

## **TAXREP 07/02**

### **LOAN RELATIONSHIPS, DERIVATIVE CONTRACTS AND FOREIGN EXCHANGE GAINS AND LOSSES**

*Text of a memorandum submitted in February 2002 to the Inland Revenue in  
response to a technical note published on 19 December 2001*

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# **LOAN RELATIONSHIPS, DERIVATIVE CONTRACTS AND FOREIGN EXCHANGE GAINS AND LOSSES**

## **INTRODUCTION**

- 1 We welcome the opportunity to comment on the Technical Note. We also welcome the positive approach adopted by the Inland Revenue to this consultation.
- 2 We commented on the previous consultation document (published in July 2001) and our response was published as TAXREP 24/01. We also commented on the earlier technical note (published in November 2000) and our response was published as TAXREP 01/01.
- 3 As we mentioned in our last response, we think that the use of a working party approach has been highly successful and are pleased to have been represented in those discussions.
- 4 Our detailed comments on the proposals have been made via representatives at the working party meetings. Rather than repeat the detailed points already made in those meetings, we have set out below the key issues that arise which still need to be addressed.

## **GENERAL COMMENTS**

### **Commencement date**

- 5 We welcome the deferral of the commencement date to accounting periods beginning after 1 October 2002.

### **The rewritten provisions and the Tax Law Rewrite**

- 6 Whilst of course we welcome the 'consolidation' of the existing sets of rules into one code, the fact remains that the legislation is highly complicated and far from easy to understand. We remain disappointed that the opportunity was not taken to rewrite all of the provisions from scratch in one comprehensive new code. The approach adopted, namely the extensive amendment of existing provisions, has not helped to simplify what are some of the most complicated tax rules in the UK. Indeed, the approach adopted has made the rules arguably more complicated than they need to be.
- 7 For example, the new rules make a number of amendments to section 92 of the Finance Act 1996. However, the amendments are spread across both the Forex rules (see paragraph 6 of Schedule 1) as well as more substantive amendments in draft clauses 9 and 10. The result is that it is far from easy to see at a glance how the various provisions interact. It is difficult enough for a specialist in this area to gain a full understanding of the rules and we suspect that general practitioners will find them an uphill struggle.
- 8 The approach adopted in the drafting should be consistent with the objectives of the Tax Law Rewrite (TLR) project, which should be the standard by which all new tax

legislation is judged. The TLR objectives are essentially to rewrite the entire UK tax code in simple and straightforward English. The detailed legislation set out in the Technical Note is not in our view consistent with the TLR objectives, even allowing for the inherent complexity of the subject matter. We are concerned that, before the ink is dry on this revised code, practitioners and business will be lobbying for the provisions to be rewritten in a more intelligible and user friendly style,

- 9 We think an opportunity has been missed by not drafting this revised code using the TLR approach.

#### **Updating of existing guidance**

- 10 Once again, we would like to emphasise a point made in our previous representation TAXREP 24/01, namely that it will be important to ensure that existing guidance on these rules is updated to explain to the non-specialist how the legislation works in its amended form. In addition, the new rules need to be adequately publicised.

### **DETAILED COMMENTS**

#### **Appendix 2a - Forex & Regulations**

##### **Proposed matching regulations**

- 11 We are not convinced that the proposed matching rules will always produce a satisfactory result. A rigid statutory matching rule which pays no regard to the actual commercial relationship between particular assets and liabilities is bound to produce unfair results in some cases. In particular the outcome of the system proposed in paragraph 2.10 of the Technical Note would depend critically on whether a particular asset is disposed of in one accounting period or the next, which is bound to lead to capricious results and would potentially be open to manipulation. It is vital that the rules should produce a fair result, given that matching will be mandatory and not merely elective. On the basis that the rules are designed to follow the accounting treatment, the default rule should be that the identification of matching assets and liabilities should, as far as possible, follow the accounting treatment. In cases where the position is not clear from the accounts, then statutory rules are required but the taxpayer should have some measure of protection in the event that the result was unfair in the particular circumstances. This points to the use of a 'just and reasonable' type of provision, which would protect both the taxpayer and the Revenue.

##### **Convertible loan stock**

- 12 We expressed concern in our earlier representation that Forex movements on convertible loan stock within section 92 of the Finance Act 1996 were to be brought into the loan relationships regime (as per clause 7 in Appendix 5 of the July 2001 consultation document), although they are currently excluded from the Finance Act 1993 regime. The new rules (at paragraph 6 of Schedule 1) confirm that this treatment will apply.
- 13 We remain concerned at the approach adopted. We said in our earlier response that

*'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.*

So far as we are aware there has still been no adequate justification given for this fundamental change to the regime.

**Bad debts: Paragraphs 4 and 9 of Schedule 1**

- 14 Paragraph 2.34 of the Technical Note asserts that the existing Forex treatment of bad debts is preserved. Currently, where all or part of a debt is irrecoverable, no taxable or deductible exchange gains or losses are accrued on the portion of the debt that is considered to be irrecoverable (section 144, Finance Act 1993), irrespective of whether the parties are connected. New paragraph 5(2A) of Schedule 9 to the Finance Act 1996 preserves the current treatment in respect of debts where the parties have no connection. However, paragraph 6(3) of Schedule 9 continues to hold in relation to connected-party debt. As a result, it seems that a company would have to recognise exchange gains and losses on debt assets that are irrecoverable and for which no tax relief has been given, and which are not reflected in the company's accounts.

**Non-arm's length loan relationships: Paragraph 11 of Schedule 1**

- 15 New paragraph 11A(4) and (5) of Schedule 9 to the Finance Act 1996 provides that Forex movements are to be left out of account by the creditor to the extent that the loan relationship would not have been entered into between parties at arm's length. Unlike the corresponding provisions for the debtor, this rule is not confined to cases where the counterparty is within the charge to UK corporation tax. We are concerned that the rules could therefore apply in an asymmetric way if both parties to the loan relationship are within the charge to corporation tax. This would result in exchange gains and losses arising to the creditor being disallowed for tax purposes, with corresponding exchange gains and losses arising to the debtor being taxed/disallowed.

**Unallowable purpose test: Paragraph 13 of Schedule 1**

- 16 We remain concerned that the proposed amendments to paragraph 13 of Schedule 9 to the Finance Act 1996 do not go far enough. As we mentioned in paragraph 35 of our earlier representation '*... the proposed amendment to paragraph 13 ... 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.*'
- 17 We remain of the view that where a debit has been disallowed under this rule, any subsequent credit should not be taxed.
- 18 Paragraph 7.9 of the July 2001 Technical Note stated that the Inland Revenue proposed to publish guidance in the Company Tax Manual on the types of case where it would expect paragraph 13 to operate. This latest consultation document does not appear to mention when such guidance will be published. We would welcome

confirmation of the likely publication date of such guidance and that it will include guidance in relation to the application of the unallowable purpose test to Forex and derivative contracts.

**Transitional: Paragraph 21 of Schedule 1**

- 19 The wording of subclause (2) does not seem wholly to reflect the fact that the 'subsequent accounting period' would not actually have been an accounting period if it had not been for the change of accounting date. Therefore, the taxpayer's intention cannot be said to have been to increase the debits or reduce the credits for that specific period. The same point arises in paragraph 42 of Schedule 3.

**Appendix 2b - Derivative contracts**

**Excluded contracts: Paragraph 3 of Schedule 3**

- 20 Paragraph 3 defines contracts which are not derivative contracts. However, in order for this exclusion to apply, the underlying subject matter must consist *wholly* of certain defined categories, for example shares in a company. In practice, however, practically all derivatives contracts are likely to involve a cash element and therefore such contracts will apparently not be excluded. The definition should be amended so that contracts are not excluded if they include an element of cash.
- 21 Also, the provision does not take account of the fact that contracts may be settled in cash even though the original intention of the parties may have been to settle the contract in the underlying asset. Would such contracts then be excluded, even though they were originally included? We would welcome clarification.

**Definition of a future: Paragraph 9 of Schedule 3**

- 22 The definition of a future is set out in paragraph 9(5) of Schedule 3. The definition includes all contracts where delivery occurs after the contract is made, for a price agreed at the time of the contract. On the basis of this definition, a great many ordinary commercial contracts (both for the delivery of goods and services) will fall to be classified as derivative contracts for tax purposes when, commercially, they are nothing of the sort. Further, it is unclear whether financial futures are actually included, since nothing tangible is required to be delivered, although we expect that these are precisely the types of assets at which this section is aimed.
- 23 If this definition is not amended, the result will be that many contracts will be required for tax purposes to be brought into account on an accruals basis or a mark-to-market basis, even though for accounting purposes they may not have been recognised at all. This would appear to defeat the general principle underlying these rules, namely that the tax treatment will follow the accounting treatment.
- 24 The solution would appear to be that the definition of a future needs to be amended to exclude contracts entered into in the ordinary course of the company's business for the delivery of goods and services to be used in the business, but where delivery takes place at some specified time in the future. The specified time could be by reference to what would be normal business practice in the particular circumstances.

**Contracts for unallowable purposes: Paragraph 19 of Schedule 3**

- 25 Presumably where a contract is entered into only partly for an unallowable purpose the credits referred to in subparagraphs (5) and (6) are meant to be credits which, on a just and reasonable apportionment, are referable to the unallowable purpose. However in that case the exclusion of 'relevant credits' is rather confusing, since it would appear that such credits would never have been brought into account anyway, by reason of subparagraph (2).

**Contracts not at arm's length: Paragraph 22 of Schedule 3**

- 26 This paragraph appears to be wrong in principle, involving a form of double counting. If, for example, the purchase price for a derivative contract is adjusted under Schedule 28AA of ICTA 1988, that should be the end of the matter. The contract, subject to that adjustment, is then on arm's length terms and all the normal tax consequences should follow. Exclusion of the exchange gains and losses is only logically justifiable in the exceptional case where the contract (or part of it) would not have been entered into at all between parties at arm's length, so Schedule 28AA causes it to be ignored altogether for tax purposes. It is notable that the similar rule in the new paragraph 11A of Schedule 9 to the Finance Act 1996 is confined, insofar as it relates to Schedule 28AA adjustments, to that exceptional case.
- 27 Even if the general principle were accepted, there are serious practical difficulties in paragraph 22. It is not at all clear why the proportion of the Forex differences which is to be excluded should be measured by reference to the proportionate effect of the Schedule 28AA adjustment on the profit or loss under the contract, rather than (in the case mentioned above) on the purchase price. It appears that even the smallest Schedule 28AA adjustment would result in the Forex differences being excluded altogether, if the contract happens to produce a very small loss which the Schedule 28AA adjustment eliminates.
- 28 It is not clear whether the appropriate proportion as defined in subparagraph (3) is computed over the whole life of the contract, or separately for each accounting period concerned. Only the latter would be practicable under the CTSA regime, but if that is what is meant the legislation needs to say so; and computing the proportion on an annual basis in this way seems likely to produce capricious results.
- 29 If the Schedule 28AA adjustment doubles the profit on a contract, the appropriate proportion as defined would be 100%. The effect of the legislation as drafted would then be to exclude 100% of the Forex differences, whereas the intention is presumably to exclude only 50%.

**Transitional: Paragraph 43 of Schedule 3**

- 30 Paragraph 43 is a transitional rule for derivative contracts that were previously chargeable assets. It effectively treats the pre-commencement book value as a chargeable gain or allowable loss, which crystallises at the time when the company ceases to be party to the contract. We are concerned by the possibility of an allowable loss accruing on the contract up to commencement of the new rules, but a profit arising under the derivative contracts rules. If this were the case, tax could become payable even though no profit arose over the life of the contract. We therefore suggest

that the company should be able to elect to treat the allowable loss as a loan relationship debit in the period of disposal.

- 31 We are concerned also that the new legislation does not cater adequately for derivative contracts already in existence prior to commencement of the new rules. Paragraph 43 deals with the particular case of existing instruments which were previously within the chargeable gains regime. It does not, however, appear to deal adequately with the transitional position where items may have been taxed or allowed in an earlier accounting period. For example, where a contract to hedge a debt is terminated and replaced, the accounting treatment will be to spread the impact of the old financial instrument over the life of the underlying debt. However, for tax the debits or credits will have been effected at the termination date. We suggest that the legislation needs to include a provision to the effect that items taxed or allowed under the old rules, whether the Finance Act 1994 provisions or any other legislation, will not be taxed or allowed again under the new rules.

## **Appendix 2c - Loan relationships**

### **Carry-forward of non-trading deficits: Paragraph 3 of Schedule 4**

- 32 The new section 83(3A) of the Finance Act 1996 provides, as a default rule, that a non-trading deficit is to be carried forward and set against non-trading profits of the next accounting period. However, it does not say what is to happen if there are insufficient non-trading profits in that period. As a result, it appears that any unused deficit will be stranded, and cannot be used at all, if a section 83(2) claim has not been made within the two-year time limit. The wording (in contrast to the existing section 83(3)) is not such as to allow the new subsection to operate successively until the deficit is absorbed. The effect of this amendment, as currently drafted, is therefore the exact opposite of what we understood to be intended, i.e. to avoid any possibility of leaving a stranded deficit.

### **Partnerships: Paragraphs 8 and 31 of Schedule 4**

- 33 We are generally in favour of the look-through approach to partnership loan relationships, and it appears to be much more successfully implemented in this draft than in the previous one. Nevertheless, there are still a good many details which are unclear, specifically how the calculations are to be performed if the partnership and any particular partner have different authorised accounting methods, different accounting periods, or different local currencies. It is also unclear how the proposed mandatory matching regulations would work in relation to a partnership.
- 34 There appears at present to be an overlap between new section 89A(3) and new paragraph 19(7) to (9) of Schedule 9 to the Finance Act 1996. We think that section 89A(3) should be expressed to apply only to cases which are not within paragraph 19(7).
- 35 We consider also that paragraph 19(8) is too wide, in that it would treat a connection as existing between the partners in question for the purposes of section 87(3)(a) generally. This would affect any loan relationship which happened to exist directly between them, quite independently of their participation in the partnership. Paragraph

19(8) should treat the connection as existing only for the purposes of section 87(3)(a) as it applies to the particular loan relationship referred to in sub-paragraph (7).

- 36 The commentary suggests that the new paragraph 19 of Schedule 9 does not deal adequately with the case where a company controlled by a partnership has loan relationships with that partnership. However, we do not see that anything further is required, except perhaps to extend the control definition in section 87A(3) so that property etc. held by two or more partners who are connected with one another within the paragraph 19(9) definition is aggregated. Since the principle of section 87A is (rightly, in our view) to look through the partnership when applying the test of control, we do not think it is relevant whether or not the partnership itself controls the company, and no special rules are therefore required if it does.

**Revocation of section 89 of the Finance Act 1996: Paragraph 9 of Schedule 4**

- 37 We are not persuaded that section 89 is redundant, because there may be cases, such as paragraph 6 of Schedule 9 to the Finance Act 1996, where the tax legislation directs that an authorised accounting method be applied in a particular way. In such a case, if there is a change in the way that the authorised accounting method is applied, there will be no adjustment in the actual accounts to correct any inconsistency (or the adjustment in the accounts will not be appropriate to the way in which the accounting method is being applied for tax purposes) so section 89 is still needed in order to avoid any mismatch.

**Impaired debt rules: Paragraphs 22 to 24 of Schedule 4**

- 38 We very much welcome the relaxation of the 75% test proposed in the July 2001 consultation document. In our earlier response, we argued that there should be no threshold and we are pleased that the Government has accepted that no threshold is appropriate.
- 39 We are, however, disappointed again that this provision has not been given retrospective effect because this change corrects a clear defect in the original rules which should have been addressed much earlier. We requested in our earlier representation that consideration be given to giving this provision retrospective effect and we remain firmly of that view.
- 40 We do not see why this should not be possible, given that targeted anti-avoidance measures were introduced in the draft legislation published on 26 July 2001 and that these latter measures apply with effect from that date. As a minimum, it would seem reasonable to back-date this relieving provision also to 26 July 2001 but, ideally, we think the provision should be treated as having effect from the original introduction of the rules in 1996.
- 41 With respect to the drafting of paragraph 22, we are concerned that the detailed rules may be ambiguous and that the provision may not operate as intended, with anomalous results. In particular new paragraph 6(5B) of Schedule 9 to the Finance Act 1996 appears to give no relief in a situation where impaired third-party debt is initially written up to some extent in the accounts of the purchaser because the debtor's situation has improved, giving rise to a taxable credit, but subsequently has to be written down again. In order to avoid anomalies of this sort the legislation needs



to treat debits and credits symmetrically, so that a credit is not taxable to the extent that it represents an increase in the value of the debt which arises while the parties are connected.

- 42 We can see no justification for the extension of the 'no connection' rule in new paragraph 6(5A) to periods more than 12 months before the date of the acquisition. The possibility of manipulation of bad debt relief in such circumstances is remote in the extreme, and the rule will have capricious results if the continuing process of mergers and acquisitions brings together a debtor and a creditor which happened to be connected long before in entirely different circumstances.

- 43 We also said in our earlier response that

*'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.'*

It may be that the general rule on tax-neutrality for intra-group transfers of loan relationships would provide an answer to this problem, but at the least we consider that the position needs to be clarified.

- 44 We welcome the provision in paragraph 24 to the effect that, where bad debt relief has been denied under paragraph 6(3) of Schedule 9 but the parties later cease to be connected, any subsequent increase in the value of the loan relationship will not be taxable. However, consistent with the policy of the other amendments in this area, we think there should be a corresponding amendment covering the case where the parties to an existing loan relationship become connected. If the creditor has made a provision against the value of the loan relationship, we understand that the present view of the Revenue is that a taxable credit arises at the time when the parties become connected and the loan has to be written back up to face value for tax purposes to comply with paragraph 6(3). Since the loss in value accrued at a time when the parties were unconnected, we consider that there should be no such clawback of the relief previously given.

#### **Convertible securities: Clauses 9 and 10**

- 45 The effect of the draft clause 9(15) and clause 10(4) is that, where an existing security ceases to qualify under section 92 of the Finance Act 1996 as a result of the changes in the law effective from 26 July 2001, it is deemed to be disposed of at market value immediately before that date and any gain or loss is held over under section 116(10), TCGA 1992. This means that the held-over gain or loss will crystallise when the security is converted, since it is disposed of at that time and section 116(10) contains no provision for a second rollover or hold-over. This is unreasonable. Under the existing law, any gain or loss on the security would be rolled over into the shares

issued on conversion, and would crystallise only when those shares are sold. The new legislation should preserve that position in respect of gains or losses accrued before 26 July 2001. This requires that for this purpose, the ‘subsequent disposal referred to in section 116(10)(b) should not include any transaction which would be treated by virtue of sections 127 to 130 as not being a disposal were it not for section 116 itself.

## CONCLUSIONS

46 Our key comments on the draft legislation are:

### Drafting and guidance

- Whilst we welcome the consolidation of the existing sets into one code, the actual approach adopted, namely substantial amendments to existing legislation, is highly complicated and difficult to follow. We are disappointed that the new rules have not been consolidated into a comprehensive new code written in the Tax Law Rewrite style.
- It is important that existing guidance on the rules is updated to reflect the amended rules and that the new rules are given adequate publicity.

### Forex

- We are not convinced that the proposed matching rules will always produce the desired result and suggest the addition of a ‘just and reasonable’ provision.
- We are concerned as to why Forex movements on convertible loan stock have been brought within the loan relationships rules and would welcome clarification as to why this was considered necessary.
- We are concerned that exchange gains and losses on bad debts for which no tax relief has been given will still have to be taken account of for tax purposes and that the rules should be amended.
- Where a debit is disallowed under the unallowable purpose test, the rules should ensure that any subsequent credit should not be taxed. We would also welcome the promised guidance on when the Inland Revenue would expect the unallowable purpose test to apply in relation to loan relationships. This guidance should also extend to include Forex and derivative contracts.

### Derivative contracts

- The definition of derivative contracts needs to be amended to that contracts are not excluded if they include an element of cash.
- The definition of a future needs to be amended to exclude ordinary commercial contracts where delivery may happen to take place at some time in the future.
- The rule for taxing contracts not at arm’s length and subject to a transfer pricing adjustment under Schedule 28AA of ICTA 1988 should be amended so that amounts are not taxed twice.

- We are concerned that, under the transitional rules, a tax charge may arise under the new rules but an earlier loss in respect of the same contract is not allowed.

### **Loan relationships**

- The rules for the carry forward of non-trading deficits need to be amended to avoid the possibility of an unrelieved deficit.
- The rules for partnerships need to be clarified to ensure that they operate as intended.
- In order to prevent any possible mismatches, the rules set out in section 89, FA 1996 are still required.
- We welcome the withdrawal of the 75% test for impaired debts but request that this rule is backdated to reflect the fact that this provision is correcting a defect in the original rules. In addition, we do not see why the 'no connection' rule has been extended to periods of more than 12 months before the date of acquisition.
- The rules should allow for gains and losses accrued before 26 July 2001 which cease to qualify under section 92, FA 1996 (following the amendments which apply with effect from 26 July 2001) to be rolled over into the shares issued on conversion.

- 47 We would be happy to discuss these points further, if that would be helpful. We would also welcome any feedback from the responses to this consultation. In particular, we would be grateful for feedback on the items we have highlighted above that require clarification.

FJH  
15 February 2002  
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