



The Law Society

Potential Debt Cap Changes for Finance Bill 2012

Response of the Corporation Tax Sub-Committee of the Tax Law Committee of the Law Society of England and Wales

Introduction

1. The Law Society is the representative body for over 140,000 solicitors in England and Wales. It negotiates on behalf of the profession, and lobbies regulators, Government and others.
2. This response has been prepared on behalf of the Law Society by members of the Corporation Tax Sub-Committee. The Sub-Committee is made up of senior and specialist tax lawyers from across the country.

General Comments

3. We welcome the opportunity to participate in the informal consultation on the Debt Cap rules. We believe those in HMRC responsible for dealing with these rules should be congratulated on the frequency with which they have identified (or others who have drawn to their attention) potential issues involving the Debt Cap rules and sought views in consultation.
4. However the frequency with which it has been necessary to consult and, as appropriate, make significant changes to the rules in primary and secondary legislation does reveal two fundamental issues which merit consideration over and above the specific questions raised in this consultation document.
5. Those concerns are, first, the fact that by using a “comparator” which is based on accounting standards - i.e. the “available amount” - legislation may need to be changed from time to time either to give effect to, or to ameliorate the inadvertent consequences from a tax perspective of, changes to accounting standards.
6. Secondly - and ignoring the “ambulatory effect” of using a comparator whose ambit is not defined by legislation (i.e. accounting standards), the frequency of change to corporate tax legislation is in itself perceived to be a deterrent to the UK being seen as a competitive jurisdiction to the extent that costs are involved in understanding changes and complying with the changes.
7. Particularly with the on-going consultation on Controlled Foreign Companies and the possibility of there being “double economic taxation” if there are restrictions under the Worldwide Debt Cap on upstream loans but group companies that are CFCs may have income attributed back to the UK, one of the rationales for the debt cap is being eroded - namely concerns over upstream loans.

8. While the CFC legislation contains provisions under section 751AA for a reduction in the apportionment to be made where there has been a debt cap restriction, there is a school of thought suggesting that the debt cap legislation in its entirety might not be necessary, if instead a full CFC apportionment (in accordance with whatever rules are implemented in 2012) is made. That would only leave one other rationale for the debt cap rules, namely “excess allocation” of interest expense where there is a non-UK headquartered group where, as HMRC have identified that only approximately 1,800 groups are involved, transfer pricing legislation might instead deal with any concerns in this area.

Specific issues

9. In these comments we have responded only to certain of the consultation questions set out in the Technical Note.

De Minimis Amounts

Question 1: Do you think that there is a need to address this issue?

10. We support the idea that groups can elect out of the £500,000 limit where individual companies have net financing income of less than that figure but other members of the group have net financing deductions which exceed that figure. In our view, the election must automatically fall away with effect from the day that a company leaves a particular group (and not continue to affect that company if it joins a second group where no such group-wide election has been made). Correspondingly, we would expect that if a company leaves a group in respect of which no such election has been made and joins a worldwide group that has made an irrevocable group election, that election would automatically to apply with effect from the day on which the company joins the second group.

Question 2: If so do you think that the proposed solution addresses the problem?

11. Subject to our comments in response to question 1 above, we believe that the solution does address the problem.

Partnerships

Question 3: Do you think there is a need to address the discrepancy that arises under the debt cap for loans by a partnership?

12. We recognise the possibility that there may be discrepancies even following section 332B and section 332C and TIOPA and would support the idea of legislation dealing with loans *by* partners.

Question 4: If so do you think that this is best addressed through legislation drafted specifically for the partnership issue?

13. We would want to see a more detailed description of the way in which the legislation would change if loan relationship debits were to be a more central concept - as canvassed in the second sentence of the paragraph entitled “possible solutions”.

Functional Currency

14. We have no comments on this topic.

Mergers & Takeovers

15. The issues identified by HMRC are, to some extent, a function of the way in which accounting standards provide for rules which are inconsistent with the legal position. So, for example, we are not convinced that it would be worth lengthening the debt cap legislation in relation to “reverse acquisitions”. However, we think that there are significant uncertainties, in turn leading to legal ambiguities, where companies leave or join “large groups” in connection with allocation of disallowances. We believe that the legislation should be changed to deal with these issues.

Question 7: Do you think that the current debt cap rules – for example on establishing the ultimate parent of a worldwide group and dealing with situation where there are non-existent accounts will be sufficient to enable the debt cap rules to apply to companies joining and leaving groups and mergers and takeovers?

16. In our view, it has not been demonstrated there is a need for further legislation in relation to situations where there are non-existent accounts.

Question 8: Do you think that it would be worthwhile legislating for changes in group structure?

and

Question 9: If so what changes to group structure do you consider should be included in such legislation?

17. In our view the principal difficulties that arise under the current debt cap rules relate to the operation of Chapters 3 and 4 of Part 7 TIOPA 2010, namely the statements of allocated disallowances and statements of allocated exemptions. A similar uncertainty arises where there is a failure to submit a statement of allocated exemptions or allocated disallowances in respect of companies that have left a group.
18. Acting on M&A transactions it is customary to seek warranties and indemnification in relation to past (and in some cases future) tax exposures and to provide, in effect, for pre-completion tax liabilities that fall on a target company to be met, directly or indirectly, by the vendor group. When a company leaves a worldwide group part-way through the relevant period of accounting, it is not clear that the maximum amount of disallowance that can be allocated to it is restricted to the proportion of its accounting period that falls within the period of account of the vendor group. (Note this is not a comment on the proportion of relieved income or disallowed expense that could be attributed to the company for the part of its accounting period that overlaps with the period of account of the vendor group - that is dealt with in section 313(6) and 314(6) TIOPA).
19. Similarly, if it turns out that there is a greater disallowed tested expense amount after a company has left a group, we do not believe that a further amount could be allocated to the “exiting company” than was previously allocated to it.
20. Additionally we believe that where a company is appointed to be the “reporting body” in relation to a group and then ceases to be within the group part-way through the relevant

period of account, its role as a reporting body should continue to have effect up to and including the date on which it ceases to be a member of the relevant group.

Question 10: If not how do you think best practice on changes in group structure and examples should be included in the debt cap guidance?

21. As is evident from our comments on questions 8 & 9 above, we believe that in some cases it is insufficient to deal with issues by guidance. We could only see an argument for putting forward guidance on areas of uncertainty *pending legislative change* for unless differing views are reached on how the existing legislation operates (i.e. whether the guidance put out is legally challengeable) it would then provide a model for Parliamentary Draftsmen subsequently to prepare amending legislation. (After all, much of HMRC guidance illustrates existing law, at least as HMRC sees it).

Changes to the definition of available amount

Question 13: Do you have any views on including in the available amount the loan relationship debits identified in section 313?

22. We can see that if groups that consist solely of UK members had an option only to report loan relationship debits - rather than interest, discount, premium and ancillary costs - in the components of the "available amount" this would provide a useful simplification. This could be elective (presumably the election falling away upon the admission of a non-UK group member) or simply a statutory alternative in the way in which the "available amount" is calculated.

Question 14: Do you think this would simplify application of the debt cap rules?

23. We can see advantages of taking account of loan relationship debits arising from the hedging of liabilities and so far as UK companies are concerned, drawing on computations of available loan relationship debits and credits for determining the financing expense and income amounts. As regards the definition of the available amount, we could see an argument that since accounts are meant to be IFRS based, it should not be too difficult for amounts that would have been eligible under the loan relationship legislation had members of the group been UK resident (or trading through a permanent establishment in the UK) being "super imposed" on the amounts treated as financial liabilities in IFRS compliant accounts.
24. Essentially this would mean further moving away from the perceived attraction of comparing amounts in worldwide accounts ("the available amount") with amounts drawn up in accordance with the UK tax code i.e. the tested expense amount. This would, in effect, mean that amounts calculated on a consistent basis would be taken into account in computing the "tested expense amounts" and "available amounts".

Prospective Changes to IFRS 10 Consolidated Financial Statements

Question 17: Can you identify any immediate issues arising from the proposed changes that will impact on the debt cap? If so could you provide us with specific examples?

Question 18: Do you think there is a need to address any issues that arise from the proposed changes?

Question 19: If there is a need to make changes, can you identify any solutions to the issue?

25. As with any change which could have an impact on past tax liabilities, let alone future tax liabilities, we wonder whether there might need to be some “grandfathering” i.e. for accounting periods part-way through which any changes may take effect from an accounting perspective, the “available amount” be computed by reference to the standards in the form that they were immediately prior to replacement. In this way, taxpayers are given certainty and there are no issues of “retrospection”. If a taxpayer particularly wants to take advantage of the proposed changes there would be nothing to stop them considering, on a group-wide basis, changing their accounting reference date or local law equivalent to when accounting standards change.

Contact details

If you have any questions on these representations, please contact the Chair of the Corporation Tax Sub-committee, Lydia Challen of Allen & Overy (tel: 020 3088 2753, e-mail: lydia.challen@allenoverly.com).