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Clients&FriendsMemo

UK Tax Summer Update 2010

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The summer of 2010 has seen a number of important tax developments and initiatives which will set the context of key legislative changes for the remainder of 2010. Foremost among the raft of consultations and discussion documents which have been published by the Government have been the proposals regarding a UK bank levy, a consultation paper on the overseas branches of UK companies and further insight into the proposed anti-avoidance measures to counteract "group mismatch schemes". We have included a summary of these initiatives in this Clients & Friends Memorandum as well as some important, but perhaps less prominent, changes such as the introduction of a double tax treaty "passport scheme" and a summary of the new guidance on the changes to the complex legislation relating to debt buybacks.

Speed-read

- *Double tax treaty passports.* A procedure has been established for applications for relief at source under the UK's double tax treaties. This will sit alongside existing procedures, but it is expected to reduce the administrative burden on lenders and shorten the time taken by HMRC to issue directions to borrowers to pay interest gross.
- *Consultation on UK bank levy is launched*. Further detail is emerging regarding the potential shape of the UK bank levy with the release of a consultation document on the subject. The potential for double taxation is emerging as one of the principal problems to be resolved.
- *Profits of overseas branches of UK companies*. The Government has issued a consultation paper on profits of overseas branches of UK companies providing more detail on the options currently being considered. The consultation is part of the wider move towards greater territoriality for the UK corporate tax system. The aim is to exempt the profits arising to overseas branches subject to CFC-style protections to prevent the use of branches in low tax jurisdictions eroding the tax base. Losses will generally be disallowed but the Government is considering allowing terminal losses (and possibly other losses) of overseas branches to be used subject to clawback protections.

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- *Proposed interim changes to the CFC rules*. More details on CFC reform have been released by HMRC. The Government intends to enact interim changes to the CFC regime in 2011 prior to the full overhaul due in 2012. It seems these will include a new exemption based on the relevant subsidiary carrying on "commercially justifiable activities" and an extension to the scope of the period of grace practice of HMRC to situations where subsidiaries have not previously been controlled from the UK.
- *Group Mismatch Schemes*: An open meeting between HMRC and tax professionals in July 2010 has discussed the scope of proposed anti-avoidance measures aimed at counteracting arrangements which are designed to produce an asymmetrical tax treatment across UK groups of companies when compared to the economic result of such arrangements.
- *Technical paper on derecognition of loan relationships and derivative contracts*. In response to continued tax avoidance in this area, HMRC proposes to replace the existing rules on derecognition of loan relationships and derivative contracts with a new rule which assumes loan relationships and derivative contracts always to be fully recognised for tax purposes if amounts are derecognised as a result of any arrangements.
- *Debt buy-back guidance published*. HMRC has now clarified the scope of the exceptions to the requirement for a debtor company to realise a profit when a debt is bought back into a group at a discount.

The double taxation treaty passport

As from 1 June 2010, corporate lenders in jurisdictions with which the UK has a Double Taxation Treaty containing an interest or income from debt claims Article may apply for a Double Taxation Treaty Passport ("**Treaty Passport**"). The effect of the Treaty Passport scheme is to simplify the standard procedure for applying for relief at source in relation to loans made to UK companies on or after 1 September 2010.

Background

Currently, in order to apply for relief at source from a withholding of UK income tax on interest payments under a Double Tax Treaty, an overseas lender must generally submit a form containing information, regarding the circumstances of the loan being made and regarding itself, to HM Revenue & Customs ("**HMRC**") in respect of each loan made by that lender. The form is also required to contain a certification by the overseas tax authority that the lender is resident in the relevant overseas jurisdiction for the purposes of the Double Tax Treaty. If the application is granted, HMRC will then send a direction to the borrower to make payments to the lender free from withholding of UK income tax (or at the lower rate applicable under the Double Tax Treaty). This process will continue to apply to non-resident lenders which are not treated as corporations in their jurisdiction of residence for tax purposes and to all claims for

repayment of tax withheld at source. Similarly, the syndicated loans element of HMRC's Provisional Treaty Relief Scheme will remain in place (although it is due to be re-launched as the Syndicated Loan Scheme).

The Treaty Passport Scheme

Under the new Treaty Passport scheme, a non-resident corporate lender will simply be required to apply once for a Treaty Passport and will then be entered by HMRC into a register on the HMRC website and granted a Treaty Passport number. HMRC will deal with any application within 30 days of it being made.

Once the lender is registered, its only obligations in relation to each new loan are to notify the borrower of the lender's Treaty Passport number and of the requirement to send a Form DTTP2 notification to HMRC within 30 days of making the loan. However, the lender is also entitled to represent to the borrower that the borrower's interest payments will attract relief at the appropriate rate under the Double Tax Treaty.

The borrower must then submit a Form DTTP2 to HMRC disclosing certain details regarding the loan and the lender's Treaty Passport number. On receiving the notification, HMRC will decide whether to issue a direction to the borrower to pay interest to the lender free of withholding (or at the lower rate applicable under the Double Tax Treaty) and may request copies of the loan documents if it wishes. The requirement for the information provided to HMRC to be accurate and complete for the direction to be valid remains.

The Terms and Conditions of the Treaty Passport mean that each Treaty Passport holder must only use the Treaty Passport where, to its certain knowledge and belief, all conditions for relief under the relevant double taxation arrangements are present. As a result of this requirement, HMRC states that the Treaty Passports can be used where the borrower and the lender are connected (e.g. parent and subsidiary). A breach of this requirement, however, may ultimately lead to the removal of passport holder status (with any suspension or removal being recorded on the publicly available online register).

While the Treaty Passport holder will broadly "self-assess" its entitlement under the relevant Double Tax Treaty, it may still be required to provide HMRC with certification of residence by the relevant overseas tax authority, unless the Treaty Passport holder has been granted a standalone certificate of residence **or** the Treaty Passport holder has made a certified claim under the Double Tax Treaty within the previous 12 months.

The Treaty Passport holder is required not to use the Treaty Passport where the circumstances surrounding the loan (including the sourcing of the funds) might call into question the Treaty Passport holder's beneficial ownership of the interest it receives. This reflects the decision in *Indofood International Finance Ltd v JP Morgan Chase Bank NA* [2006] EWCA Civ 158, which suggested that there is an "international fiscal meaning" of "beneficial ownership" with the consequence that a claim cannot be made under some Double Tax Treaties where the

recipient of the interest does not have the "full privilege to directly benefit from the income" (typically where the lender is a conduit vehicle).

The interest received by the lender must also be "subject to tax" in its jurisdiction of residence (for the purposes of the relevant Double Tax Treaty).

There is a continuing obligation on the Treaty Passport holder to notify HMRC of any changes in its legal form or circumstances which might affect its entitlement under the Double Tax Treaty. HMRC may also request information from the Treaty Passport holder for the purpose of reviewing its status, including copies of loan documentation and schedules of "passported" loans entered into in periods specified by HMRC.

HMRC reserves the right to not to apply the Treaty Passport scheme in relation to a particular loan or borrower. Once granted, the Treaty Passport will be valid for 5 years. HMRC may apply a shorter duration to avoid a glut of renewal applications in five years time if there is a high demand for registration from the outset.

The standard procedure will remain available for borrowers or lenders who do not wish to make use of the lender's Treaty Passport.

Conclusion

One key benefit of the Treaty Passport scheme is likely to be that some time is saved when the new Treaty Passport procedure is compared to the standard procedure. This derives primarily from the removal of the need to certify the lender's residence each time an application for relief at source is made. The time in which HMRC are required to process the Form DTTP2 submitted by the borrower will be "as soon thereafter as is practicable". While HMRC informally had previously indicated that this might mean two or three weeks, no commitment has since been made. However, given the comparative simplicity of the Treaty Passport process when compared to the standard procedure, the Treaty Passport is likely to result in an improvement on the current system in respect of which applications will usually take between six weeks and three months to process (and longer in complex or exceptional cases).

UK Bank Levy consultation document published

On 13 July 2010, HM Treasury published a consultation document on the scope and detail of the proposed UK bank levy (the "**Levy**") which was announced in the UK Emergency Budget on 22 June 2010. The Levy is to be introduced from 1 January 2011. The genesis of the Levy as described in the consultation document is very clear and originates from the design of the Government to encourage the UK banking sector to "move away from riskier funding models"[1], reduce systemic risk in the sector and increase institutional resilience. Allied to these

[1] HM Treasury "Bank Levy: A Consultation", page 3.

objectives is the stated intention to ensure that banks make a "fair contribution in respect of the potential risks they pose to the UK financial system and the wider economy".[2]

These objectives have not changed materially from those we reported on in the Cadwalader Clients & Friends Memorandum published on 23 June 2010 following the UK Emergency Budget, although they must also be placed in the context that the Levy is expected to raise an amount of £2.5 billion annually. The combination of these objectives, and the prominence given in the consultation document to the aim of encouraging the use of certain lending models within the UK banking sector, distinguishes the Levy from being primarily focused on financial reparation for the costs of governmental support during the recent financial crisis.

Although the main features of the Levy are broadly as announced in the Emergency Budget, we have briefly set these features out below together with some further thoughts and questions regarding the issues which will now need to be faced by the Government and the UK banking sector regarding the detailed operation of the Levy.

Main features

(1) The Levy will apply to:

(a) the global consolidated balance sheet prepared under IFRS of UK banking groups and building societies;

(b) the aggregated UK subsidiary and branch balance sheets of foreign banks and banking groups operating in the UK; and

(c) the balance sheet of UK banks in non-banking groups.

Owing to the application of the Levy to bank consolidated balance sheets, questions may well arise concerning the extent to which accounting reform, such as the IASB's project to replace IAS 39, may affect the valuation of liabilities under the Levy. Banking institutions and groups will only be liable for the Levy where their relevant aggregate liabilities which are subject to the Levy amount to £20 billion or more, a move calculated to catch only larger banking institutions. The consultation document confirms that the calculation of branch liabilities and Tier 1 capital for the purposes of the Levy will be based upon the existing capital attribution methodology already employed for corporation tax purposes. However, there remain a number of questions regarding whether calculation of branch liabilities under the existing capital attribution methodology will most optimally reflect the policy aim of the Levy in focussing on the funding profile of the overall bank business and risk profile (rather than just the risks located in the branch itself).

[2] HM Treasury "Bank Levy: A Consultation", page 3.

(2) The consultation document proposes for the definition of a "bank" for the purposes of the Levy to follow the definition in paragraph 43, Schedule 3, FA 2010 (for bank payroll tax purposes). The Government has also proposed to use the bank payroll tax definition of "banking group", albeit with suitable amendments to reflect the fact that the Levy is based on accounting group concepts and not the definitions of tax grouping used in bank payroll tax. Some of the tensions and difficulties experienced in the bank payroll tax relating to which institutions fell within that tax may therefore be translated into the Levy, although the £20 billion threshold for banks should alleviate many of the problems which relate to certain funds falling within the definition of a "bank".

(3) As described in the Emergency Budget, the Levy will be based on total liabilities and equity, excluding:

(a) Tier 1 capital,

(b) insured retail deposits,

(c) repos secured on sovereign debt; and

(d) policy holder liabilities of retail insurance business with banking groups.

Derivatives would be included on a net liability basis. Some questions will be inevitable regarding the definitions of retail funding and deposit insurance, and there will be challenges to align the exempt liabilities from the Levy with equivalent provisions in other banking levies to be introduced by France, German and the United States. The excluded liabilities identified all serve to reinforce the objectives of the Levy in encouraging banks to strengthen their capital base and promote certain forms of funding which are perceived to be safer and "relatively stable"[3] bearing in mind the lessons of the financial crisis.

(4) The Levy will be imposed annually at a rate of 0.07 per cent. HM Treasury estimates that this will raise around £2.5 billion annually. A lower rate of 0.04 per cent. will be set for 2011. There will be a reduced rate for longer-maturity wholesale funding (with more than one year remaining until maturity) to be set at 0.02 per cent. rising to 0.035 per cent. This reflects the stated policy objective of encouraging the UK banking sector towards longer term funding. The consultation document makes it clear that there is no intention to utilise the revenue generated by the Levy as a bail-out or insurance fund for the UK banking sector.

(5) The relative expense of wholesale funding (relative to Tier 1 capital, insured retail deposits and sovereign debt repos) will be increased on an after-tax basis owing to the UK bank levy not being deductible for UK corporation tax purposes. A "targeted" anti-

[3] HM Treasury "Banking Levy: A Consultation", paragraph 3.8, page 16.

avoidance rule will also be introduced to prevent Banks mitigating their liability to the Levy.

(6) The processing, administration and collection of the Levy will be the responsibility of HMRC, with banking companies self assessing their liability. Payment of the Levy will be the joint and several liability of all members of a banking group, with a single group member being appointed as a "responsible company" for Levy administration purposes.

There remain a number of key issues relating to the introduction of the Levy, perhaps the main being the risk of double taxation. The consultation document acknowledges that liabilities under the Levy will not constitute "tax" for the purposes of the UK's double taxation treaties, raising the risk that a foreign jurisdiction might not give relief under an existing treaty for the amount of the Levy payable by the UK branch of a bank in that foreign jurisdiction. This problem is also relevant to any bank balance sheet levies imposed by foreign jurisdictions which are not assessed on income or gains and which would be borne by the foreign subsidiaries and branches of UK banks. In the event that such bank levies are not eligible for foreign tax credits or relief under double tax treaties or domestic legislation, the cost to multinational financial institutions may well be very substantial. Resolving the issues in this area will clearly be a priority for the Government[4], not least because press reports of banks contemplating the location of their headquarters have already started to emerge in the UK media[5]. While the Levy is just one of a large number of taxation and commercial aspects a bank would consider in reviewing the location of a headquarters in the UK, the Government will be aware of the particular sensitivities relating to the taxation of banks in the wake of other Government initiatives including the Code of Practice on Taxation for Banks, the proposals for a general anti-avoidance rule and other legislative initiatives regarding financial instruments[6]. Whether the combined effect of such initiatives and the Levy will be sufficient for UK headquartered banks to seriously consider a corporate inversion and an exit from the UK marketplace remains to be seen, and will no doubt be closely monitored by the Government and HM Treasury.

Consultation on exemption for profits of foreign branches

On 27 July 2010, the Government launched a consultation on reforming the taxation of profits arising from overseas branches of UK tax-resident companies with a view to introducing an exemption in relation to those profits (and a corresponding restriction of loss relief). The primary impetus for change is the desire to achieve greater territoriality in relation to corporation tax, a principle that is already reflected in the overseas dividend exemptions which were

[4] This is acknowledged in paragraphs 4.13 and 4.25 to 4.27 of the consultation document, with the Government noting that they will "urgently take forward discussions on resolving [issues regarding the risk of double taxation] with other countries that plan to introduce bank balance sheet levies".

[5] "London is becoming less attractive, Standard Chartered warns", Daily Telegraph 5 August 2010; "HSBC to review London HQ as Osborne's levy hits banks", Independent 15 August 2010.

[6] Including the legislative consultations on group mismatch schemes and accounting derecognition, both covered in this Clients & Friends memorandum.

enacted with effect from 1 July 2009 and which derives its origins from a consultation process on foreign profits which began in 2007.

Currently, UK companies are subject to corporation tax on the profits of their foreign branches, with double taxation relief ("**DTR**") given for the foreign tax paid on the same profits to prevent double taxation. Where the foreign tax paid is less than the UK tax, the company must pay the additional UK tax.

A number of questions are posed by the consultation document in relation to the perceived difficulties which need to be overcome to achieve an effective exemption. The key questions relate to:

- the scope of the exemption (and how closely it should be linked to the UK's double taxation arrangements with overseas territories);
- the treatment of accrued and unrealised chargeable gains;
- preventing artificial diversion of profits (with proposals to align the exemption with the controlled foreign companies ("**CFC**") legislation at Chapter IV of Part XVII of ICTA 1988);
- the extent to which losses arising from the activities of an overseas branch will continue to remain available;

The options available will also be assessed by their degree of fairness and simplicity. Detailed proposals and draft legislation will be published later in 2010, with legislation to be included in Finance Bill 2011.

Scope of the exemption

The Government is currently considering two options with regard to defining the scope of the exemption. The first option is to follow the allocation of profits required under the business profits article of the relevant double tax treaty. This route entails potential uncertainties when it comes to resolving issues that need to be dealt with under the mutual agreement procedure. However, it does have the virtue of following the income measure used for the purposes of double taxation relief.

The second option under consideration is drafting the scope of the exemption as a mirror image of the profit calculation used in relation to UK branches of overseas companies. The problem with this measure, however, is that it will not necessarily match the profit allocation determined by the applicable double tax treaty. This could lead to double taxation or double non-taxation (where the scope of the foreign profits exemption is wider than the profits taxable by the overseas territory under the treaty) and would require the retention of double tax relief rules alongside the exemption. As such the Government does seem to be currently favouring the option of following attribution for the purposes of the relevant treaty on grounds of simplicity

and fairness. However, this does pose the question as to what happens where there is no treaty.

One major issue for insurance companies and banks, when it comes to determining the amount of branch profits, is how capital should be attributed to the branch. For banks this will affect the amount of interest expense that may be claimed against branch profits. The two authorised methods under the OECD guidelines are the "capital allocation" approach (which is rooted in the Basel I and II regimes) and the "thin capitalisation" approach. The Government's view is that HMRC's current thin capitalisation approach for UK branches of overseas banks effectively adopts a capital allocation methodology in any case (as its starting point is to take the bank's overall capital ratio after attributing risk-weighted assets to the UK branch), however it notes that a discrepancy may occur where the capital ratio of the non-resident bank falls below a level which is comparable to other UK banks.

For insurance companies, the problem centres around how much investment income to allocate to the branch in the first place. The Government currently believes that the most appropriate method of attributing capital is the allocation method used for the purposes of double taxation relief. It points out that the alternative thin capitalisation method could require more assets than are held by the insurance company to be allocated to the branch.

The Government is also considering extending the scope of the exemption to cover chargeable gains on assets held by the overseas branch. This raises questions as to how to treat accrued but unrealised gains and how to apportion gains on assets used partly by branches and partly by headquarters.

Anti-avoidance

A major area of the proposed reform will be how to frame the anti-avoidance rules needed to prevent the exemption being used as a means of circumventing the CFC legislation. A degree of conformity will be needed and the Government is considering three options which, by and large, attempt to limit the scope of the exemption to the profits which would not otherwise fall within the CFC apportionment were the overseas branch to be a subsidiary. An obvious problem arises from the fact that reformed CFC rules are not due until Finance Bill 2012 (whereas a foreign profits exemption is expected to be introduced by Finance Bill 2011). However, the CFC-type limitation to the branch profits exemption will be revised again in 2012 to bring them into line with the new CFC legislation. Three options are under consideration. Two options appear to merely limit the scope of the exemption, with branch profits falling outside the exemption being subject to corporation tax with credit for overseas tax (as is currently the case). The third option appears to envisage the CFC legislation being applied to the branch as if the branch were a subsidiary. This last option would appear to be more complex, and may result in the profits of the branch having to be recalculated on a different basis depending on how the scope of the exemption is defined in the first place. Conversely, the incorporation of exemptions similar to those in the CFC rules, offer the opportunity of a

having a level playing field when it comes to the taxation of overseas branches and overseas subsidiaries.

The Government is also considering limiting the exemption to overseas branches in territories with which the UK has double tax arrangements containing a non-discrimination provision. There would seem to be an element of "doubling-up", if the Government were to introduce CFC-type restrictions as well as a treaty-based qualification, and adding this extra condition to the exemption would also undermine the conformity of the branch profits exemption to the distribution exemption (in respect of which only dividends received by "small" companies are required to be received from treaty jurisdictions to benefit from the distribution exemption). Indeed, the Government does not believe that it is appropriate in any case to extend the branch profits exemption to small companies which have branches in non-treaty jurisdictions due to the potential for avoidance to which this might give rise. Plans for a specific anti-avoidance rule applying to small companies only are also being considered.

Branch losses

A symmetrical corollary of a branch profits exemption, is the disallowance of branch losses (at least in so far as the losses of subsidiaries cannot be used in analogous circumstances). The Government is therefore proposing to allow terminal loss relief but also accepts that there is a strong case for the exemption to be accompanied by rules allowing relief for losses beyond only terminal losses.

This will obviously be an area of concern for those enterprises which favour a branch model of business (principally in the banking, insurance and oil and gas sectors). The loss of current year loss relief and group relief in respect of losses made by overseas branches will disproportionately affect these sectors. Accordingly the Government intends to consult on allowing companies to elect out of the branch profits exemption or, alternatively, to allow loss claims to be made but for tax to be "clawed back" once the branch moves back into profit. The possible claw-back mechanisms the Government is considering includes taxing subsequent branch profit either with or without double tax relief until the tax saved by the losses used is recovered.

The use of brought forward branch losses is also being consulted upon. The proposed branch profits exemption would potentially delay the point at which brought forward losses are exhausted and the Government is therefore considering a number of options to redress the balance. At one extreme, brought forward branch losses could be cancelled. A "claw-back" treatment is also being considered which would essentially require a company to match all its brought forward branch losses with branch profits before it would be entitled to an exemption in respect of branch profits. A variation of the "claw-back" treatment under consideration is to apply the claw-back as if the branch profits exemption had always applied.

Reform of the controlled foreign companies ("CFC") legislation

HM Treasury has now produced more details regarding what will and what will not be dealt with as a part of the interim reform to the CFC legislation proposed to be included in Finance Bill 2011 next year. A timetable has also been published.

Background

An overhaul of the UK's CFC legislation has been long awaited, and continues to be consulted upon as part of the ongoing consultation on the UK taxation treatment of the foreign profits of UK companies. Some changes were introduced by Finance Act 2009, which included the phasing out of the acceptable distribution policy exemption to the CFC rules (to coincide with the introduction of the distribution exemptions) and the superior holding company exemption. While an entirely new code on CFCs is expected in Finance Bill 2012, the Government is continuing to consult in relation to further interim changes in the CFC legislation to "ease" the operation of the rules in certain areas.

A discussion document was issued in January 2010 setting out proposals for the new CFC regime including:

- retaining a primarily entity-by-entity based regime but introducing new rules to allow for certain income streams to be separately identified and taxed differently (in effect leading to a hybrid system);
- retaining an exemption-based system of CFC taxation;
- a possible replacement to the "lower level of tax" test;
- a redesigned motive test to exclude "genuine trading activities" from the ambit of the CFC regime; and
- new provisions relating to intellectual property and monetary assets (possibly including a treasury company exemption and a potential new tax charge for the transfer of intellectual property offshore).

A stakeholder event was held at the Treasury on 23 February 2010 at which HMRC expressed the hope that some changes would be included in Finance Bill 2011 with proposals being published in Autumn 2010.

Outline of interim proposals

The broad outline of the changes is still quite unclear. It seems that the Treasury is considering excluding what it terms "commercially justified activities" (being activities which do not erode the UK tax base but which would give rise to the CFC charge under the current rules) from the scope of the CFC rules. This would seem to suggest that the Treasury are looking at widening the definition of "exempt activities" set out at Part II of Schedule 25 of ICTA 1988 but, as was suggested at the stakeholder event on 23 February 2010, this may also involve a review of the

"motive test" and moving away from the presumption that activities of CFC's could be moved to the UK. HM Treasury give the example of a UK group which restructures its overseas operations by transferring a profitable non-UK business from one territory to another as being the type of transaction which should not be generally brought within the CFC regime.

HM Treasury are also looking at extending the scope of the "period of grace" currently available for UK companies which acquire an overseas group. This would involve extending both the length of the period of grace given (which is usually only until the end of the first full accounting period of the parent following acquisition) and the circumstances for which a period of grace may be given. Currently those circumstances only expressly encompass the purchase by a UK group of an overseas group (in order to allow a period in which the group can be restructured). However, HMRC have been known to exercise discretion in granting periods of grace in analogous circumstances where a non-UK group of companies is migrated to the UK as part of a restructuring or reorganisation. It appears to be these kinds of transactions which HM Treasury wishes to facilitate. Indeed, the suggestion that transactions which do not "erode" and "have no impact on the UK tax base" should fall outside the CFC rules is good news and may evidence a desire to definitively exclude overseas subsidiaries from the scope of the rules where the subsidiaries have not previously been controlled from the UK (such as where there has been a takeover by a UK company or group or where a group parent has migrated its tax residence to the UK).

Although there is not much detail beyond this, it is clear that HM Treasury are continuing to consider any worthwhile improvements that could be made in the interim under Finance Bill 2011. This also extends to what is proving to be one of more controversial areas of the consultation, that of intellectual property. While addressing the treatment of intellectual property of CFCs will largely be deferred until Finance Bill 2012, HM Treasury will listen to proposals for amending the legislation in the meantime to allow transactions in intellectual property which do not erode the UK tax base. However, this will not be the case for monetary assets and interest income, the treatment of which will be left for final resolution as part of the new regime anticipated in Finance Bill 2012.

Working group meetings are taking place throughout August and September 2010 with further open events anticipated for September or October. Draft legislation is expected in October or November after which there will be a further open event.

Group Mismatch Schemes: Proposed legislation and open meeting on 23 July 2010

In the Budget held on 24 March 2010, HMRC published a discussion document regarding the proposed introduction of a generic or principles-based rule to respond to certain arrangements termed "group mismatch schemes". These proposals were discussed at an open meeting hosted by HMRC on 23 July 2010 and attended by representatives from industry and the tax profession, including Cadwalader.

As described by HMRC in the discussion document, a "group mismatch scheme" is an arrangement relying on an asymmetrical corporation tax treatment in respect of companies in the same group. Such arrangements create tax mismatches through, very broadly, the value of corporation tax relief attributable to a company in respect of a loan relationship or derivative contract exceeding the corporation tax charge (if any) in a counterparty group company. HMRC's stated concern is that transactions employing tax mismatches which are economically neutral when viewed at a group level will reduce the effective rate of corporation tax over the whole group. The group mismatch in question may be the result of differing accounting treatments for the financial instrument in question, or the differing tax treatment of the transaction for the group companies concerned, or both.

The HMRC discussion document published on 24 March 2010 noted that existing legislation contains several targeted measures to ensure that connected party loans and derivatives are taxed symmetrically. However, HMRC now appears to consider that the network of anti-avoidance provisions in the loan relationships and derivatives regimes (which already encompasses legislation introduced in Finance Acts in 2004, 2005, 2006, 2008 and 2009) can be characterised as constituting merely a "piecemeal" approach. Considering the breadth of transactions caught by existing targeted legislation and the effort HMRC has expended to ensure such legislation responds to recently disclosed avoidance arrangements, HMRC's concerns are perhaps surprising especially when those concerns are placed in the context that many accounting mismatches which may currently exist within UK groups are likely to be lessened when all UK companies will be required to adopt converged UK GAAP or IFRS during the next few years. Nevertheless, HMRC has proposed in the discussion document the introduction of generic, or "principles-based", legislation as a method of eliminating perceived tax avoidance in this area, possibly following the example of the two previous instances of such "principles-based" legislation in the disguised interest and transfer of income streams legislation.

In this context, HMRC have proposed that the "principle" to be enshrined in any generic anti-avoidance legislation should be that "intra-group loans or derivatives should not be used for the purpose of producing an overall tax loss within the group as a result of transactions that do not give rise to any economic loss for the group as a whole".[7] The provenance of this "principle" is perhaps less than clear; such a principle has not been articulated in existing tax legislation, in Parliament or through the Courts in quite this form to date. Indeed, the discussion document does not address situations where intra-group transactions are expressly taxed in an asymmetric manner under the existing legislation. Such situations point to the difficulty for HMRC in elevating a legislative intention (such as for taxation symmetry to be imposed in circumstances where tax avoidance is present) to the status of an over-aching "principle", and also illustrates the intricate drafting which will be required in ensuring that any anti-avoidance legislation on group mismatch schemes is fully integrated into existing legislation without adversely affecting bona fide commercial transactions.

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[7] HMRC discussion document, paragraph 6.

The HMRC discussion document proposes that a group mismatch scheme would be an "arrangement" (broadly defined) between connected companies where it was reasonable to assume that any part of the arrangement, or any resulting transaction, was "designed" to secure a reduction in the group's rate of UK tax as a result of the differing tax treatment of the loan or derivative by the companies concerned.[8] The use of the term "designed" has been intended by HMRC to signal that the legislation "should not apply merely because of a difference in the rate of tax applying to the two parties, or because one has losses that will shelter any gain".[9] However, the discussion document did not suggest the inclusion in the draft legislation of a typical anti-avoidance "filter" based on a "main purpose", "main intention" or "motive" test.[10]

The open meeting on 23 July 2010 gave both HMRC and the tax professionals attending an opportunity to discuss HMRC's proposals in the discussion document. These discussions were further stimulated by the circulation before the meeting of an early draft of the proposed legislation on group mismatch schemes. HMRC were at pains to emphasise that the draft legislation circulated for the purposes of the open day would change as a result of the ongoing consultation and discussion with interested parties. Nevertheless, certain features within the draft legislation on group mismatch schemes were of considerable interest and added to the information in the discussion document. For example, the proposed sanction for a group mismatch scheme to which a company is a party would be for the "scheme profits and losses" to be left out of account in determining credits and debits for the purposes of the loan relationship and derivative contract regime.[11] For this treatment to apply a company would need to fall within certain conditions, namely (i) that it was "certain" that at the time the company enters into the scheme, the scheme would secure a relevant tax advantage; (ii) that the "probability" of a relative tax advantage arising multiplied by the amount of that tax advantage exceeds the probability of a relevant tax disadvantage arising multiplied by the amount of that tax disadvantage; or (iii) that one of the above conditions would be met but for there being "a chance" at the time of entry into the scheme that scheme profits would be made by the group on the scheme being carried out and a second scheme is entered (perhaps several years later) with the purpose of securing that those scheme profits are never made.

As drafted, the proposed legislation would be applicable only to transactions between UK corporation tax payers and controlled foreign companies of UK corporation tax payers and would be restricted to loan relationships and derivative contracts (including quasi-loans and manufactured payments). Both of these features were objectives which commentators saw as desirable prior to the meeting. A series of examples of group mismatch schemes were provided by HMRC in both the discussion document and at the open meeting, perhaps the most

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[8] HMRC discussion document, paragraph 25.

[9] HMRC discussion document, paragraph 27.

[10] As under, for example, CTA 2009, ss. 441 and 442 (loan relationships for unallowable purposes).

[11] A "scheme profit" and "scheme loss" were separately defined as a profit or loss brought into account under the loan relationships or derivative contracts rules from a series of transactions that does not affect the pre-tax economic profit or loss of the group over the period of the scheme.

interesting of which was a previously unpublished example involving a group company and a third party. This example was based on two companies ("A" and "B") being associated, with B holding an index-linked gilt and A entering into a total return swap corresponding to B's gilts and under which A is required to make payments equal to the increase in value or other benefit which B receives in respect of the gilts. HMRC identified the group mismatch as being the absence of taxation on B where the gilts rise in value in consequence of an increase in the retail price index, whereas A obtains a corporation tax deduction on the total return swap. Unlike the examples of a group mismatch scheme published in the HMRC discussion document[12], the index linked gilt/ swap example is perhaps indicative of how a series of related or cross-referencing group assets or financial instruments may comprise a group mismatch scheme even though the transaction under which a tax deduction is obtained is with a third party and is on full arm's length terms. It is interesting, however, to note that HMRC's concerns with such a transaction would appear to already be addressed through the provisions of the recently enacted FA 2010, schedule 15 (index linked gilt securities: relevant hedging schemes).

In addition to discussions regarding the breadth of legislation (including the difficulties of ascertaining the "probability" of certain tax advantages arising, and the breadth of the definition of "arrangement"), attendees at the open meeting also expressed concern that the draft legislation did not currently contain a "filter" requiring the company entering into a group mismatch scheme to have a main purpose, intention or design of avoiding tax. A taxpayer company's purpose or intention was only relevant, as currently drafted, in one of the three conditions acting as requirements for falling within the draft group mismatch legislation, leading to concerns that the legislation could inadvertently catch innocent transactions.

It was announced by HMRC that a revised draft of the legislation would be proposed in September 2010. While the timetable for the introduction of legislation on group mismatch schemes has been identified by HMRC as being Finance Bill 2011, this timetable does look very ambitious given the need to dovetail any legislation with other legislative initiatives, discussions and consultations which are ongoing at the present time.

Loan Relationships and Derivative Contracts: Derecognition of Income

The summer has seen a number of examples of HMRC acting to limit tax avoidance involving accounting (and, therefore, tax) derecognition of credits arising on a company's loan relationships and derivative contracts. For accounting purposes, where a loan relationship or derivative contract is derecognised it is treated as having been disposed of, with no income (and therefore no taxable income) arising from that loan or derivative being shown in the accounts of the company concerned. The legislation governing loan relationships and derivative contracts in CTA 2009 already contains provisions to counter tax avoidance on such a derecognition of a loan or derivative taking place for accounting purposes. Legislation was introduced to extend these anti-avoidance provisions in Section 8 and Schedule 5 of Finance

[12] See HMRC discussion document, chapter 4.

(No.2) Act 2010 ("**F(No.2)A 2010**") to prevent a number of arrangements involving accounting derecognition which HMRC considered offensive and which had been disclosed to HMRC. These measures were supplemented by the publication of a Technical Paper by HMRC on 6 July 2010 which sets out the background to HMRC's concerns regarding tax planning which focuses on the accounting derecognition of a loan or derivative and which also considers the introduction of a general anti-avoidance rule in this area to prevent "persistent" avoidance.

The Technical Paper published by HMRC on 6 July 2010 sets out the background to the changes in Finance (No.2) Act 2010 in greater detail. The Technical Paper also notes the continuing concern of HMRC, regarding further disclosures under the Disclosure of Tax Avoidance Schemes legislation in FA 2004 (et seq.) which have been perceived by HMRC as indicating that corporation tax avoidance schemes involving derecognition continue to be developed. The Technical Paper cites two arrangements which are viewed by HMRC as instances of unacceptable tax planning, being:

(a) derecognition where a company (company "A") with a loan asset has entered into an agreement with another entity under which, in return for additional shares or an increased interest in that entity, company A undertakes to make payments equal to the amounts it receives (interest and principal) which transfer the benefit of that loan to the other entity; and

(b) where a company (company "B") with a loan asset derecognises that loan in an accounting period because it is contractually committed to issue securities to a connected company in the following accounting period that will form part of company B's capital in that following period.

Legislation has now been enacted under Finance (No.2) Act 2010, Sch. 5 addressing the two examples given by HMRC of unacceptable tax planning on derecognition. The legislation includes new conditions to be added to CTA 2009, s. 311 (as CTA 2009, s.311(4B)) where a company acquires or varies a "relevant interest" in another company, or a partnership or a trust. "Relevant interest" is defined as meaning an interest in the other company's shares or other capital, or an entitlement to the partnership's profits or capital, or an interest in the trust's property. The legislation also provides that the current rules in CTA 2009, s. 311 are extended so that they apply where derecognition is triggered by an event that occurs in a later accounting period to that in which the accounting derecognition takes place. These changes have effect from 22 June 2010. Equivalent provisions, introduced as CTA 2009, s.599A(5A), have been introduced for derivative contracts.

As a result of HMRC's view that tax avoidance involving derecognition schemes is "persistent", with "repeated manifestations" of such schemes, the Technical Paper also includes a proposal from HMRC that it will consult on recasting the loan relationship provisions in CTA 2009, s. 311 and the equivalent derivative contract provisions in CTA 2009, s.599A and 599B so that the legislation operates as a general rule that derecognition in the accounts is not followed for the purposes of the loan relationships and derivative contracts rules in Parts 5 to 7 of CTA

2009. HMRC has proposed that CTA 2009, ss. 311 and 599A would be amended by repealing the "conditions" in which derecognition in the accounts is not observed for tax purposes, and replacing them with a general rule that a creditor loan relationship or derivative contract is always fully recognised for tax purposes if amounts are derecognised in accounts as a result of "arrangements". HMRC intends that the term "arrangements" would take the meaning commonly used in such legislation to include any arrangements, scheme or understanding of any kind, whether or not legally enforceable, involving a single transaction or two or more transactions. HMRC have commented in the Technical Paper that "recasting" the rule in this way will result in its application to a wider range of circumstances than is currently the case, and should obviate the need to insert new conditions each time further examples of tax avoidance involving derecognition arise.

A significant concern with the proposals made in the Technical Paper is that the definition of "arrangements" is very wide and would encompass a number of circumstances where tax avoidance is not a motivating factor. There is, however, no "filter" mechanism (such as a "main purpose" or "main intention" test) under which transactions which are not predicated on the avoidance of tax can be excluded from the effects of the proposed rule. While HMRC note in the Technical Paper that changes to the proposed general rule would be made to prevent "unfair" tax results, no details are given and, the inclusion in the legislation of a "main purpose" test is not suggested. Another concern with HMRC's proposals regarding a general anti-avoidance rule regarding accounting derecognition is that the interaction of such provisions with other legislative discussions and initiatives, such as proposals for group mismatch scheme legislation and the possibility of the introduction a general anti-avoidance rule, remains uncertain. The Technical Note contemplates draft legislation being included in Finance Bill 2011.

Debt buy-back guidance published

HMRC has now published guidance in its Corporate Finance Manual on the changes to the connected party loan relationships rules which relate to debt buy-backs. A release of a debtor loan relationship owed by a company which is connected to the creditor does not generally result in a credit being brought into account by the debtor or a debit being allowed for the creditor. This treatment does not apply in certain circumstances where a company acquires a loan relationship at a discount from a third party which is owed by a company with which the purchaser is connected at the time. In these circumstances, there is a deemed release of the loan relationship in an amount equal to the difference between the third party's carrying value for the loan and the amount paid by the purchaser (i.e. the discount).

For many years there was an exception to this "deemed release" where the loan relationship was purchased by a company which was not connected to the debtor within a three year period beginning four years before the acquisition. This allowed groups to establish new companies with the sole purpose of buying in debt at a discount without triggering a "deemed release" (and corresponding taxable credit in the debtor company).

This was perceived by the Government as abusive and pursuant to two announcements, one on 14 October 2009 and one on 9 November 2009, the scope of the exceptions to the deemed release provision were narrowed with the substitution of three new exceptions: (i) the corporate rescue exception, (ii) the debt for debt exception and (iii) the debt for equity exception. Guidance issued by HMRC has clarified how HMRC will interpret the corporate rescue exception and the debt for debt exception.

The corporate rescue exception applies where there is a change of ownership of the debtor company within the year before or the 60 days following the debt buy-back (i.e. a "rescue" of some sort). One of the conditions which must be met in relation to the corporate rescue exception is that is must be "reasonable to assume" that, but for the change of ownership, the debtor company would have gone into insolvent liquidation, administration or receivership (the "insolvency condition"). HMRC will accept that this condition will be met where (i) the insolvency is avoided not only by change of ownership but by steps taken subsequently, (ii) enforcement action might have been taken against another company in the debtor's group as a result of guarantees given in respect of the debtor's borrowing and (iii) there is evidence that the insolvency condition would be met but the company has not publicly acknowledged its potential insolvency because of a need to engage in sensitive discussions with auditors and lenders over banking covenants and its ongoing status.

The debt for debt exception applies where a loan relationship is replaced, in an arm's length transaction by a new loan relationship which has the same nominal value and substantially the same market value. Loans represented by securities must be replaced by loans represented by securities and other loan relationships must not be replaced by loans represented by securities (i.e. the exchange must be like-for-like in this respect). HMRC have clarified that while the nominal value of the exchanged debts needs to be the same and the market value needs to be substantially the same, minor differences in interest, repayment and other terms will not prevent the exception applying.

Furthermore, while the legislation states that the consideration for the release of the old debt must "consist only" of the new debt, HMRC will accept that the consideration may also include an agreement to pay accrued but unpaid interest on the old debt and will also accept that the old debt can be exchanged for a mixture of shares and new debt (in which case the consideration must be apportioned – with the debt for debt exception applying in part and the debt for equity exception applying in part). Note that the main difference between (i) the debt for debt and corporate rescue exceptions and (ii) the debt for equity exception, is that a later release of debt bought back in under the debt for debt and corporate rescue exceptions will result in a deemed release (and a corresponding taxable credit) for the debtor in the amount of the discount on the original buy-back of the loan. This will not be the case on a later release of debt bought back using the debt for equity exception.

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