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

**Minutes of meeting of Working Group 4 (funds)**

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| **Date and time:** Tuesday 16 July 2013, 11 a.m. |
| **Venue:** 100 Parliament Street, London, SW1A 2BQ |
| **Attendees:** Andy Stewardson (**"AS"**), Chris Murricane (**"CM"**), John Buckeridge (**"JB"**), Geoff Heaton, Peter Drummond, Sandy Bhogal (**"SB"**), Ben Fryer, Paul Hale (PH), Roy Lonergan, Jorge Morley-Smith (**"JM-S"**), Angela Savin (**"A.Savin"**), Nigel Kay, Phil Cullis, Matt Roach, Leon Cane, Tom Fitchett, Stuart Chalcraft (**“SC”**) |

This note records the main points of discussion from the meeting referred to above.

**Introduction**

1. CM summarised the background to the HMRC consultation on modernising the taxation of corporate debt and derivative contracts (the **"Consultation"**). It was noted that the intention is to review and update the loan relationships and derivative contracts tax regimes to make them simpler, clearer and more robust against tax avoidance.
2. It is anticipated that legislative changes will be introduced over two years, in Finance Bill 2014 and Finance Bill 2015, with the most significant structural changes in Finance Bill 2015.
3. Working group 4 will focus on proposals for changes to legislation in:

• Chapter 3 of Part 6 Corporation Tax Act 2009 (**"CTA 2009"**), referred to as the "bond fund" rules (with equivalent rules for derivative contracts in section 587 CTA 2009); and

• Chapter 3 of Part 4 of the Authorised Investment Funds (Tax) Regulations 2006, referred to as the "corporate streaming" rules.

1. "Bond fund" refers to certain types of collective investment scheme - namely authorised investment funds (**"AIFs"**), unauthorised unit trusts, and offshore funds - that invest primarily in debt-type assets. With respect to the "bond fund" rules, it was noted that the rules were designed to ensure that the investment returns made by entities within the charge to corporation tax that have holdings in such funds are taxed appropriately. The rules counter arrangements whereby underlying debt investments are packaged in a fund which may have the effect of deferring tax until redemption or sale of units in the fund and/or leading to investments not being taxed as income at all: the rules therefore tax, on a fair value basis, the holdings in such funds as if they were loan relationships.
2. If a company invests in a "bond fund" and more than 60% of the underlying investments are, at any time in an accounting period of the investing company, "qualifying assets" as defined in section 494 CTA 2009 (essentially debt and some derivative-type assets), then the investing company's holding is treated as if it were a creditor loan relationship of the investing company.
3. CM noted that the "bond fund" rules are widely acknowledged to be complex and, although the purpose of the rules is to counter tax avoidance, they have themselves been extensively exploited in avoidance schemes, often involving large amounts of tax.
4. Therefore, consideration is to be given to simplifying the "bond fund" rules. As noted in the Consultation document, it has been proposed to repeal the current rules. However, certain additional rules may be needed to address specific points.
5. CM noted that a particular cause for concern is "in house funds" controlled by a small number of investors. Disclosed tax avoidance schemes involving bond funds have invariably made use of funds under the control of a single investor, or very few investors, often in the financial sector. Therefore, to protect against possible attempts to exploit a repeal of the bond fund rules, it is proposed to introduce a targeted anti-avoidance provision for these funds: corporate investors could be taxed differently, in a way which reflected the underlying returns, for example, on a "look through" basis.
6. For offshore funds, as they are not generally within the charge to UK tax in the absence of the bond fund rules, interest returns could effectively be received by a corporate investor without any tax being suffered. Therefore, for offshore funds, it is proposed to retain simpler rules. It is proposed that a provision similar to that in section 378A Income Tax (Trading and Other Income) Act 2005 be introduced for corporate investors so that where an offshore fund failed to meet the "qualifying investments" test (i.e. debt-type assets exceed 60% of the total value) at any time during its period of account, then any actual distribution or reported income would be taxed as an interest distribution.
7. Proposals with respect to life insurance companies are to be considered further.
8. CM stated that there are as yet no fully formed proposals with respect to amending/repealing the "bond fund" rules. The aim was to replace them with new simpler rules which achieve the same anti-avoidance objectives. One possible outcome of the review might be to retain the existing rules, although this would not be regarded as the best outcome.
9. With respect to the "corporate streaming" rules, it was noted that the rules were designed to counter the possibility that a corporate taxpayer could, by investing indirectly in assets such as loans through an AIF, pay tax on the investment returns at a lower rate than a company which invested directly in the same underlying assets. However, the rationale behind the "corporate streaming" rules has weakened as the main rate of corporation tax has become more closely aligned with the rate applicable to AIFs. It has therefore been proposed to repeal the "corporate streaming" rules.

**Timing**

1. JM-S questioned the timing of proposed legislative changes to the "bond fund" and "corporate streaming" rules and the relevance of the 29 August 2013 closing date for comments on the Consultation document.
2. AS noted that the timeline proposed in the Consultation document envisaged that legislative changes to the "bond fund" rules would be effected in Finance Bill 2014. As the "corporate streaming" rules are contained in regulations, they are not tied to the legislative cycle so any changes would not be subject to the same timeline.
3. Finance Bill 2014 will deal with changes to the loan relationships and derivative contracts tax regimes which are designed to counter areas of potential tax leakage and other changes which can be effected on a discrete basis.
4. However, the Finance Bill 2014 target may be re-visited if necessary.
5. The 29 August 2013 closing date for comments on the Consultation document is not a deadline for all comments on the Consultation as the Consultation is an ongoing process. The idea is that the Consultation document will generate comment and lead to continuing discussion on its proposals.
6. Another document relating to the Consultation generally is expected to be published next year but as the expectation is that bond fund rules changes will be made in FB2014 if possible, any later consultation document would probably not cover that subject.
7. It is envisaged that the Consultation working groups will continue for as long as necessary and possibly through to 2015.

**Gross-interest distributions**

1. JM-S noted that at Budget 2013, the government announced that it will consult on proposals to allow bond funds to pay gross interest distributions.
2. JB said that the consultation paper relating to this is due to be published in the week commencing 22 July 2013.
3. AS noted that a number of parallel proposals may interact with the Consultation and it will be necessary to identify areas of cross-over. HMRC's approach to the Consultation will be as holistic as possible.

**Comments on Consultation proposals with respect to the "bond fund" rules**

1. Various attendees noted that funds potentially caught by the "bond fund" and/or "corporate streaming" rules are required to perform complex calculations every day to price their units and any relevant legislative changes will need to be factored into those calculations. Therefore, any changes to the rules should take account of the practical impact on funds that may be caught.
2. AS responded that it is exactly these types of issue which HMRC need to understand more fully.
3. With respect to the "corporate streaming" rules, JB noted a potential concern is that if the corporation tax and income tax regimes diverge in the future, there may be issues to re-consider if the "corporate streaming" rules have been repealed at that time.
4. AS noted that it could be considered whether to build in a mechanism in the legislation to deal with any future divergence in tax rates – for example, a regulatory power (contained in primary legislation) to reinstate the rules as required.
5. With respect to "bond fund" rules, Stuart Chalcraft (SC) noted that two distinct regimes for "bond funds" in legislation – one in CTA 2009 and the other in the Authorised Investment Funds (Tax) Regulations 2006 – causes confusion for taxpayers.
6. The 60% test in CTA 2009 is particularly difficult to monitor in some cases and it can be difficult for investors to know whether a fund in which they have invested has breached the 60% threshold in a period. The rules in CTA 2009 may also catch funds not intended as the main target of the rules – for example, certain hedge funds and equity funds which might only briefly fail the 60% test.
7. For UK funds, the 60% test could be monitored relatively easily. However, for offshore funds, the test could only be monitored with difficulty, or not at all; in many cases the fund managers would not be aware of the requirements of the test, or would not care.
8. The proposed changes would leave a 60% test in place for precisely the funds where monitoring was not possible.
9. An attendee noted that in some cases the fair value requirement of the bond fund rules could give a harsher outcome than if loan relationships are held outside a bond fund. They might be seen as doing more than you would need to give parity.
10. SC noted that because the "bond fund" rules in CTA 2009 'trump' the offshore funds rules, it may often be preferable to utilise a non-reporting offshore bond fund. SB queried whether the mischief HMRC are concerned about is that amounts are not taxed as income where they ought to be, or that tax is deferred/avoided. CM commented later that both concerns are intended to be addressed by the rules.
11. JB noted that a key aspect of the "bond fund" rules (and offshore funds rules) is to catch disguised interest/interest like returns, but they are also intended to address avoidance concerns.
12. PH said that as he understood the proposals, if a fund onshore paid distributions to a corporate, they could be exempt dividends. But if an offshore fund paid distributions, they would be taxable interest, if the 60% test was failed. He questioned whether HMRC had considered possible discrimination issues where "bond fund" rules are left in place for offshore funds but repealed for domestic funds.
13. JB and AS said that this is something that will need to be reviewed.
14. SC suggested that if disguised interest is the key focus, relevant fund investments could be made subject to tax on a "mark-to-market" basis as a means of distinguishing between bond funds and non-bond funds (e.g. long term equity funds
15. Other suggestions were that holdings in all offshore funds could be made subject to tax on a mark-to-market basis, or perhaps as an alternative, non-reporting offshore funds could be marked to market. AS said this could be considered.
16. SB noted that further thought could be given to defining what an "interest-like return" is and to consider how this would interact with wider changes to the loan relationship regime. Interest can be hard to define. Can this be wrapped up in the disguised interest rules?
17. AS noted that Consultation working group 1 will consider what the loan relationship regime should catch as a whole.
18. Attendees noted that a distinction needs to be made between funds which produce "smooth" returns (e.g. property/leasing/infrastructure funds) and those funds which produce interest-like returns – e.g. cash or gilt bond funds.
19. AS noted that a concern with specifying exactly which funds are subject to specific rules and which are not may present an avoidance risk. Imprecise rules may help to satisfy anti-avoidance objectives although it is acknowledged that taxpayers require commercial certainty.
20. SB queried whether the general anti-abuse rule (**"GAAR"**) had been considered in relation to 'abusive' bond fund arrangements.
21. AS noted that the impact of the GAAR had not yet been fully considered in that context, but it is something envisaged in the Consultation. It is anticipated that specific anti-avoidance rules will still be required with respect to bond fund arrangements to the extent the rules are preserved.
22. A.Savin noted that one option may be to look at the taxation of the other 40% of bond fund investments under the 60% test. So, fair value taxation could be based on the proportion of underlying investments which would be taxed under the loan relationship rules – therefore, equity investments should be excluded.
23. JB agreed that this could be an option. One attendee noted that derivative products can often be used to change an income to a capital return. Therefore, one possibility may be to tax a return as income/capital depending on investors' intended outcome, with a fund prospectus as the 'gatekeeper'. AS responded that this would be a difficult concept to reconcile with legislation.

**Comments on Consultation proposals with respect to the "corporate streaming" rules**

1. JB noted that the objective of the "corporate streaming" rules was to capture situations where a corporate taxpayer could, by investing indirectly in assets through an AIF, pay tax on the investment returns at a lower rate by receiving dividend distributions from funds.
2. JB noted that avoidance schemes had been developed to exploit the fact that under certain circumstances, credit is given for tax supposedly paid by the AIF on the underlying income referable to the unfranked element of distributions. Taxpayers may then set out to ensure, by various means, that no tax is actually suffered by the AIF on the underlying income and/or by the investor on the gross amount of the annual payment. In cases where the investing entity has no liability to corporation tax, it may claim repayment of the deemed credit, regardless of whether the AIF has in fact paid tax or not. The existence of such schemes supported the repeal of the rules.
3. However, JB noted that the "corporate streaming" rules may still be of use to life insurance companies with non-BLAGAB business in 2 principal cases:

• investments in "mixed funds" giving dividend and interest returns; and

• investments in PAIFs through feeder funds

1. As most UK funds are bond or equity funds, it was noted that it may not be an issue to repeal the "corporate streaming" rules in the context of mixed funds. However, the concern remains for PAIF feeder funds.
2. AS queried whether the "corporate streaming" rules are relevant to any entities other than life insurance companies.
3. PH noted they may still be of relevance to investment trusts and any corporate with expenses which can be used, although insurance companies are perhaps the only significant category.
4. JM-S noted that consideration could be given to preserving the "corporate streaming" rules for affected entities. SB noted than an elective regime could be considered for the "corporate streaming" rules
5. Comments were made that the abolition of the rules would be welcome, subject to the insurance issues.

**Banking issues**

1. CM queried whether there were any specific issues to discuss at this stage for banking business. No issues were raised.

**A.O.B**

1. CM queried whether there was any scope for a separate insurance sub-group to working group 4.
2. Various attendees responded that they did not see any need at this stage.
3. CM noted that the next meeting of working group was scheduled for Monday 9 September 2013. [Subsequent note – that meeting was later cancelled].
4. Meeting closed at 12:55 p.m.