**Modernising the taxation of corporate debt and derivative contracts**

**Minutes of Working Group 3 meeting on 10 September 2013**

**100 Parliament Street 11:30 to 13:00**

Attendees:

##### Andrei Belinski, Centrica

##### David Boneham, Deloitte / CIOT

##### Neil Edwards, PwC

##### Paul Freeman, KPMG

##### David Hill, Grant Thornton

##### Matthew Hodkin, Norton Rose

##### Chris Kell, HSBC

##### Jason Luke, Rolls-Royce

##### Anne Murphy, Legal & General / ABI

##### Chris Murphy, KPMG

##### Kieran Sweeney, LBG

##### Fiona Thomson, Ernst & Young

##### Stephen Weston, Deloitte

##### Charles Yorke, Allen & Overy

##### Richard Daniel, HMRC

##### Andy Stewardson, HMRC

##### Andrew Gribble, HMRC

##### Rob Harvey, HMRC

##### Fiona Hay, HMRC – item 1 only

##### Nicola Rass, HMRC – item 1 only

##### Julia Scott, HMRC (by telephone conference)

1. Perpetual debt and regulatory capital

## HMRC confirmed that it was their intention that the treatment of banking regulatory capital should not be impacted by the proposals in the “Modernising the taxation of corporate debt and derivative contracts” consultation document (“the ConDoc”). The treatment of such regulatory capital was instead to be governed by specific regulations, a draft version of which had been published earlier in the year and was the subject of a separate consultation process. Various revisions were being made to the draft regulations and a revised draft should be being published soon.

## It was noted that the existing draft regulations dealt only with banking regulatory capital and that concerns had been raised regarding the position of the insurance industry. The new regulatory position for insurers is currently unclear but, if required and subject to ministerial approval, the Government could introduce special rules for insurers. HMRC is working with industry to explore this issue further.

## It was confirmed that it was HMRC’s intention that perpetual debt instruments (meaning those which become repayable only in the event of a liquidation) should be explicitly excluded from the loan relationship regime and that the coupons on them would be distributions. It was noted, however, that the proposed change was for this exclusion to apply to newly issued instruments only. HMRC had no intention to change the treatment of perpetual debt already in existence.

## The proposed treatment of perpetual debt was based on the view that such instruments more closely resembled equity than debt and that their inclusion within the regime was therefore inappropriate. This had always been HMRC’s view; the decision to legislate for an explicit exclusion was motivated by legal advice that, contrary to HMRC’s expectations, such instruments may technically be debt, rather than by any underlying policy change.

## There was some questioning of the policy basis for the exclusion: whilst such instruments had some equity like features they could also have debt like features (for example, a mandatory coupon payable even in the absence of distributable reserves). Moving away from the legal definition of debt in determining the boundaries of the regime could introduce anomalies (for example, perpetual debt and 1,000 year term debt with otherwise identical features could be given different treatments). HMRC noted these challenges, but reiterated their basic view that perpetual debt was not appropriately dealt with within the loan relationship regime.

## It was felt that if such instruments were excluded from the loan relationship regime then it would be important to give clarity about how the instruments (and any coupon) should be treated, both for the issuer and for the holder. For example, would they be treated as shares?

1. Timings regarding transition to FRS 101 and FRS 102

## A note on timing issues (i.e. the interaction between the introduction of FRS 101/102, IFRS 9 and the proposals in the ConDoc) had been circulated prior to the meeting. This summarised HMRC’s views as to the main considerations and possible approaches.

## It was reiterated that HMRC wished to avoid unnecessary rule changes and was looking to improve the regime for the medium-to-long term. However, they were open to discussing straightforward, targeted changes to the existing proposals that would ease companies’ transition to new UK GAAP or IFRS 9.

## An example of the type of issue which had been raised was the potential uncertainty over the effect of designating hedges on the adoption of FRS 102; it had been argued that this designation was prospective only, meaning that companies needed to rely on the Disregard Regulations in relation to transitional adjustments reflected in opening balances.

## More generally it was felt by a number of the participants that the Disregard Regulations would continue to perform a useful function, although there was a widespread perception that they could be very difficult to understand for companies/advisers coming to them for the first time and it would therefore be helpful to take any available steps to mitigate this.

## HMRC in particular noted the concern of how undesignated hedges are treated. HMRC confirmed not looking to move away from the current approach ahead of FB 2015. As such, they were not planning any significant changes in this area that would affect the transition across to FRS 101 or FRS 102 for the year ended 31 December 2015.

## HMRC had suggested that they were considering whether it would be possible to amend the Disregard Regulations so that statutory references within the Regulations pointed to current legislation in CTA 2009 rather than the original legislation in FA 1996 and FA 2002; most people agreed that this would significantly aid the comprehensibility of the rules. There was also broad agreement that it was helpful to preserve the existing numbering of the Regulations, although a corollary of this was that a full rewrite would not be possible.

## There was some interest in exploring the possibility of rewriting Regulation 6 as this had a reputation for being particularly unclear which the removal of spent legislation could address. HMRC were open to looking at this and other options for making the Regulations more usable, but noted that there was no appetite for a major exercise at the present time.

## Returning to the question of transition, one of HMRC’s proposals was to amend the legislation to give s315 *et seq.* CTA 2009 explicit priority over s308 CTA 2009 in cases of a change in accounting policy. It was felt that it would be helpful if some examples illustrating the problem that this proposal was intended to address could be provided, as the motivation for the change was not well understood.

## More generally, simplification of the rules at s308 CTA 2009 and s315 *et seq.* CTA 2009 was felt to be worth exploring.

## HMRC asked about the treatment of holders of convertible debt instruments and that section 12 of FRS 102 did not permit bifurcation. The group thought that this did not affect very many companies. It was also noted that such companies would have the option of applying the IAS 39 principles under FRS 102.

## There was some discussion of the effect of transition on “permanent as equity” loans. In a case where such loans had been held at historic cost then transition would be expected to result in historic foreign exchange gains and losses being recognised and potentially being brought into account for tax purposes. It was not clear if there was an easy fix for this situation, although one suggestion was to introduce a transitional rule, the application of which was governed by a company’s historic accounting policies.

## Whether “permanent as equity” loans were currently held at historic cost or revalued with foreign exchange gains and losses taken to reserves, there were also potential problems with the position going forward. Previously the unrealised foreign exchange gains and losses were effectively ignored for tax purposes (potentially brought back into account where there is a disposal of the loan). This would also be the case going forwards if the proposals in the consultation document to only tax exchange movements on trading loan relationships were put into effect. The difficulty would be the period (in many cases 2015) in which the company had adopted IFRS/new UK GAAP but the changes to the loan relationship rules had not come into force: in this period the exchange gains and losses would usually to the income statement and be brought into account for tax purposes on a current year basis.

## HMRC confirmed that they are not adverse to a position where such amounts would be excluded from tax in the period following transition. However, they were concerned about companies picking and choosing - they were keen not to effectively allow people a choice of treatments such gains were exempt and losses brought into account. This would need to be taken into account in drawing up any possible solution.

## One possible approach might include bringing the situation within the scope of the Disregard Regulations, possibly with a view to deferring the taxation of any exchange gains and losses accruing prior to the exemption for non-trading movements until the maturity of the debt concerned.

## HMRC noted the difficulty in creating a cut off between companies that had previously transitioned to IFRS and companies to transition over the next couple of years. There was a generally feeling that this is more of an issue now than it was for companies moving to IFRS in and around 2005 – those companies typically had the option of avoiding the issue by continuing to use SSAP20 in their entity accounts.

## HMRC were keen to understand how big an issue this was for companies moving across to FRS 101 and FRS 102.

1. Proposal to tax only amounts recognised in profit or loss

## HMRC circulated a discussion document summarising the amounts which at present are not recognised in profit or loss.

## HMRC’s basic intention is that only amounts recognised in profit or loss should be taxed, subject to some additional rules to bring in amounts recognised in OCI that are not subsequently recycled through profit or loss.

## There was some questioning as to whether it was in fact appropriate to tax amounts that would never be recognised in profit or loss, but HMRC stated that the policy continued to be to tax such amounts – generally the amounts recognised in OCI represent income of the company. Accordingly, the proposed changes were not concerned primarily with the scope of the charge to tax, but rather with the timing of when that charge was imposed.

## As the change was primarily concerned with timing, it was noted that further thought would need to be given to appropriate transitional measures to ensure that amounts were not taxed twice or allowed to fall out of charge as a result of the new rules.

## HMRC noted that an initial review of consultation responses received suggested support for the proposals, although concerns had been raised by the life insurance industry.

## HMRC noted that the position with amounts taken directly to equity was slightly different. Here the amounts would not typically represent income of the company.

## The participants of the meeting noted that the proposals could adversely impact some commercial instruments. For example, mandatorily convertible debt with a discretionary coupon would typically be accounted for as equity and the coupon as a distribution. Currently tax relief would be available for the coupon, but this would be lost if the proposals came into effect. It was unclear if this was in line with the wider policy on what instruments should be within the scope of the regime and in some respects raised similar issues to those noted in the context of perpetual debt.

## HMRC confirmed that there was no intention to change the treatment of capitalised interest costs, although the relevant statutory wording may be reviewed to ensure that the provision operated as intended.

## HMRC were also proposing to change the existing legislative approach of focussing on particular statements within the accounts to one of referring simply to amounts recognised in profit or loss. This change would bring the statutory language into line with the accounting terminology, which typically referred to amounts being recognised ‘in profit or loss’ or ‘as an item of other comprehensive income’ instead of in a particular performance statement. The hope was that this would simplify the legislation and remove any potential ambiguity caused by the increasing flexibility under accounting standards over the inclusion and naming of particular statements.