MOHAMMED AMIN OF PRICEWATERHOUSECOOPERS CONSIDERS WHAT THE BUDGET MEANS FOR TREASURERS.

Gordon Brown's last Budget?

Almost everyone is expecting a general election this year, and by the time this magazine lands on treasurers' desks, the campaign may well be underway. There were some modest targeted giveaways for pensioners: it is no surprise that with extra council tax rebates and free local bus travel, the elderly are the big winners in the Budget. As the membership of the Association will mostly be well short of qualifying for such largesse, what does the Budget hold for corporate treasurers?

THE GOOD NEWS There is always some good news.

Long Gilts The government recently consulted on the merits of issuing very long dated conventional Gilts and index linked Gilts. It also floated the possibility of issuing Gilts structured as annuities. i.e. for lending £100 to the government, you would receive for example 100 six monthly payments of £X each but no terminal repayment.

The government will proceed to issue 50-year conventional Gilts starting in May. Initially, only conventional Gilts will be issued as respondents to the consultation explained that they would find it hard to assess proper prices for very long dated index linked Gilts until there was a proper very long yield curve for conventional Gilts. Accordingly, the issue of very long dated index linked Gilts will follow a few quarters after the first issue of the very long dated conventional Gilts.

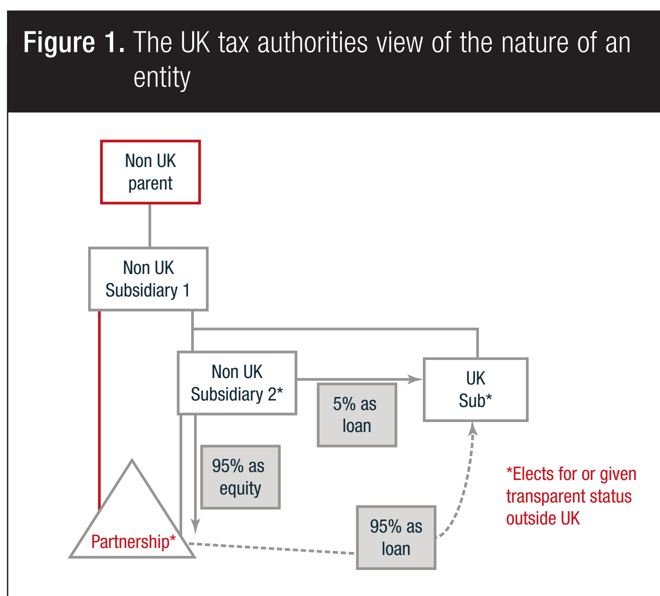
Treasurers often serve as pension fund trustees and also need to consider the risks of their pension fund as part of their company's overall risk management. Until now, pension funds have been unable to find sufficiently long duration bonds to hold as investments against their long duration pension liabilities. Accordingly, I would expect treasurers to welcome the availability of these long Gilts.

In response to the consultation, the government has decided not to proceed with the issue of Gilts structured as annuities.

Sharia Financing It is well known that devout Muslims avoid the receipt or payment of interest. What is not well known is that London is one of the main centres for financing arrangements that are compliant with Sharia (Islamic Law). This financing is being structured from London despite there being many uncertainties under UK tax law. Briefly, financing returns which are acceptable under Sharia (broadly returns which involve the lender sharing in the risks of the business) are in danger of being treated as non deductible as the corporation tax rules treat interest which is dependant on the results of the business as a distribution.

Changes to the tax law will be made to put Sharia financing on the same tax basis as equivalent conventional financing. While this may appear only relevant to specialists, there is a significant potential implication for treasurers. It could enable them to tap into the very large pools of Islamic funds that are seeking Sharia compliant investment opportunities, if their company can issue Sharia compliant debt.

Figure 1. The UK tax authorities view of the nature of an entity



THE BAD NEWS Although Gordon Brown's Budget speech was the shortest since one of Benjamin Disraeli's, the small print issued by the Inland Revenue continued the theme of recent Budgets by announcing large amounts of new anti-avoidance legislation.

Stamp Duty Many businesses, especially large retailers, have been selling their freehold or long leasehold property and becoming tenants under shorter term operating leases. While there is relief for the leaseback component of a sale and leaseback, the original sale transaction typically gives rise to stamp duty land tax (SDLT) at 4% of the consideration. This tax cost borne by the buyer is of course reflected in the effective cost of finance to the company.

There have been a number of methods available for selling a property while paying either zero or a reduced amount of SDLT. Most have now been blocked which will make sale and leaseback transactions a less attractive form of finance.

The SDLT relief for commercial buildings in disadvantaged areas was withdrawn on Budget day. This relief was due to expire on 31 December 2006 as it had only been allowed by concession by the European Union. However no policy reason was given for its immediate abolition. I assume that the reason was simply increase the tax yield from business.

Executive summary

- **The Budget small print continued the theme of recent Budgets by announcing large amounts of anti-avoidance legislation. Much of this impacts on the way that corporates structure their financing.**
- **The government will issue 50-year conventional Gilts in May this year. The issue of very long dated index linked Gilts will follow later.**
- **Changes to the tax law will be made to put Sharia financing on the same tax basis as equivalent conventional financing.**
- **Stamp duty land tax (SDLT) relief for commercial buildings in disadvantaged areas was withdrawn on Budget day. The relief was due to expire on 31 December 2006.**
- **Cost of borrowing to companies will increase following a crackdown on tax efficient structured finance deals.**

Structured Finance For many years, banks have devised structures that allow them to make loans in a tax-advantaged manner whereby the economic return to the bank suffers less than 30% tax. Competition between banks typically means that part of the benefit is shared with the borrower allowing a cost of finance lower than otherwise available.

Anti-avoidance legislation announced in the Budget will cancel most if not all of the schemes currently in use by banks (such as tax advantaged repo transactions) with a consequential increase in the effective cost of funds to borrowing companies.

Equity Derivatives About a decade ago, the tax authorities realised that it was possible to use combinations of options to produce a guaranteed return equivalent to interest income. See the case of Griffin (Inspector of Taxes) v Citibank Investments. In response, legislation was introduced with the goal of taxing returns achieved in this manner as income rather than capital gains. Despite several iterations of legislation, it was still possible to devise structures which included the use of equity derivatives and that gave rise to capital gains rather than income. Instead of continuing with targeted legislation, the government has announced that the derivative contract rules will be changed so that all gains on equity derivatives are treated as income with some minor exceptions.

The changes recognise that investors owning a portfolio of shares often transact equity derivatives to hedge their equity portfolio. In this circumstance the gain or loss on the equity derivative will remain within the capital gains tax rules. However, the changes are seriously adverse for investors who hold cash but wish to acquire equity exposure via derivatives. For example, an investment trust may be very liquid but expect that over the next three months the stock market is likely to rise. It therefore purchases a three-month FTSE 100 future. Prior to the Budget, any gain on the futures contract would have been a capital gain and exempt from tax in the case of an investment trust. Now, it will be income and therefore taxable. I cannot believe that it was intended to tax such innocent transactions and hope that the changes will be modified.

Cross-Border Arbitrage A year ago, the UK joined in a multi national task force to combat tax avoidance along with the US, Australia and Canada. This appears to have the first outputs, with measures aimed at cross border arbitrage and the use of hybrids.

For example tax authorities can differ regarding the nature of an entity. *Figure 1* is taken from an Inland Revenue illustration. The UK tax authorities regard UK Sub, Non UK Subsidiary 2 and Non UK Subsidiary 1 as separate entities, and therefore allow UK Sub to deduct the interest expense on its borrowings. However, the foreign tax authority sees UK Sub, Non UK Subsidiary 2 and Partnership as 'transparent', so all of the cash flows are deemed to take place within Non UK Subsidiary 1, so there is no taxable interest income. The Inland Revenue considers the absence of foreign taxation improper, and in future the tax deduction will be denied to UK Sub unless it can show that the structure was not devised to save tax.

The Inland Revenue recognises that sometimes foreign countries have rules aimed at preventing tax arbitrage, which could cause the foreign country to deny a tax deduction. In such cases, the Inland Revenue is happy to announce that both countries will deny the tax deduction and does not appear to consider this result unjust.

Voting with their feet The changes may drive some treasurers into deciding to retire, especially if of pensionable age.

A few years ago, several major US companies concluded that the US had become so difficult regarding the way that it taxed international businesses that they carried out reorganisation transactions to emigrate the parent company from the US to a foreign country, usually Bermuda. While political pressure and legislative change has staunched the exodus of companies from the US, it is notable that none of the emigrants has chosen to leave their more favourable foreign tax environment and return to the US. While companies have no votes, in the preceding sense they can 'vote with their feet' and I wonder at what stage we will see companies choosing to emigrate from the UK for similar reasons.

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