Sticks and carrots


NEIL EDWARDS AND **GRAHAM WILLIAMS** ASSESS THIS YEAR'S BUDGET.

The Budget on 23 March 2011 (and the Finance Bill issued on 31 March 2011) confirmed the introduction of the corporate tax reforms and anti-avoidance measures announced in December. The chancellor, George Osborne, also announced a surprise additional 1% reduction in the UK corporation tax rate on top of the reductions announced last year; the full UK rate will now be 26% from 1 April 2011, falling to 23% from 1 April 2014.

The various tax changes include a combination of a fair bit of stick but also some carrots for UK companies. The stick is a continuing emphasis on closing the tax gap. As part of this a series of anti-avoidance measures have been announced, some of which may affect benign transactions. On top of the rate reduction, the main carrot is the ongoing reform of the UK's controlled foreign companies (CFC) regime, including confirmation of the proposals for a low-tax offshore finance company regime. There are also changes enabling companies to hedge foreign exchange (FX) risk on a post-tax basis more effectively.

THE STICKS

■ **Group Mismatch Scheme** An important change is the introduction of the Group Mismatch Scheme (GMS) provisions. The rules are designed to counteract arrangements which result in a tax deduction in one company but no corresponding tax charge or a deferred tax charge in the counterparty. The GMS rules are broadly drafted and principles-based in an effort to prevent avoidance. They are designed to ensure tax neutrality on loan relationships and derivative contracts between group companies.

However, it is unclear how the GMS rules will interact with existing tax code rules which are intended to apply in an asymmetric manner. For example, to ensure an effective post-tax hedge, foreign currency debt used to hedge a group's net investment in foreign operations may be lent to another group company. This eliminates any tax effect of the borrowings of one group company, let's call it UK 1 (see Figure 1), moving the tax exposure to another group company (UK 2) which does not tax any gain and losses using the tax matching rules. As a result of this asymmetric treatment of the parties, the loan between UK 1 and UK 2 could be argued to be a GMS.

The changes made to the most recent draft of the provisions try to amend the conditions that must be met for a scheme to qualify as a GMS. If the scheme may result in a tax disadvantage (as in any case involving hedging where an FX gain rather than a loss may arise on the loan in UK 1), it is necessary to consider the amounts and probabilities of the potential advantage or disadvantage and then determine whether the expected value of the scheme is positive. HMRC seems to consider there is an equal chance of realising an FX gain as a loss so that the loan from UK 1 would not be a GMS. This approach is overly simplistic, and is clearly not effective for hedging arrangements such as options and participating forwards.

Further clarifications may be made before the Finance Bill is enacted, but for now it appears that the GMS provisions may need to be considered when looking at most intragroup transactions involving loan relationships or derivative contracts.

■ **FX movements arising on a change in functional currency** New provisions counter tax avoidance involving a change in the functional currency of an investment (i.e. a non-trading) company. The new rules are designed to ensure that, in the period in which a UK-resident investment company changes its functional currency, no FX gains or losses arising from loan relationships or derivative contracts will be brought into account. The rules will apply for accounting periods beginning on or after 1 April 2011.

■ **Matching against own share capital (reverse matching)** Many companies with unhedged foreign currency receivables (often intragroup loans to foreign subsidiaries which are considered equity at group level) have used these rules to ensure that losses and gains are tax-neutral. It is expected that changes will be made to these provisions for accounting periods commencing on or after 1 July 2011, and that the potential scope to use these rules to hedge intragroup loans for tax purposes is likely to be curtailed significantly. Some companies will need to act quickly to find an alternative means of hedging these FX exposures for tax purposes. The functional currency election discussed below is likely to be an option in some cases.

■ **Corporate capital gains reform** Current tax legislation includes provisions to prevent value from being extracted from a company in a tax-free manner in situations where HMRC would expect a taxable gain to arise. The Finance Bill 2011 replaces the existing rules with a single provision which, due to the broad drafting, could catch many previously unaffected "routine" transactions. Companies have until July to consider their impact and consider whether further action is required. HMRC's draft guidance suggests it will look to apply the rules where groups are attempting to mitigate capital gains that have arisen due to FX movements on subsidiaries, even where there is no disposal outside the group and the company is simply being liquidated or struck off.

■ **Derecognition** Loan relationships and derivative contracts are generally taxed by reference to the amounts recorded in the accounts. This has encouraged avoidance where loans and derivatives may no longer be recognised (or are derecognised) for accounting purposes even though they still legally exist. A new principles-based regime has therefore been introduced. The rules, which apply from 6 December 2010, override accounting derecognition for tax purposes where it arises as a result of tax avoidance arrangements. A purpose-based filter should ensure that benign transactions are unlikely to be impacted.

Figure 1: The Group Mismatch Scheme

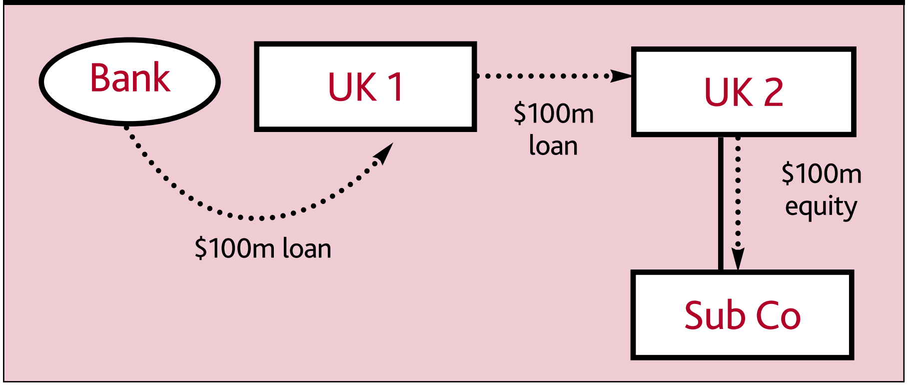
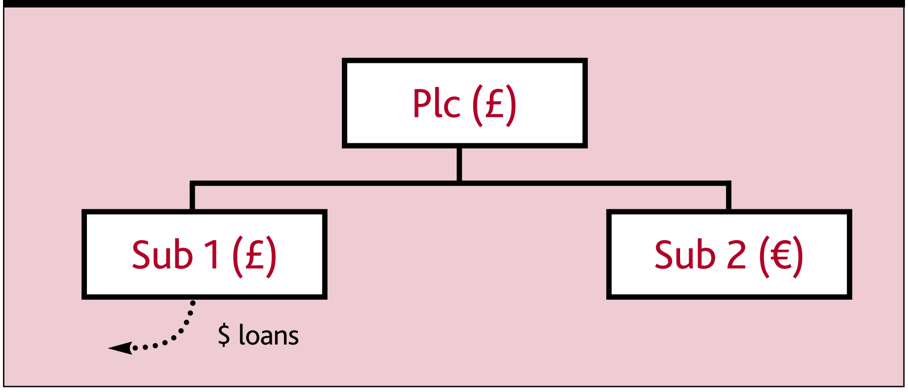


Figure 2: Designated currency election



THE CARROTS

■ **Designated currency election** The Finance Bill 2011 provides companies with a new tool for hedging FX for tax purposes. For accounting periods beginning on or after 1 April 2011, investment companies can elect for a designated currency to be used for tax purposes that is different to the currency used in the company's accounts.

The election must be made before the start of the accounting period for which it is to have effect. To enable companies with March year-ends to utilise the election immediately, companies have been able to make the election since 9 December 2010.

Newly incorporated companies may opt for the election to apply from the date of their first accounting period.

The election may apply in the two situations illustrated below:

1 A company (such as Sub 1 in Figure 2) can elect to use a currency other than its book functional currency as its designated currency for tax purposes if a significant proportion of its assets or liabilities are denominated in that currency (here potentially US dollars).

2 A company (such as Sub 2) can elect to use a currency other than its book functional currency as its designated currency for tax purposes on the basis that it is the functional currency of Plc, the ultimate parent company of the group.

The designated currency election is likely to be widely used by groups seeking to avoid tax exposures to FX gains and losses on intercompany loans.

■ **FX exposures on share disposals and acquisitions** It is not always currently possible, without further structuring, to hedge on a post-tax basis FX exposures arising from a disposal of a subsidiary where the proceeds arise after the date of disposal. Budget 2011 announced that changes would be made to enable companies to match the disposal proceeds and defer the FX movements until the proceeds have been received. We understand that the rules will also ensure that the FX movements are taxed in the same manner – i.e. they will attract capital rather than income treatment. Finally, the rules may be extended to deal with similar issues around hedging FX exposures arising on the acquisition of subsidiaries. The rules are expected to apply to accounting periods beginning on or after 1 January 2012.

■ **Overseas financing companies** While the Budget contained very little detail in relation to the corporate tax reform proposals published in November (see Andrew Roycroft's article in the March edition of The Treasurer, page 28), the chancellor announced that the effective UK tax rate imposed on companies within the finance company regime will be 5.75% (rather than the 8% previously proposed). This is based on a debt-equity ratio in the CFC of 3:1 and the new 23% corporate tax rate which will apply from 1 April 2014. Further details about the new regime will be released later in the year.

Neil Edwards is a partner, and Graham Williams is a director, in PwC's Finance & Treasury Tax Network.
neil.edwards@uk.pwc.com
graham.j.williams@uk.pwc.com
www.pwc.co.uk/budget