THE CITY OF LONDON LAW SOCIETY

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Mr Richard Rogers
3rd Floor
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6 March 2008

Dear Mr Rogers

HMRC Consultation: "Principles-based approach to financial products avoidance"

The City of London Law Society (CLLS) represents over 13,000 City lawyers, through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. **Enclosed** for your consideration is the CLLS response to HMRC Consultation "Principles-based approach to financial products avoidance", which has been prepared by the CLLS Revenue Law Committee as a whole. The Committee is made up of a number of solicitors from City of London firms who specialise in revenue law. The Committee's purpose is to represent the interests of those members of the CLLS involved in this area.

Yours sincerely

David McIntosh
Chair City of London Law Society

Encl.

HMRC Consultation:
"Principles-based approach to financial products avoidance"

Comments from the City of London Law Society Revenue Law Committee ("CLLS")

"PRINCIPLES-BASED APPROACH TO FINANCIAL PRODUCTS AVOIDANCE": CONSULTATION DOCUMENT

We are grateful for the opportunity to comment on HMRC's consultation document on the "Principles-based approach to financial products avoidance" published in December 2007 and the amended draft legislation, commentary and guidance on "disguised interest" published in February 2008 (together referred to in this paper as the "Consultation Document").

1 **General Comments on the Consultation Document**

We can understand that HMRC sees potential merit in applying a principles-based approach to tax avoidance. However, we are concerned to see that where a principles-based approach is taken:

1.1 the principles relied upon are in accordance with the law as it currently stands;

1.2 the principles are applied consistently (so that, for example, different sides of a transaction are not treated in different ways for tax purposes);

1.3 there is sufficient certainty and clarity for taxpayers on the principle underlying the relevant legislation; and

1.4 taxpayers are not required to place undue reliance on HMRC guidance (which does not have the force of law and which may be withdrawn at any time) in their interpretation or application of the law.

It does not seem to us that either the "disguised interest" or the "transfer of income stream" proposals, as presently put forward, satisfy these basic requirements.

2 **"Disguised Interest"**

2.1 We consider that the "disguised interest" provisions would benefit from a motive test, to give taxpayers certainty and clarity on the law and its application. This would also help to reduce reliance by taxpayers on HMRC's published guidance alone. We note the comments made by HMRC under the heading "Main changes following open day" in the revised Consultation Document with regard to the new paragraph 2(5) in the revised legislation. Whilst the new paragraph 2(5) is helpful, we do not consider that it alone will give sufficient certainty to taxpayers.

2.2 We can see scope in the draft provisions and guidance for different sides of the same transaction to be treated in different ways for tax purposes. The principle set out in Section 1 of the (revised) draft legislation is stated to be intended to ensure that returns designed to be economically equivalent to interest are treated in the same way as interest for corporation tax purposes. However, the draft legislation does not also bring the borrower side of the transaction within the principle. We do not see why, subject to the usual provisions that may apply to restrict the deductibility of interest, a "borrower" in this type of transaction which is a UK corporation taxpayer should not also be treated as paying interest and accordingly having an entitlement to relief for amounts it incurs in respect of the "borrowing" that equate to financing costs. We would request that HMRC reconsider the application of this principle so that it may be applied consistently.

2.3 We welcome certain of the changes to the exceptions in the revised draft legislation to the extent that the exceptions are now better equipped to deal with tiers of companies.

2.4 We note that paragraph 4(2) of the revised legislation disapplies the exception in paragraph 4(1)(b) to the extent that a tax charge under paragraph 2 would be sheltered by the use of carried forward non-trading loan relationship deficits. We do not see why the principle outlined in the draft legislation should extend to the use of bona fide loan relationship deficits against corresponding income.

3 "Transfer of Income Stream"

3.1 It is a well established principle of English law that the consideration for the sale of an income stream relating to a capital asset is not income (per the judgement of the Court of Appeal in *IRC v John Lewis Properties plc* [2003] STC 117). Accordingly, we do not consider the principle outlined in paragraph 1 of the draft legislation relating to transfers of income streams to be the most obviously correct principle to form the basis of legislation in this area. The proposal suffers from a fundamental difficulty of circularity; it is only by reference to the existing case law that one can establish what does "equate in substance to income".

3.2 In addition to the point made at paragraph 3.1 above, in our view the principle chosen by HMRC gives rise to conceptual difficulties. For example, it is not clear to us what the analysis would be if:

3.2.1 there is a part disposal of the underlying capital asset;

3.2.2 an intermediate lease is granted;

3.2.3 there is an assignment of the benefit of a partnership interest;

3.2.4 a novation takes place (novations not being included in the list of examples of transfers in paragraph 1(8) of the draft legislation); or

3.2.5 the amounts transferred are in the form of profits rather than income.

We therefore consider that the law is not sufficiently clear to enable taxpayers to assess their positions.

3.3 Similarly to the "disguised interest" draft legislation, there appears to be an inconsistency in the treatment of taxpayers on different sides of a transaction. In this case, the consideration given by the transferee for a right to receive an income stream will not be taken into account for tax purposes unless the transferee is a trader.

3.4 We consider that the draft legislation is capable of giving rise to double taxation. For instance, the interaction between the draft legislation and the capital gains degrouping charge in Section 179 TCGA 1992 gives scope for double taxation even in the context of a bona fide commercial transaction. Taking an example:

- A Limited and B Limited are companies that are in the same group for the purposes of corporation tax on chargeable gains;
- B Limited acquires an income stream from A Limited; and
- Within six years of the acquisition, B Limited leaves the group.

In the above example, the draft legislation would apply to treat the consideration paid by B Limited as income in the hands of A Limited (and presumably Schedule 28AA TA 1988 may apply to adjust the amount of the consideration if the consideration is not an arm's length amount). However, the acquisition of the income stream by B Limited will still be a capital transaction (assuming that the tests in *John Lewis* are met) because the draft legislation would only recharacterise the consideration as income; it would not recharacterise the underlying transaction. Therefore, when B Limited leaves the group it appears that Section 179 TCGA 1992 will apply a degrouping charge to B Limited, by reference to the value of the consideration it has paid to A Limited for the income stream. We would note that Section 37 TCGA 1992 would not be in point here, as the amount charged to income will not be chargeable on the same person as the degrouping charge. Accordingly, we should be grateful if consideration could be given to disapplying Section 179 TCGA 1992 in circumstances where the draft legislation will apply.

3.5 Further, we should be grateful if further consideration and clarification could be given in respect of the interaction of the proposed legislation with other existing legislation, for instance:

3.5.1 the rules relating to sales and repurchases of securities (the "repo" legislation); and

3.5.2 other anti-avoidance rules which operate in similar circumstances, notably Section 774A et seq Income and Corporation Taxes Act 1988. In this case, we note that Example 10 in the draft guidance refers to Section 774A, but it is not clear that the position stated in that example follows from paragraph 1(6) of the draft legislation.

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REVENUE LAW COMMITTEE

This response has been prepared and reviewed by the Revenue Law Committee as a whole.

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