TAXREP 01/01

REFORM OF CORPORATE DEBT, FINANCIAL INSTRUMENTS AND FOREIGN EXCHANGE GAINS AND LOSSES

Text of a memorandum submitted in January 2001 to the Inland Revenue in response to a Technical Note issued on 14 November 2000

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INTRODUCTION

1 The Tax Faculty is pleased to respond to the Technical Note ('the Note') published on 14 November 2000.

2 We welcome the review of these three sets of rules. We congratulate the Revenue on the preparation of the Note; it is well-considered, balanced and we are in agreement with the broad thrust of the proposals. We understand that the British Bankers' Association has a committee reviewing this and we suspect that banking and financial institutions will be commenting on the proposals in this Note in detail.

3 Our substantive response is divided into two parts. Firstly, we have set out our general comments on the proposals. Secondly, we have then set out specific comments on some of the questions posed in the Note. We have followed the format of the Note and set out in full the questions upon which we have commented.

4 We participated in the consultation which resulted in the introduction of sections 105 and 106 of the Finance Act 2000. We welcome those changes. We agree with the comments in paragraph 1.6 of the Note of the importance of ensuring that the UK is an attractive location to undertake international business.

GENERAL COMMENTS

Complexity and compliance costs

5 We do not think that it is necessary or desirable that there are three separate regimes to deal with these types of financial transactions. The complexity of the resulting rules makes it difficult for all concerned (including the Revenue's own staff) to have a thorough grasp of these rules.

6 This creates uncertainty and compliance problems and increases costs. We share the desire set out in paragraph 1.11 of the Note to reduce compliance costs by making the legislation simpler to understand and operate. Well-advised and compliant taxpayers will invariably seek specialist knowledge on the impact of these rules, even when the transaction is relatively straightforward. This is particularly important with the advent of corporation tax self assessment (CTSA).

Consolidation of the three codes

7 We therefore support the suggestion in Chapter 6 that all three of the existing blocks of legislation covered by the Note should be merged into a single consistent scheme. Merging the three separate codes into one should go some way towards producing shorter and simpler legislation. More specifically, it will avoid the need for the complex rules which deal with transactions on the borderline between two or all three

of the existing regimes, and will remove any risk of overlap or of transactions falling down a gap between two regimes.

8 It would also be a considerable improvement to have a single set of rules which applies equally to all three types of transactions rather than having different rules, for example anti-avoidance rules, that apply to each of them. To some extent each of the existing sets of rules was developed in the light of experience with those which went before, so now is the time to consolidate them on the basis of whichever of the three has proved to be more successful.

9 For example, we think it is more satisfactory that one should be told (broadly) to follow generally accepted accounting principles (GAAP), as in the loan relationships rules in FA 1996, rather than that the tax legislation should try to rewrite the GAAP rules itself, as in the exchange gains and losses rules set out in FA 1993. We would therefore now wish to see a rule of the former type applied to all three types of transaction.

10 Paragraph 6.11 identifies six examples in which the three regimes deal with similar subject matter differently. Paragraph 8.2 then lists another eight differences between the Financial Instruments and loan relationships rules. None of these differences appear to have any discernible basis in policy. We think that the underlying policy should be to consolidate these rules as far as possible. Separate rules should be retained only where there is a clear policy reason to retain a difference.

11 The Note outlines the changes which might be made to combine the three regimes. However the details would undoubtedly be much more complicated and should be the subject of further consultation. Sufficient time should be allowed for this consultation process. Since the existing legislation is working reasonably satisfactorily it is more important to get the revision right than to do it quickly.

12 The new consolidated code should be rewritten by the Tax Law Rewrite team.

Anti-avoidance

13 We are opposed to anti-avoidance rules based on broad criteria such as the 'main benefit' test found in section 135, FA 1993 or the 'unallowable purposes' test found in paragraph 13 of Schedule 9, FA 1996. Whilst of course we understand the need for measures to prevent abuse, any such measures need to be properly targeted. Our objection to the above measures is that they are too broadly drafted with the result that uncertainty is created. This is a particularly serious problem under CTSA.

14 Avoidance by means of non-arm's length transactions can and should be dealt with specifically rather than by having three separate sets of special rules. We suggest that the appropriate anti-avoidance rule should be to extend the transfer pricing provisions of Schedule 28AA, ICTA 1988 to the three regimes in question.

15 Beyond that, the anti-avoidance rules should be certain and not give the Revenue wide powers to decide for itself whether or not a particular commercial transaction, which may produce some tax saving, is acceptable. If the Revenue regards any

particular type of transaction as abusive, then it should be dealt with by specific targeted rules.

Accounting developments

16 Since the publication of the Note, the Accounting Standards Board (ASB) has published a consultation paper 'Financial Instruments and Similar Items' prepared by the Joint Working Group of Standard Setters. Although we have not yet had time to study the document in detail, it appears that the document proposes far-reaching changes to accounting for financial instruments and similar items.

17 Whilst the ASB has not yet formed a view on the proposals contained in the document, it appears that this may be a seminal document and that at some stage major changes will have to be made to the existing accounting treatment of financial instruments. From a tax viewpoint, the key proposals appear to be that:

- financial instruments should be revalued to fair value at each balance sheet date;
- any resulting gains and losses will be reflected through the profit and loss account in the periods in which they arise; and
- hedge accounting will be abolished.

18 In principle of course we favour the tax treatment following the accounting treatment wherever possible. However, in view of the importance of the ASB's proposals, we need to consider the ASB's document further and how it will impact upon the proposals made in this Note.

19 We suspect that there will be major accounting developments in this area over the next few years and that these could have an important impact upon the proposals made in the Note.

20 We suggest that the Revenue meets with the representative bodies in the near future to discuss the ASB's paper and its implications for the Technical Note.

SPECIFIC COMMENTS

Chapter 3: Forex issues

3.7 Do respondents have ideas for making the transitional rules for assets and liabilities other than fluctuating debt simpler? Would there be any advantages in bringing them to an end when the other transitional rules expire? If that course were adopted what issues might have to be addressed?

21 The transitional rules were introduced for good reasons and after extensive consultation, with the intention that they would operate until the relevant event occurred, which would normally be the disposal of an asset or liability. It would be

wrong to defeat taxpayers' legitimate expectations by bringing them to an end prematurely.

22 An alternative approach that we would prefer is to allow taxpayers to elect out of the transitional regime at this stage if they prefer to avoid the continuing compliance obligations.

3.19 *Has the stage been reached where repeal of this relief would be appropriate?*

23 We do not think that the stage has been reached where the repeal of this relief (i.e. deferral) is appropriate. We note that retaining a special relief which applies to only one of the three regimes does perhaps run contrary to our arguments above for merging the three regimes. However this particular relief was introduced for reasons specific to foreign exchange transactions. We believe that the original reason for deferral relief was that the volatility of currency movements made it particularly likely that a regime which recognises unrealised profits for tax purposes could cause cash flow problems for a company with a sudden very large forex gain. We do not think that the circumstances have altered such that this relief is no longer appropriate or necessary and we therefore think that it should be retained.

Chapter 4: Financial Instruments Issues

4.9 Are there any grounds for extending the FI rules to other types of derivative, where the underlying assets are not debt or currency related? If so, what types of contract should be included, and would any special rules be needed for such contacts to prevent them being used for tax avoidance?

24 We think that the FA 1994 regime (or its merged successor legislation) should .be extended to other types of derivative contracts. This is consistent with our general desire to see accountancy practice followed wherever possible. It will also have the advantage that it will reduce the number of boundary issues which arise as between derivatives which are within the regime and those which are not, thus providing welcome simplification.

25 In principle, there seems to be no reason why any sort of derivative should be excluded, except for those which are held to hedge a capital transaction and are accounted for as such, and those which actually give rise to a capital transaction (eg an option to acquire a capital asset).

Chapter 5: Loan Relationships Issues

5.8 Should ESC C28 be incorporated in the legislation? Is any alteration to its scope required, whether or not it is legislated?

26 ESC C28 should be incorporated in legislation, with further consultation on the detailed terms. The subject is much too complicated and too important to be left to an ESC. In any event, we think that wherever possible ESC's should be incorporated into legislation.

5.13 Would section 840, with appropriate modifications, provide a suitable control test for inter-corporate transactions? Or should a tailor-made test be found, and if so what should it cover?

27 Section 840 would be a much more appropriate test. The rationale behind section 87, FA 1996 is that manipulation may occur, particularly in relation to bad debts, where the debtor and creditor are related. The section 840 test would go directly to the circumstances in which this is likely to happen and so is much more relevant than the complex and artificial tests in section 416, ICTA 1988. The need for ECS C28, which is itself long and complicated, illustrates the inappropriateness of the present statutory rule.

5.21 Should the application of the connected persons rules to partnerships with company members be rationalised and, if so, how?

28 There seems to be no reason why the connected persons rule should not apply as between a company partnership and a partner who as a matter of fact satisfies the control test in section 840, ICTA 1988 (treating of course the partnership as a body corporate for this purpose).

29 However, we do not think it is appropriate to apply that rule as between a partnership and a company which the partnership (taken as a whole) controls. Company partnerships are in general relationships between independent companies which, despite the use of the partnership vehicle, will each be pursuing their own commercial objectives. The partnership is generally treated as transparent for tax purposes, and that principle should also apply in this context. Hence the connected persons rule should apply, if at all, only in computing the share of the partnership profit which is to be attributed to a partner whose interest (without aggregating the interests of other partners) is such that it controls the partnership and therefore the company.

5.29 If it is accepted that there is a good case for remedying the perceived injustice where a company acquires debt at a discount on becoming connected with the debtor, is there also a case for altering the treatment of acquired impaired debt where the creditor is already connected with the debtor?

30 We welcome the recognition of the injustice which arises where a company acquires impaired debt from an unconnected company and simultaneously becomes connected with the debtor by acquiring its shares. We hope that this at least will be rectified by legislation at the earliest possible date. The present regime is equally unjust in the case where a loan is made between unconnected parties, but the debtor subsequently joins the creditor's group at a time when the debt is already impaired: this situation also should be rectified.

31 There is also a very strong case for altering the treatment of acquired debt where the debt is transferred within a group, at least to the extent that the debt was already impaired at the time when it came into the group (whether by acquisition of the debt or on a change in the membership of the group). Otherwise, an intra-group transfer will reinstate the injustice which it has been agreed should be rectified in relation to

the group's original acquisition of the debt. This will inhibit commercially driven group reorganisations and is a very nasty trap for the unwary.

5.31 Should the treatment of trade debts which are not loan relationships be aligned with that for loan relationships?

32 In the interests of simplification we think that the treatment of trade debts that are not loan relationships should be aligned with the loan relationships rules.

5.33 Should the connected persons rule that prevents taxability of a release in this case be overturned?

33 We do not think that the rule should be overturned in this instance. Further, we do not think that the principle of symmetry is a fundamental rule of tax law. Cross-border transactions are inherently unsymmetrical, but that is only a reason for special treatment to the extent that it creates scope for avoidance. In principle the appropriate tax treatment of a particular type of transaction is not dependent on the residence status of the parties. In the present case the only justification for the connected-party bad debt rules is that, rightly or wrongly, connected-party loans and releases of such loans are perceived as not being ordinary commercial transactions, so they are excluded from the normal tax regime.

34 If the above interpretation is correct, then it applies whether the entry in question is a debit or a credit and regardless of the residence status of the counterparty. In any event, if a non-resident creditor wishes to inject funds into a connected UK debtor it is very easy and unobjectionable for it to do so in non-taxable form, for example by subscribing for new shares. There is no reason for penalising the UK company if the creditor chooses instead to provide the funds by releasing an existing debt.

5.36 Should the rules be amended so that amounts due to pension schemes should be covered by the paragraph in all cases?
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35 Paragraph 2 of Schedule 9, FA 1996 prevents manipulation by the artificial deferral of interest payments due from a UK debtor to a connected non-resident creditor (assumed not to be taxable on interest accrued). In this case it was recognised (c.f. 5.33 above) that the inherent asymmetry between resident and non-resident was not in itself enough to justify a departure from the normal rule of accrual-based accounting: there has also to be a connected-party relationship.

36 The position is no different for a pension scheme. Paragraph 2 applies, for good reason, only if the parties are connected and there is no reason to change that now. It is true that the connection rules will often not apply between a company and the trustees of its own pension scheme, even though there will in practice be a close business relationship between the two. However that is no more than a reflection of the fact that the trustees' obligations are owed to the trust and not to the company: trust law prevents them from engaging in uncommercial practices to suit the company's convenience, even if they felt inclined to do so.

5.38 Should there be a statutory rule laying down the order of payment?

37 The case-law rules summarised in paragraph 5.37 of the Note appear sufficient for these purposes and we do not think that there is a need for a statutory rule.

5.40 Should the issue of a funding bond be treated as payment for paragraph 2 purposes? Is there in fact any role left for section 582 so far as corporation tax is concerned?

38 We are inclined to agree that section 582, ICTA 1988 no longer has any role left for corporation tax purposes.

5.43 Should the rules for these discounted securities be fully aligned with section 87 (or any replacement)?

39 The rules for discounted securities should be fully aligned with section 87, FA 1996.

5.45 Should these rules for the discounted securities be relaxed where the securities cease to be owned by a participator?

40 The rules for discounted securities should be relaxed where the securities cease to be owned by the participator.

5.47 Should PIBS now be included in full as was the original intention? Is there any reason why all building society shares should not be brought fully into the loan relationships rules?

41 We think that PIBS should now be included in full. We see no reason why building society shares in general should not now be brought within the loan relationship rules.

5.59 Do users think that this approach will meet the concern that has been expressed that paragraph 13 can introduce unwelcome uncertainty for business? What situations should the proposed guidance seek to cover?

42 We refer to the comments we made in paragraphs 13 to 15 above concerning anti-avoidance rules. The sort of non-statutory 'guidance' suggested here as to when the Revenue would and would not expect paragraph 13 to operate is wholly inadequate to deal with an important issue of liability under a self-assessment regime.

5.61 Section 80. Is there scope for clarifying the meaning and effect of section 80(5) so that it is absolutely clear where the loan relationships rules override any other conflicting legislation, particularly where the effect of the loan relationship legislation is that no amounts actually fall to be brought into charge to tax?

43 It would certainly be desirable to remove any doubts there may be as to the scope and effect of section 80(5), including making it clear that where the effect of the loan relationship legislation is that no amounts actually fall to be brought into charge to

tax, a charge cannot arise under some other, more general legislation covering the same subject.

5.63 Should section 83(3) be amended to operate as a true default provision so that any amounts not utilised rather than 'not the subject of a claim' are carried forward and treated as a deficit arising in the next period?

44 Section 83(3) should be amended so as to operate as a true default provision.

5.66 Should the usage be made consistent or at least clarified?

45 The usage should be clarified, though we suspect the meaning of 'debits' and 'credits' may actually not be intended to be the same wherever the terms are used. Therefore, any proposed changes should be the subject of further consultation.

5.69 Should the legislation be amended to put this beyond doubt?

46 We are not sure that we understand the two (or is it three?) interpretations being put forward and would welcome clarification. If it is being suggested that a method should be 'authorised' for tax purposes provided that the company uses it correctly, even though it is not appropriate under GAAP for the company to be using that method at all, we would accept that this is wrong and we would not object to the legislation being amended to make the point clear.

47 On the other hand it equally clearly cannot be right for a method to be authorised merely because it is 'normal' for the company in question, even if the company has been "normally" using a method which does not comply with GAAP.

5.70 Should the legislation make it clear that such payments must also be allocated to appropriate periods?

48 The legislation should make it clear that profits and losses from 'related transactions' must be allocated to appropriate periods.

5.74 Should the legislation be amended accordingly?

49 We welcome the fact that in practice the Revenue is treating section 94(6), Finance Act 1996 purposively and allowing twelve months of indexation although a literal interpretation of the section would suggest that only eleven months' indexation is due (i.e. that indexation should run from the month of the closing balance sheet date of the previous accounting period and not the opening balance sheet date of the accounting period). However, the legislation should be amended to put beyond doubt that twelve months' indexation is available.

5.76 Should the legislation be clarified accordingly?

50 The legislation should be clarified to make it clear that section 94 applies regardless of whether the taxpayer uses a mark to market valuation.

5.80 Are there any other areas of the loan relationships legislation where you feel that changes could be made to clarify the rules, make them operate more fairly or reduce compliance burdens without opening up opportunities for tax leakage? Such changes need not be legislative ones - there might be cases where Inland Revenue guidance would be sufficient.

51 In relation to anti-avoidance, there should be less reason to be overly concerned about avoidance if, as we are proposing, the regime of taxation of income based upon accounts is extended to substantially all financial transactions. Where most of the avoidance concerns arise at present is in situations where the limits of the income regime make it possible for taxpayers to engineer transactions whereby losses fall within that regime but gains do not. Under an accounts-based regime, tax relief is not available unless a loss is shown in the accounts. Commercially, taxpayers will not suffer a real loss just for the sake of the tax relief.

Chapter 6: Consolidation of the Financial Legislation

6.14 Do respondents agree that there are benefits to be gained from a consolidation of the legislation? Or could this only be achieved at the cost of the certainty which the FX rules in particular now give?

52 As noted in the general comments above, we think that there are benefits to be gained from a consolidation of the legislation. We do not see that this could only be achieved at the expense of certainty currently provided by the FX rules.

FURTHER INFORMATION

53 If you require any further information, please let us know. We would also be interested in any feedback on this latest consultation.

FJH
12 January 2001
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