The City of London Law Society

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

The City of London Law Society ("CLLS") represents approximately 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. This response in respect of the HMRC consultation "Principles based approach to financial products avoidance" has been prepared by the CLLS Revenue Law Committee. 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 of law.

We are grateful for the opportunity to comment on HMRC's consultation document on the "Principles-based approach to financial products avoidance" published in November 2008.

1 **General comments on the Consultation Document**

1.1 We note that in producing the revised consultation document and draft legislation HMRC has taken into account many comments which have been made in the first round of the consultation process and we are grateful for this.

1.2 In our representations of March 2008 on the December 2007 Consultation Document on the principles-based approach, we raised concerns about the need for such legislation to reflect the law as it currently stands, be applied consistently, be sufficiently clear and certain and ensure that taxpayers are not required to place undue reliance on HMRC guidance in their interpretation or application of the law.

1.3 While the "disguised interest" provisions appear to have progressed, in our view the "transfer of income streams" provisions are still not sufficiently well developed to be brought into force. We would recommend that the proposal to introduce principles based legislation for "transfers of income streams" be dropped in its entirety.

2 Comments specific to the "Disguised Interest" provisions

2.1 It is not clear exactly how these provisions are intended to interact with the proposed Foreign Profits legislation which is proposed to be introduced as part of Finance Bill 2009. In particular, certain of the provisions which have been drafted as part of Schedule 1 to Finance Bill 2009 ("Corporation tax treatment of company distributions", inserting new Part 9A of Corporation Tax Act 2009) would in our view work better as part of the "disguised interest" provisions. The provisions in question are Clause 930H (Dividends in respect of shares accounted for as liabilities), 930J (Schemes involving quasi-preference shares) and 930N (Schemes in the nature of loan relationships).

2.2 Paragraph (a) of Clause 485B(2) of the "disguised interest" provisions refers to amounts which are "economically equivalent to interest" by reference to time value of the money. In line with the case law in this area, we would suggest amending this wording so that it reads "it is reasonable to assume that it is a return by reference to the time value of *the use of* that amount of money".

2.3 Paragraph (b) of Clause 485B(2) refers to "a rate reasonably comparable to a commercial rate of interest". As discussed at the recent Open Day, the "commercial rate of interest" will vary depending on numerous factors including, for example, the term of the deposit and the credit risk of the counterparty. We therefore support the suggestion that this drafting should be expanded so that it refers to a commercial rate of interest having regard to all relevant features of the arrangements. We would suggest that the drafting should also refer to all relevant circumstances of the parties to the arrangements to make it clear that regard should also be had to issues such as the credit risk and status of the parties to the arrangements.

2.4 The reference to there being "no practical likelihood" that the return will cease to be produced in paragraph (c) of Clause 485B(2) could cause some uncertainty as to the application of the provisions, since this requires a judgement to be made as to the financial ability of the payer to produce the return. To add certainty to the application of the provisions, we would support reinstating an exclusion from this clause to cover the risk of a default by the payer (as discussed at the Open Day).

2.5 We would welcome clarification on the application of the draft legislation where a return is accrued but not realised. As presently drafted, it is not certain that relief would be available for impairment where a return is expected (and therefore has been accrued) but is ultimately not paid; the loan relationship regime is stated to apply specifically to the return (Clause 485B(1)).

2.6 In Clause 485C, returns arising in respect of property should also be specifically excluded from the application of Chapter 2A.

2.7 In relation to Chapter 6A (Shares Accounted for as Liabilities), the Unallowable Purpose rule in Clause 520D as drafted could cause dividends paid on preference shares to be subject to tax. An investor might be attracted to acquire fixed rate preference shares because of the tax advantage which arises from investing in the preference shares. As drafted, this is likely to be an unallowable purpose. This could (for example) mean that investors are less likely to acquire bank preference shares on a future disposal by HM Government. We would therefore support the reinstatement of an exclusion relating to publicly issued shares.

2.8 In Clause 520E(3), the words "or, as the case may be, ceased to apply" need to be added after "began to apply" to cover the case where Section 520B ceases to apply to shares.

2.9 We do not consider that the existing drafting in Section 37 TCGA 1992 is sufficient to avoid double taxation. The draft legislation proposes that the interest-like return on an investment would be taxed over the life of that investment, whereas Section 37 TCGA 1992 does not appear to exclude from the CGT charge a return which has been previously taxed in this way. Similarly, Section 80(5) FA 1996 (clause 464 of the Corporation Tax Bill 2009) does not appear to put the matter entirely beyond doubt. Nor does the deeming provision in Section 117 TCGA 1992 (which deems a company's loan relationships to be qualifying corporate bonds for the purposes of corporation tax on chargeable gains) - only the <u>return</u> from an arrangement falling within the proposed legislation will be subject to the loan relationships regime. Neither the arrangement itself nor any investment comprised in the arrangement is treated by the proposed legislation as being a qualifying corporate bond. In contrast, Section 91B FA 1996 provides that a share producing an interest-like return is itself to be treated as rights under a creditor loan relationship and section 91G makes it clear that this results in the share being treated as a qualifying corporate bond for CGT purposes. We would therefore propose that a specific provision be inserted into the proposed legislation or into the TCGA 1992 to avoid double taxation.

3 Comments specific to the "Transfers of Income Streams" provisions

3.1 As we have mentioned above, we would recommend that these provisions be dropped altogether. They are not consistent with current law (notwithstanding overseas case law, there is no established principle of English law that the sale of an income right must of necessity give rise to an income receipt: on the occasions when the issue has come before our courts, the decisions have reflected the fact that the position is rather more nuanced) and continue to give rise to a number of other significant concerns. In particular, there is a real conceptual difficulty in attempting to create a single regime for the taxation of the transfer of income streams when the taxation of those income streams in the absence of transfer is not itself subject to a unified code. In addition, we note that significantly revised legislation was produced at the Open Day on 23 January and that HMRC asked on that Open Day that comments address the revised proposal.

Despite these revisions, we remain of the view that the existing law is clearer and more certain than that proposed.

3.2 We nonetheless include some relatively high level comments below (we understand that the detail of the drafting is to be revised in any event).

3.3 It is difficult to see any real justification for the lack of symmetry of treatment under the draft provisions. If a transferor is to be taxed on the sale of an income stream on an income basis, we would expect the transferee to be entitled to relief for the acquisition cost (for example on the basis of an amortising loan or the purchase of a security at a discount, where that is appropriate). However, we note from the "Update on the Transfers of Income Streams Consultation" posted on the HMRC website on 9 February 2009 that the issue of symmetry will be addressed by providing that the acquisition cost is to be deductible against the income in accordance with GAAP. Will that be suitable for individual (as distinct from corporate) transferees?

3.4 These measures inevitably highlight the existing oddity that the purchaser of an annuity obtains no relief in respect of his purchase price, and so is taxed on a profit in excess of that which he has actually made. If the intended changes are to go ahead, this asymmetry should also be addressed as it will look untenable in the light of a new principle of English law that the consideration for the purchase and sale of income streams should be taxed and relieved on an income basis. If it is not, but a deduction is allowed for the buyer of an income stream under the new rules as seems only fair, what is to stop annuities being issued to financial traders for on-sale to the real buyers? No doubt HMRC would see this as avoidance, but we find it hard to characterise a taxpayer's attempt to be taxed only on the profit he makes as such.

3.5 The provisions relating to "pure income assets" are too widely drafted. We understand that an exclusion for real property assets is under active consideration, but what of other income generative assets such as intellectual property rights? A reasonable measure of whether a transfer should be included in the legislation might be to exclude from the definition of "pure income assets" those assets which give rise to rights in an insolvency of the income stream payer in addition to the right to make a claim as a creditor in its liquidation for the amounts of income due (for example, the right to take possession of a property where a tenant fails to meet its rental payment obligation). The distinction is between a proprietary right in respect of an asset of the income stream payer which could be asserted in the insolvency and a purely personal claim against the income stream payer as a debtor.

3.6 The legislation should make it clear which definition of the phrase "market value" is to be used (for example, reference could be made to Section 272 TCGA 1992 or to some other appropriate definition).

3.7 We note HMRC's question in the Consultation Document as to whether the legislation should include a purpose statement. Our view is that it should not include such a statement.

3.8 In the revised draft legislation circulated at the recent Open Day, in paragraph 1(6) the words “(to that extent)” should be added after “the income is” so that the accounting treatment governs the time of recognition of the part of the consideration recognised in the accounts.

3.9 Also in the revised draft legislation, we consider that paragraph 1(9)(c) should be expanded to provide that “transfer” includes the transfer of part of an asset or the grant of an interest in all or part of an asset.

3.10 Paragraph 3.15 of the Consultation Document asks whether the paragraph 4 (transferee) approach should be applied to Section 774A structured finance transactions. We think it should be applied to these arrangements so that both parties are taxed on the economic substance of the transaction.

THE CITY OF LONDON LAW SOCIETY
REVENUE LAW SUB-COMMITTEE

The City of London Law Society is the local Law Society for solicitors practising in the City of London. It has a number of specialist Sub-Committees, the Revenue Law Sub-Committee being one of them. This response has been prepared and reviewed by the Revenue Law Sub-Committee as a whole.

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