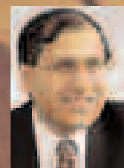
Treasury tax: where are we now?



MOHAMMED AMIN OF PRICEWATERHOUSECOOPERS TAKES STOCK OF THE INCREASING TAX COMPLEXITY FACING TREASURERS.

In the April issue of *The Treasurer* I shared my initial reactions to the Budget. Since then, we have had three Finance Bills, two Finance Acts as well as more Statutory Instruments. Treasurers are expected to absorb all this while doing their day job of managing their organisation's funding and liquidity. To illustrate how complex the treasurer's life has become, I want to look at three relatively common scenarios.

COMPANIES WITH INTEREST-TYPE ASSETS Much of the Budget was concerned with countering perceived tax avoidance. The first Finance Bill proposed radical changes to the taxation of companies owning shares in other companies which in turned owned assets giving an interest-like return. If one looks at the group in *Figure 1*:

- Holdco B would, of course, be taxed on the interest earned on its cash deposit.

- Holdco A owns shares in Holdco B. Holdco B owns a cash deposit, so one would expect Holdco B's shares to increase in value over time, reflecting the return on the cash deposit. Accordingly, Holdco A would be required to mark to market its shareholding in Holdco B each year end, with the gains being taxed as income. This is of course double taxation, as Holdco B has already been taxed on the interest income.

- Parent's shareholding in Holdco A would get the same mark to market treatment, since Holdco A's asset (namely Holdco B) is one expected to increase in value like a cash deposit. Now it is triple taxation.

HM Revenue & Customs agreed that such multiple taxation was not actually intended, and the proposals were radically revised. The key changes being:

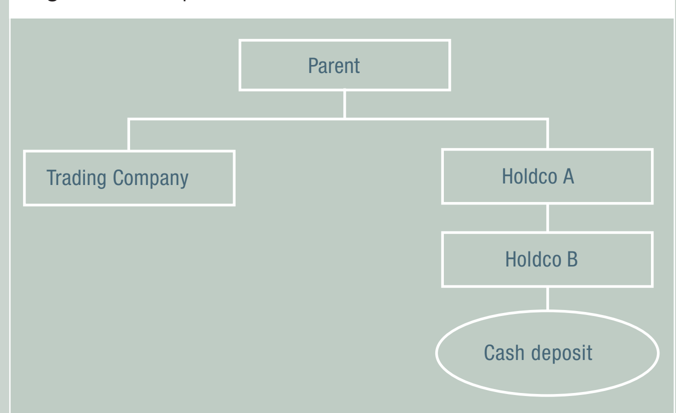
(1) Assets (such as a cash deposit) that give rise to regular periodical income are, in general, acceptable and will not taint the Holdco B shares. Accordingly, Holdco A will not have to mark to market Holdco B's shares.

(2) If Holdco B happens to own 'bad' assets so that Holdco A has to mark to market its investment in Holdco B at each year end, then the Holdco A shares are expressly excluded from getting the same mark to market treatment in the hands of Parent. This is intended to prevent the tax charge multiplying as one goes up the corporate chain.

While the changes have reduced the risk of 'collateral damage' from these anti-avoidance rules, I think there is still scope to fall into the new rules inadvertently, with potentially significant adverse tax consequences. Accordingly, every group company should be reviewed to ensure there is no impact. Don't forget to review foreign companies, as the Controlled Foreign Companies (CFC) rules will apply these rules when assessing the CFC status of your foreign subsidiaries.

SUPPLY CONTRACTS DENOMINATED IN FOREIGN CURRENCY By now, most treasurers will be familiar with International Financial Reporting Standard (IFRS) treatment of convertible debt. However, embedded derivatives can often be found inside contracts that are not loan relationships. In *Figure 2*, Seller and Buyer are both assumed to be UK companies with a sterling functional currency. The commodity being sold in the supply agreement is one normally priced in sterling. However, Seller and Buyer have contracted for prices in

Figure 1. Group structure



Executive summary

- Many Budget provisions were concerned with anti-avoidance and although some provisions have been revised treasurers need to be wary of unintended consequences.
- Despite extensive consultation the tax law is still failing to cope satisfactorily with common situations.
- Treasurers need to think seriously about the need to have access to tax expertise at all times.

dollars, perhaps under guidance from their parent companies.

The treasurer should not be surprised if his accounting colleagues decide that the supply agreement in dollars should be bifurcated into a supply agreement priced in sterling and a series of £/$ currency forward contracts being the embedded derivatives. The embedded derivatives are then marked to market, like other derivatives under IFRS. What is the tax treatment?

After much thought and consultation, tax law requires the bifurcation to be ignored for tax purposes when computing profits arising from the supply contract. However, a company can elect to have the bifurcation respected for tax purposes. While the election is irrevocable, an element of hindsight is possible since the time limit for electing is the end of the first applicable accounting period ending on or after 17 August 2005. Depending on the facts, making an election may accelerate tax relief.

DOLLAR BOND SWAPPED INTO STERLING Despite all the consultation mentioned above, tax law still fails to cope satisfactorily with some very common situations. In *Figure 3*, Borrower has issued a 20-year fixed-rate dollar bond and swapped the proceeds into floating rate sterling. Under UK Generally Accepting Accounting Principles (GAAP), it would have accounted for the bond as a floating rate sterling obligation, fixed at the exchange rate specified in the currency swap contract.

Under IFRS, the bond liability will be retranslated each year, with foreign exchange differences taken to the profit and loss account. The currency swap will also be marked to market with value changes taken to the profit and loss account. Movements on the bond and the swap will not cancel out exactly, as the swap revaluation takes account of its future fixed interest rate dollar payments, while the bond is simply being retranslated for foreign exchange movements.

The tax treatment of this very simple and commonplace structure is still unclear. While regulations were laid before Parliament last December as the Loan Relationships and Derivative Contracts (Change of Accounting Practice) Regulations 2004 and the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004, the regulations have already been amended by statutory instrument and more amendments are planned. Accordingly, eight months into their first IFRS year, companies still do not know definitively how this arrangement is taxed.

It is tolerably clear that, year by year, the currency swap will be treated on an accruals basis in the tax return, retranslated only for foreign exchange fluctuations, so the taxable IFRS results for the bond and swap together should be the same as they would have been under UK GAAP. It is less clear how the transitional adjustments will be dealt with, i.e. what do you do with the difference between the closing UK GAAP value on say 31 December 2004 and the opening IFRS number on 1 January 2005?

The existing text of the Regulations produces asymmetry between the treatment of the swap and the bond.

NEVER STOP THINKING ABOUT TAX When such simple situations can give rise to difficult tax considerations, treasurers knows they can never stop thinking about tax when undertaking any transaction. One arrangement that helps is relocating one or more members of the tax department into the treasury department so that they are always on tap. That can also be a first step towards internal recruitment for the treasury function!

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Figure 2. Seller and buyer

Figure 3. Fixed-rate dollar bond