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29 August 2013

Dear Sirs

Revenue Law Committee response to consultation document on Modernising the Taxation of Corporate Debt and Derivative Contracts

The City of London Law Society ("CLLS") represents approximately 14,000 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 has been prepared by the CLLS Revenue Law Committee.

Introduction and summary

Thank you for the opportunity to comment on the proposals for changing various aspects of the loan relationships and derivative contracts codes. The consultation document raises a number of very difficult questions (indeed in many ways it contains a number of different, if inter-related, consultations), but we agree that it is appropriate to undertake a significant review of the loan relationships code even if in many cases our recommendation is to make only minor changes.

We have addressed most of the chapters in the consultation document in turn in this response. Given the volume of material to get through in limited time over the holiday season, our comments are in places are at a relatively high level, but we hope that they are nonetheless of assistance. In most cases we have addressed the specific questions in the consultation document, but in some we have adopted a more discursive approach. We have not provided comments on chapter 5.

We have also not provided comments specifically on chapter 6. However, it will be apparent from our responses to other chapters that we favour a regime which follows the

results of GAAP accounting except in the case of express statutory exceptions. Given that many if not most of the appropriate exceptions would likely be different for loan relationships than they would be for derivative contracts, we are not sure whether such a regime should properly be regarded as unified or not. However, that is how we think it should work.

We would welcome the opportunity to remain involved as the proposals develop.

Chapters 3 and 4 Tax and Accountancy

Chapters 3 and 4 address the interplay between tax and accountancy in identifying profits and losses from loan relationships/derivative contracts in terms of a default process, departures from the default process and modifications to the default approach. We, however, prefer to address that interplay in terms of a straightforward priority rule and express exceptions.

As regards the priority rule, we believe that it must address both the threshold issue of the identification of profits and losses from loan relationships/derivative contracts and the ensuing issues of measurement and timing.

We base this distinction between threshold and ensuing issues on that applying to trading profits. The identification of trading profits is a threshold question of law to which accountancy is relevant but not determinative. Other relevant issues are economic and commercial law and practice. Once trading profits have been identified, they must then be calculated in accordance with GAAP, subject to any adjustments required by law (CTA 2009 s.46). See *Pertemps Recruitment Partnership Ltd v HMRC* [2011] STC 1346.

Priority given to GAAP

As regards the proposed regime for loan relationships/derivative contracts, our strong preference is that both the threshold issue of the identification of profits and losses from loan relationships/derivative contracts and the ensuing issues of measurement and timing of those profits and losses should be determined in accordance with GAAP, subject only to express exceptions.

In our view, a regime under which the identification of profits from loan relationships/derivative contracts is a threshold question of law and the measurement and timing of those profits is determined (subject to any adjustments required by law) by GAAP will not give the certainty that business is entitled to expect from the reformed regime. In effect, every debit and credit given by the accounts will have to be tested against a requirement that it must reflect a profit or loss identified as a matter of law. Although, in the majority of cases, this test will not reveal any difference between tax and accountancy, at the margins considerable uncertainty will be created.

It follows from the objective of creating as much certainty as is reasonably possible that we do not favour a regime under which the identification, measurement and timing of profits and losses from loan relationships/derivative contracts are determined in accordance with GAAP, subject to exceptions for cases in which profits or losses determined by GAAP diverge from, or do not fairly represent, the profits or losses at which tax is aimed or to which it is intended that tax should apply. This would simply reverse the priority rule and give priority to tax law over accountancy.

Accordingly, in our view, profits and losses from loan relationships/derivative contracts should be determined in accordance with GAAP, subject only to *express* exceptions.

Express exceptions

The Consultation document identifies a number of the express exceptions which we would expect to feature in the reformed regime. They include:

- derecognition;
- loan relationships influenced by other instruments (eg composite instruments);
- TAARs.

We would also like to see exceptions for cases where companies carrying on a business (other than a financial trade) are required to fair value assets or liabilities and, as a result, to bring into account unrealised profits or losses. In such cases, tax should be aligned with cashflows (a realisation basis), rather than with the accounting treatment.

In particular, whether in the context of fair value accounting or not, we do not believe that any tax consequences should result if GAAP requires the recognition of a change in the value of the burden of a debt obligations in circumstances where the amount of that obligation has not changed as a matter of law.

Chapter 7 Connected Party Debt

1. As a general point, we agree that it is preferable and simpler for companies as much as possible to be able to follow the accounting treatment in preparing their tax computations, and not to be required to make additional computations specifically for tax purposes. Nevertheless, where there is a good policy or commercial reason for the tax treatment to differ from the accounts, we think this does justify a departure from the accounting treatment.

2. With this in mind, we would strongly oppose removing the tax-neutral nature of connected party debt releases, even if this means the accounts are not followed in every case. Being able to release connected party debt without triggering a tax charge in the debtor is important commercially, especially in the context of debt restructurings where tax neutrality may be key. Where a company is in financial difficulties, it is often commercially necessary for debt for which there is little prospect of repayment to be waived, in order to prevent the debtor from being required to enter into an insolvency procedure - and if a tax charge were to arise on such a debt waiver, it would be counter-productive for a company that is already in financial difficulties. We are therefore not in favour of Option 2.

3. Our preference would be to keep the current rules, and make only minimal changes to them where necessary (e.g. to align with changes in the accounting definition) – therefore we have a strong preference for Option 1. Regarding the extent to which retaining the current rules would entail additional computational complexity, we believe this is moderate in comparison with the benefits achieved by allowing for tax-free debt releases between connected parties.

4. If Option 2 were to be adopted, then, regarding removing "asymmetry" where debts are owed to a UK company by a connected offshore company (para 7.14), we would query the justification for seeking to correct this "asymmetry" in circumstances where there has been no tax avoidance. Where such a debt release is purely commercially-driven, it seems inappropriate to deny the UK creditor company a deduction for the amount of debt waived. Therefore out of the two choices offered in para 7.14, we would advocate relying on an amended "unallowable purpose" rule rather than a "fair value" rule (which would also entail additional complexity in having to make the requisite calculations).

5. We would also welcome a simplification of the "deemed release" rules, and express a wish that we do not see any more retrospective legislation to change this part of the legislation to deal with specific schemes that may come to light.

Therefore our responses to the specific questions asked are as follows:

Question 7.1: Which of the options outlined above do you prefer, and why?

Option 1, for reasons given above.

Question 7.2: Do you anticipate difficulties with Option 2 set out at paragraph 7.12 to 7.14 and, if so, how might they be addressed?

We do not favour Option 2, for the reasons given above.

Question 7.3: Which of the approaches set out in paragraph 7.14 would be preferable?

An amended "unallowable purpose" rule.

Question 7.4: Are there other relevant issues which are not addressed in this chapter and, if so, how would you address them?

None identified.

Chapter 8 Intra-Group Transfers (Group Continuity)

1. We believe there continues to be commercial and practical justification for retaining the ability for loan relationships and derivative contracts to be transferred tax free within a group. The rule provides flexibility, especially in the context of debt restructurings and intra-group reorganisations of debt prior to company disposals. Conceptually the rule is justified, in that it is fair not to tax transfers where economically no gain has been realised on a group basis; just as with intra-group transfers of other types of assets (e.g. s.171 TCGA). Therefore we are not in favour of Option 3.

2. We are not persuaded of the need to make radical changes to the current rules. Once it is decided to allow for tax-neutral intra-group transfers of any asset, then some element of complexity will be inevitable; however, we consider that the current rules work reasonably well in the majority of cases and are generally well understood. We currently live with similar complexity in other parts of the tax code which allow for intra-group tax-free transfers of assets in the CGT regime, and so do not see the desire for simplification as a sufficient justification for rejecting the principle of allowing for intra-group tax-neutral transfers in the context of debt and derivatives.

3. The "backward continuity" rule (Option 2) is unattractive, in that (as the consultation document says at para 8.15) it is likely to trigger a taxable gain or loss on an internal group transfer – which would not accord with a policy intention to allow for intra-group transfers on a tax-free basis. The proposed modification in para 8.16 (spreading the gain or loss over the term of the instrument) would only mitigate, rather than remove, the impact of this, and would introduce additional complexity, which would not be welcome. Similarly the deferral rule in Option 3 would be unattractive for the same reason.

4. To the extent that the current rules "attract abuse", this could be dealt with by the new regime TAAR (or the GAAR) such that new rules to counteract specific examples of abusive behaviour should not be necessary.

5. We would therefore favour no change at all, or limited changes as per Option 1, rather than Options 2 or 3.

6. Specifically on Option 1, we would query why there is a perceived need to prevent the intra-group rules from applying where the transferee (but not the transferor) applies fair value accounting.

7. We would also advocate making the following changes to the current rules, as follows:

7.1 HMRC guidance (at CFM 34030) expresses the view that for a debt transfer to fall within the scope of the group continuity rules the entire loan relationship, and not just a part of it, must be transferred. We disagree with this interpretation, and consider that a transferee company may be said to have replaced the transferor "as party to a loan relationship" (for the purposes of s.336(1)(b) CTA 2009) even where only part of that loan relationship is transferred. We do not see any policy reason why this provision should be read as narrowly as HMRC appear to do, especially as this would run counter to the equivalent group continuity rule in the CGT regime (where an intra-group disposal of an asset would include a part disposal). Moreover, to comply with HMRC's interpretation can cause unnecessary complexity in practice, in that where only part of a debt is to be

novated, the debt must first be split into two separate tranches, one tranche to be novated and the other to remain in place. We would be grateful if HMRC would reconsider their view on this point and either issue revised guidance allowing for partial transfers of loan relationships to be covered by the group continuity rule, or, better still, explicitly reflect this position in any revised legislation.

7.2 Regarding the degrouping charge where a transferee leaves the group after a loan relationship/derivative contract has been transferred to it, we would advocate the introduction of a rule equivalent to s.179(3A) TCGA 1992 such that the charge would not arise to the transferee, but would instead increase the consideration deemed to be received by the transferee's parent on its sale of the shares in the transferee. The charge could thus be exempted by the substantial shareholdings exemption, in the same way as the CGT degrouping charge can now be, following the introduction of s.179(3A) TCGA. This would align the treatment of degrouping charges in the loan relationship/derivative contract rules with that for capital assets; and we do not see the justification for the charges not to be aligned in this way (moreover we believe the same should also apply to the degrouping charge in the intangible fixed assets code).

7.3 At present the de-grouping regime applies following novations of the burden of debt as well as transfers of the benefits of debt. It is in our view debatable whether this is a good policy outcome, not least because the total debt burden to which the departing company is subject does not change as a matter of law even if the market value of that debt varies due to changes in the debtor's circumstances (see also our suggestions as to the circumstances in which the methodology of tax following the accounts should be overridden – we think that any accounting adjustment to the fair value of the burden of a debt should be ignored for tax purposes if the amount of the debt legally due is unchanged). Furthermore, it is conceptually extremely hard to apply the valuation test as required by the legislation, given the significance of the particular features of the entity assuming the burden of the debt to the question of how much that entity would need to be paid in order to assume it.

Therefore our responses to the specific questions asked are as follows:

Question 8.1: What is your preferred approach, and why?

Option 1, for the reasons set out above.

Question 8.2: Do you see any difficulties with any of the options set out and, if so, how might they be addressed?

We see difficulties with Options 2 and 3, set out above.

Question 8.3: To what extent does ensuring tax neutrality on intra-group transfers of loan relationships and derivative contracts remain an important commercial consideration?

Yes we believe this remains important, for the reasons set out above.

Question 8.4: How would the changes proposed under each option ease or intensify the burden of complying with group continuity?

We believe Options 2 and 3 would increase the burden of complying.

Question 8.5: Are there issues with the group continuity rules not considered in this chapter and, if so, how might they be addressed?

We have identified three particular issues, set out in para [7] above.

Chapter 9 Partnerships and transparent entities

Question 9.1: Which of the options outlined above would you prefer, and why?

We consider that which of the options is preferable depends upon whether there is to be a comprehensive review and consolidation of partnership taxation rules in general. If such reform is to take place, then Option 1 would be preferable as it would require the least amount of change to the existing rules. If, however, no such reform of partnership taxation is likely to take place in the next few years, then Option 2 is preferred, provided it would adopt a similar approach to that taken in relation to chargeable gains by SP D12.

Question 9.2: Are there any particular circumstances where you would see Option 3 as being either appropriate or inappropriate?

It is not considered that a requirement to use fair value accounting to bring unrealised profits into the charge to tax where there is a change in partnership 'shares' would be appropriate. A requirement to fair value loan relationships would introduce uncertainty and increased compliance costs.

Note in particular that as set out more fully in our response to 9.4 below that it is very common, for entirely commercial reasons, for partners' proportionate entitlement to profits to change on a continual basis without any change in their holdings of interests in their partnerships. Any move to requiring taxable/relievable fair value adjustments on changes of partnership share would therefore either have to exclude such situations from the definition of changes in partnership shares or would face considerable practical problems and the likelihood of some quite arbitrary results (which would by the nature of the problem be as likely to favour the taxpayer as HMRC). We would be concerned at the potential for avoidance through pre-wired changes in entitlements if such situations were to be excluded from the definition of changes in partnership shares, so our conclusion would be that Option 3 should not be attempted.

A move towards adopting an SP D12 approach to capital-like assets and liabilities taxed within the income regime (loan relationships, intangibles and derivative contracts) would however be welcomed.

Question 9.3: Are there any types of arrangement, other than foreign entities treated as transparent and trust arrangements, where you consider the partnership approach could or should be adopted?

No. Given the intrinsic problems involved with dealing with loan relationships held by partnerships in the context of the overall design of the loan relationships code (as to which see below), we would suggest that the number of entity types to which the rules apply should be kept to a minimum.

Question 9.4: Are there other relevant issues not addressed in this chapter? If so, what are they and how might they be addressed?

How to operate accounts based taxation when the assets in question are not shown in the relevant accounts?

Partnerships provide a challenge to the operation of the loan relationships regime at a most basic conceptual level. The same challenge applies in relation to the other parts of the tax code – most notably the intangibles regime – where assets which would be capital assets on general principles have been brought within an accounts-based income tax regime. Indeed the problem is far more pronounced in the context of intangibles than

it is in the context of loan relationships, since there is far greater scope for the underlying assets to increase materially in value. As an aside, we would strongly urge a review of the partnership rules in that context as well.

The core problem is that all these regimes operate on the basis of delivering tax results derived from the accounting treatment of the holders of the assets. However, where the assets are held within a partnership, the assets will typically not be recognised in the taxpayer companies' accounts: those accounts are much more likely to show the partnership interest as an asset. There are therefore no entries in the taxpayers' accounts off which the tax regime can run.

In this context any system which seeks to tax by reference to the accounting treatment of the assets, but also seeks to tax at the level of the partners rather than the partnership, will inevitably require its own set of rules which will in many ways be likely to be problematic. We are certainly not suggesting that either of these fundamental features of the tax system should be changed, rather we are noting that with them in place any regime for the taxation of loan relationships (and other capital assets taxed on an income basis as per accounting results) will inevitably be complex and imperfect.

As noted above, however, we consider that it would be extremely beneficial to extend the approach of SP D12 to capital assets within the income regime. At present, of course, SP D12 has no application to such assets and in consequence the results of changes in partnership sharing ratios can be extremely unclear.

What is a partnership share?

The concept of partnership shares underpins the existing legislation and is likely to continue to do so in any new legislation. Section 381 CTA 2009 currently provides that the total credits and debits are to be apportioned between the partners in the shares in which any profit or loss would be apportioned between them in accordance with the firm's profit-sharing arrangements. Similarly, in the context of SDLT, the Finance Act 2003 (Sch 15, paragraph 34) provides that a partnership share is the proportion in which he is entitled at that time to share in the income profits of the partnership. There is no specific definition of partnership share for the purposes of capital gains, where one is required by s.59/59A TCGA to tax partnership gains as if they were gains of the partners, and so one assumes that gains are apportioned in accordance with the terms of the partnership's constitution.

Despite this, it can (even in normal commercial situations) be impossible to determine the partnership share at a particular moment in time. For example, particularly in a funds context, priority profit shares (which provide that one of the partners receives a certain amount of the initial profits or gains of the partnership in priority to the other partners) are not unusual. Such an arrangement means that the percentage of total profit to which each partner is entitled varies according to the amount of the total profit. If one is required to identify a partner's profit share at a given moment which is not the very end of an accounting peiod (as might be the case where a transaction occurs between a partner and the partnership), it is mathematically impossible to do so. This has proved a particularly acute problem in the field of SDLT, but the point is equally valid in the context of loan relationships.

In addition, the interests of some partners can be contingent upon certain conditions being met (such as financial performance in a funds context) and it will often not be possible to ascertain whether the relevant conditions are met until the accounts are drawn up following the end of the accounting period, which could mean that the tax

treatment of a transaction which relies on partnership share is not known at the time of the transaction.

In cases such as this there is no question of avoidance or manipulation of profits of the sort currently being considered under the aegis of a separate consultation. It is simply the case that it is very common for entirely commercial reasons that the percentage entitlements of different partners to profits will vary according to the level of profit made. Due to this, any regime seeking to tax loan relationship based profits (or relieve loan relationship based losses) at partnership level will not be able to do so until the partnership's overall results for a given accounting period have been finally determined, unless a number of explicit and somewhat artificial assumptions are required to be made to enable a calculation to be done at an earlier point.

Chapter 10 Exchange Gains and Losses and Hedging

Question 10.1: Do you anticipate difficulties with the proposal to tax forex movements only in respect of instruments held for trading or property business purposes? If so, what are they and how might they be addressed?

We do not believe that only taxing forex movements in respect of instruments held for trading or property business purposes would be the correct approach and, for reasons stated below, think that it might distort behaviour.

As a matter of principle, we believe that the loan relationship rules and derivative contract rules should aim to tax or relieve the whole of the return on a foreign currency loan or currency derivative. A company looking to lend may have a choice of currency. For example, it might choose to lend in a currency which is expected to appreciate against sterling. It would be expected that such a loan would carry a lower rate of interest than a sterling loan because a forex gain is expected. Alternatively, the company might choose to lend in sterling, and if it did this, it would be expected to lend at a higher rate of interest than would be appropriate for the foreign currency loan. Under the proposal in the consultative document, only the interest paid on the foreign currency loan would be taxed. The forex gain would escape tax. Under the sterling loan, all the interest paid would be taxed. The taxable profits would therefore be higher with a sterling loan than with a foreign currency loan, even though the economic profit might be similar. This seems wrong as a matter of principle.

It might be argued that confining the taxation of forex movements to instruments held for trading or property business purposes may simplify the tax position. It would, however, be necessary to prevent possible avoidance and to ensure that currency hedging transactions remain effective post-tax. Ensuring this is likely to undermine much of the simplification benefit.

Within groups of companies, parent companies will often lend money to trading or property investment subsidiaries. Under the proposals in the consultative document, if these loans are in foreign currency, only one side of the loan would give rise to taxable or relievable forex gains or losses. For example, suppose that the group parent lends dollars to a trading subsidiary. For the group parent, forex movements would be outside the scope of tax but the trading subsidiary would be taxed on its forex movements. This asymmetry could work either for the taxpayer or against the taxpayer. If the parent lends to a trading subsidiary in a currency which is expected to appreciate significantly against sterling, with the intention that the parent would escape tax on the currency gain but the trading subsidiary would obtain relief in full for the currency loss, the proposed regime TAAR or group mismatch rules are likely to be in point. However, if currency movements worked against the taxpayer, so that the parent realises that a non-relievable forex loss on the loan and the trading subsidiary is taxed on a forex gain on the loan, the group as a whole has a taxable profit but no economic profit. The risk of this asymmetry may in practice force parent companies to lend in sterling, with the trading subsidiary entering into a currency swap if the trading subsidiary needs dollars. This would result in the trading subsidiary incurring the cost of a currency swap which would not otherwise be necessary.

In practice, it can be difficult to determine whether a group financing or treasury company is carrying on a trade for tax purposes. If the proposals in the consultative document proceed, the tax treatment of forex movements will depend upon this decision. We question whether this is a helpful approach.

Changing the scope of tax on forex movements is a major change, which will necessitate taxpayers reviewing their foreign currency financing arrangements. As a result of this review, they may need to restructure the arrangements to avoid the risk of mismatches. At a time when accounting standards are changing, taxpayers will already be incurring significant compliance cost. We consider that this is not the appropriate time to launch fundamental changes to the scope of tax on forex movements.

For all these reasons, we do not favour the proposal to tax forex movements only in respect of instruments held for trading or property business purposes.

Question 10.2: Do you anticipate particular difficulties with the proposal for the treatment of hedging instruments and, if so, how might they be addressed?

We believe that the proposals in paragraphs 10.21 and 10.22 (second bullet) should produce a simpler tax regime for designated cashflow and fair value hedges of loan relationships, including connected party loan relationships.

In the context of hedging foreign exchange risk, we agree with the rules proposed in paragraph 10.19. In principle, we believe that the tax treatment of a hedging instrument should mirror the tax treatment of the risk being hedged.

Question 10.3: In view of the Government's accounting standards, do you anticipate that companies with hedging relationships will generally be able to opt to apply hedge accounting?

We consider that it is too early to tell whether particular categories of companies may encounter difficulty in opting to apply hedge accounting. A significant number of companies will be moving from old UK GAAP to new accounting standards and will need to adapt to the changed rules for hedge accounting. It is possible that some, particularly smaller, companies may find the need to document hedge effectiveness onerous. We believe that it would be desirable to retain Regulation 9 of the Disregard Rules in order to deal with intended hedges where a company has not adopted hedge accounting. It might be possible to reconsider the need for Regulation 9 after an appropriate transitional period when it becomes clearer how easy companies have found it to adopt hedge accounting.

Question 10.4: Are there any other significant issues with the treatment of forex gains and losses and with hedging which are not considered in the chapter? If so, what are they and how might they be addressed?

We believe that it might be appropriate, as a transitional measure, to extend the time limit for making elections under the Disregard Rules, at least where companies are moving from old UK GAAP to the new accounting standards or IRFS. Companies engaging with hedge accounting for the first time may need additional time in order to work out whether elections would be beneficial for them.

Chapter 11 Debt restructuring

We strongly oppose that part of the proposal in Option 1 to remodel the exemption in CTA 2009 section 322(4) to link it to the insolvency conditions in section 361A. We support that part of Option 1 which would provide an exemption for corporate restructurings generally (not just where there is an issue of shares) but we do not think such an exemption should be linked to the section 361A insolvency conditions.

We doubt the proposal in Option 2 for an explicit arm's length requirement would provide additional protection against abuse and such a requirement is likely to lead to uncertainty and an increase in the number of clearance requests HMRC receives.

We make the following specific comments:

1. We understand that HMRC's view is that there must be a good policy reason not to link the debt/equity swap rules to the rescue conditions. Our understanding of the consultation is that it is driven by simplification, anti-avoidance and forthcoming accounting changes. Although we acknowledge there will be accounting changes in this area, we see this proposal as a policy change outside that remit and suggest that the law here should remain unchanged.

2. For debt for equity swaps we see no compelling policy reason for change. Indeed, we believe that it is very important from a policy perspective that companies in financial difficulty should have a lot of flexibility to be able restructure debts which have become unsustainable.

3. The vast majority of transactions in this area are genuine commercial transactions intended to restructure the borrower group so that it can continue trading and avoid any formal insolvency procedures. A condition such as that in section 361A(1)(c) is too restrictive and in practice would be difficult to apply. Whilst the condition is not prescriptive as to the type of corporate rescue being pursued, it is limited to circumstances where it is "reasonable" to assume that, but for the action taken, a formal insolvency process would have ensued within 12 months. It would be particularly difficult for directors to apply this test whilst ensuring that they do not fall foul of the wrongful trading provisions contained within the insolvency legislation. The requirement to satisfy this condition may deter them from pursuing a rescue at all. (The risks to directors may be further exacerbated if proposals to grant liquidators the right to sell or assign wrongful trading actions to third parties as set out in the Department for Business Innovation & Skill's discussion paper "Transparency & Trust: Enhancing the transparency of UK company ownership and increasing trust in UK Business – July 2013" are implemented.) Given the subjective nature of being able to satisfy the condition, we would also expect that such a condition would also lead to more, not fewer, clearance applications under section 322(4) than at present.

4. As acknowledged in the HMRC manuals, the policy of the debt for equity exemption is to ensure that any tax charge on a release does not further depress the value of the shares for a company already in difficulty and to ensure that any tax charge does not impact the borrower's ability to carry on trading. With Option 1 it is likely that in many cases the borrower will not be able to restructure its debt at all. For example, a significant number of leveraged private equity backed deals are in need of refinancing. A tax charge, in such circumstances would likely make a debt for equity swap uneconomic. The borrower may find that it cannot refinance other than by way of debt for equity swap. A change to the tax

rules may result in no form of restructuring being possible at all with the consequence of more businesses being subject to formal insolvency processes, we doubt that this is an intended consequence of the proposal.

5. We also note that, in terms of policy and principle, it is not clear to us that there is a good case to tax debt for equity swaps as proposed. If a lender subscribed for shares in the borrower and the borrower used the subscription monies to repay its debt there would be no loan relationships tax charge. It is therefore difficult to see why structuring the same arrangement as a direct debt/equity swap should give rise to a tax charge. In reality it is a reorganisation of the capital structure of the company.

6. Related to the point above, on wider policy grounds one could also argue that in cases where there is a genuine commercial restructuring that on a straight release of debt the borrower has not made a real "profit" as commonly understood. Paragraph 3.14 of the Consultation Document notes that although the accounts may not be "wrong" they sometimes give a result which is not appropriate for tax – hence the proposal to override the accounts where they don't show "profits or gains" on tax principles. There is a good argument for the same principle to apply here (in reverse) where there is no real "profit" on tax principles. Although the accounts may sometimes show a profit in the Income Statement on a debt for equity swap, it does not necessarily follow that the same result should be followed for tax. Likewise any future accounting changes which may lead to more companies recognising amounts in the Income Statement for those transactions does not necessarily lead to the conclusion that the tax treatment should follow the accounts. On a release the amount shown in the Income Statement is not really a "profit" as understood in the tax case law principles. Businesses subject to the Income Tax code will not normally be taxed on a debt release. We note here too that in terms of policy before the introduction of the loan relationship rules in 1996 most debt releases and debt/equity swaps gave rise to no tax charge for the borrower. There was asymmetry built into the system then which was accepted as a matter of policy. Further, in many cases, the lender will have 100 per cent of the economic interest in the debtor. As such the debt may have assumed the economic characteristics of equity. In these circumstances the release looks more like a capital contribution even though its legal form is a release of debt. This too would suggest that on policy grounds such debt should be capable of being written off tax free in prescribed circumstances.

7. In relation to Option 2, we have reservations about how straightforward it would be to apply an arm's length requirement. By their very nature, restructurings are often commercially difficult transactions to agree and the negotiations will often involve compromises being made on different elements of the transaction. Accordingly, although an overall restructuring transaction may be considered to be at arm's length it may not be straightforward to conclude that each element of that transaction, including a debt for equity swap, is itself at arm's length. Given the fact that each restructuring will be unique to its facts, it is also often difficult to find comparables to support the arm's length nature of the transaction. Nor, do we consider that any such change would provide HMRC with any significant advantage in terms of reducing administrative burdens. We are particularly concerned that this will lead to significant uncertainty as to the tax treatment of transactions even where the lender and borrower are (at least prior to the debt for equity swap) unconnected. If an arm's length requirement were to be introduced as proposed under Option 2, we consider that, as a minimum, such a

requirement would need to be disapplied where the borrowing and lending parties are unconnected. We also note here the point made in paragraph 6 above of lenders being in substance in the position of an equity holder in the debtor. In relation to the existing arm's length requirements in sections 361A-361C this point often makes the lenders nervous as to whether they can satisfy the test with some advisers to banks not being prepared to rely on these exemptions. Adding a similar requirement to debt for equity swaps would therefore be a retrograde step and likely to result in more proposed restructurings not going ahead for tax reasons.

8. Our understanding is that part of Option 1 is to have a new corporate rescue exemption in section 322 modelled on the condition in section 361A(1)(c). We would welcome a general corporate rescue exemption although, for the reasons given in paragraph 2 above, we think there would be major difficulties in satisfying a 361A(1)(c)-type condition. Instead we would support a rule first proposed by the LMA in 2009 that the exemption should apply to releases effected as part of *bona fide* restructuring arrangements between the debtor and its creditors for the purpose of enabling the debtor to carry on its business and to be able to meet its liabilities as they fall due (although for the reasons given above such a condition should not apply to debt for equity swaps). For cases where HMRC perceives that the rules may be being abused, reliance can be placed on purposive construction (noting here the current attitude of the Courts to strike down uncommercial tax driven arrangements); we now also have the GAAR; and, assuming as we have done in our comments on Chapter 14, a regime TAAR is a fait accompli, that would be another weapon available to HMRC.

9. Lastly, the Consultation Document asks if there are any other significant issues in this area. We note the following existing problems:

- There is specific defect in the existing "debt buy-in" rules in section 361 CTA 2009. Where a third party buys the shares of a struggling company and also its existing intra-group debt at a discount a deemed release charge arises. Had the debt been written off prior to the transaction when it was connected party debt, no tax charge would have arisen. The rules are both inequitable and a "bear trap" on vanilla company acquisitions. There is also potential here for double taxation. We would welcome consideration of ways to address this concern (whilst still preventing the potential avoidance which the rule should really be targeted at), and we believe this could be done through the working groups.

- As previously noted, the existing arm's length requirements in sections 361A-361C can be difficult to apply in practice. We are not convinced that there is a good policy reason for such a rule and ask for this to be reconsidered as part of the overall review.

Chapter 12 Hybrid Instruments

Question 12.1: Do you agree with the approach proposed in paragraph 12.14 in respect of holders of convertible and share-linked instruments? If not, why not, and what alternative could be adopted?

As a point of principle, it seems correct that a holder of a convertible or share-linked instrument should be taxed on a similar basis as would have been the case had the investment been in the underlying shares, that is on a chargeable gains basis. Where there is a significant difference between the tax treatment of physical and synthetic investments in assets such as shares then this inevitably leads to choices in relation to the form of an investment being made on the basis of tax as opposed to commercial considerations. One of the policy objectives listed at paragraph 12.10 of the consultation document is "to remove the scope for arbitrage and avoidance"; it seems to us that a choice between receiving income or capital treatment based on form rather than substance is bound to increase the potential for arbitrage (and perhaps avoidance).

Another policy objective is to "eliminate avoidable computational complexity". The provisions which permit capital gains treatment for investments in convertible and share-linked instruments are only relevant to investment companies, who would be used to dealing with the statutorily prescribed basis upon which chargeable gains and allowable losses are computed. Trading companies, for whom a "follow the accounts" approach is the norm, would not be impacted by these changes as they should already generally adopt this approach.

Having said that, we appreciate that a regime whereby a holder continues to apply IAS 39 for tax purposes after the standard has ceased to be used for accounting purposes would be less than ideal. For so long as a holder is entitled to and does apply IAS 39 we consider that the current regime should still be available. Once IAS 39 has ceased to be available, then a "follow the accounts" approach may be the only practical solution without enacting a statutorily prescribed basis of bifurcation for tax purposes. However, it would be helpful if nevertheless the effect of the substantial shareholdings exemption and the ability to set allowable capital losses arising in relation to other investments against profits and gains arising from convertible or share-linked instruments were maintained.

Question 12.2: Do you agree with the approach proposed in paragraphs 12.16 to 12.22 in respect of issuers of convertible and share-linked instruments? If not, why not, and what alternative could be adopted?

We generally agree with the approach proposed in paragraphs 12.16 to 12.22.

At paragraph 12.20, views are requested on whether an issuer should be taxed on fair value movements in relation to embedded derivatives as income or chargeable gains, or whether those movements should not be taxed at all.

It seems to us that a distinction may be drawn between instruments which convert into an issuer's own share capital (but are nevertheless accounted for as an embedded derivative for example because the embedded option is not on a fixed price for a fixed amount basis) and instruments which convert into another company's share capital (eg exchangeables). In the latter case, bringing fair value movements into account on a chargeable gains basis seems the right result, particular where the issuer hedges its position by holding the underlying shares. In the former case, however, it seems right as a matter of principle that fair value movements should not be taxed at all given that

commercially no real profit or loss would be made by the issuer, in that the "liability" under the embedded option will be satisfied by delivery of the issuer's own shares.

Question 12.3: Do you anticipate practical or computational difficulties or tax avoidance risks arising from different approaches to the taxation of holders and issuers, as proposed? If so, how could these be addressed?

We would assume that convertible and share-linked instruments would generally be held for commercial reasons by persons unconnected with the issuer, and on that basis do not foresee either practical or commercial difficulties with this asymmetry.

We would expect any concerns HMRC may have around tax avoidance to be alleviated by the various anti-avoidance provisions such as the regime TAAR and (group) mismatch rules.

Question 12.4: Are you aware that the property derivative rules are in fact used in any non-avoidance context?

We do not have significant experience of property derivatives being used in any context (avoidance or otherwise), although our members who have been responsible for preparing this response have not sought views from our membership more generally.

Question 12.5: Do you support the proposal to repeal the property derivative rules? If not, what would be an alternative approach?

We would not support this proposal. The property derivative rules create a sensible and coherent regime whereby a taxpayer can gain exposure to real estate and is taxed on a chargeable gains basis, which would be consistent with a direct investment in real estate.

While we may not have significant experience of property derivatives being used in a commercial or other context, it is entirely plausible that a taxpayer may want to enter into such arrangements and a regime should be in place which would tax such arrangements appropriately.

Question 12.6: Could a redrafting of the rule currently in section 400 CTA 2009 along purposive or principles-based lines effectively target relief in respect of increases in value attributable to inflation and prevent abuse?

We would expect that such a rule could effectively achieve this result, although would query whether it is necessary given the regime TAAR, the (group) mismatch rules and the GAAR.

Question 12.7: If not, how could the relief be targeted to provide relief in respect of index-linked gilts held for genuine commercial purposes while eliminating opportunities for abuse?

We refer you to our answer to question 12.6.

Chapter 13 Bond Funds and Corporate Streaming

Question 13.1: Overall would you support the proposed reform of the bond fund rules in Chapter 3 of Part 6 CTA 2009

As a general matter we would support the reform of the bond fund rules. These rules act in an arbitrary way in two senses. First the qualifying investment test which triggers the application of the rules operates at a sixty per cent level which is an arbitrary boundary and quite unlike the more familiar de minimis percentage tests which generally operate in a rough and ready but satisfactory manner. Second the test then shifts the entire fund into the loan relationship code even though it may have only a bare majority of the fund may be invested in loan relationship type instruments.

It is a matter of no surprise that rules framed in this way would be subject to exploitation for tax avoidance purposes and capricious in their results.

Our concern with supporting the reform lies with the proposals for further anti-avoidance measures. These include in particular the proposal to effectively retain a modified bond fund type rule, with all its flaws, for offshore funds and an anti-avoidance rule targeted at narrowly held funds which is likely to create uncertainty and unnecessary.

This seems to us an area of particular difficulty where the policy framework has not been clearly articulated since the introduction of the loan relationship code. We note that there are particular issues for the insurance sector which need to be taken up at an industry level.

The approach proposed in the consultation seems in unlikely to achieve any practical simplification..

Question 13.4: Do you think the anti-avoidance proposals are necessary and appropriate?

We would not support those proposals.

Question 13.5: Overall would you support the replacement of the current rules in Part 6 CTA 2009 as they apply to holdings in offshore funds with rules similar to those in section 378A ITTOIA.

We would be concerned that these rules operate in an arbitrary way.

Chapter 14 Anti-Avoidance Measures

Question 14.1: Do you see any difficulties in adopting a "regime TAAR" along the lines set out above? If so, how could they be addressed?

We accept, particularly in view of the fact that the corporate debt/derivatives regime is based on profit or loss for accounting purposes (and, inevitably, therefore, will not always produce the profit or loss at which tax policy is aimed), that an anti-avoidance rule is a legitimate tool to ensure that avoidance activity does not produce a profit or loss which is contrary to the statutory purpose or policy objectives of the corporate debt/derivatives regime.

In our view, the GAAR should perform that role. However, we have to accept (in view of what has been stated elsewhere in relation to TAARs generally and, in relation to this consultation, in paras 14.3 and 14.8 of the Consultation Document) that the Government does not accept this argument. Accordingly, our following comments proceed reluctantly on the assumption that relying on the GAAR, instead of introducing a regime TAAR, is not an option.

As mentioned above, we accept that an anti-avoidance rule is a legitimate tool to ensure that profits are not reduced or losses increased in a way which is contrary to the statutory purpose or policy objectives of the corporate debt/derivatives regime. It is, therefore, essential in our view that the regime TAAR should not apply more widely than this. Accordingly, the essential features of the regime TAAR should be that:

- there are arrangements the main purpose or one of the main purposes of which is obtaining a tax advantage (that is, an increase in debits or a decrease in credits, whether temporary or permanent) under the corporate debt/derivatives regime;

- the tax advantage is contrary to the statutory purpose or policy objectives of the corporate debt/derivatives regime; and

- the tax advantage is counteracted on a just and reasonable basis.

A regime TAAR with these essential features would not apply to any company which is engaged in normal financing or hedging operations whose tax results are consistent with Parliament's intent. A clear statement of the principles on which the regime is based (as discussed in Chapter 3), in particular in relation to cases where accounting profit and the profit at which tax policy is aimed diverge, will hugely assist in understanding "Parliament's intent". Of course, as with all anti-avoidance provisions, the application of the regime TAAR to a particular set of facts will give rise to uncertainty and it will often be very difficult for a company to know whether it is on the right side of the "main purpose" or "statutory purpose" line. It may, therefore, have to resort to litigation to prove that it is. So, even though the regime TAAR may be suitably restricted (and we think this is essential), it will still give rise to an unwelcome compliance burden and increased costs for business. However, we believe that the uncertainty, compliance burden and costs would be hugely increased if the regime TAAR did not include the requirement that the tax advantage must be contrary to the statutory purpose or policy objectives of the corporate debt/derivatives regime.

Where, under tax avoidance arrangements which are contrary to the statutory purpose or policy objectives of the corporate debt/derivatives regime, the accounting treatment of a loan relationship or derivative contract is modified by the influence of some other instrument, the regime TAAR would not, in our view, necessarily impose tax on the amounts that would be brought into account in respect of the loan relationship or

derivative contract in the absence of the modifying instrument. To provide mechanically for such an outcome would be a blunt approach. We prefer that the method of counteraction be such as gives rise to a just and reasonable outcome without the legislation trying to prescribe any particular outcome in advance.

In summary, therefore, we do not see any need for a regime TAAR but, if it is a *fait accompli*, we see difficulties in adopting such a TAAR if it does not include the requirement that the tax advantage must be contrary to the statutory purpose or policy objectives of the corporate debt/derivatives regime. These difficulties can be addressed by including such a requirement.

Question 14.2: Are there any particular anti-avoidance provisions (other than transfer pricing and unallowable purposes rules, which will be retained) which need to be kept separate from the regime TAAR and, if so, why?

Abolition of TAARs

If a regime TAAR is introduced, we would expect to see all existing TAARs in the corporate debt/derivatives regime (other than the unallowable purposes rules) abolished.

Imported losses and corporate migrations

The statement of the principles on which the regime is based (as discussed in Chapter 3) should cover the territorial scope of the regime and transactions involving non-UK residents. We would expect the territorial scope of the regime to be based on the principle that, having regard to people functions, capital at risk and all other relevant considerations, where a financing or hedging transaction is intended to generate profit or create value in the UK, it is within the regime but not otherwise.

We accept, nevertheless, that, even with a clear statement of the territorial scope of the regime, rules on imported losses and corporate migrations are likely still to be needed. A statement of principles sets the detailed technical rules in context but will rarely dispense altogether with the need for such rules. It is also unlikely that the regime TAAR would make such rules redundant. It is certainly possible that, in the absence of appropriate technical rules, an application of the regime TAAR to an imported loss or an exported profit might be met with the objection: that is how the rules work!

Question 14.3: Would it be helpful for legislation, or guidance, to include indicative examples of potential counteractions under the regime TAAR?

We do not think it would be helpful for legislation to include indicative examples of potential counteractions under the regime TAAR. The very adoption of a "just and reasonable", rather than a prescriptive, approach to counteraction recognises that each case is different and that the most appropriate outcome will depend on the particular facts and circumstances.

It is, however, perfectly appropriate (indeed, desirable) for HMRC to offer guidance as to its likely approach to counteraction in typical cases. Taxpayers who do not agree with HMRC's approach can always test it in court. In general, we would expect HMRC's approach to be that counteraction should typically restore the taxpayer company to the position it would be in if it had carried out the "normal", non-abusive, transaction most closely corresponding to the actual transaction (the approach in *CIR v Tai Hing Cotton Mill (Development) Ltd* FACV No 2 of 2007).

Question 14.4: Will the proposals set out in this chapter be effective in tackling tax avoidance arrangements using loan relationships and derivative contracts for an unallowable purpose?

We believe that the proposals in the first 4 bullet points in para 14.32 of the Consultation Document are unnecessary, as the tax advantages to which they relate will be caught by the regime TAAR to the extent that they constitute avoidance. The perceived uncertainties will not survive a just and reasonable approach to counteraction. If the relevant tax advantages constitute legitimate tax planning, they should not be caught by the regime TAAR or by an unallowable purposes rule.

As regards the 5th bullet point, we are extremely concerned by the suggestion that the requirement of a "tax advantage" should be met where there is no group company whose tax position is improved but (assuming this is conceptually possible) the group's tax position *is* improved. In the example of company A transferring an income stream to company B and company B having unutilised losses, we would expect company B to obtain a tax advantage, because "tax advantage" includes a "relief from tax". If it is felt necessary to extend the meaning of "tax advantage" to include the "utilisation of an unutilised relief from tax", we would have no objection. It would certainly be preferable to introducing some group concept of a "tax advantage".

As regards the 6th bullet point, we have no objection to it being made clear that a company may have a purpose of securing a tax advantage notwithstanding that securing it is dependent on the outcome of some external contingency, provided that "tax advantage" is confined to advantages which are contrary to the relevant statutory purpose or policy objectives (see below). If "tax advantage" is not restricted in this way, there will be a danger that a perfectly legitimate loss on a derivative (on which a taxable profit would have arisen if the underlying asset or index had moved in the opposite direction) will be denied.

Question 14.5: Will the proposals for the "unallowable purpose" rules impact on commercial transactions where there is no intention to avoid tax?

Yes, for two reasons.

The first reason is that it is not clear from the definition of a "tax advantage" in CTA 2009 s.441 and s.690 that the improvement in the company's tax position which is a main purpose of being a party to the loan relationship/derivative contract is confined to improvements which are contrary to the relevant statutory purpose or policy objectives. A company which is a party to a loan relationship/derivative contract for the purpose of improving its tax position consistently with the relevant statutory purpose and policy objectives is engaged in legitimate tax planning and should not be adversely impacted by the potential application of anti-avoidance legislation. We, therefore, strongly recommend that, taking the corporate debt regime as an example, CTA 2009 s.442(5) be amended as follows:

> "(5) The references in subsections (3) and (4) to a tax avoidance purpose are references to any purpose which consists of securing, for the company or any other person, a tax advantage contrary to the purpose of the relevant tax or its policy objectives."

The second reason is that there will be significant overlap between the regime TAAR and the unallowable purpose rule. It is not acceptable that a company entering into a tax efficient financing or hedging transaction should be put to the trouble and cost of having to consider the potential application of two different TAARs which cover much of the

same ground. In our view, the regime TAAR will give adequate (indeed, as we argue above, more than adequate) protection in relation to arrangements with a main purpose of obtaining a tax advantage under the corporate debt/derivatives regime and they should, therefore, be excluded from the unallowable purpose rule. We, therefore, strongly recommend that, taking the corporate debt regime as an example, a new subsection (6) be added to CTA 2009 s.442 as follows:

> "(6) For the purposes of section 441, a loan relationship of a company shall not be regarded as having an unallowable purpose to the extent that the purpose for which the company is a party to the relationship or enters into a related transaction by reference to it consists of securing a tax advantage under Part 5."

Question 14.6: Do you anticipate difficulties generally with the proposals set out above? If so, how might they be addressed?

The difficulties which we generally anticipate with the proposals on the unallowable purpose rule are fully set out above, as are our recommendations for addressing them.

Yours faithfully,

Simon Yates
Co-Chair
The City of London Law Society Revenue Law Committee

THE CITY OF LONDON LAW SOCIETY
REVENUE LAW COMMITTEE

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