



TAXREP 40/13

(ICAEW REP 114/13)

ICAEW TAX REPRESENTATION

MODERNISING THE TAXATION OF CORPORATE DEBT AND DERIVATIVE CONTRACTS

Comments submitted on 28 August 2013 by ICAEW Tax Faculty in response to HM Revenue & Customs consultation document *Modernising the taxation of corporate debt and derivative contracts* published on 6 June 2013

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation document *Modernising the taxation of corporate debt and derivative contracts*, <https://www.gov.uk/government/consultations/modernising-the-taxation-of-corporate-debt-and-derivative-contracts> published by [HM Revenue & Customs (HMRC) on 6 June 2013.
2. We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.
3. Information about the Tax Faculty and ICAEW is given below. We have also set out, in Appendix 1, the Tax Faculty's Ten Tenets for a Better Tax System by which we benchmark proposals to change the tax system.

WHO WE ARE

4. ICAEW is a professional membership organisation, supporting over 140,000 chartered accountants around the world. Through our technical knowledge, skills and expertise, we provide insight and leadership to the global accountancy and finance profession.
5. Our members provide financial knowledge and guidance based on the highest professional, technical and ethical standards. We develop and support individuals, organisations and communities to help them achieve long-term, sustainable economic value.
6. The Tax Faculty is the voice of tax within ICAEW and is a leading authority on taxation. Internationally recognised as a source of expertise, the faculty is responsible for submissions to tax authorities on behalf of ICAEW as a whole. It also provides a range of tax services, including TAXline, a monthly journal sent to more than 8,000 members, a weekly newswire and a referral scheme.

KEY POINT SUMMARY

7. We welcome the current exercise and the potential simplification of the loan relationship and derivatives regimes. We are in favour of merging what are the moment two more or less separate, legislative, regimes.
8. To the extent that the new regime will "follow the accounts" and there are new accounting regimes being introduced with FRS 101 and 102 it seems to us very sensible to seek to recast the tax regime to reflect these new accounting regimes.
9. While there is a more wide-ranging consultation underway into the taxation of partnerships there is, in our view, merit in awaiting the outcome of that wider review before amending the current loan relationship etc provisions.

RESPONSES TO CONSULTATION QUESTIONS

Chapter 2: Introduction

Q2.1 Do you think the proposed timetable is practicable (particularly in terms of what would be achievable for Finance Bill 2014)? If not, how could it be adjusted?

10. We are concerned that the timetable may be too rushed and we believe it would be better to aim to allow whatever time is necessary to deal with all the issues raised in the consultation and arrive at a regime which is acceptable to government, business and its advisers. We are conscious that the revisions to the overall Corporate Tax regime took a very long time, more or less six years, but we believe that the outcome was much more satisfactory because

government was prepared to take the time to get it right and to go back to the drawing board if proposals were deemed not to be adequate for their proposed purpose.

Chapter 3: The Framework

Q3.1 Do you think the approach outlined in this chapter would provide a secure basis for determining the existence of matters within the scope of the regime and the taxable amounts?

11. We think the aim should be to create a stable basis

Q3.2 If not, why not and how could the policy intentions be realised?

12. We think it may be overly ambitious to believe it will be possible to create a regime which is secure in an environment which is immensely complicated and ever changing.

Q3.3 Would a requirement to the effect that amounts brought into account should represent the full amount of the profits, losses and gains from a loan relationship be adequate, or would any further qualification of, or addition to, those words be useful (see paragraph 3.23)?

13. We think this is the right approach and any departures from the full amount of profits etc should be clearly categorised in the legislation, along the lines of the categorisations in Figure 3.

Q3.4 Would it be helpful to make the categories set out in Figure 3 explicit in legislation?

14. We believe it would.

Q3.5 Do the categories set out in Figure 3 comprehensively capture the scope of potential departures from the default process?

15. We believe they do.

Chapter 4: Looking behind the accounts

Q4.1 Do you agree with the rule proposed in paragraph 4.21 concerning the identification and measurement of amounts to be taken into account?

16. We have no comment on this point.

Q4.2 In what circumstances should such a rule apply?

17. We have no comment on this point.

Q4.3 Do you anticipate any particular difficulties with the rule proposed in paragraph 4.21? If so, how might they be addressed?

18. We have no comment on this point.

Q4.4 Are there specific circumstances (other than where there is no material impact on tax outcomes) in which such a rule should not apply? If so, what alternative approach could be taken in such cases?

19. We have no comment on this point.

Chapter 5: Accounting issues

Q5.1 Would you support the proposed “follow the profit and loss” approach set out in paragraphs 5.12 to 5.15?

20. We believe that the profit and loss is a good “starting point” in the majority of cases. .

Q5.2 Do you anticipate difficulties with a “follow the profit and loss” approach? If so, how might they be addressed?

21. We do not believe this would necessarily be any more complicated than the existing regime.

Q5.3 Would you support the proposal to simplify the changes of accounting policy rules so that they are based on tax adjusted carrying value in all cases (see paragraphs 5.17 to 5.21)?

22. This is acceptable in the main but we would be concerned if the spreading period was reduced from the existing 10 years.

Q5.4 Do you anticipate difficulties with the proposed simplification of the change of accounting policy rules? If so, how might they be addressed?

23. We have no comment on this point.

Q5.5 Would you support changes to align and clarify the terminology used in the legislation dealing with the treatment of capitalised amounts and the recycling of designated cash flow hedges, and why?

24. We have no comment on this point.

Chapter 6: A unified regime for loan relationships and derivative contracts?

Q6.1 What benefits and difficulties would you anticipate from combining the loan relationships and derivative contracts codes into a single body of legislation with shared machinery provisions?

25. We welcome and support any simplification of the tax code. We remain concerned by the length and complexity of the UK tax code, for instance the two most recent Finance Acts have been the longest on record. The average length of the Finance Acts this century is 475 pages which is more than twice as long as in any comparable period.

Q6.2 How might any difficulties be addressed?

26. We have no comment on this point.

Q6.3 Overall, would you support such a change?

27. Yes.

Chapter 7: Connected party debt

Q7.1 Which of the options outlined above do you prefer, and why?

28. We are happy to support the government's preference for Option 2.

Q7.2 Do you anticipate difficulties with Option 2 set out at paragraph 7.12 to 7.14 and, if so, how might they be addressed?

29. We have no comment on this point.

Q7.3 Which of the approaches set out in paragraph 7.14 would be preferable?

30. We have no comment on this point.

Q7.4 Are there other relevant issues which are not addressed in this chapter and, if so, how would you address them?

31. The GAAR Guidance which has been published in the past couple of months says (example D6) that if a company arranges its affairs to benefit from the late paid interest rules, this is nonetheless an acceptable practice and that "HMRC would not seek to apply the GAAR". This should be reflected in the new legislation. Accordingly, we do not support the repeal of the late paid interest rules in relation to loans where there is a connection between the borrowing and lending companies.

Chapter 8: Intra-group transfers (group continuity)

Q8.1 What is your preferred approach, and why?

32. This chapter covers Intra-group transfers (group continuity) and of the options put forward we have a slight preference for the first one. We are concerned that any option that is followed needs to be consistent with EU law and we are, for instance, concerned by the remark in paragraph 8.21 in relation to option 2 that provisions would be inconsistent with the EU Mergers Directive as translated into UK law.

Q8.2 Do you see any difficulties with any of the options set out and, if so, how might they be addressed?

33. We are not in support of Option 3 as we think it should be possible to transfers loans within a group in a tax neutral manner. It is difficult to see a substantial advantage in the more complex version of Option 2 over Option 1, especially as the approach in Option 1 is already well understood.

Q8.3 To what extent does ensuring tax neutrality on intra-group transfers of loan relationships and derivative contracts remain an important commercial consideration?

34. We believe it is important for groups to have the flexibility to restructure as needed without generating tax charges in respect of gains which do not represent economic profits of the group, when taken as a whole.

Q8.4 How would the changes proposed under each option ease or intensify the burden of complying with group continuity?

35. We favour Option 1 as current regime is well known and similar in concept to the regimes which apply to capital gains and intangible assets.

Q8.5 Are there issues with the group continuity rules not considered in this chapter and, if so, how might they be addressed?

36. We have no comment on this point.

We have comments on a limited number of the remaining questions in the Consultation Document and have reproduced only those questions plus our responses.

Q9.1 Which of the options outlined above would you prefer, and why?

37. We note that the government is current looking more generally at the taxation of partnerships and we believe there may be merit in awaiting that more general review before there are any changes to the corporate debt and derivative contracts regimes in this area. .

Q10.2 Do you anticipate particular difficulties with the proposal for the treatment of hedging instruments and, if so how might they be addressed?

Q10.3 In view of developments in accounting standards, do you anticipate that companies with hedging relationships will generally be able to opt to apply hedge accounting?

38. Some of our members are extremely concerned by the proposals in chapter 10 because it is not clear to them that when the new accounting standards are in place they will be able to hedge account. For them the maintenance of the Disregard Regulations will be of absolutely paramount importance.

39. Their more detailed comments on the situation, and the current proposals in chapter 10, are set out below:

40. The proposal contained in Chapter 10 regarding the tax treatment of hedging relationships is predicated on the basis that, under IFRS 9, the profit and loss account volatility recognised in relation to hedging relationships will be significantly reduced. Consequently, a basis of taxation which seeks to simply tax the amounts recognised in the profit and loss account should reduce cash tax volatility. We understand that there has been no overall change in the policy objective which is to minimise cash tax volatility arising from hedging arrangements. However, the proposal now seeks to achieve this through reliance on the

accounting treatment rather than through a separate tax regime such as the current Disregard Regulations.

41. We have a number of observations in relation to the current proposal:
42. As a general principle it is fair to say that the changes which have been proposed under the current draft of the general hedge accounting section of IFRS 9 seek to make hedge accounting more straightforward. As a result, more entities may choose to apply hedge accounting and more hedging relationships may qualify for hedge accounting than currently is the case under IAS 39. Therefore, this may result in an overall reduction in fair value volatility recognised in the profit and loss accounts of many companies. However, the section in IFRS 9 on macro hedge accounting¹ has yet to be released with a discussion paper, rather than an exposure draft, only expected to be issued in Q3/Q4 of 2013 at the earliest.
43. Until this part of IFRS 9 is finalised, it will be difficult for companies reliant on macro hedge accounting to conclude on the impact of the standard on their hedging arrangements and to determine the impact that this will have on any individual company's profit and loss account. As a result, a basis of taxation which relies solely on the accounting result for a company may create cash tax volatility for some companies going forward which may not be experienced currently.
44. The general hedge accounting section of IFRS 9, as observed above, is likely to result in more hedging arrangements qualifying for hedge accounting. Whilst this may result in a reduction in fair value volatility recognised in the profit and loss accounts of many companies, it will not eliminate it. For example, where a hedging relationship is only 70% effective, hedge designation would not be possible under IAS39 as the requirement to demonstrate that the hedging relationship is effective within a range of 80%-125% both prospectively and retrospectively is not met. Under the existing legislation, no cash tax volatility would arise as provided the company is party to the derivative contract with an intention to hedge an appropriate hedged item, the conditions in Regulation 7,8 or 9 of the Disregard Regulations would be met and an appropriate accruals basis of taxation imposed instead. Under IFRS 9, provided that the derivative was entered into in accordance with the group's risk management objective and satisfies the more relaxed hedge accounting criteria in IFRS 9, that same hedging relationship would now be capable of designation in a hedging relationship. However the fair value movement relating to the ineffective portion of the hedge would be recognised in profit and loss account, in this case 30% of the overall fair value volatility on the derivative. Under the proposal in Chapter 10, fair value movements would be brought into account for tax purposes and would continue to create cash tax volatility. Detailed transitional rules would be required to ensure that amounts do not fall out of account for tax purposes in respect of the ineffective component of the derivative when transitioning between the two regimes and this is unlikely to be straightforward.
45. Some small and medium-sized companies may decide not to apply hedge accounting because the administrative burden of maintaining the appropriate hedge accounting outweighs the benefits of the hedge accounting treatment. Having a rule which is based solely on the accounting treatment would mean that companies which conclude that the hedge accounting requirements are too onerous for them will suffer cash tax volatility.
46. As a result of the points raised above and the fact that there does not appear to have been a change in overall policy with respect to the taxation of hedging arrangements, we would recommend that rules similar to those currently contained within Regulations 7, 8 and 9 of the

¹ Macro hedging is the hedging of open portfolios which are groups of transactions which are more fluid, with items being removed or replaced on a regular basis. This is particularly relevant to financial institutions but also to corporate groups with significant transactions denominated in foreign currencies or transactions in currencies which the group is seeking to hedge.

Disregard Regulations are retained. However, we accept that the Disregard Regulations are complex. This has in part been caused by several changes introduced over the years in relation to circumstances where the rules do not operate effectively or as intended. A simplification of the Disregard Regulations which continues to achieve their current objective of minimising overall cash tax volatility from economic hedges would therefore be welcome.

47. An alternative basis of taxation which permits a company to simply tax the amounts recognised in its profit and loss account is also required to enable larger companies with more complex hedging arrangements to avoid unnecessary compliance complexity where they have successfully managed to reduce any fair value volatility recognised in their profit and loss accounts to a level which they consider to be an acceptable level.

Chapter 14 Anti-avoidance measures

48. We are very concerned by what we consider to be a glut of potential TAARs. The final paragraph of the Chapter floats the idea that even more anti-avoidance provisions will be needed as “the revised framework of the regime is developed”. We would hope that a general regime TAAR would be more than adequate for the purpose.

Chapter 15 Tax Impact Assessment

49. The time needed to complete the Loan Relationship part of a corporate tax return is often disproportionately long not least because very large sums are often involved in this part of the businesses activity and advisers need to be extremely cautious to ensure that their advice, and hence the entries in the tax return, are correct.

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APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see icaew.com/en/technical/tax/tax-faculty/~media/Files/Technical/Tax/Tax%20news/TaxGuides/TAXGUIDE-4-99-Towards-a-Better-tax-system.ashx)