RINGING THE CHANGES

MOHAMMED AMIN OF PRICEWATERHOUSECOOPERS FINDS OUT WHAT'S IN STORE FOR THE TREASURY COMMUNITY IN THE CHANCELLOR'S 2002 BUDGET.

Gordon Brown has presented us with another short Budget speech along with a lengthy Finance Bill. From all this detail, I have chosen the changes that I consider the most important for corporate treasurers.

LOAN RELATIONSHIPS, DERIVATIVE CONTRACTS AND FX GAINS AND LOSSES. In the January issue of *The Treasurer*, you may remember Paul Minness and I reviewed the proposed changes to their tax treatment (*p23*). It is now confirmed that this new regime will apply to accounting periods of companies beginning on or after 1 October 2002. The main changes to the old law are as follows:

▪ **Exchange gains and losses.** The FA 1993 rules for the taxation of foreign exchange gains and losses will be repealed. Instead of a separate code, exchange gains and losses will fall within the loan relationship rules and the new derivative contracts rules.

The matching rules, where foreign currency liabilities hedge assets, such as overseas subsidiaries, will be retained for both debt and currency contracts but will become mandatory where the appropriate accounting treatment is followed. Exchange differences on liabilities matched with shares that are capital gains exempt under the substantial shareholdings rules will be disregarded.

▪ **Derivative contracts.** The financial instrument rules in FA 1994 will be replaced by a new 'derivative contracts' code in FA 2002, under which the tax treatment of such contracts will generally follow the accounting treatment, closely following the loan relationship rules. The old rules covered only interest rate, foreign exchange and debt contracts and options. The new regime will apply accounts-based income treatment to all derivatives within the scope of FRS 13, with the exception of contracts whose underlying subject matter is land, chattels other than commodities, intangibles, shares and unit trusts.

▪ **Anti-avoidance provisions.** A number of new anti-avoidance provisions are already in force. From 26 July 2001, only debts linked to qualifying ordinary shares could qualify for capital gains tax treatment under FA 1996 Section 92, loans convertible into shares. After 19 December 2001, no intra group debt can qualify. The new derivative contracts rules will contain an 'unallowable purpose' provision modelled on the loan relationship anti-avoidance rule in FA 1996, Schedule 9 Para 13. A comparable provision has applied from 26 July 2001 under the old FA 1994 financial instruments rules.

▪ **Other changes.** There is a relaxation of the rules applying to loan relationships that are acquired at less than face value when a company joins a group. It will no longer be necessary to assume that the debt will be repaid in full on the due date, and therefore not necessary to accrue the purchase discount as taxable income.

The definition of 'connected party' loan relationships will be based on control along the lines of ICTA 1988 Section 840, rather than the existing Section 416 test. This will make it more narrowly focused for the purposes of determining whether bad debt relief is available and whether the rules require accruals basis accounting.

A wider definition of connection will apply specifically in determining whether interest or discount is deductible on an accruals or paid basis. This will include situations in which two persons both have a loan relationship with a company and each has at least a 40% interest in that company, and loans made by participators or their associates to close companies.

EXEMPTION FOR COMPANY GAINS ON SHAREHOLDINGS. Capital gains arising on the disposal after 1 April 2002 by companies of substantial shareholdings in trading companies will be exempt from tax. This is a major change culminating from two years of consultation, including draft legislation.

The rule is symmetrical, so such disposals will also no longer give rise to allowable losses. It is not possible to sidestep this restriction by making a retrospective negligible value claim in respect of a substantial shareholding after 1 April 2002.

▪ **Criteria that have to be met.** There are three main requirements that must be satisfied for an exemption to be given:

- The company making the disposal must own at least 10% of the ordinary share capital in a company for at least 12 months.

- The company making the disposal must be either a standalone trading company, or a member of a trading group, throughout the period during which the substantial shareholding requirement was met, and immediately after the disposal.
- The company whose shares are being disposed of must be either a qualifying trading company, or a qualifying holding company, throughout the period during which the substantial shareholding requirement was met, and immediately after the disposal.

As mentioned above, the investing company must also continue to be a standalone trading company, or a member of a trading group, immediately after the disposal. This requirement will prejudice groups which ceased business and would therefore be faced with a chargeable gain when they sold their last trading subsidiary. This is likely to cause problems in practice.

EXEMPT ASSETS. Relief is only available where a substantial shareholding is held, and this test is measured by reference to ordinary share capital only. However, provided there is a substantial shareholding, relief is also given for disposals of any class of share, including preference shares, and for disposals of 'assets relating to shares' (broadly, options to buy, sell and subscribe for shares, and securities convertible into shares) and of 'interests in shares' (broadly, rights as co-owners of shares).

Unlike other countries that exempt gains on sale of foreign participations, there is no restriction on interest relief for loans to buy foreign subsidiaries. The rationale is that dividend income from foreign subsidiaries continues to be taxable in the UK with double tax relief given as a credit.

Given the major attack two years ago on overseas 'dividend mixer' companies, it is possible that many more companies will hold their foreign subsidiaries directly from the UK. In future, any capital gain on selling the subsidiary will be exempt and direct holding will avoid the limits that mixer companies impose on available double taxation relief.

The exemption of capital gains, combined with the availability of interest relief for acquisition debt, potentially makes it attractive for foreign groups to use their UK subsidiaries to make third country acquisitions. However, I doubt if this will become a significant trend given the present rapidity of change in UK tax law.

RESERVE POWER TO DENY CONTROLLED FOREIGN COMPANY EXEMPTIONS. A controlled foreign company (CFC) is an organisation that:

- is resident outside the UK;
- pays tax in its territory of residence, which is less than 75% of the tax the company would have paid if it had been a UK resident company; and
- is controlled by UK residents.

UK resident companies with an interest of 25% or more in a CFC must self-assess and pay tax on their share of the profits of the CFC. However, UK resident companies need not make this self-assessment if the CFC meets any of certain exemptions. Measures are to be introduced that will give the Treasury the reserve power to effectively deny CFC exemptions for designated jurisdictions. The OECD has targeted countries that appear to have tax and banking secrecy regimes that might facilitate tax evasion or money laundering. This reserve power is clearly being enacted to threaten countries that don't cooperate with the OECD.

'WHILE TREASURERS OF UK-BASED COMPANIES WILL NOT BE RELYING ON THE SECRECY REGIMES INVOLVED, PERFECTLY PROPER SUBSIDIARIES MAY BE CAUGHT IN THE CROSSFIRE IF THESE PROVISIONS HAVE TO BE INVOKED'

While treasurers of UK-based companies will not be relying on the secrecy regimes involved, as CFC disclosures are required anyway under self-assessment, perfectly proper subsidiaries may be caught in the crossfire if these provisions have to be invoked.

TAXATION OF UK BRANCHES OF FOREIGN COMPANIES. UK branches of companies are taxed on the basis of the trading profits that would arise if the branch took the form of a separate company. Generally, however, there is no deduction available for the cost of financing the branch through, for example, a branch balance with its head office. Even if the branch accounts record interest on such a balance, legally, there is no interest expense because a company cannot pay interest to itself.

However, in the case of banks and some other financial traders, interbranch interest is recognised, since in commercial terms it is a fundamental component in determining the profit attributable to their UK trading activity.

The interest deduction may, however, be restricted under notional free capital rules, which in concept are similar to the restrictions that can arise for a UK company which borrows from its overseas parent when it is thinly capitalised.

In practice, the notional free capital adjustment for the UK branches of banks have not been large. Many banks in practice borrow money in London and their UK branches are net lenders to the rest of the company and so no adjustment has arisen, as the branch effectively has no capital.

The UK operations of foreign companies will, for accounting periods starting on or after 1 January 2003, be treated as if they had a mixture of equity and debt financing on the same terms that would have applied in a hypothetical separate company. Draft legislation will be published for consultation.

If relief for interest paid to head office is extended to branches without financial trades, this should reduce their UK taxable profits. However, at present, branches are in widespread use only in regulated organisations such as banks, where there will be a restriction in the interest that is currently tax deductible.

The measure is estimated to raise £1bn a year when fully implemented. This is a significant sum for a technical measure that is described as modernising the tax system and will mainly be collected from a handful of international banks. Its impact on the competitiveness of the UK as a global financial services player is difficult to assess.

There are supposedly only two certainties in life: death and taxes. Perhaps one should add a third, which is continuous and rapid change in the tax system, with steadily increasing complexity.

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