Modernising the taxation of corporate debt and derivative contracts
Minutes of Working Group 3 meeting on 17 July 2014
100 Parliament Street at 2pm

Attendees:

Anne Murphy (L&G / ABI)
Chris Kell (HSBC)
David Boneham (Deloitte / CIOT)
David Hill (Grant Thornton)
David Lindsay (KPMG)
Fiona Thomson (E&Y)
Graham Williams (PwC)
John Lindsay (Linklaters)
Kieran Sweeney (Lloyds Banking Group)
Matthew Hodkin (Norton Rose)
Paul Freeman (KPMG)

Richard Daniel (HMRC)
Roger Muray (HMRC)
Andy Stewardson (HMRC)
Robert Harvey (HMRC)

Apologies:
Andrei Belinski (Centrica)
Charles Yorke (Allen & Overy)
Jackie Latham (Rolls Royce)

1 Introduction

Previous meetings

1.1 Apologies were given for the cancellation of the previous meetings; this was primarily because it had taken slightly longer than originally anticipated for draft legislation to become available.

1.2 Draft minutes from the meeting on 21 May 2014 were with HMRC and would be circulated shortly.

1.3 Following on from the discussions at that meeting it was confirmed that HMRC was proposing to amend the Taxation of Regulatory Capital Securities Regulations 2013 [SI 2013/3209] to ensure that the change to taxing only amounts recognised in profit and loss did not result in the relief currently available for coupon payments on banks' regulatory capital instruments ceasing to be so. HMRC was also considering 'grandfathering' other equity instruments which might similarly be adversely affected by the move to simply following profit and loss.

Draft legislation

1.4 A set of draft statutory instruments had been circulated the previous day; it was proposed to give over the majority of the current meeting to a discussion of these.

1.5 Draft primary legislation had also been circulated shortly before the meeting, but it was intended to defer detailed discussion of this until the meeting planned for 29 July 2014. It was noted, however, that the draft legislation reflected a slight change in approach whereby the taxation of amounts recognised in equity and not recycled was to be achieved using a generic rule rather than being dealt with on a case-by-case basis.

1.6 Further draft legislation, which would be circulated in due course, was currently being prepared to deal with:

- the relaxation of the connected party rules for debt subject to a fair value hedge;
- amendments to the functional currency rules;
- amendments to section 313(4) CTA 2009 [definition of amortised cost];
- amendments to the legislation governing changes of accounting policy;
- the regime TAAR; and
- recognition and de-recognition issues.

2 Secondary legislation

Overview

2.1 Five documents had been circulated in advance of the meeting. Two of these were simply updating the references to primary legislation within the Disregard and COAP regulations; these changes would in practice be integrated with the substantive changes to these regulations made in the other drafts circulated, so as to give only three new statutory instruments, as follows:

i. *The Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) (Amendment) Regulations 2014* to make miscellaneous changes to the Disregard Regulations including the updating of statutory references.

ii. *The Loan Relationships and Derivative Contracts (Change of Accounting Practice) (Amendment) Regulations 2014* to make miscellaneous changes to the COAP Regulations including the updating of statutory references.

iii. *The Changes in Accounting Standards (Loan Relationships and Derivative Contracts) Regulations 2014* to address issues previously identified in relation to “permanent as equity” debt.

2.2 It was currently intended that all three sets of regulations should be in force before the end of the year: (i) and (ii) could be dealt with under negative procedures which should make this relatively straightforward, (iii) would require affirmative procedures which had the potential to be slightly more time-consuming.

2.3 In the interests of keeping to the planned timetable it was HMRC’s intention that drafts of all three sets of regulations be published for consultation over the summer, ideally by the end of July.

2.4 HMRC confirmed that there was currently no intention to update the statutory references in other secondary legislation, such as the EGLBAGL Regulations [SI

2002/1970]. This was in part because it was not clear that it was appropriate to update all the references in this legislation (for example, the EGLBAGL Regulations would in some cases be operating to bring back into account amounts previously disregarded under the 'old' legislation) and also because HMRC's understanding was that such updates were generally only be carried out in conjunction with other substantive changes. It was also thought that the Disregard Regulations and the Change of Accounting Practice Regulations were used more than with the other sets of Regulations.

Changes to Disregard Regulations

2.5 HMRC confirmed that the approach being adopted was so far as possible to make only straightforward changes now, with the intention of carrying out a more thorough review of the Disregard Regulations in due course.

2.6 Various comments were made by the non-HMRC participants of the working group in relation to the proposed amendments to the Disregard Regulations, including:

- Was the breadth of the proposed new Regulation 6 (1) (a) sufficient? In particular, was the treatment of ineffective hedges appropriate?
- Was the wording of the proposed new Regulation 6 (1) open to misinterpretation? This talked about Regulations 7, 8 and 9 applying whereas what was meant was Regulations 7, 8 and 9 were not precluded from applying in cases where the conditions within each of those regulations were met.
- The slight awkwardness of the drafting arose in part from the decision to move to an opt-in rather than opt-out regime; it was not clear to all the non-HMRC participants that the case for this switch had been made. Both viewpoints were motivated by a concern for the position of smaller companies which, in general, were thought to be less likely to be aware of the impact of the Disregard Regulations. HMRC's view was that it was preferable in this situation for the default to be to follow the accounts (making compliance easier at the cost of greater tax volatility in certain cases where no election is made) whereas the non-HMRC participants generally preferred the default to be for the Disregard Regulations to apply (minimising the risk of cash tax volatility at the cost of greater computational complexity).
- It was proposed to introduce a new Regulation 6B to the Disregard Regulations to deal with intra-group transfers of derivative contracts to which the Disregard Regulations applied. Did the scope of the new provision preserve the existing treatment in all cases; for example, in relation to fair value hedges of connected party debt?
- Was the proposal to omit Regulation 9 (2A)correct as it was unclear why this was needed? HMRC confirmed that this was not the intention, and that this would be remedied before publication.

2.7 The proposed changes to the Disregard Regulations included a new provision [Regulation 6 (1) (c)] bringing arrangements with a main purpose of obtaining a tax advantage within the scope of the Regulations. In HMRC's view this type of protection was needed if the time limits for elections were to be extended, and also given the increased flexibility for making hedging designations in the first year of adopting FRS 102. This was because there remained a concern that the extended time limits would be used to make (or to refrain from making) elections with the benefit of hindsight and that whilst this should generally only give a timing

advantage (itself problematic) this might also be combined with further steps so as to give an absolute tax advantage.

2.8 There was some concern on the part of the non-HMRC participants that the motive test as drafted was too broad, creating ambiguity as to its impact. For example, it was not explicitly limited to cases where the tax advantage being sought arose from the Regulations otherwise not applying. It was felt that as a minimum clear guidance on the draft provision was required. This was particularly the case in relation to use of hindsight when making elections. It was inevitable that with extended time limits elections would be made (or not made) with some knowledge of the likely impact on the cash tax position; it was unrealistic to expect that that knowledge would not be a factor in making any decision. Taxpayers therefore required some reassurance as to where HMRC would seek to draw the boundary between this scenario and cases of avoidance caught by the new provision. HMRC saw that there were three main approaches that companies could take with hedging derivatives – (i) apply hedge accounting; (ii) apply regs 7 / 8 / 9 of the disregards; or (iii) be taxed on fair value volatility. As long as companies were taking one of these approaches and applying it consistently then HMRC would be content. What HMRC was not happy with was groups picking and choosing between these approaches with the benefit of hindsight.

Changes to COAP Regulations

2.9 The proposed changes were to address potential issues with distressed debt on transition from 'old' UK GAAP. Arrangements to restructure such debt could, in certain situations, have no direct profit and loss impact under 'old' UK GAAP but give rise to a credit on transition followed by a stream of corresponding debits. The changes to the COAP regulations would mean that such a credit and subsequent debits would all be disregarded for tax purposes in cases where, in the absence of the arrangements to restructure the debt, one of the usual insolvency conditions would be met.

2.10 It was noted that the proposed commencement date was 1 January 2015, not 1 January 2014 as stated in the draft.

Changes to rules governing "permanent as equity" debt

2.11 The proposed changes were broadly intended to preserve the existing treatment of "permanent as equity" debt on transition from new UK GAAP. The changes were intentionally shown as having retrospective effect from 1 October 2012; this was because the transitional adjustments that would arise in the absence of the proposed changes could be in either HMRC's or taxpayers' favour and it was therefore important to HMRC that so far as possible there should be no mechanism for choosing whether or not to apply the new rules with the benefit of hindsight (e.g. by early adoption of new accounting standards or by changing accounting dates). HMRC did not see that many companies (if any) would be affected, but was interested to hear of any particular concerns.