MOHAMMED AMIN OF PRICEWATERHOUSECOOPERS CONSIDERS WHAT THE CHANCELLOR'S BUDGET MEANS FOR CORPORATE TREASURERS.

A BUDGET THAT MEANS BUSINESS

As Chancellor, Gordon Brown has often stated that he wants to create a more entrepreneurial culture, in particular by implementing changes to the tax system. However, every tax change creates the opportunity for tax planning, or tax avoidance, depending on your point of view. Much of the Budget was taken up with countering tax planning. Along the way, there were some worthwhile modernisation changes announced, as we will explain in this article.

INTERNATIONAL FINANCIAL REPORTING STANDARDS

All EU-listed companies must use International Financial Reporting Standards (IFRS) for their consolidated accounts for periods beginning on or after 1 January 2005, which is less than nine months away. Accounts drawn up in accordance with either IFRS (as approved by the European Union) or UK Generally Accepted Accounting Principles (UK GAAP) will be acceptable for tax purposes for periods beginning on or after 1 January 2005.

ACCOUNTING METHODS. The concept of 'authorised accounting methods' adopted within the corporate debt and derivative contracts tax regimes will be replaced with a single requirement that GAAP be followed – be that IFRS or UK GAAP. Exceptions will remain where a particular accounting method must be followed, for example, transactions between connected parties. The Inland Revenue (IR) is concerned that a tax advantage could arise if one group company uses UK GAAP and another uses IFRS. If a transaction directly, or indirectly, between two such companies produces a tax advantage, then the IFRS company will be taxed as if it had used UK GAAP for that transaction. No tax avoidance motive is needed for this rule to apply.

HEDGE ACCOUNTING. IFRS has strict documentation and effectiveness tests before a company may 'hedge account' for transactions it undertakes to manage identified foreign exchange, interest rate or other business risks. Sometimes companies adopting IFRS will be unable to adopt hedge accounting in circumstances where they would have previously been able to under UK GAAP. Hedging will be allowed for tax purposes, even if possibly failed for IFRS purposes, in certain cases, as follows:

- where, under current UK GAAP, currency contracts would be held off-balance sheet to hedge future revenues and other forecast transactions;
- where interest rate swaps are used to hedge balances that are themselves not fair valued under IAS; and
- liabilities held to hedge investments in overseas subsidiaries against translation risk.

EMBEDDED DERIVATIVES. Under IFRS, instruments such as convertible bonds that contain an embedded derivative are often divided in two, with the derivative being accounted for separately to the debt. If applied in the accounts, this treatment will be followed for tax purposes, with the host instrument wholly within the existing loan relationship tax regime, and the embedded derivative being taxed within the existing capital gains tax rules.

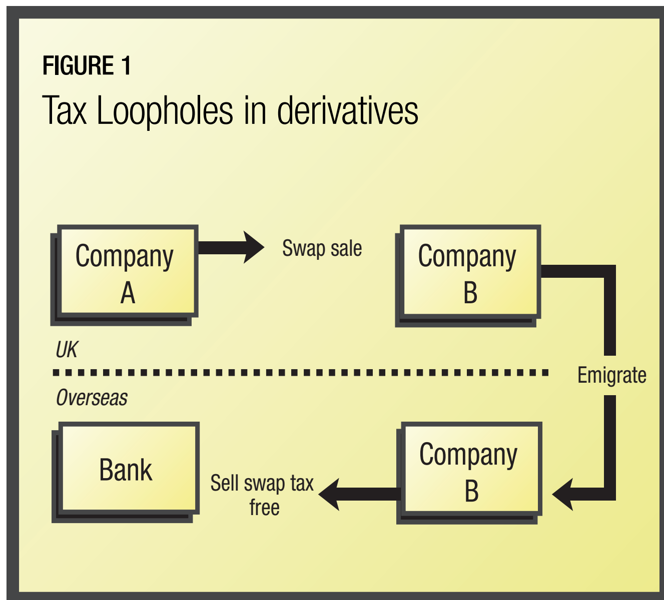
UK-UK TRANSFER PRICING AND THIN CAPITALISATION

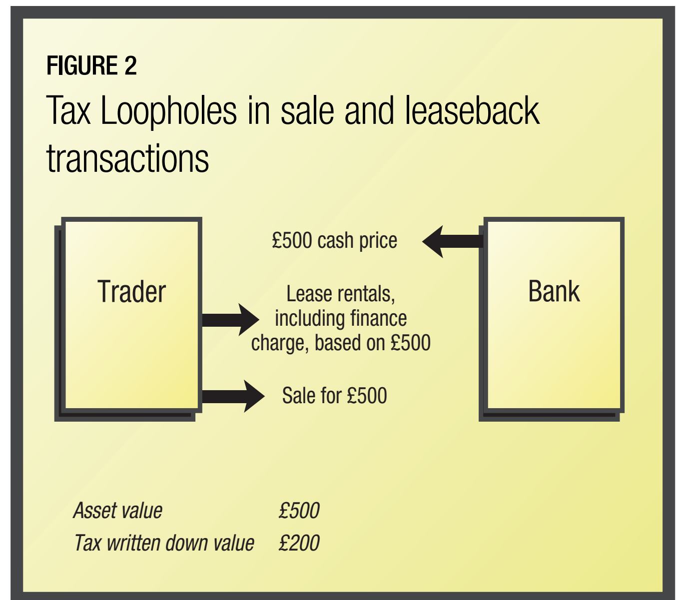
These rules came into force on 1 April 2004, as announced in the Chancellor's 10 December 2003 Pre-Budget Report. Two changes to the rules will aim to tackle potential problems:

- Companies that are dormant on 1 April 2004 will be exempt from the transfer pricing rules for as long as they remain dormant – this avoids needing an audit or filing a tax return.
- Tax liabilities arising from transfer pricing adjustments to the profits of special purpose vehicles (SPVs) set up in securitisations – these may, by election, be met by companies outside the securitisation structure, which will require IR approval.

LOAN RELATIONSHIPS AND DERIVATIVE CONTRACTS

The new rules enacted in the Finance Act 2002 continue to be revised. The most important change blocks a potential loophole that could allow profits on loan relationships or derivative contracts to be realised tax-free (see *Figure 1*). The sale of a valuable swap





'THE INLAND REVENUE IS CONCERNED THAT A TAX ADVANTAGE COULD ARISE IF ONE GROUP COMPANY USES UK GAAP AND ANOTHER USES IFRS'

from Company A to Company B would be tax-free if both companies were UK resident and members of the same group. Company B then proceeds to transfer its residence overseas. Once non-resident, it could sell the swap for cash without the profit being taxable in the UK. The same idea could be applied to loan relationships such as bond investments. The law is to be changed to impose an 'exit charge'. Gains on loan relationships and derivative contracts held by a UK resident company will be charged to tax when, on or after 17 March 2004, the company ceases to be UK resident.

'DOUBLE BENEFIT' LEASING

New legislation will restrict relief for finance lease rentals to attack certain sale and leaseback or lease and leaseback transactions. As a result of legislation introduced by the Chancellor in 1997, *Figure 2* shows that on this sale and leaseback, the tax written down value (TWDV) of £200 is removed from the trader's capital allowances pool, but there is no tax on the £300 excess of the sale proceeds over TWDV. The IR contends that the trader has borrowed this £300 from the bank and unfairly receives tax relief for both the finance cost and repaying the £300 in lease rentals.

A similar effect could arise if the trader granted the bank a lease over the asset for a premium, which is treated as a tax-free capital sum, and then entered into a sub-lease back paying deductible periodic rentals. The legislation will restrict the amount of the tax-deductible finance lease payments. In the case of a sale and leaseback, the deductible amount will be limited to the sum of:

- the finance charge element of the lease rental as shown in the accounts; and
- the disposal proceeds brought into account for capital allowances purposes, in our example the £200 as spread over the life of the lease, in proportion to the depreciation of the leased asset.

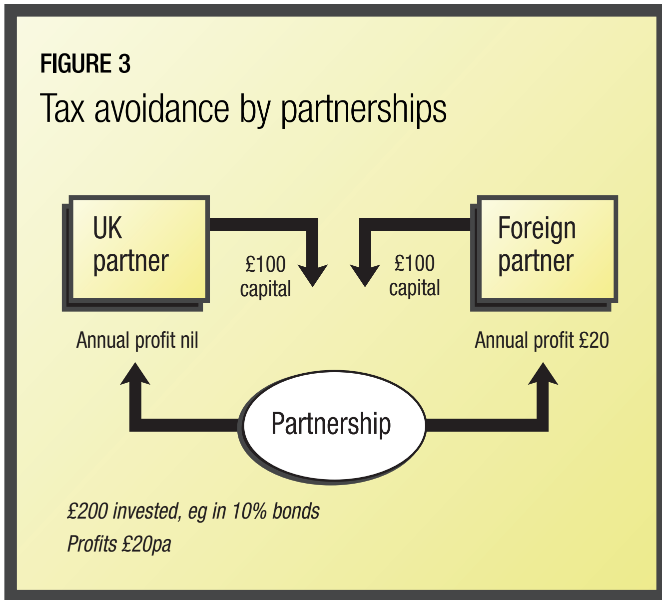
In a lease and leaseback, as no disposal proceeds will be brought into account for capital allowances purposes, the deductible amount will simply be the finance charge element of the lease rental. There will be similar reductions in the amounts on which the lessor will be taxable.

The new legislation will apply to all rentals payable arising on or after 17 March 2004, irrespective of when the transaction took place. The effect will be to significantly worsen the tax position of traders that have previously undertaken such transactions, while providing an equivalent benefit to the banks that acted as lessors on those transactions.

COMPANIES IN PARTNERSHIP

New legislation will impose a tax charge on a company that realises capital from a partnership, to counter the scope for tax avoidance. For tax purposes, profits and losses are computed for the partnership as a whole and then allocated to the partners. However, the profit allocation can be arranged so as to reduce liabilities to UK corporation tax, as in *Figure 3*. Over 10 years, the foreign partner receives £200 of income, not taxed in the UK. The foreign partner's capital is then extinguished, so the UK partner receives £200 of capital from the partnership. Each partner has doubled their money, but the UK partner has had no taxable income. Where the legislation applies, the UK company will be taxed on the lower of:

- the amount of capital withdrawn from the partnership; and
- the partnership profits, arising on or after 17 March 2004, which would have been taxed in the UK if profits had been allocated in proportion to partnership capital.



DISCLOSURE OF TAX AVOIDANCE SCHEMES

After 1 August 2004, tax scheme promoters will be required to provide details of certain schemes to the IR shortly after they are first marketed, including a description of the scheme, its tax consequences and the statutory provisions relied on. The proposals target schemes based on financial products and employment-based products.

The IR will register each scheme and allocate a reference number, which taxpayers using the scheme will be required to include on their tax return. Where a scheme has been purchased from an offshore promoter or devised in-house, the taxpayer himself will be required to disclose details to the IR shortly after it is purchased or first implemented.

Registration will not change the tax treatment. However, the requirement is clearly intended to ensure that the IR learns about schemes early so that the law can be changed rapidly to block any perceived loopholes.

PENSIONS TAX REFORM

The government's proposals for changes to the tax rules governing pensions are to go ahead, largely unchanged, albeit with implementation delayed by a year to 6 April 2006 and the initial lifetime allowance revised to £1.5m. While there is insufficient space here for a full analysis of this issue, treasurers should note that, for persons well below the £1.5m lifetime allowance, the changes dramatically increase the amount of pension funding possible. Pension contributions can be up to the lower of 100% of salary or £215,000 per year. Consider renegotiating the salary package for maximum tax efficiency.

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