Modernising the taxation of corporate debt and derivative contracts

Mike Lane

The reform of the loan relationships and derivative contracts rules was announced in this year's Budget following an internal review and, on 6 June 2013, HMRC published a lengthy (109 page) consultation document "Modernising the taxation of corporate debt and derivative contracts" (the "Condoc"). Responses to the Condoc are due by 29 August, 2013 with a view to legislating in Finance Bill 2014 and Finance Bill 2015.

It is fortunate that I am not a cynic. Because a cynic reading this document might think this is merely HMRC seeking to rewrite the legislation in the manner in which, with hindsight, they would like it always to have been written and in which, in many cases, they are still arguing the existing legislation can be read after the donning of suitable “purposive” glasses. And then seeking to camouflage that exercise as a taxpayer-demanded simplification.

However, I think that is, at least in part, a symptom of the fact that this reform has two key drivers: the simplification of what is now a remarkably complicated and patchwork regime; and the reduction of future avoidance opportunities. And, of course, the latter intention is effectively given precedence by the proposal to bring in anti-avoidance measures in Finance Bill 2014, with the rest of the reforms to follow in Finance Bill 2015.

Clearly, there is much scope for simplification and improvement of the existing rules. For a regime which is often paraphrased as “follow the accounts”, there are a number of pitfalls and bear traps for the unwary and a lot of opportunities for those so minded to seek to exploit. Take, for example, the commercial sale of a partnership interest from one UK corporate to another at fair market value. It is often surprising for the seller to find that if the partnership has some in-the-money loans or derivative contracts whose fair value, reflected in the sale price, is higher than their book value, it may not be taxed on the profit realised as a result of there being no “related transaction” at the partnership level; conversely, the purchaser may find it is effectively inheriting a lower basis in those items than it has paid for. Or the numerous situations in which a taxpayer effectively has to maintain a separate set of tax accounts because it is subject to one of the many specific examples (connected party rules, group continuity, disregard regulations, etc.) where the credits and debits arising for tax purposes fall to be calculated on a different basis to that used for the same items in the taxpayer’s accounts (and notwithstanding that, as the Condoc acknowledges, in many cases simply following the accounts would still produce a perfectly acceptable result).

That said, most corporation taxpayers have learned to work well with the current regime, for all its foibles. And the initial reaction of tax and treasury departments to the Condoc is very much that we must avoid introducing uncertainty, particularly at a time when many of them already have intensive projects underway to cope with the impact of the imminent transition to FRS 101 and FRS 102. Telling the treasury department of a multinational group, already tasked with ensuring that the group’s multi-billion pound hedging arrangements will continue to be tax effective under new UK GAAP, that it has to factor in not only known changes to the accounting regime but also unknown changes to the tax regime, is a bit like throwing an extra couple of balls to the unicyclist already juggling at capacity.
It is certainly a point HMRC are alive to. One of the stated objectives of the new regime is that it be “certain and predictable in its application – because the structure and detailed rules are clearer”. No-one wants a repeat of the reaction to the ill-fated 2007 “Taxation of foreign profits” discussion document just when the UK has finally got its corporation tax regime into pretty decent shape. The key here will be for taxpayers, and not just advisers, to get fully involved in the consultation process as early as possible. All the indicators are that HMRC is ready to listen to problems and issues identified. Indeed, in many areas the Condoc simply puts forward options for dealing with a particular matter and invites stakeholders to indicate which option they would prefer and why. This means that the ball is now very much in the taxpayers’ court for the next couple of months to identify which options would work well and which would not, together with better alternatives, and to bring those to HMRC’s attention.

THE KEY PROPOSALS

It is, of course, impossible to summarise all of the potential changes in a single article, but some of the key proposals to be aware of 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 regulatory debt capital will continue to be deductible but, without similar treatment, insurers will note with dismay the pyrrhic victory hidden at the bottom of page 32 of the Condoc that although HMRC has now had legal advice to the effect that perpetuals are debt (see “Is a perpetual note debt for tax purposes?” (John Meehan and William Watson), Tax Journal, dated 2 May 2012), they propose to make changes to ensure that perpetuals are not loan relationships and coupons on them are distributions (without noting that banks’ regulatory debt capital, the treatment of which we are told will be undisturbed, will of course be perpetual debt). Initially, I had assumed that lack of reference to insurers’ regulatory capital was merely an oversight and that it is not the case that banks are thought to be more deserving of tax deductible regulatory capital but, rather, the fact that Basel III comes ahead of Solvency II. However, the current rumour is that it may be a deliberate distinction. This is one for the ABI to take up.

- 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 of which, despite their victory, they could not convince the Supreme Court in DCC Holdings [2010] UKSC 58. Coming back to the need for certainty, this must not become a rule which allows HMRC to accept the accounting result in the vast majority of cases but to override it in those cases where HMRC do not believe that the taxpayer is paying its “fair share”.

- 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 (back to the impact on certainty again). 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 (six of which are listed in paragraph 14.30 of the Condoc). So, for example, making it clear that the rules still apply 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”, which of course has echoes of 2008’s “extended paragraph 13” proposals. Indeed one might have thought that a target of the TAAR was one of the targets of
extended paragraph 13, namely “thinning out” arrangements of the type described at paragraph 14.31 of the Condoc where a multinational group undertakes an internal reorganisation which has the effect of gearing up the UK. The debtor company will generally have a good commercial purpose for borrowing, namely to fund its investment in its newly acquired subsidiaries with a view to future capital gain, ongoing dividend stream, or a combination of the two and that might be expected to negate any challenge under section 441 CTA 2009 which focuses exclusively on the company’s purposes for borrowing. However, stepping back, it might be the case that the group as a whole has good commercial reasons for undertaking the restructuring, or it may simply be rearranging the existing furniture to introduce leverage. But HMRC appear to think that section 441 CTA 2009 is the appropriate tool for seeking to disallow deductions based on the purposes of the overall arrangement, although they do note they hold “differing views” to “some taxpayers” here.

- Overhauling the forex regime will mean 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. This is an area that has been crying out for simplification for some time given that a lot of the key provisions are contained in secondary legislation, most notably the “Disregard Regulations” (SI 2004/3256) and the “EGLBAGL” Regulations (SI 2002/1970), which have not been updated to refer to the rewritten CTA 2009 provisions. However the proposed change, only taxing forex movements for trading and property businesses, is perhaps one of the more radical changes proposed in the Condoc. Such an approach would, as the Condoc notes, attribute particular significance to the distinction between trading activities and non-trading activities. It is often far from clear, for example, whether an intra-group treasury function is trading or not. Indeed paragraph 60 of HMRC’s draft guidance on the “CFC Charge Gateway” notes that whether or not such an activity constitutes a trade will be a question of fact in each case which is why the new CFC rules allow group treasury companies to choose trading or non-trading treatment. It may be that something similar is required here to provide certainty. Another obvious area to keep an eye on will be what happens on intra-group instruments between a trader and a non-trader if forex movements are recognised for tax purposes in the former but not in the latter.

- Combining the loan relationships and derivative contracts regimes into a single regime would reduce the length of the legislation and reduce the scope for discrepancies between the two. Superficially, there is some attraction to this – currently a lot of provisions are duplicated – but it is likely to be of little practical relevance. There are still a number of rules which would only apply to loan relationships or, as the case may be, derivative contracts – the connected party debt rules, for example – and so it would not be a single unified code which applied to all financial instruments.

- 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). Groups which still use the late-paid interest rules to manage the timing of their interest deductions should note that whatever other changes are made in relation to the connected party rules, it is intended that the late paid interest rules will be repealed (paragraph 7.17 of the Condoc). There will possibly be a bespoke anti-avoidance provision to address the original mischief at which those rules were aimed, namely taking UK interest deductions when accrued rather than paid where there is no corresponding pick up in the creditor. Another significant potential change is that HMRC’s preferred option would see any profit recognised by the debtor on a connected party debt release being taxable.

- 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 (sensible) 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. However, it should recognise the difficulties of treating certain transactions at the partner level (a reduction in a partnership interest, say) as a related transaction when the relevant instruments are only accounted for at the partnership level and of allocating credits and debits in accordance with income profit shares when the regime covers both income and capital gains.

- HMRC wants to replace the “bond fund” rules, themselves an anti-avoidance rule to prevent companies rolling up taxable income offshore, with more targeted anti-avoidance rules because those rules themselves have been “extensively exploited in avoidance schemes”. The “bond fund” rules are the provisions of Chapter 3 of Part 6 CTA 2009 which seek to tax interests in certain collective investment schemes which have invested primarily in debt-type assets as though they were themselves creditor loan relationships and on a fair value basis. The Condoc recognises that the proposed changes here may have a particular impact on life companies and has invited specific comment from that sector.

WHERE DOES THIS LEAVE US?

There is a lot to absorb in this Condoc. The above is certainly not an exhaustive list of proposed changes. Legislating in Finance Bill 2014 and Finance Bill 2015 is probably an ambitious, but realistic, target. 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 existing arrangements are not grandfathered from some of the changes, such as any extension to the existing anti-avoidance rules, that could introduce a significant burden on many groups forced to review existing and accepted arrangements for compliance with the new regime.

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