies

Alex Jupp (Skadden)
Stuart Sinclair (Bingham McCutchen)

1. Introductions and background

HMRC opened the meeting by summarising that the main focus was to discuss the revised draft partnership legislation and discussion paper (addressing how they see the rules on changes in partnership shares operating in practice); both documents having been circulated by HMRC to the group on 21 February 2014.

It was noted that HMRC had not yet received any comments on these documents but hoped that such comments would be addressed as part of the day's meeting or would be sent to HMRC separately afterwards.

2. Timing

A member of the group queried whether HMRC still proposed to include final legislation in the Finance Bill 2014.

HMRC noted that, given the short timeframe and the amount of work still to be done (e.g. revising the current draft, incorporating rules regarding derivative contracts etc) they would not be dissatisfied if the measure was deferred to Finance Bill 2015.

HMRC made clear that in any event, they would not railroad legislation for the sake of meeting the Finance Bill 2014 deadline.

3. Section 380A CTA 2009

HMRC noted the following main changes to section 380A CTA 2009 since its draft publication:

- A new subsection (2)(d) intended to allow certain third-party scenarios to be taken into account e.g. where a creditor to a loan (to which a corporate partner is the debtor) transfers the loan to a connected party. HMRC had raised the potential of combining subsections (2)(c), (2)(d) and (2)(e) with Parliamentary Counsel but he had not favoured this approach.

- Subsection (3), which clarifies the disapplication of section 1259 CTA 2009, no longer refers to money debts as this was felt unnecessary.
- Subsection (7), which defines the term “appropriate share”, no longer makes reference to a fraction. It was felt that not doing so allowed for greater flexibility in capturing the range of profit sharing arrangements in practice.

A member of the group commented that subsection (2)(b) makes reference to “property, rights, liabilities or powers” whereas subsection (7) refers to “any profit or loss”. They queried whether a disconnect arose by virtue of the definition of “appropriate share” referencing all profits or losses i.e. not just those relating to property, rights, liabilities or powers.

HMRC commented that they were cautious against being too prescriptive in defining “appropriate share”.

In response to this, another member of the group commented that whilst they appreciated HMRC’s reservations in being too prescriptive, as currently defined this created the potential for “odd” results e.g. when applying section 380D (changes in partner’s profit sharing ratios). This is addressed in further detail below.

Other than the points raised above, no additional observations were made in respect of the changes to section 380A CTA 2009. HMRC welcomed comments in writing following the meeting.

4. Section 380B – Partner replacing partnership as party to a loan relationship

HMRC: The approach adopted is to apply the group continuity rules (Part 5 Chapter 4 CTA 2009) where (as a result of section 380A(2)) a corporate partner is treated as replacing itself as party to its share of a loan relationship.

A member of the group commented that section 336 CTA 2009 makes reference to a transaction between ‘two companies’ and that section 338 CTA 2009 (relevant in the context of a novation) to ‘one company replacing another company’ as party to a loan relationship. It was therefore queried whether Chapter 4 CTA 2009 read across to the scenario where (as in subsection 380B(2)) a company is replacing ‘itself’ as party to a loan relationship.

HMRC commented that arguably explicit reference was not needed on the basis that, as currently drafted, effectively section 380B(1) requires for Chapter 4 to be applied in the same way as it would otherwise apply in the context of two group companies. HMRC agreed to consider the point in more detail.

HMRC also noted that arguably subsection 380B(2) (which states the requirement to read references to being a member of a group in accordance with section 170 TCGA 1992) was not strictly necessary but felt that there was no harm in including it.

5. Section 380D – Changes in partner’s profit sharing ratios

HMRC: As currently drafted section 380D is intended to deal with increases or decreases in partners’ appropriate shares and does not currently address partners joining or leaving the firm.

A member of the group provided an illustrative example of a scenario they felt aptly portrayed the difficulty applying “appropriate share” to determine the extent to which a partner is deemed to have a share of a loan relationship.

Two corporate partners operate in partnership. The partnership has a £200m equity investment and a £100m loan asset (which typically generates £100k of income).

The profit sharing arrangements state that the first partner (the priority partner) is entitled to the first £100k of profits and the second partner to the rest of the profits.

In the first period, the equity investments perform well. As a result, the priority partner receives the first £100k of profits and the second partner the balance. In the second period, the equity investment is materially impaired and as a consequence the priority partner receives all of the firm's profits (i.e. £100k).

Applying the definition of "appropriate share" (as currently drafted) would imply that the priority partner's share of the firm's loan relationships has increased from a smaller percentage of the profits to 100% of the profits, despite the fact that in reality there has been no commercial change to the partner's entitlement (i.e. he remains entitled to the first £100k of the profits).

Members of the group agreed that this gave rise to an "odd" result and expressed concern this could represent one of any number of scenarios whereby such an "odd" result arose.

Members of the group also expressed concern over the potential difficulty in advising clients of the appropriate tax treatment when it would seem (from the illustration above) that the answer may be entirely dependent on external factors.

Another member of the group also queried how the above scenario would work in the context of an impairment loss arising in the first period followed by a reversal in the second period. For example, would it be the case that the impairment loss is split between partners in the first period but that the reversal belonged in its entirety to the priority partner in the second period?

HMRC agreed that the application of section 380D, particularly in the context of the definition of "appropriate share", was an area that warranted further thought and discussion. With this in mind, HMRC noted that they would appreciate any additional thoughts from the group in writing.

6. Connected Party Debt

HMRC: The intention is to treat partners as acquiring / disposing of debt at the book value of the debt without any adjustments for connected party debt and group continuity. Therefore, if for example the debt is measured at amortised cost and had been impaired, this would be its value in the accounts (i.e. net of any impairment).

In the scenario where a partner is connected with the debtor and the debt is held at fair value in the accounts, the intention would be for a decrease in profit sharing ratio to result in a taxable credit where the debt has increased in value above the amortised cost and a restriction for any loss (under section 352 CTA 2009) where the debt is impaired.

Members of the group commented that this could result in inequitable results to the taxpayer where for example the change in partner's profit sharing ratios arose as a result of the scenario illustrated above (but where there had not actually been a change to the partner's entitlement).

7. Next steps & Timing

- HMRC welcomed comments on the revised draft partnership legislation and discussion paper.
- HMRC committed to giving further thought to section 380D and commencing drafting for partnership legislation in the context of derivative contracts.
- HMRC committed to drafting guidance setting out illustrative examples of how they intend the revised draft legislation to work in practice.