TAXREP 24/01

CORPORATE DEBT, FINANCIAL INSTRUMENTS AND FOREIGN EXCHANGE GAINS AND LOSSES

Text of a memorandum submitted in October 2001 to the Inland Revenue in response to a consultation document published on 26 July 2001

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INTRODUCTION

1 We welcome the opportunity to comment on this consultation. We also welcome the positive and thoughtful approach adopted by the Inland Revenue to this consultation.

2 We commented on the previous Technical Note which was published in November 2000; our response was published as TAXREP 01-01.

3 We welcome the use of the 'working party' approach and are pleased to have been represented. Our detailed comments on the proposals have been made via representatives at the working party meetings. We have set out below the major points that arise.

GENERAL COMMENTS

4 We are concerned about the proposed start date for the new rules. The proposals in this consultation document are both complicated and highly technical and there are many areas of detail that still need to be resolved. We doubt that many practitioners understand the impact of all of the changes set out in this document; even practitioners who specialise in this area are finding it difficult to understand all of the ramifications of these proposals. We think that more time is needed to refine the draft legislation. Given that this reform requires further work to bring it to a successful conclusion, the proposed start date of 1 January 2002 now looks unsatisfactory. For many taxpayers, the first accounting period affected by the new rules will already have been running for some time before the legislation comes into force, and probably before we have even seen a final draft of the rules.

5 Given that the start date has already been announced as 1 January 2002, we suggest that it would be reasonable to allow 'grandfathering' for any accounting period which begins on or after that date but before the enactment of the Finance Bill 2002. A precedent for this approach can be found in paragraph 8 of Schedule 3 to the Capital Allowances Act 2001 where anyone affected by changes in the law can elect that the changes do not apply for the chargeable period straddling the commencement date of the rewritten legislation.

6 We are disappointed that the opportunity was not taken to rewrite all of these provisions from scratch in the Tax Law Rewrite style. The approach adopted, i.e. amending further the existing rules, has not helped to simplify what are some of the most complicated tax rules in the UK.

7 It will be important to ensure that existing guidance on these rules is updated to explain to the non-specialist, so far as is possible given the complicated subject, how the legislation works in its amended form.

SPECIFIC COMMENTS

Chapter 3: The assimilation of Forex

Paragraph 3.9

8 The purpose of matching was always that if a currency asset was hedged by a debt the hedging effect should not be defeated by asymmetrical tax treatment of the asset and liability. We presume this is why the existing regulations bring the deferred Forex charge back in as a capital gain or loss.

9 We think the same logic should still apply: it should come in as a capital gain or loss. Further, the deferred Forex charge should be exempt if the matched asset is a qualifying shareholding within the new regime for substantial shareholdings. In any event, charging the deferred gain as a loan relationship credit would leave one unable to offset a capital loss on the asset against the deferred gain which is supposed to match it and so would defeat the purpose of the matching.

Paragraph 3.10 - deferral relief

10 We note that the Government proposes not to retain this relief. In our response to the November 2000 Technical Note, we argued that this relief should be retained. We stated in our earlier representation (at paragraph 23) that *'this particular relief was introduced for reasons specific to foreign exchange transactions. We believe that the original reason for deferral relief was that the volatility of currency movements made it particularly likely that a regime which recognises unrealised profits for tax purposes could cause cash flow problems for a company with a sudden very large forex gain. We do not think that the circumstances have altered such that this relief is no longer appropriate or necessary and we therefore think that it should be retained.*'

11 We note the Government's statement that 'an examination of a number of deferral relief claims suggests that it is no longer necessary', but it is difficult to agree with this conclusion in the absence of any further details as to what examination was undertaken. We therefore remain of the view that it should be retained.

Paragraphs 3.15 - 3.18 Transitional rules

12 As we stated in our earlier representation, *'the transitional rules were introduced for good reasons and after extensive consultation, with the intention that they would operate until the relevant event occurred, which would normally be the disposal of an asset or liability. It would be wrong to defeat taxpayers' legitimate expectations by bringing them to an end prematurely.'*

13 We suggested in our earlier representation that an alternative approach would be to allow taxpayers to elect out of the transitional regime at this stage if they prefer to avoid the continuing compliance obligations. We still think that this approach would be a reasonable compromise.

Paragraph 3.19 - Trading assets and liabilities

14 Regulation 6(3) assets should give rise to chargeable gains or allowable losses, but subject to an option to have a loss treated as a non-trade debit.

Forex draft legislation

15 Paragraph 17 inserts a new section 94A into the FA 1993. Section 94A is itself a re-enactment (with minor modifications) of section 135A, FA 1993, which was inserted by section 106(7), FA 2000. Whilst we appreciate that this is re-enacting an existing provision, we think that this review provides an opportunity to re-examine this provision.

16 Section 135A is a wide-ranging anti-avoidance provision that is too uncertain in its application and enables the Revenue to tax exchange gains with hindsight. It is important to remember the policy purpose behind the FA 2000 changes was to increase the attraction of the UK as a base for group financial and treasury operations and eliminate the tax effect of exchange gains and losses which have no commercial relevance to a company which prepares its accounts in a currency other than sterling. The inclusion of a wide-ranging anti-avoidance provision within those changes appears on the face of it to defeat the objective of the rules. We appreciate that the Government needs to counter tax avoidance, but this provision should be deleted and replaced with a targeted provision more in keeping with the underlying policy purpose.

Other points

17 Off balance sheet forward contracts used to hedge long-term receivables will be taxed because sections 150(6) and (11) of FA 1993 are not reinstated in the proposed new rules. This should be corrected so that companies that hedge their foreign exchange exposure in this way are taxed in accordance with their accounting treatment.

18 The matching rules should include currency contract liabilities as well as debt.

Chapter 4: Extending the scope of financial instruments

Paragraph 4.11

19 The present draft definition of a future appears too wide and includes any transaction where the normal terms of sale include delivery at a later date.

Paragraph 4.14

20 The definition of 'derivative contracts' should at least exclude any contract, whether a 'future' or an option, which actually results in the acquisition or disposal of an asset which is within the capital gains tax (CGT) regime. In principle, contracts which are used to hedge assets within the CGT regime should also be excluded, but since a formal matching regime seems to be impracticable, this should be done by excluding as 'equity derivatives' those types of instrument which are most likely to be used for such hedging. This appears to be what the consultation document is suggesting but we would welcome clarification.

21 Equity derivatives are best identified by reference to the nature of the underlying assets and should at least include contracts relating to listed shares and indices thereof.

22 An option to sell a subsidiary, or land held on capital account, should also be excluded from the financial instruments regime, whether or not it is exercised and whether held by a trading or an investment company. There are various ways this could be done but the precise method will depend upon the approach adopted to defining equity derivatives.

Chapter 5 - Connected persons and bad debts

Definition of control

23 We welcome the proposal to base the definition of control on that found in section 840, ICTA 1988.

Proposed rules

24 Paragraph 2 amends section 87, FA 1996 to extend the meaning of connection between two parties to include a participator and a close company. However, this has the result that any company holding shares in a close company will be connected with that company. The result will be that no tax relief will be available where the participator company loaned money to the close company which became a bad debt. This is far too wide and will catch many straightforward commercial arrangements, for example where a bank has taken an equity interest in a close company borrower. We consider that bad debt relief should only be restricted where the participator has control of the close company, but at the least the new restriction should not apply to loans made in the normal course of the lender's business.

25 The major interest test set out in section 87A(3) is another new restriction, and we are concerned that this too will prevent relief for genuine commercial transactions where the debt ultimately proves to be bad. Again, this proposed test appears too wide and if the Government is concerned about tax avoidance, then it should instead propose targeted legislation.

26 We welcome the reversal of the case *Toshoku Finance Plc, Kahn and another v CIR* [2000] STC 301. However, it appears that relief will not be available where, for example, a company is placed into administration rather than liquidation. This treatment will not encourage a 'rescue culture', as the debtor will only obtain tax relief if the creditor is put into liquidation.

27 Paragraph 6 of Schedule 9 FA 1996 sets out the basic assumption that debts will be repayable in full, subject to certain assumptions. Paragraph 5(5) of Schedule 2 in the draft legislation inserts a new sub-paragraph (5A) into paragraph 6, which allows this assumption to be not applied where the debt was acquired at a price which did not exceed 75% of the amount which would be required to pay the debt in full.

28 The Government has accepted that the existing treatment of impaired debt is unfair. It is no less unfair, and the amounts involved could still be extremely large, if the degree of impairment is only 20% or indeed 1%. A threshold of this sort is sometimes

justified on the grounds that it avoids the need to enquire whether the rule in question applies in marginal cases, for example where a question of market value is involved. However, that argument is not relevant here since both the price paid for the debt and the amount required to pay it in full will be known exactly.

29 Where the transaction is at arm's length (as is required in any event), we do not see why there should be a minimum level of impairment required. In the event that the Government's policy is to have a minimum figure, then the 25% threshold appears too high. We suggest that a threshold of 5%, i.e. a requirement that the price should not exceed 95% of the amount required to pay the debt in full, would be more reasonable.

30 Paragraph (5A) also needs to be extended to cover the case where the company in question acquires the impaired debt by an intra-group transfer from a company which itself acquired it in a transaction meeting the requirements of sub-paragraph (5A)(a). Otherwise the intra-group transfer, perhaps undertaken in the course of a group reconstruction some time after the original acquisition, will result in the transferee having to write the debt up to full face value for tax purposes. This is a particularly nasty trap, and one which is not justified by the criterion suggested in paragraph 5.5 of the consultative document i.e. whether the group had the benefit of tax relief for the original loss.

31 We also request that paragraph (5A) be given retrospective effect since it is correcting a manifest injustice, so that any company which has had to write up the value of an impaired debt in circumstances where paragraph (5A) would have applied can write it down again.

Partnership rules

32 The partnership clauses set out in section 87A do not appear to achieve what the consultation says they are designed to achieve, namely to reverse the practice set out in SP 4/98. We assume that only the paragraphs of SP 4/98 which deal with section 87 are meant, but even so those paragraphs are concerned with the application of section 87 to loans between a partnership and its members, whereas the draft legislation seems to be concerned with the treatment of loans made by a partnership to a company which it controls.

33 Although we are broadly in favour of the approach taken by the draft legislation, i.e. attributing rights held by a partnership to its members in proportion to their profit-sharing ratio, it is unclear what the effect of the new section 87A(10) is actually intended to be, given that taxable profits still have to be computed initially at the level of the partnership and it is still the partnership which is the party to the loan relationship. As we said in the previous consultation we believe that a partner should not be denied relief for his share of a bad debt on a loan made by the partnership to a company, if he does not actually have control of either. This implies that two separate computations should be required under section 114 if there is another partner who, applying the attribution rule in section 87A(10), does have a controlling interest in both and is therefore affected by the restriction on bad debt relief.

Chapter 7: Arm's length and other rules

Extension of 'unallowable purposes' rule

34 We remain opposed to the extension of the 'unallowable purposes' rule in the loan relationships legislation to cover Forex and financial instruments. We maintain that anti-avoidance rules should be properly targeted. We said in our earlier representation that:

> *13 We are opposed to anti-avoidance rules based on broad criteria such as the 'main benefit' test found in section 135, FA 1993 or the 'unallowable purposes' test found in paragraph 13 of Schedule 9, FA 1996. Whilst of course we understand the need for measures to prevent abuse, any such measures need to be properly targeted. Our objection to the above measures is that they are too broadly drafted with the result that uncertainty is created. This is a particularly serious problem under CTSA.*
>
> *14 Avoidance by means of non-arm's length transactions can and should be dealt with specifically rather than by having three separate sets of special rules. We suggest that the appropriate anti-avoidance rule should be to extend the transfer pricing provisions of Schedule 28AA, ICTA 1988 to the three regimes in question.*
>
> *15 Beyond that, the anti-avoidance rules should be certain and not give the Revenue wide powers to decide for itself whether or not a particular commercial transaction, which may produce some tax saving, is acceptable. If the Revenue regards any particular type of transaction as abusive, then it should be dealt with by specific targeted rules.*

35 In any event, since the effect of a financial instrument is generally the net result of cash flows in both directions, it is wholly unreasonable that the draft section 168A, FA 1994 excludes the payments on a contract with an unallowable purpose but not the receipts. Further, the proposed amendment to paragraph 13 (described in paragraph 7.11 of the consultative document) does not go far enough. It excludes credits only in relation to Forex but, for example, if the debit arising due to a bad debt has been disallowed under paragraph 13, a subsequent credit when the debt proves to be collectable should not be taxed.

36 We remain convinced that properly targeted legislation is the correct response to tax avoidance.

Chapter 8: Anti-avoidance targeted measures

Paragraph 8.19

37 We think that confining section 92, FA 1996 to listed securities would be likely to inhibit proper commercial financing transactions. There is no reason why an unlisted company should not raise finance in perfectly bona fide circumstances by issuing a convertible and, although the investor may very often be within Case I, this will not always be the case. However, we note that the draft legislation does not appear to

require the shares to be listed. We would welcome clarification of the Government's intention.

38 It is also proposed that Forex movements on section 92 assets, within the amended definition, should be brought into the loan relationships regime (see clause 7 in Appendix 5), although they are currently excluded from the FA 1993 regime. This appears to be a complete reversal of the accepted principle that all gains and losses on equity-type instruments held as investments should remain outside the income regime. This is one of the points listed in paragraph 8.17 as 'the solutions'. However, no reason is offered as to why this change in the tax treatment of the bona fide convertibles which will still remain within section 92 should be a necessary or appropriate part of 'the solution' to the perceived problem that some artificially-devised instruments should not be within section 92 at all.

CONCLUSIONS

39 The proposals need further time for consultation and refining. If the regime is to start on 1 January 2002, there should be grandfathering provisions to cover accounting periods which straddle the date of enactment.

40 Section 135A FA 1993 is too wide-ranging and should be replaced with a more targeted anti-avoidance provision.

41 The proposals on impaired debt between connected parties are welcome but we do not understand why a threshold is required. In the event that Government believes that one is required, we suggest that a 5% threshold would be more appropriate. The proposals should be given retrospective effect.

42 We remain opposed to the extension of the unallowable purposes test to Forex and financial instruments. We remain convinced that properly targeted legislation is the correct response to tax avoidance.

43 If you have any questions, please let us know.

FJH
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