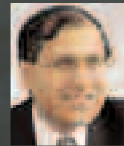
Emerging tax themes

MOHAMMED AMIN OF PRICEWATERHOUSECOOPERS



REVIEWS THE PRE-BUDGET REPORT FROM THE TREASURER'S PERSPECTIVE.

Gordon Brown, the Chancellor, delivered his Pre-Budget Report (PBR) in a short speech accompanied by the usual blizzard of technical notes, draft legislation and consultation documents. Amid all the details, do any themes emerge, and what should treasurers be focusing on?

ARBITRAGE MUST BE STOPPED If your company owns an asset that another company would value more highly, then your selling the asset to the other company makes both of you better off. However, if the asset is a tax attribute (such as losses), you need to consider at least two of the following changes:

Leasing Consider a new company with losses in the first few years which then starts to make significant profits. It spends £1,000 buying an asset on commencement which is financed by a bank loan. If it does not use up its initial losses until the end of year five, its tax payment profile will match the Buy example in *Table 1*. Over the first eight years, starting in year six, it saves tax of £270. If it leases the asset from the same bank, the bank's tax saving from the allowance is as shown in the 'Lease' example in *Table 1*, assuming the bank is profitable and taxpaying. Over the first eight years, the bank saves the same £270, but much earlier than the company does in the Buy example. In a competitive world, the bank's earlier tax saving is shared with the customer via a lower finance cost for leasing compared with a bank loan to buy the asset.

In 2006, a revision of tax law will mean that this benefit will be eliminated for most new leases (starting after 1 April 2006). In the case of long funding leases, capital allowances will be given to the lessee (who does not actually want them) rather than the lessor (who does). A funding lease is one that satisfies at least one of the following three tests at its inception:

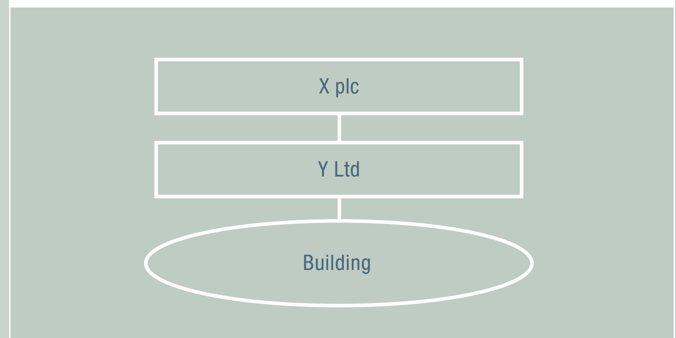
- It is treated as a finance lease under generally accepted accounting practice.
- The net present value of the usage rentals defined in the agreement (in other words, excluding service charges) is more than 80% of the fair value of the asset.
- The minimum lease term is more than 65% of the remaining useful life of the asset, but with exceptions for assets subject to a succession of leases.

A long funding lease is broadly a funding lease with a term longer than five years. The tax treatment will depend on the accounting treatment.

For those accounted for as finance leases, the lessee will be able to claim capital allowances on the net present value of the minimum lease payments specified in the agreement (discounting using the rate implicit in the lease). In addition, the lessee will be able to deduct the finance charge elements in each accounting period. Thus, for the lessee, the total qualifying capital allowance expenditure and tax-deductible finance charges should equal the total rentals payable. The lessor will be taxable only on the finance charge elements of the rentals. The position is more complex where the lease is accounted for as an operating lease, and the lessor's total income is not necessarily the same as the lessee's total tax deductions.

Buying capital gains or losses In the past, if you owned a subsidiary that had made a capital loss and you did not expect capital gains in the foreseeable future, you would sell the subsidiary to someone expecting an imminent capital gain. However, legislation to restrict the setting off of pre-entry losses against the acquirer's gains, and the setting off of the acquirer's losses against pre-entry gains, was introduced in the 1990s. This legislation appears insufficient, so new

Figure 1. Capital Gains and Losses



Executive summary

- The Chancellor is seeking to crack down on tax arbitrage and is looking in particular at leasing and buying capital gains or losses.
- Treasurers undertaking any form of reorganisation need to understand the change in the rules on capital losses.
- The Pre-Budget Report did contain some good news on spreading extra tax payable on work in progress by service entities, the definition of a securitisation company, and the putting back of a deadline for an election under the Disregard Regulations.

rules are being introduced to supplement the existing rules in TCGA 1992 Schedule 7A (in relation to loss buying) and replace the existing rules in Schedule 7AA for gain buying.

The existing legislation in Schedule 7A will remain in force, and will apply in all cases that do not involve tax avoidance, such as commercial mergers and acquisitions. But where there is a tax avoidance purpose, the new rules take priority to the existing provisions.

The new rules will apply whenever there is a change of ownership of a company if one of the main purposes of this is to secure a tax advantage involving the deduction of a capital loss from any chargeable gain. When these new rules apply, the loss will not be deductible from the gain.

The new loss-buying provisions do not prevent the setting off of a loss where the loss is set off against a gain which arises to a company on the disposal of an asset (if either disposed of or owned) prior to the change of ownership. The new provisions apply where a tax advantage arises on or after 5 December 2005. This can include situations where a loss arose before this date and the gain that it is intended to reduce arises after this date. It can even apply where the change of ownership takes place before this date.

Relief is only for genuine commercial losses on genuine commercial disposals Existing case law states that capital gains tax is "a tax on gains… it is not a tax on arithmetical differences" (WT Ramsay Ltd v CIR). However, consider the following example (see *Figure 1*).

X plc originally set up Y Ltd with share capital of £1,000 so that Y Ltd could buy the building from a third party for £1,000. Due to a fall in market prices, the building is worth only £900 today, but the group wishes to retain it, as the market value is expected to recover.

X plc buys the building from Y Ltd for £900. This intra-group transfer operates on a no gain/no loss basis, and X plc takes over Y Ltd's original £1,000 base cost of the building for use on a future external disposal. X plc then liquidates Y Ltd, receiving £900 against its original investment of £1,000. This is a disposal of Y Ltd shares, so can X plc claim a capital loss of £100 for use against future capital gains?

Before 5 December 2005, the general answer was that X plc did indeed have a capital loss of £100. However, the PBR announced a change in the law. Now, because X plc has not disposed of the underlying asset (the building) commercially, the capital loss on the Y Ltd shares is disallowed. Draft legislation has been published, and treasurers undertaking any form of reorganisation need to assess the implications of the new rules.

SOME GOOD NEWS The PBR did not consist entirely of changes increasing the effective tax burden. Several changes are potentially helpful to taxpayers.

Spreading the extra tax payable on work in progress by service entities In March 2005, the Accounting Standards Board issued Urgent Issues Task Force Abstract 40 Revenue recognition and service contracts. The aim of the abstract was to clarify UK GAAP for

Table 1. Timings on Tax Savings

Lease				Buy				
Year	Pool	Allowances	Tax saved @ 30%	Year	Pool	Allowances	Losses c/f	Tax saved
1	1000	250	£75.00	1	1000	250	250	0
2	750	188	£56.40	2	750	188	438	0
3	562	141	£42.30	3	562	141	579	0
4	421	105	£31.50	4	421	105	684	0
5	316	79	£23.70	5	316	79	763	0
6	237	59	£17.70	6	237	59	0	£246.60
7	178	45	£13.50	7	178	45	0	£13.50
8	133	33	£9.90	8	133	33	0	£9.90
			£270.00					**£270.00**

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recognising revenue within year-end work in progress. As a result, only work undertaken for a contingent fee will appear as work in progress in the year-end balance sheet. All other unbilled work will be included in the profit and loss account at sales value with appropriate profit being recognised. Service providers will therefore face a one-off uplift in reported profits which will be taxable in the period of change under general taxation principles.

Over the summer, the accountancy bodies in particular have lobbied for the introduction of deferral relief to mitigate the tax impact of this accounting change. Material published as part of the PBR states that "the government will legislate in Finance Bill 2006 to enable most business affected by the March 2005 changes in the income recognition rules in UK GAAP to spread any extra tax charge over three years, while those businesses most severely affected will be able to spread the charge over a period not exceeding six years".

Definition of a securitisation company The pricing of securitisation transactions is critically sensitive to taxation assumptions. Assumptions used in pre-2005 transactions would have been fundamentally disturbed if tax in 2005 and subsequent years was based on the accounting results of a company that moved to either new UK GAAP (FRS 26 *Financial Instruments: Measurement*) or IFRS. Accordingly, Finance Act 2005 s53 required securitisation companies (as defined in the Act) to continue to use UK GAAP, as it stood on 31 December 2004, to calculate their tax liabilities for periods of account beginning on or after 1 January 2005 and ending before 1 January 2007 (the "temporary tax basis").

It has been announced that the temporary tax basis will be extended by a further year (to periods of account ending on or before 31 December 2007), pending consultations on a permanent tax regime for securitisation of financial assets.

The current tax definition of a securitisation company in the Finance Act 2005 s53 is so wide that many non-securitisation companies would have found themselves liable to tax in 2005 on the basis of old UK GAAP accounting (despite setting up systems and arranging their affairs to accommodate taxation based on their actual transition to new UK GAAP or IFRS). One example would have been companies that had issued listed debt instruments.

Regulations to appear in early 2006 will amend the definition of a securitisation company for all periods of account beginning on or after 1 January 2005. The only details available are that the changes will prevent the temporary tax regime (that is, mandatory use of old UK GAAP) from "applying to non-securitisation companies (such as banks) who issue capital market investments in the course of their normal trade".

New election under Disregard Regulation 9A The Disregard Regulations were enacted to avoid undue tax volatility in accounting for derivative and loan relationships under IFRS or FRS 26. Regulation 9A will allow companies (very broadly) to follow the profit and loss account in respect of their hedging interest rate derivatives. However, the decision on whether to elect is not straightforward. While 9A has been trailed for some time, it has always been stated that the deadline for election would be 31 December 2005. This deadline has now been put back to 30 March 2006. For more explanation of Regulation 9A and other tax issues, visit my new blog (see below).

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