TACKLING THE ISSUES OF TAX

MOHAMMED AMIN AND **PAUL MINNESS** OF PwC REVIEW THE PROPOSED REFORM OF THE TAXATION OF TREASURY INSTRUMENTS.

The tax law governing foreign exchange, corporate debt and derivatives was rewritten in Finance Acts 1993, 1994 and 1996. This legislative regime has lasted about seven years, which may account for the Inland Revenue's desire to reform it. Consultations began in December 2000. First draft legislation was published in a consultative document on 26 July 2001. (The Association's response to the consultative document can be found at **www.treasurers.org/corpdebt.html**.)

After receiving consultation responses, many of them protesting about the proposed early commencement date, the Inland Revenue held meetings with representative bodies and with the key professional firms. In the autumn statement on 27 November, it announced that the effective date for the new rules has been put back. Now they will generally apply to accounting periods commencing on or after 1 October 2002. However, several anti-avoidance measures, such as changes to the definition for tax purposes of 'convertible securities', take effect from the original announcement on 26 July 2001. Revised draft legislation is expected during December 2001.

OVERVIEW OF THE CHANGES. Foreign exchange differences will no longer have their own code. Instead, the foreign exchange rules will be assimilated into the corporate debt legislation and the derivatives legislation. While this looks straightforward, there are some far-reaching anti-avoidance implications (see below).

Finance Act 1994 addressed only a limited range of derivatives, essentially covering foreign exchange and interest rate contracts. Since then, derivatives use has continued to grow. The intention is to include all derivatives in the new rules, other than equity derivatives entered into for non-trading purposes. The draft legislation removes the restrictive definitions of "qualifying contracts" so everything is included, and then specifically excludes equity derivatives.

Unfortunately, the current draft rules potentially cover items other than derivatives. For example, the proposed definition of a 'future' includes "… a contract for sale under which delivery is to be made (a) at a future date agreed when the contract is made, and (b) at a price so agreed." This implies that the legislation applies to any contract where an item is delivered at a future date, such as the acquisition of plant and machinery. Clearly not what was intended. Many of the consultation representations to the Inland Revenue suggest that more thought should be given to what is included and excluded.

MATCHING ELECTIONS. The matching rules defer recognition of otherwise taxable foreign exchange differences on liabilities hedging certain qualifying assets (primarily, overseas subsidiaries) until the underlying asset is disposed of. Matching is optional for tax-payers, with a 92-day time limit (from the acquisition of the asset) for making an election, which is retrospective to the date of acquisition.

The Inland Revenue wants to remove the existing 92-day time limit. Instead, matching will be compulsory when an investing company hedges investments with currency liabilities. The removal of the 92-day retrospective election comes as no great surprise. It favoured the taxpayer, since companies could wait to see how exchange rates moved before deciding whether to elect. However, compulsory matching will pose its own problems.

In the example below (see *Table 1*), how are the items to be matched? It could be argued that a pro rata basis is the most sensible approach. But if one of the investments is sold, how will the company decide what part of each liability's exchange differences should now be taxed/deducted? If everything was acquired on the same date, then there should be no problem. But if the assets and liabilities were acquired on differing dates, the impact on the tax return could be significant.

Of course, this example considers a simple situation with only one foreign currency and two assets. If a group has numerous overseas entities and uses a number of currencies to hedge them, the complications and potential compliance burden increase significantly. An easier way to deal with the one-way bet currently enjoyed by companies would be to abolish the retrospection in the election. An election would be effective from the day that it reaches the Inland Revenue. Surely this would be manageable with faxes, but tax law recognises nothing more modern than 'snail' (postal) mail.

ACQUISITION OF IMPAIRED DEBT. Ever since the introduction of the corporate debt legislation in 1996, the Inland Revenue has accepted that there was an unintended consequence from the

TABLE 1
MATCHING ELECTIONS – PROBLEMS

Company Liabilites	Company Assets
Loan 1 $200m	Subsidiary 1 $150m
Loan 2 $100m	Subsidiary 2 $50m

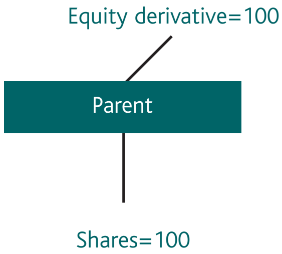
If subsidiary 1 is sold realising, say an exchange gain, what foreign exchange differences on the liabilites should be used to offset the gain? The options include:

a) $150m of loan one
b) All of loan two plus $50m of loan one
c) $75m of each loan
d) $100m of loan one, plus $50m of loan two

Depending on the acquisition dates of the loans, the amount of exchange differences recognised in the tax return could be significantly different.

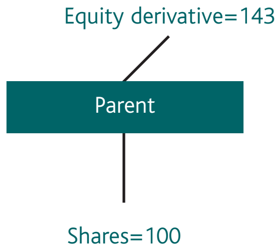
TABLE 2
GROSSED UP HEDGING

EXAMPLE 1 – LEVEL HEDGING



Shares fall in value by 10%	(10)
Equity derivative increases by 10%	10
Tax on equity derivative @ 30%	(3)
Hedge shortfall	(3)

EXAMPLE 2 – GROSSED UP HEDGING



Shares fall in value by 10%	(10)
Equity derivative increases by 10%	14
Tax on equity derivative @30%	(4)
Hedge shortfall	0

connected party bad debt rules. Suppose a company acquires the shares and debts of a company, paying less than full value for the debts. Once the two companies become connected, the parent has to assume that the debt will be repayable in full. For tax purposes, this means writing up a potentially bad debt to its face value and taxing the uplift, despite there being no economic gain. This rule can have potentially devastating effects. We are aware of at least one instance where a company was forced into liquidation by the Inland Revenue's insistence on applying this rule. Despite five intervening Finance Acts, this injustice has not yet been rectified. Even now, amendments to eliminate the problem will not take effect until all the other changes come into force, unlike the anti-avoidance rules which took effect on 26 July.

CONNECTED COMPANIES. The definitions of connection are also changing. The existing rules (based on ICTA 1988 s.416) are very widely drawn, and can connect companies which are genuinely independent. The new rules are based upon a more practical test of control set out in ICTA 1988 s.840. However, the Inland Revenue is concerned about joint ventures. Presently, two joint venturers, who invest equally in the joint venture, are not connected with it. If the joint venture makes losses, the investors can get a double deduction; once for writing down their loans and once as consortium relief in respect of the joint venture's losses.

Accordingly, it is proposed that investors will be connected with the joint venture (thereby, disqualifying bad debt relief) if there are at least two partners each holding at least 40% of the shares. This goes wider than tackling the issue. A more targeted approach would be to directly remove the doubling up of consortium relief and bad debt relief.

ANTI-AVOIDANCE. At present, the foreign exchange, financial instruments and corporate debt rules each have their own, independent anti-avoidance rules. The Inland Revenue clearly prefers the anti-avoidance rule for corporate debt in FA 1996 Schedule 9 para 13, which disqualifies deductions where the loan has an "unallowable purpose". Accordingly, it has decided to also apply it to foreign exchange and derivatives.

Guidance on the new anti-avoidance rules has been promised. However, we are still awaiting guidance on the original corporate debt version promised in 1996. With so much new anti-avoidance legislation, one should never forget a well-established principle from case law. If there are two different ways of carrying out a commercial transaction, the taxpayer is entitled to choose the one that involves him paying the least amount of tax.

A challenging question is whether any anti-avoidance legislation is needed for derivatives entered into with third parties on arm's length terms. Taxing/relieving all derivatives gains and losses would eliminate the need for complex boundaries (such as equity derivatives). If companies were concerned that gains on an equity derivative hedging shares would be taxed, they could simply 'gross up' the hedge as indicated in *Table 2*. However, to protect the taxpayer, certainty of tax treatment is needed, which militates against potentially capricious anti-avoidance rules.

STILL MANY BRIDGES TO CROSS. There is little evidence that the Inland Revenue has considered the possible impact on the siting of international mobile treasury companies. A key requirement when siting a treasury company is certainty as to how its transactions will be taxed. If that is not available in the UK, due to uncertainties in the legislation and the application of anti-avoidance rules, multinational companies may simply choose to move their treasury operations and the related jobs elsewhere.

Also, not addressed are proposed changes to accounting standards over the next few years. These include using International Accounting Standards for all EU-listed companies in 2005 and the use of mark to market valuations for all financial instruments. The failure to either wait for these changes or to anticipate their implications suggests that in a few years' time, another rewrite will be required.

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