MOHAMMED AMIN LOOKS FORWARD TO THE 2005 BUDGET IN THE LIGHT OF THE MAJOR TAX ISSUES AND CHANGES IMPACTING ON CORPORATE TREASURERS.

Europe raises the taxing questions

The baseball player Yogi Berra once said: "It's tough to make predictions, especially about the future." Fortunately for treasurers, many of the tax-related themes that will continue to affect them during 2005 are already known.

IMPACT OF INTERNATIONAL FINANCIAL REPORTING STANDARDS Most of us spent 2004 anticipating the introduction of International Financial Reporting Standards (IFRS) across Europe on 1 January 2005. While International Accounting Standard 39 (IAS 39) never made the front pages of tabloid newspapers, even the President of France developed a new interest in accounting standards, joining us humble corporate treasurers, tax advisors and accountants.

Companies with a 31 December year-end will already have gone

Executive summary

- If a company has existing derivatives that fall within the regulations and has a calendar year end, it must decide to make an election out of the relevant regulation by the 31 March.
- In recent years the governments of the UK and other EMU countries have lost a string of tax cases. During 2005 a number of cases will be working their way through the UK courts with the aim of referral to the European Court. Treasurers must decide whether the issues being litigated are relevant to them. If so, they must decide whether to join in the litigation.

THE BROAD GOAL IS TO ENSURE THAT A COMPANY'S HEDGING TRANSACTIONS RECEIVE THE SAME TAX TREATMENT IN FUTURE AS WHEN ACCOUNTED FOR UNDER 2004 UK GAAP, IRRESPECTIVE OF WHETHER THEY MEET THE STRICT HEDGE ACCOUNTING REQUIREMENTS IN IAS 39.

through the change. However companies with 31 March and later year-ends will still be making plans for the transition. While a change so big can seem overwhelming, treasurers particularly need to think about two key areas, namely hedging and consistency in the adoption of IFRS in subsidiary accounts.

Hedging Under IFRS all derivatives are accounted for at fair value. However, taxing all fair value changes could make a company's taxable profits very volatile. The Government's view is that "where the tax treatment of a hedging instrument and of a hedged item are not broadly symmetrical for tax purposes, the tax system should intervene to ensure that there is no undue volatility in profits or losses for tax purposes."

The broad goal is to ensure that a company's hedging transactions receive the same tax treatment in future as when accounted for under 2004 UK Generally Accepted Accounting Principles (GAAP), irrespective of whether they meet the strict hedge accounting requirements in IAS 39. The tax law changes introduced during 2004 aim to achieve this as follows:

Effective hedges – The accounting will be followed for tax purposes, by taxing the figures in the profit and loss account (P&L). With fair value hedges, changes in the hedge and in the underlying item will both be in the P&L and taxed/relieved. With cash flow hedges, fair value changes in the hedging derivative taken to equity will only be taxed when recycled to the P&L account.

Ineffective hedges and other appropriate situations that don't qualify for IAS 39 hedge accounting will receive special tax treatment, departing from simply taxing the P&L numbers:

- gains and losses on derivatives hedging risks (e.g. foreign exchange) in transactions not recognised in the accounts, such as forecast sales, are deferred for tax purposes until the hedged item affects the P&L. The deferral applies even though gains and losses on the hedge may be included in the P&L as they arise;
- with cash flow hedges of interest rate risk (i.e. hedging floating rate interest into fixed rate interest) fair value changes shown in the accounts are disregarded, and the interest rate hedging instrument is taxed on an 'appropriate accruals basis'. The result is that the net amount taxed equates with the accrual of fixed rate interest. This applies regardless of whether the hedge is effective (fair value movement taken to equity) or ineffective (fair value movement taken to P&L); and
- intended fair value hedges of interest rate risk (i.e. hedging fixed interest instruments into floating rate interest) that fail the IAS 39 tests (so that the loan intended to be hedged is actually not fair valued) are treated in the same way – the fair value movements on the hedging instrument in the P&L are disregarded and the company is taxed on an 'appropriate accruals basis'. The result is that the net amount taxed equates with the accrual of floating rate interest.

In some cases, companies might prefer to ignore the 'tax hedging ' rules above, and simply be taxed (or relieved) on all derivative gains and losses, regardless of where they fall in the accounts. If so, they can elect out of most of the tax hedging rules.

If the company has existing derivatives that will fall within the regulations, an election out of the relevant regulation must be made by the later of

(i) the start of the first accounting period beginning on or after 1 January 2005;
(ii) 31 March 2005.

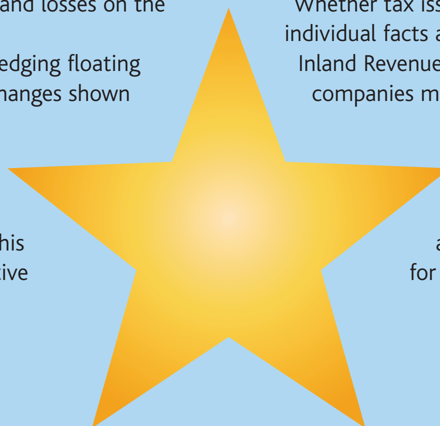
Accordingly, the election in general can only be made prospectively. However, for companies transitioning to IFRS on 1 January 2005, the election allows three months of hindsight. Accordingly, treasurers need to consider carefully whether they wish the tax hedging rules mentioned above to apply to their companies, or to elect out of them. It is a complex decision, needing full consideration of existing derivatives, hedges, and future plans, and may have a significant impact on the tax payable.

Consistency in subsidiary accounts A statutory instrument has introduced Section 227C(1) of the Companies Act 1985: '*(1) The directors of a parent company must secure that the individual accounts of (a) the parent company, and (b) each of its subsidiary undertakings, are all prepared using the same financial reporting framework, except to the extent that in their opinion there are good reasons for not doing so.*'

The goal is to ensure consistent use of either UK GAAP or IFRS, rather than allowing 'mix and match'. However, in certain cases, a group may wish to transition almost all of its companies to IFRS, but find that for some companies there are significant adverse tax implications from moving off UK GAAP. Accordingly, what constitutes 'good reasons' for company law purposes?

The Department of Trade and Industry has issued guidance notes. They do not make any specific mention of tax either as a 'good reason' or otherwise. However, they emphasise the key point that the directors of the parent company must be able to justify any inconsistency to shareholders, regulators or other interested parties.

Whether tax issues are a 'good reason' will depend on the individual facts and circumstances. Informal discussion with the Inland Revenue has established that it appreciates that some companies may choose to remain on UK GAAP because using IFRS would cause additional tax costs or accelerate tax cash payments. I understand that the Inland Revenue is encouraging groups to discuss with it in advance their reasoning for retaining UK GAAP for particular subsidiaries.



EUROPEAN TAX LITIGATION In recent years, the governments of the UK and other EMU countries have lost a string of cases where taxpayers have argued that particular provisions in national laws discriminate against non-residents and contravene fundamental freedoms conferred by the treaties establishing the European Union. Some of the restrictions struck down are:

- the UK rules on consortium relief determined the status of a consortium holding company by only looking at UK subsidiaries (ICI v Colmer);
- the German thin capitalisation rules, which only applied to German companies borrowing from related non-German companies (Lankhorst-Hohorst);
- Finnish tax rules granted taxpayers a tax credit only on dividends received from Finnish companies (Manninen); and
- the French capital gains exit charge on individuals who ceased to be resident in France (de Lasteyrie).

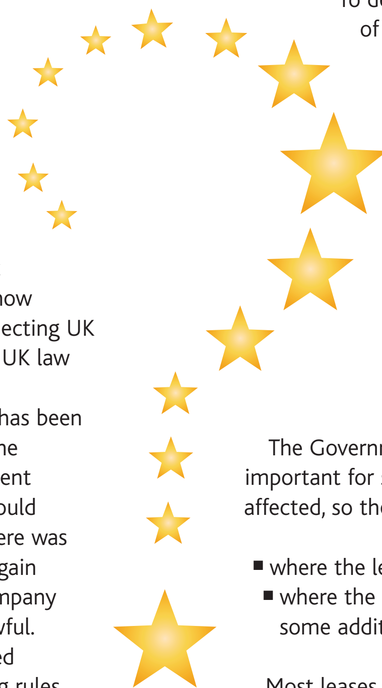
In response, the UK government has been forced to modify UK tax law so that it no longer contravenes European law. A simple example is that UK companies with a common foreign parent can now surrender group relief to each other without a connecting UK resident company, whereas this was not possible in UK law prior to 1 April 2000.

While giving effect to EMU law, the government has been anxious to protect its tax base. For example, after the Lankhorst-Hohorst decision above, the UK government recognised that the UK's thin capitalisation rules would similarly be struck down by the European Court. There was also concern that the transfer pricing rules, which again only impacted upon transactions between a UK company and a related foreign company, would also be unlawful. Accordingly, on 1 April 2004 the tax law was 'levelled down' so that thin capitalisation and transfer pricing rules now also apply to transactions between UK companies.

During 2005, quite apart from any cases involving foreign taxpayers, a number of cases will be working their way through the UK courts, with the aim of referral to the European Court. Indeed some have already moved from the UK to Europe. These challenge various 'basic' principles of the UK tax system such as:

- group relief only being available for losses of UK resident group companies, but not foreign resident loss makers;
- dividends received by UK companies from other UK companies being tax tree, while dividends received from overseas companies are taxable (albeit with double taxation relief); and
- subsidiaries resident in EMU countries being treated as 'controlled foreign companies', with UK parent companies being taxed on various types of 'passive' income of the subsidiary.

The key thing for treasurers to consider is whether the issues being litigated are relevant to them. If so, should their companies join in the litigation, or start filing their tax returns on the basis that the disputed UK provisions are unlawful? Equally, treasurers might want to start considering how UK law might be changed (to be non-discriminatory) if the current litigation is decided in favour of the taxpayer, as the government has made it clear that it wants to protect UK corporation tax revenues. For example, if it is discriminatory to allow group relief only for losses of UK resident group companies, one way to stop discriminating would be to abolish group relief altogether.



LEASING The 'lease or buy' decision is going to become much easier for treasurers, at least for leasing that is entirely UK-UK.

The Government has decided to legislate next year, in Finance Bill 2006. The aim is to broadly equalise the tax treatment of leasing with funding the purchase with a loan.

The proposed new regime will only apply to new leases, presumably those entered into post Finance Act 2006. The taxation of existing leases will remain unchanged.

To define the leases affected, there will be the concept of a 'funding lease'. Any one or more of the following conditions will make a lease a funding lease:

- it is treated as a finance lease under UK GAAP;
- the net present value of the minimum lease rentals is more that 75% of the market value of the asset;
- the minimum term of the lease is more than 50% of the expected remaining useful economic life of the asset; or
- the asset is of such a specialised nature that no other user of the asset could reasonably be expected.

The Government considers that the tax regime is less important for short leases. Only 'long' funding leases will be affected, so the new rules will not apply:

- where the lease term is less than four years; or
- where the lease term is between four and six years, subject to some additional conditions.

Most leases within the new regime will already be accounted for as finance leases. In that case, the tax treatment for both lessor and lessee will effectively end up following the accounts. The lessor will not be able to claim capital allowances, but will only be taxed on the finance charge element of the lease rental payments. The lessee will be able to claim capital allowances, but will only be able to deduct amounts equivalent to the interest contained in the lease rental payments.

The main companies disadvantaged by the new rules will be those expecting to make losses on commencement. To such companies, immediate capital allowances have little value. Effectively leasing transactions (under the current regime) transferred the benefit of the allowances to the lessor, to whom they were of value, with the overall tax efficiency being shared appropriately between the parties.

While these major themes are already known, the Budget may still contain some surprises for treasurers, as well as other taxpayers. Otherwise life might become too predictable.

Mohammed Amin MA FCA CTA (Fellow) AMCT is a tax partner in PricewaterhouseCoopers LLP and UK leader of their Finance and Treasury Network.
mohammed.amin@uk.pwc.com

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