Away from the headlines

MOHAMMED AMIN REVIEWS THE CHANCELLOR'S PRE-BUDGET REPORT, LOOKING AT THE CHANGES THAT ARE ALREADY AFFECTING TREASURERS.

The newspaper headlines for the Pre-Budget Report given on 9 December 2009 concentrated on the macroeconomic aspects, in particular the overall level of government borrowing. As always, the changes that will directly affect the day-to-day work of treasurers did not receive any headlines.

CHANGES TO WORLDWIDE DEBT CAP RULES Schedule 15 of the Finance Act 2009 contains a set of measures (the worldwide debt cap) to prevent multinationals leveraging their UK operations to a greater extent than the group as a whole. The measures need to be considered by every corporate treasurer as they can result in part of the UK interest expense being disallowed for tax purposes. A number of changes are being made, which will be effective from the commencement of the debt cap rules on 1 January 2010.

- Companies within the special UK tax regimes for securitisation companies will not have their interest expense taken into account when computing the total UK interest expense that is tested for potential disallowance. However, their debt will still be taken into account when calculating the "gateway test", Under the gateway test, if the total net UK debt is less than 75% of the group's worldwide gross debt, the rest of the worldwide debt cap rules can be ignored, saving significant computational efforts.

- It is possible for a particular debt to be counted differently when computing the worldwide gross debt and the aggregate UK net debt. For example, the debt may be accounted for under different principles. In that case, the figure included in the UK net debt total is to be computed using the amount derived from the consolidated accounts, instead of the amount in the UK company's own accounts.

- Under international financial reporting standards (IFRS), preference shares are often accounted for as a financial liability and not as share capital. A new provision puts it beyond doubt that preference

Table 1: Exposure to translation risk

	$ strengthens by 10%	$ weakens by 10%
Increase/(decrease) in assets of US subsidiary from sterling perspective	10	(10)
Tax on asset revaluation	-	-
Foreign exchange gain/(loss) on $138m liability	(13.8)	13.8
(Tax)/tax relief on FX gain/loss	3.8	(3.8)
Net translation effect	-	-

shares issued are not to be treated as borrowings for the debt cap rules, and preference shares held are not treated as financial assets (to be netted off debt to compute net debt).

- The existing debt cap rules contain a pitfall for group treasury companies. Schedule 15 para 57 of the Finance Act 2009 allows a group treasury company to elect for its financing expense and its financing income to be disregarded in the debt cap calculations. If there is more than one treasury company in a group, all must elect (or not elect) together. There is a problem in the existing law with the definition of a treasury company, which is one deriving 90% or more of its total income from treasury activities. At present, where several companies carry on treasury activities, their total incomes and their total treasury incomes are aggregated for the 90% test. Accordingly the existence of a general trading company with significant "other" income and a small amount of treasury activities can cause any real treasury companies in the group to fail the 90% test, since that test is applied to all the companies aggregated together. The Pre-Budget Report announces changes so that the 90% test will be applied company by company to ascertain which companies in the group are treasury companies.

RISK TRANSFER SCHEMES HM Revenue and Customs has been consulting for some time on legislation to counter what it calls "risk transfer schemes". These are best illustrated by an example.

Assume that UK Parent owns US Subsidiary, whose accounts carrying value is $100m. If UK Parent wishes to avoid translation risk in respect of the US net assets of $100m, it can take out $100m of actual or synthetic dollar liabilities, so it is hedged for accounting purposes, with dollar assets and liabilities being an identical $100m. For tax purposes, the Disregard Regulations will apply to UK Parent's monetary dollar liability, so no tax effects will arise.

However, when dollar interest rates were much lower than sterling interest rates, many UK groups hedged their translation risk using structures similar to the one shown in Figure 1.

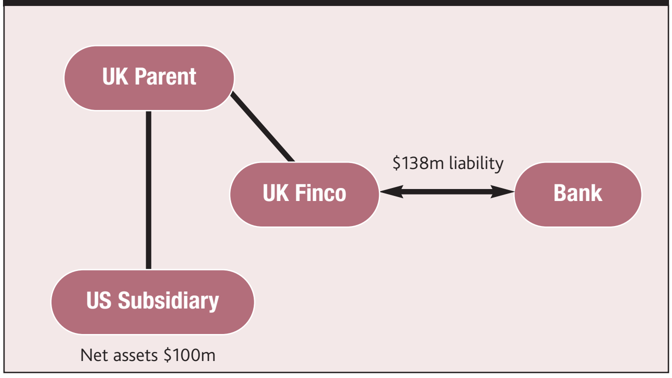
Instead of UK Parent undertaking actual or synthetic dollar borrowing of $100m, it arranges for another company, say UK Finco, to borrow $138m. As UK Finco has no US subsidiary, its borrowings are not subject to the Disregard Regulations. Instead, the foreign exchange differences are taxable/deductible.

Despite having $138m of dollar liabilities and only $100m of dollar assets, the group is not exposed to translation risk as shown by Table 1.

Overhedging was attractive when sterling interest rates were much higher than the relevant overseas interest rate, here dollars. By overhedging, UK Finco is able to borrow (actually or synthetically) an extra $38m without foreign exchange risk, and thereby earn the sterling/dollar interest rate differential on that amount.

Recently, as sterling weakened, HMRC found itself paying out very large amounts of tax relief on foreign exchange losses incurred by corporates using overhedging. Arguments from the corporate sector that the UK Exchequer has generally benefitted, and would benefit in future, from the additional tax revenues overhedging usually gives rise to have been unpersuasive. Instead legislation will prohibit tax relief in respect of losses on the overhedge amount, here $38m. Foreign exchange gains will, however, be taxed; losses can only be offset against future gains from the overhedge. In practice, groups can be expected to stop overhedging. The legislation will also apply to underhedging.

Figure 1: Overhedging



INDEX-LINKED GILTS The inflation uplift in the repayable amount of an index-linked government security is exempt from corporation tax. Apparently this has been used for tax avoidance by companies purchasing index-linked gilts and then insulating themselves from any Retail Price Index (RPI) risk by using derivatives. From 9 December 2009, a company will not be able to treat the RPI-linked uplift on an index-linked gilt as tax-free if the company or the group is not economically exposed to the RPI-related risk of holding the gilt.

REGULATION-MAKING POWER The International Accounting Standards Board (IASB) is proposing some changes to its IAS 39 standard, which are likely to be mirrored in the UK standard FRS 26. These will make a number of changes to the accounting rules for financial instruments. Perhaps most significantly, companies may no longer need to bifurcate convertible securities to account separately for the embedded equity derivative.

It is proposed that instead of amending the tax law to ensure it continues to operate "properly" by primary legislation, power will be given in the Finance Act 2010 for the necessary changes to be made by statutory instrument. While apparently more practical, the danger with secondary legislation is always the risk of a lower level of parliamentary scrutiny.

As usual, the "PBR for treasurers" bears no relationship to the newspaper headlines. The UK tax system is growing ever more complex for treasurers to navigate.

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