On 6 June, 2013 HMRC published the consultation document announced in this year’s Budget looking at overhauling (their word) the loan relationships and derivative contracts regimes (the “Condoc”). Whilst it may not give War and Peace a run for its money, at 109 pages it is no light pamphlet either so it is just as well interested parties are given until 29 August, 2013 to digest its contents and respond.

There are twin drivers for this project. They are cited throughout the Condoc as being simplification of what is now a remarkably complicated and patchwork regime, principally as a result of responses to developments in accounting practice and new avoidance opportunities, and the reduction of future avoidance opportunities. Though always given in that order, when reading the Condoc it is difficult to escape the feeling that the latter is much more of a priority – a feeling that is only enhanced by the proposal to use Finance Bill 2014 to introduce the anti-avoidance measures with the structural changes to follow in Finance Bill 2015.

It seems that avoiding uncertainty will be key here. “Looking behind the accounts”, as Chapter 4 is headed, is all very well but only if the circumstances in which that can be done, and the outcomes which will follow, are clearly prescribed. Otherwise there is a real risk of undoing some of the good work that has been done over recent years to ensure that the UK’s tax regime is not a disincentive to doing business here. What this cannot be – but which there are hints of throughout the Condoc – is a regime under which companies are allowed to follow their accounts for tax purposes most of the time unless HMRC feels that that does not result in the company being taxed on its true economic profit in which case it may tax the company on a “fair” amount instead. It must not be a one way street!

The key proposals in outline are:

• to move away from recognising, as the general starting point for tax purposes, any amounts recognised in the company's accounts to only amounts flowing through profit and loss. Comfort is given that banks' Tier Two and Additional Tier One debt capital will continue to be deductible but, absent similar treatment which surely must be merited, insurers will note with dismay the pyrrhic victory hidden at the bottom of page 32 that although HMRC has now had legal advice to the effect that perpetuals are debt, they propose to make changes to ensure they are not loan relationships and coupons on them are distributions;

• making it clear that the purpose of the regime is to tax a company on the full amount of the profits, gains and losses arising from its loan relationships and derivative contracts which will not always be the same as the corresponding accounting profit and loss. It seems HMRC wants to bring the law into line with the view it has always taken of the words “fairly represent” in section 307(3) CTA 2009 and which, despite their victory, they could not convince the Supreme Court of in *DCC Holdings*;

• anti-avoidance in the new regime will come in a number of layers. First, the scope for avoidance is expected to be reduced by greater flexibility to depart from the accounting treatment. Secondly, the existing unallowable purpose rules (section 441 CTA 2009 and section 690 CTA 2009) will be beefed up using HMRC’s experience of various arguments routinely used against them in practice. So, for example, making it clear that the rule still
applies in relation to fungible pools of funding rather than specific borrowings. There will always be transfer pricing and, it is to be hoped only at the abusive margins, the GAAR. But there will also be a new “regime TAAR”. It is envisaged that the regime TAAR would apply “where a company is party to arrangements which have a main purpose of avoiding or exploiting the loan relationship or derivative contracts rules to obtain a tax advantage for one or more parties to the arrangements”;

- overhauling the forex regime such that fx gains and losses are generally only brought into account for trading and property business purposes with certain other exceptions, e.g. for hedging relationships;

- combining the loan relationships and derivative contracts regimes into a single regime to reduce the length of the legislation and reduce the scope for discrepancies between the two;

- views are invited on several options for dealing with certain particular issues under the new regime including connected party debt, intra-group transfers, debt restructuring (meaning loan relationship releases, debt-for-equity swaps and the like) and hybrid/special instruments (such as convertibles and index linked gilts);

- on partnerships, the Condoc accepts that there are various difficulties with the way the current rules are drafted and that they do not necessarily always achieve the stated policy aims. The aim seems to be to tax partners on their appropriate share of financial instruments in a partnership in a manner similar to section 59 TCGA 1992 and SP D12. At the moment, for example, a partner who reduced their interest in a partnership which had a financial instrument standing at an unrealised gain should not realise a taxable profit as a result of there being no related transaction at the partnership level; and

- HMRC wants to replace the “bond fund” rules (Chapter 3 Part 6 CTA 2009), themselves anti-avoidance rules to prevent companies rolling up taxable income offshore, with a more targeted anti-avoidance rule because those rules themselves have been ”extensively exploited in avoidance schemes”.

There is a lot to take in in this Condoc. Finance Bill 2014 and Finance Bill 2015 are probably an ambitious, but realistic, target. Clearly it will be imperative that, as the consultation process develops, and the proposals evolve, HMRC engages closely with businesses and their advisers. For many groups already grappling with the implications of moving to IFRS any uncertainty as to how they will be taxed on financial instruments in the future is unlikely to be welcome.

At the moment there are no transitional rules set out. The Condoc rightly recognises that working out where we want to get to is a big enough task for the moment and how we get there is more of a second order question. Nonetheless views on issues surrounding transition are still welcomed, particularly if they may raise issues serious enough to influence policy decisions.

If you would like to discuss this consultation in more detail please contact Mike Lane (mike.lane@slaughterandmay.com) or your usual Slaughter and May contact.