PO-CH/NL/0509
PART A

PO CH/NL/0509
PART. A.

PO CH/NL/0509
PART. A.

1989 BUDGET FOREIGN EXCHANGE GAINS AND LOSSES.

10.3.89

THIS FOLDER HAS BEEN REGISTERED ON THE REGISTRY SYSTEM

CONFIDENTIAL

**Inland Revenue**

Business Tax Division
Somerset House

From: E McGIVERN

Date: 8 December 1988

FINANCIAL SECRETARY

FOREIGN EXCHANGE GAINS AND LOSSES: CONSULTATIVE DOCUMENT

1. I attach a draft consultative document on this complex and difficult subject. You will recall that you asked for the draft to be prepared to enable Ministers to decide whether it should be issued in response to the continuing pressure for legislative reform of the existing system.

2. As I say, the subject matter is complex and inevitably this is reflected in the draft itself. The document is of course aimed at a highly specialist audience which will be familiar with the concepts and language involved, but we expect if will also be read by a wider circle of interests in industry and the professions and we have tried to put it together in such a way that it is as "user-friendly" as anything on this subject can ever hope to be.

3. You will not I think need to study the whole of the document in detail, but you might find it helpful to concentrate on the Introduction, Chapters 1, 6 and 8 to 12.

---

cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Peretz
Mrs Lomax
Mr Ilett
Mr Gilhooly
Mr Riley
Mr Ritchie
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Hewitt (BoE)

Chairman
Mr Isaac
Mr Deacon
Mr Johns
Mr McGivern
Mr Skinner
Mr J F Hall
Mr J W Calder
Mr Keith
Mr Weeden
Miss Brand
Miss Reid
PS/IR

The international comparisons in Annex C will attract attention; and Annex D summarises briefly the only important suggestions for change which have been put forward in recent years (by The Institute for Fiscal Studies and the Group of Nine representative bodies).

4. The draft has not yet been cleared with the Treasury, although we have tried to take account of suggestions and comments they made on an earlier working draft. And if it is to be published, we shall want to take on board the views of the Bank who are seeing a draft for the first time and will clearly want to look at it very carefully. In particular, we shall need to be certain that our analysis is consistent with the way in which the capital and foreign exchange markets operate.

A workable solution

5. You will see that the document does not put forward any preferred solutions but simply identifies the main issues which would need to be addressed in any comprehensive reform aimed at bringing into the tax system those exchange gains and losses which are not already recognised for tax (Chapters 8-10). It also discusses the scope for some, more limited, changes (in Chapter 11) if an acceptable basis cannot be found for a comprehensive scheme.

6. The further work we have done in recent weeks in putting together the consultative document has confirmed our earlier views that any comprehensive reform would -

a. carry major risks for the Exchequer (Chapter 1, paragraph 12 and Chapter 10); and

b. involve formidably complex legislation both to provide companies with an acceptable regime and to guard against the worst excesses (and even then the underlying rules - assuming that they could be

devised - would be seen as arbitrary and unfair, particularly to company groups).

7. However, in drafting the document, we have deliberately not ruled out the possibility of a comprehensive scheme. Instead, the document identifies the issues that would need to be addressed and answered by those proposing such a radical approach. At this stage, I am bound to say that we ourselves do not yet see a solution to the major issues of, for example, the repayment and renewal of loans and matching assets and liabilities (to ensure that relief is not given for an "exchange loss" on foreign currency borrowing matched by a gain on foreign currency assets which the borrowing financed). Nor do we see any easy or acceptable solution to the particular problems of groups, especially the multinationals - there is a summary of the difficulties here in paragraphs 17 to 32 of Chapter 10.

8. But it might just be possible to do something to ease the problems which the present rules can create for -

a. hedging transactions (ie Mr Chown's "tax fragmentation");

b. accounts prepared in foreign currency; and

c. foreign currency denominated share capital.

9. The scope for changes in these areas is discussed in Chapter 11 but before we could be certain that workable and defensible rules could be devised which could be safely recommended to Ministers, we would need to have the views and comments of the various bodies on the possible approaches outlined in that Chapter.

International comparisons

10. Comparisons of international tax systems, and especially of particular parts of them, are notoriously difficult and can

often be very misleading. The treatment of exchange gains and losses is no exception. Annex C contains a summary of the information available from published material about the rules in France, Germany, Australia, Canada and the USA. It also reflects some (very limited) supporting details which we were able to obtain from one or two High Commissions or Embassies.

11. You will see that all of the five countries give relief, to some extent at least, for exchange losses on capital borrowing for which the UK representative bodies are pressing. But the published material does not tell us how the countries deal with exchange differences on matching assets and liabilities or with those arising on intra-group loans, in particular within multinational groups. And given the complexities of the subject and, in some cases the language difficulties, discussion with local High Commission or Embassy officials is of little help. If we are to pursue these matters in any detail - and I think there is a case for doing so with the US and Canada if the document is to be published - it would be necessary to discuss the issues direct with the experts in the countries concerned.

12. But it may well be that some of these countries can be more relaxed about the implications for the fisc of recognising exchange gains and losses on capital borrowing. As paragraph 10 of the Annex explains, much might depend on the -

a. the size of the flows across the exchanges;

b. the extent to which the national tax system restricts the charge to tax (and hence relief for related losses and expenditure) on certain foreign business income; and

c. the countries experience of fluctuations in their exchange rate.

And as in other areas, CGT indexation which is peculiar to the UK, adds its own complexities.

13. The European Commission has not yet addressed the question of foreign exchange gains and losses but could well do so as part of any detailed discussions on a draft directive for harmonising the business tax base. The approach in the preliminary draft directive followed very closely continental accounting principles for determining business profits and it could well be that they will argue that the tax treatment of currency fluctuations should also follow accounting practice.

Should a consultative document be issued?

14. The arguments in favour of issue are -

a. The Group of Nine proposals are on the table and were made in response to Ministers' invitation for suggestions for legislative change. They need to be answered and indeed several bodies are pressing in their Budget representations for legislation and/or publication of draft Clauses. Annex D explains that they are incomplete and fail to address several key issues which will be central to any comprehensive scheme of relief.

b. Publication would get home to a much wider audience than those who at present command the field (and the attentions of the financial and professional press) that the issues are far more complex than reports so far have suggested and that legislation to give companies what they are seeking would be formidably complex if the Exchequer were not to be wide open to abuse.

c. There are parts of the present system which are more rough than just (eg tax fragmentation of SWAPS) and while a comprehensive reform might not be obtainable at an acceptable cost to the Exchequer, it might be possible to make more limited changes on at least some of the issues where the present rules are not

easy to defend (see Chapter 11). It would be essential to have prior consultation here so that the strength of the case for change can be gauged and we can be sure that we have a workable scheme which was reasonably free of distortion and the risk of serious abuse.

d. The pressure for change will clearly not go away. If Ministers decide against publication, they will need to make their decision public. After the initial protests had subsided, we could probably hold the line for a year or so, but we would soon be back at the stage where Ministers were being asked to see the representative bodies and to agree to further reviews and, possibly, joint working parties with the Revenue.

e. A very considerable amount of time and effort has gone into the preparation of the draft document and if the Treasury and Bank agree with us that the analysis stands up, there would be considerable presentational and tactical advantages in publishing it and inviting those who are pressing for radical, comprehensive reform, to come up with sensible solutions to the very real problems which have been identified.

f. Finally, the document itself does not put forward specific proposals for change and publication could be on an entirely without commitment basis.

15. On the other hand, the arguments against publication - and the line Ministers might take in defence of the decision - appear to be -

a. There is no acceptable solution in sight to the major problems inherent in any comprehensive reform and publication - even on the most guarded basis and without commitment - might raise false hopes.

b. Consultation might well mean that even the more limited changes outlined in Chapter 11 might not prove possible and again expectations would be dashed.

c. A document which fails to put forward a clear comprehensive solution will inevitably be criticised; and it will provoke the familiar cry that the Revenue is obsessed with avoidance.

d. The potential costs to the Exchequer might be too great and consequently rule out any scope for change and hence consultations.

e. If UK companies do lose out on the tax treatment of foreign exchange gains and losses, they nevertheless enjoy one of the lowest corporate tax rates in the industrialised world. And to date, no evidence has been produced to show that UK companies are at a significant competitive disadvantage compared with their major trading competitors.

f. Nor is there any evidence that the existing rules are inhibiting outward or inward investment.

16. When the Labour Government last looked at this issue in 1977, the then Chancellor decided that the case for relief was finely balanced; that there were areas where the balance of argument pointed against any relief and that the tax at stake could be considerable. For all these reasons, and the priority which he was giving at the time to income tax reliefs, Mr Healey decided against change. The appropriate extract from his Budget speech is set out in the Annex. Although sterling is now in a much stronger position in world markets, Ministers could argue that the administrative complexities and, to a lesser extent, the potential Exchequer costs have not significantly changed since 1977 and that there is no point in further detailed consultation.

Timing

17. If Ministers decide to go ahead and issue the consultative document, we think it could be got ready for publication in early February. But that would take us uncomfortably close to the Budget and you will want to consider whether it would be sensible to hold back publication and announce it either as part of the Budget Statement or in a press release on the same day.

18. If Ministers decide against publication or any other form of consultation, we presume you would not want to announce this in advance of the Budget and some further thought will need to be given to the content and timing of the announcement.

The Woolworth case

19. This is not now likely to be heard by the House of Lords until June or possibly July. The details of that case were set out in my submission of 5 October but, briefly, the question at issue is whether loans with a maturity of five to six years were on revenue or capital account. If they were capital, the large exchange losses which were incurred would not qualify for tax relief under existing law. A decision in favour of the taxpayer could have significant Exchequer implications.

20. We see no real difficulty over timing or presentation here. A decision in favour of the taxpayer would give the corporate sector some additional relief but would stop well short of what the representative bodies are asking for. And as you yourself recognise, a decision in this one case could not solve the many difficult issues which arise in this area and which are set out for discussion in the consultative document.

Interest swaps

21. Mr Johns' sent you with his note of 30 November a draft consultative document on the tax treatment of the recurring annual fees payable under interest swap agreements. This is

quite a separate point from the treatment of exchange gains and losses on the loans themselves and although there would be advantages if both documents could be published together, it is not essential that this should happen; and certainly an interval between the publication dates would not inhibit consideration of the respective issues.

Recommendation

22. Subject to the views of the Treasury and the Bank on the draft itself, our firm recommendation is that the balance of argument favours publication if Ministers themselves feel that the analysis and arguments have been presented in a balanced and defensible way.

23. But the critical responses from some sectors are predictable. It will be said that the document is long on analysis and short on positive solutions. And it will be asked, why, if other countries can find workable solutions, sensible arrangements cannot be devised to give UK companies the relief for capital borrowings which their main competitors enjoy. And, as I have said, no doubt we shall hear again the suggestion that the Revenue is obsessed with avoidance.

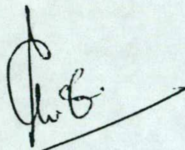
24. On the other hand, we would hope that most commentators, including the major representative bodies themselves, will recognise that there are real difficulties here. Indeed, some of the problems were identified (and left unsolved) in the proposals which the Group of Nine put to Ministers. So the line taken in the consultative document should not come as a surprise to those who have been most closely involved in the debate.

25. Nevertheless, some of the representative bodies will no doubt take the line that it is up to Government to find solutions to all these problems. We must therefore expect some unfavourable reactions to the document. The answer to the critics must be that while Government is prepared to listen to any proposals that are put forward, and is genuinely interested

in achieving a balanced and sensible scheme of relief, it simply cannot ignore the major issues which have been identified in the document, in particular the potential large Exchequer costs which have been of concern to successive Governments.

Handling

26. When Ministers have had an opportunity to consider the document, you might it helpful to have a meeting with ourselves, the Treasury and the Bank to discuss whether or not to proceed to publication. Detailed drafting amendments from the Treasury and the Bank can be taken on board at a later stage.



~~E~~ McGIVERN

EXTRACT FOR BUDGET SPEECH, 29 MARCH 1977

FOREIGN CURRENCY BORROWINGS

In my Budget speech last year, I referred to the question of tax relief for the extra cost to companies of repaying foreign currency loans where sterling has fallen in value. I have now considered this question fully in the light of the report I have received of the extensive discussions the Inland Revenue subsequently had with those affected.

As I made clear last year, the arguments for general relief for exchange losses are finely balanced. There are major areas where the balance of argument would be against relief, and in these areas there are real problems in distinguishing between different cases and in drawing lines between them. Moreover, although the recovery of sterling has reduced potential losses, the sums of tax at stake are considerable. I have had to conclude that, since this year there is an urgent need to concentrate on income tax reliefs, I cannot at the same time propose relief for exchange losses.

HANSARD - 29 MARCH 1977 - COLUMNS 277/278

chex.ul/j.ph/6

RESTRICTED

FROM: J M G TAYLOR
DATE: 9 DECEMBER 1988

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Peretz
Mrs Lomax
Mr Ilett
Mr Gilhooly
Mr Riley
Mr Ritchie
Mrs Chaplin
Mr Tyrie
Mr Call

Mr Battishill - IR
Mr Isaac - IR
Mr McGivern - IR
PS/IR

**FOREIGN EXCHANGE GAINS AND LOSSES: CONSULTATIVE DOCUMENT**

The Chancellor has seen and noted Mr McGivern's note of 8 December, and the attached draft consultative document.

2. He has commented that he has reservations about publishing the document. He looks forward to the Financial Secretary's advice in due course.

J M G TAYLOR

I am clear that, with the growing globalisation of business, the present arrangements are indefensible & a better system must be put in place. I therefore strongly favour a Budget Day consultation document, provided it is the right document. Is this in line with [illegible] FST's views.

Ch,

<u>Foreign exchange gains + losses</u>

You were asking Alex about this.

2. FST is holding a meeting on 19/1 to discuss the draft consultative doc. submitted by IR in early December. He will then minute you with views on handling etc.

3. Anything you would like me to feed in now? I had interpreted your earlier comment as meaning that you had reservations about IR's recommendation that we should publish. Shall I now let FST know that it might be worth considering publication on Budget Day? JS 11/1

RNHAM (06286)2454

DORNEYWOOD,
BURNHAM,
BUCKS,
SL1 8PY

Alex

Aftermath of Dorneywood

~~1. Pl draft a letter for me to sign thanking the local police~~

2. What is the latest state of play on foreign currency gains & losses, which I meant to raise at Chequers? There is a case for putting a consultative document out on Budget Day.

3. For the 'non-overview' mtgs we shall be having on the overview 80/85, pse tell all Mins that they have a standing invitation, but that there is no three-line whip.

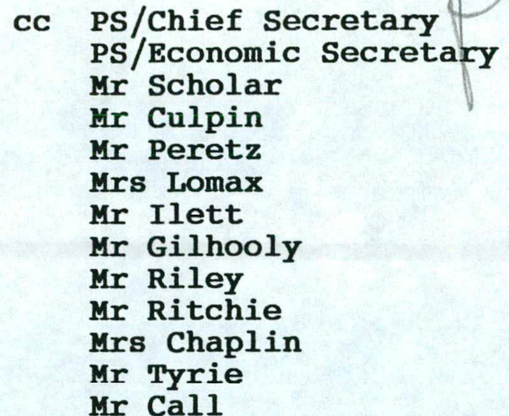
N.L.

Jonathan ←
please deal
Alex

chex.ps/jmt/24 RESTRICTED

FROM: J M G TAYLOR

DATE: 13 January 1989



PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Peretz
Mrs Lomax
Mr Ilett
Mr Gilhooly
Mr Riley
Mr Ritchie
Mrs Chaplin
Mr Tyrie
Mr Call

Sir A M W Battishill - IR
Mr Isaac - IR
Mr McGivern - IR
PS/IR

**FOREIGN EXCHANGE GAINS AND LOSSES: CONSULTATIVE DOCUMENT**

The Chancellor has been considering this further.

2. He is now clear that, with the growing globalisation of business, the present arrangements are increasingly indefensible and a better system must be put in place. He therefore strongly favours a Budget Day consultative document (provided it is the right document). He looks forward to the Financial Secretary's urgent views on the draft circulated with Mr McGivern's note of 8 December.

J M G TAYLOR

fim2.cr/Ritchie/d.FST CONFIDENTIAL

It would be useful to publish this, especially if it was expanded to spell out a few specific options on which people could comment.

FROM: ALLEN RITCHIE
DATE: 18 JANUARY 1989

1. MR ODLING-SMEE
2. FINANCIAL SECRETARY

cc PS/Chancellor
Mr Scholar
Mr Culpin
Mr Peretz
Mr Gilhooly
Mr Ilett
Mr Matthews
Miss O'Mara
Mr Neilson
Mr N Williams
Mrs Chaplin
Mr Tyrie
Mr McGivern )
Mr Calder ) IR
Mr Keith )

cc Mr Hardcastle (+ McGivern of 8 December)

18/1

**Foreign Exchange Gains and Losses**

Mr McGivern has submitted to you, under cover of his minute of 8 December, a draft of a proposed consultative document on the tax treatment of foreign exchange gains and losses, which are due to discuss with us tomorrow morning. The key decision now is whether or not to go ahead and publish a consultative document along the lines of the present draft - and, if not, how to respond to the continuing pressure for tax reform in this area. The Chancellor has now said that he strongly favours a Budget day consultative document - provided that it is the right document. This note sets out FIM views on this subject.

**The Case for Publication**

2. The arguments in favour of publication are set out in para 14 of Mr McGivern's covering minute. The case for publication is that:-

i. there has been substantial lobbying for legislative reform, which shows no signs of going away;

ii. the lobbyists do seem to have a case - there are aspects of the present system which are anomalous, to say the least;

CONFIDENTIAL

iii. there have been two sets of detailed proposals for changes - from the Group of Nine and the IFS;

iv. there is no each solution and it is worth spelling out in some detail the problems with the proposals put forward to date.

v. this is a complex and difficult subject, and a consultative document is clearly the right way forward, if major legislative changes to the tax system are in prospect.

3. It is, however, possible to mount a respectable case against publication. The Revenue have looked at the various options for change and have found flaws in practically all of them. There is no reason to believe that inviting comments on a consultative document will produce an acceptable, workable solution, where the Revenue have failed. But publishing any consultative document is tantamount to saying that the government believes that reform is both desirable and feasible, and that the government is seeking views on the specific options for change.

4. Nonetheless, in view of the representations received on this subject, publication of some kind of response is highly desirable. Up to now, there has no government response whatever to the proposals put forward, even though we believe them on the whole to be impractical and/or over-simple. It would not be sufficient merely to devote a few sentences of the Budget speech as did Mr Healey in 1977 - to saying that the government does not propose to do anything. It is at least a step forward to document convincingly the drawbacks to some of the ideas which have been put forward. Thus we in FTM favour publication of some form to consultative document. But we have some doubts about the present draft, which we feel goes to somewhat extreme lengths in its agnosticism about the workability of any kind of solution.

**The Nature of the Problem**

5. The volume of representations received in the tax treatment of exchange gains and losses is ample evidence that the present

tax system has its faults in this area. What is not clear from the Revenue's draft consolidated document is that there is an alternative tax treatment which does not have equally as many faults, if not more.

6. In many ways, the root of the problem lies in the distinction which the tax system makes between income and capital gains, and the rather different ways in which income and capital gains are taxed. The distinction between income and gains is inevitably somewhat arbitrary at the margin, but the tax treatment can be very different, according to whether an item of income is taxed under IT/CT or CGT rules. The difference is accentuated in this area by the fact that CGT only applies to assets; exchange gains and losses on capital borrowing are thus outside the tax net altogether ('they are a nothing'). This means that the revenue/capital distinction is crucial in determining whether or not exchange gains and losses on foreign currency borrowing count for tax purposes. It this also introduces a potential for tax fragmentation in essentially matched transactions for hedging purposes - because one side of the transaction is classed as a capital asset (and thus counts to CGT) and the other is classed as a capital liability (and hence is a 'nothing'). Chapter 6 of the draft consultative document contains a good example of such tax fragmentation for a currency swap agreement.

7. The draft consultative document takes the income/capital distinction in the tax system as given, and looks at possible changes to the tax treatment of exchange gains and losses within this system. The Revenue are right to do so; this is meant to be a consultative document on the tax treatment of exchange gains and losses, not a treatise on the general principles of the tax system. But if the main source of distortions in this area remains, then it is not surprising to find that the various solutions examined aimed at removing the present distortions merely create new ones. It is important to recognise that any revised tax treatment of exchange gains and losses will still contain distortions of some form or other. And distortions provide scope for tax avoidance, which in turn means rules -

CONFIDENTIAL

inevitably arbitrary - to guard against some of the more blatant examples.

**Tax Fragmentation**

8. Whether or not it proves possible to arrive at a 'comprehensive reform' - type solution, there would be attractions in at least dealing with tax 'fragmentation'. It is perhaps arguable whether the tax system should dampen the risk which firms may take in unhedged foreign currency transactions. But the present system also works against hedged transactions - where the firm has taken steps to avoid any pre-tax exchange risk and can yet end up with a tax loss or gain because of the different ways in which the two parts of the hedged transaction are treated.

**The Draft Consultative Document**

9. Is the Revenue's draft consultative document the "right sort of document" to publish? The main problem with the draft is that whilst it provides a comprehensive review of the problems in this area, it offers no solutions. A thorough discussion of the various options for reform finds flaws in practically all of them. As there are clearly also flaws in the present system, the reader is left very unclear as to where the Revenue think we might go from here. The agnosticism of the draft document is well founded; there are genuine problems here, and no obvious clear cut solutions. But, at the end of the day, some kind of solution will be needed - even if it is only a decision that the tax system we have got already is, for all its faults perhaps the best available.

10. It might help to better focus the debate if the document were to develop some specific illustrative options for alternative tax systems for treating exchange gains and losses. One possibility would be to have three options - a 'comprehensive reform' option, incorporating some of the ideas in Chapter 9, a 'partial reform' option, incorporating most of the changes in Chapter 11, and a 'do nothing' option. The specification of these options would need to spell out the safeguards which the Revenue feel are necessary to

prevent an unacceptable level of tax avoidance were such a scheme to be in operation.

11. There is already a clear strand of a 'preferred option' for comprehensive reform running through Chapter 9, in that some possible changes are given rather shorter shrift than others. Thus an option for comprehensive reform might include the following:-

i. abandoning the capital/revenue distinction for foreign exchange gains and losses arising in the course of trade, and replacing it with a 'purposes of trade' test - with all gains and losses passing this test taken into the Case I computation;

ii. all other foreign exchange gains and losses to be charged to CGT, on a settled transactions basis - which would entail the extension of CGT to foreign exchange gains on losses on liabilities - with:-

a. rules for adjustment to allow for gains and losses already taken into tax (in the Case 1 computation);

b. no indexation of liabilities for CGT purposes (so as not to give an advantage to foreign currency loans over sterling loans);

c. deferral of tax in all cases where foreign currency was repaid and immediately renewed.

12. The option for partial reform might include (following Chapter 11):-

i. removal from change to CGT of foreign currency acquired under forward contract - to the extent that it served the purpose of meeting/hedging a liability;

ii. ditto for forward sales of foreign currency proceeds of loans;

iii. allow the adoption of a non-sterling functional currency in preparation of accounts for tax purposes in specified exceptional circumstances

iv. deferral of tax on exchange gains and losses on foreign currency assets matched by foreign currency share capital.

13. We would favour some expansion of the consultative document along the above lines. Spelling out some options - including tax avoidance safeguards - would at least give the audience for the document something to shoot at. And there is no need to actually endorse any of the particular options - the document could continue to voice the Revenue doubts about the acceptability of any comprehensive reform package which contains adequate safeguards against tax avoidance.

**Risks to the Exchequer**

14. There is a clear danger that legislative reform in this area may turn out to be a charter for tax avoidance, particularly for groups, with tax relief being claimed for exchange losses, but exchange gains somehow never coming into tax. The draft consultative document devotes a full chapter (Chapter 10) to 'Risks to the Exchequer'. It is right to do so. It is important that the Revenue's concerns be fully spelt out, and that it is made crystal clear to interested parties that the government will not legislate to bring all exchange gains and losses into tax, unless that legislation includes the safeguards considered necessary to protect the Exchequer. These safeguards might well turn out to involve complex and arbitrary rules. Providing that the government's intention to proceed in this way is made clear from the outset, then there should be no cause for complaint later on.

15. We are less concerned about the possibility that bringing all exchange gains and losses into tax might lead to greater volatility of tax receipts from year to year. Cyclical factors already impart a degree of volatility into the pattern of tax

CONFIDENTIAL

receipts over time. It is by no means clear that the additional fluctuations arising from taxing exchange gains and losses will necessarily increase the volatility of total tax receipts. Indeed, it is possible, depending on the relative timing of the two kinds of fluctuations, that the volatility of total tax receipts could actually be reduced. But we would need to look at this further before coming to a final view.

**Procedures**

16. The Chancellor has suggested a Budget Day consultative document. There would seem little point now in an earlier publication date. No-one will be expecting any government pronouncement on the tax issues - even the issue of a consultative document - in the run-up to the Budget.

**ALLEN RITCHIE**
**FIM2**

gasmu.cg/minutes/

CONFIDENTIAL

FROM: A J HARDCASTLE
DATE: 27 January 1989

CHANCELLOR

cc Chief Secretary
Financial Secretary
Economic Secretary
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Peretz
Mr Gilhooly
Mr Ilett
Mr Matthews
Miss O'Mara
Mr Ritchie
Mrs Chaplin
Mr Tyrie
Mr Call

Mr McGivern )
Mr Calder ) IR
Mr Keith )
PS/IR )

Ch/ Since Mr H. agreed that we should go ahead + did not differ from FST's advice, I minuted out your agreement (behind). JF 27/1

Thanks.

**FOREIGN EXCHANGE GAINS AND LOSSES: CONSULTATIVE DOCUMENT**

You asked for my views on the draft consultative document attached to Mr McGivern's minute of 8 December.

2. The tax treatment of exchange gains and losses is a very complex issue which has been the subject of many representations to the Treasury and Inland Revenue over the years. The draft document covers the ground very well. I support the suggestion that the consultative paper should be published, and I am sure that it will be welcomed by those specialists who are most directly concerned with the subject, but we have to expect that their responses may well lead us no further forward than before, while publication of the paper will inevitably lead to an expectation that something will be done. Nonetheless full exposure of all the issues, and particularly the difficulties, will at least correct some misapprehension about the ease with which the problems can be solved.

3. On a more detailed level, I generally support the approach suggested in Mr Allen Ritchie's minute of 18 January at paragraphs 9-13.

A J HARDCASTLE

chex.ps/jmt.48 BUDGET CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 27 January 1989

PS/FINANCIAL SECRETARY

cc PS/Chief Secretary
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Peretz
Mr Gilhooly
Mr Ilett
Mr Matthews
Miss O'Mara
Mr Ritchie
Mrs Chaplin
Mr Tyrie
Mr Call

Mr McGivern - IR
Mr Calder - IR
Mr Keith - IR
PS/IR

Mr Hardcastle

FOREIGN EXCHANGE GAINS AND LOSSES: CONSULTATIVE DOCUMENT

The Chancellor was grateful for the Financial Secretary's note of 23 January. He is content to go ahead on the basis proposed by the Financial Secretary: ie an expanded and redrafted Chapter 12, a 'snappy' Summary, Budget Day publication, and a two page resumé.

2. He notes the Financial Secretary's comment that the paper makes clear the potential risk of a loss of yield to the Exchequer. He has commented that this should not be a decisive factor; if our present treatment is too harsh, then it is right that there be some reduction in yield.

JT

J M G TAYLOR

Robert 01.23.1.89

BUDGET CONFIDENTIAL

FROM: FINANCIAL SECRETARY

DATE: 23 January 1989

**CHANCELLOR**

cc
Chief Secretary
Economic Secretary
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Peretz
Mr Gilhooly
Mr Ilett
Mr Matthews
Miss O'Mara
Mr Ritchie
Mrs Chaplin
Mr Tyrie
Mr Call

Mr McGivern )
Mr Calder ) IR
Mr Keith )
PS/IR

**FOREIGN EXCHANGE GAINS AND LOSSES: CONSULTATIVE DOCUMENT**

I have discussed with officials the draft consultative document on foreign exchange gains and losses which was attached to Mr McGivern's minute of 8 December. I think it is a good paper.

This is a very difficult, if not intractable, issue, and it is not at all easy to see one single clear way forward. The paper sets out a number of areas of particular difficulty; the distinction between capital and income, and the fact that CGT applies only to assets and not liabilities. It also highlights the very real difficulties inherent in each of the possible "solutions" (the conversion, settled transaction and translation bases), not least the fact that each problem requires a different solution in different circumstances. And although it tentatively puts forward a number of more limited proposals, it also makes clear that these are not without their problems either, not least the potential risk of a loss of yield to the Exchequer.

I favour publication. There is pressure for change (if only the unfocussed "something must be done" variety); and a growing feeling that we are dragging our feet in this area. Publication would help to dispel the latter, as well as to put the onus firmly on those who believe a simple solution is at hand if only we look hard enough. I believe it would be welcomed by the specialists.

The present draft may be criticised as somewhat agnostic, though it reflects the realities of the problems. I have considered the option of making clear a "preferred way forward". But I do not believe we can do much more than the draft does at this stage. People may well ask why we can not, when other countries can. But that does not take account of other differences in national tax systems.

I have however asked officials to expand and redraft Chapter 12, and to include a snappy summary at the front. I agree that we should go for a Budget Day publication; and a 2-page resume will help to interest a wider audience than just the specialist. I have also asked for the parallel Press Release to be written in the same vein.

R.C.M.S.

pp NORMAN LAMONT

chex.ps/jmt.56 CONFIDENTIAL

FROM: J M G TAYLOR
DATE: 27 January 1989

MR A J HARDCASTLE

cc PS/Chief Secretary
PS/Financial Secretary
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Odling-Smee
Mr Odling-Smee
Mr Peretz
Mr Gilhooly
Mr Ilett
Mr Matthews
Miss O'Mara
Mr Ritchie
Mrs Chaplin
Mr Tyrie
Mr Call

Mr McGivern - IR
Mr Calder - IR
Mr Keith - IR
PS/IR

FOREIGN EXCHANGE GAINS AND LOSSES: CONSULTATIVE DOCUMENT

The Chancellor was grateful for your note of 27 January.

J M G TAYLOR

BUDGET CONFIDENTIAL

**Inland Revenue**

Business Tax Division
Somerset House

FROM: M A KEITH
DATE: 10 FEBRUARY 1989

1. Mr McGivern
2. Financial Secretary

I hope these proposed changes will meet the points you asked us to look at further. Of necessity a brief summary of this kind has to be very general in content.
10/2

FOREIGN EXCHANGE GAINS AND LOSSES: CONSULTATIVE DOCUMENT

1. You and the Chancellor have agreed in principle that a consultative document on the tax treatment of foreign exchange gains and losses should be published on Budget Day. At the meeting you held on 19 January to discuss the draft submitted with Mr McGivern's note of 8 December, you asked us to do some further work on the document prior to publication. A fresh version is attached which we hope does what you wanted.

---

cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Peretz
Mr Odling-Smee
Mr Ilett
Mr Gilhooly
Mr Ritchie
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Hardcastle
Mr Hewitt (BoE)

Chairman
Mr Isaac
Mr Deacon
Mr Johns
Mr McGivern
Mr Skinner
Mr J F Hall
Mr J W Calder
Mr Keith
Mr Weeden
Miss Brand
Miss Reid
PS/IR

2. The main changes, which have been cleared with the Treasury and the Bank, are:

a. A new short summary, as you suggested. This is designed as a free-standing preface to the document which will allow journalists (for example) to get a general idea of what the document says fairly quickly.

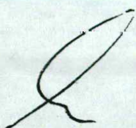
b. A revised version of the Introduction. The first four paragraphs are new; they are intended to put the document into context and explain the Government's aim in publishing it.

c. A new version of Chapter 9; the main changes are sidelined in the attached copy. The Chapter has been reordered, so that the interest section (which discusses the option of treating foreign exchange gains and losses as if they were interest received and paid) now forms part of a section at the end which brings together all the options for dealing with gains and losses which do not form part of a trade within the income tax regime (paragraphs 9.37-9.54). This change is designed to make the Chapter rather easier to follow. The other main change is to the section which discusses the option of dealing with non-trading exchange gains and losses under new rules within the income tax regime (paragraph 9.45-9.54). This section has been expanded to meet the point raised at the 19 January meeting that the balance of the argument of the Chapter required this option to be covered in greater depth.

d. Again at your suggestion, we have redrafted Chapter 12 to make it a fuller and more comprehensive summary of the document and to round the document off more satisfactorily than the previous version.

3. There are also some minor changes in other Chapters, mainly thrown up by discussions with Bank and Treasury officials. These are also sidelined in your copy.

4. We shall be glad to know as soon as possible whether you are content with these revisions to the document and for printing to proceed. We will of course be sending you a draft of the parallel Budget Day press release in due course.



M A KEITH

BUDGET CONFIDENTIAL

R Satchwel 6.17.02.89

PWP

FROM: R C M SATCHWELL
DATE: 17 February 1989

MR KEITH - IR

cc: PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
Mr Hardcastle
Mr Scholar
Mr Culpin
Mr Peretz
Mr Odling-Smee
Mr Gilhooly
Mr Ilett
Mr Ritchie
Mrs Chaplin
Mr Tyrie
Mr Call
Mr Hewitt - Bank

Mr McGivern ) IR
Mr J W Calder )
PS/IR

**FOREIGN EXCHANGE GAINS AND LOSSES: CONSULTATIVE DOCUMENT**

The Financial Secretary was grateful for your minute of 10 February. He is content with the revisions to the consultative document. He is also content with the additional suggested indent in paragraph 12.8 we discussed on the phone, namely:

- "the extent to which other options for change discussed in the document might affect the compliance costs of businesses".

The Financial Secretary is content for printing to proceed.

R.C.M.S.

R C M SATCHWELL
Private Secretary

BUDGET CONFIDENTIAL

**Inland Revenue**

Business Tax Division
Somerset House

FROM: M A KEITH

DATE: 22 FEBRUARY 1989

PWP

1. Mr Isaac
2. Financial Secretary

FOREIGN EXCHANGE GAINS AND LOSSES: CONSULTATIVE DOCUMENT

I attach, for your approval, a copy of the Budget Day Press Release announcing publication of this consultative document.

The synopsis on the first page outlines the broad scope of the document and invites representations on the matters discussed. The summary is a slightly shortened version of the one that appears at the front of the document.

M A KEITH

---

cc PS/Chancellor
PS/Chief Secretary
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Peretz
Mr Odling-Smee
Mr Ilett
Mr Gilhooly
Mr Ritchie
Mrs Chaplin
Mr Tyrie
Mr Hardcastle
Mr Gieve

Chairman
Mr Isaac
Mr Deacon
Mr Johns
Mr McGivern
Mr Skinner
Mr J H Hall
Mr J W Calder
Mr Keith
Mr Weeden
Miss Brand
Mr Denton
Miss Reid
Ms McFarlane
PS/IR

[3X] 14 March 1989

FOREIGN EXCHANGE GAINS AND LOSSES-CONSULTATION ON TAX TREATMENT

The Chancellor has approved publication of a consultative document on the tax treatment of foreign exchange gains and losses.

Increasingly, business is conducted across national boundaries, so that many UK companies are exposed to currency fluctuations. Most of the foreign exchange gains and losses arising from these fluctuations are already taken into account for tax purposes, but significant problems remain in certain areas, particularly in the treatment of borrowings of a capital nature.

The Government recognise the importance which industry and its advisers attach to the need for change in this complex area of the business tax system. The consultative document examines the scope for comprehensive legislative reform, and also identifies a number of individual areas where business has found particular difficulty. In each case the document identifies in some detail options for change, and the practical implications that these would seem likely to entail.

The Government have published this document as a detailed response to the calls for change. The Government would welcome further comment on the practical implications of the options discussed in the document, and on how the particular problems which have been identified might best be approached.

Copies of the document may be obtained by calling at or writing to the Inland Revenue Reference Room, Room 8 New Wing, Somerset House, Strand, London WC2R 1LB. The cost of the document is £4.50 (including postage). Payment should be made by cheque or postal order (payable to "Inland Revenue") or in cash. Postage stamps cannot be accepted in payment.

Representations are invited on the matters discussed in the document, if possible to be received by 30 September 1989. They should be sent to:

The Board of Inland Revenue
Exchange Consultation
Room 69 New Wing
Somerset House
London
WC2R 1LB

/SUMMARY OF DOCUMENT

## SUMMARY OF DOCUMENT

<u>Present Tax Treatment</u>

1. Under the present UK tax system, gains and losses resulting from currency fluctuations are not always taken into account for tax purposes in the same way, or even at all. For example, some may be treated as trading profits or losses, and some as capital gains or losses, while others fall outside the tax system altogether so that gains are neither taxed nor losses relieved.

2. This leads to difficulties, in particular:

- the absence of relief for exchange losses on capital borrowings (although, as a corollary, gains are not taxed);
- the hedging of currency exposures may be made ineffective because the hedge is treated differently from the underlying transaction;
- changes in the sterling value of foreign currency denominated share capital are not taken into account for tax purposes.

<u>Main Options</u>

3. The document considers how these problems might best be tackled for the corporate sector within the broad framework of the existing tax system.

4. It considers:

- when exchange differences should be taxed or relieved - perhaps when a transaction is settled by cash payment; or when assets and liabilities are translated into sterling in the annual accounts; or some combination of these;
- how they should be recognised - perhaps as part of the trading profit or loss; or as capital gains or losses; or under new rules within the income tax system.

5. It also considers the kind of rules which would be needed to protect the Exchequer against potentially very high costs from:

- relief for exchange losses which in commercial terms are matched by corresponding untaxed gains so that there is no overall gain or loss within the company or group;
- repayment and renewal of foreign currency loans to crystallise accrued exchange losses while deferring accruing exchange gains;

/. exploitation of timing

- exploitation of timing and other differences on intra-group transactions, especially within multinationals.

6. These problems may be especially difficult to solve because of the complex financing arrangements used by large companies and groups in the normal course of their business. For example, it may not be easy to draft clear and objective rules to establish whether a particular loss is in fact linked with a gain which may have been made elsewhere in the group; or whether a new loan can be said to replace another which has been repaid.

7. If an acceptable basis for comprehensive reform cannot be found, it may be possible to make important but more limited changes to deal with specific problems, for example, the need for symmetrical tax treatment of a hedge or exchange differences on share capital denominated in foreign currency. The document discusses some possible alternative approaches to these problems.

---

NOTES FOR EDITORS

1. Current Inland Revenue practice on the tax treatment of foreign exchange gains and losses is set out in Statement of Practice SP1/87. When this Statement of Practice was published, the Financial Secretary said:

> "We have certainly not ruled out the possibility of major legislative reform but, before committing itself, the Government would need to be satisfied that a scheme could be devised which could be applied effectively in practice and reflect a broad measure of agreement without entailing an unacceptable cost to the Exchequer."

2. Following publication of the Statement of Practice, proposals for change were made by a group of nine major trade and professional bodies in July 1987. Their report was an important contribution to the debate on the need for a new scheme of relief, but as the group itself recognised, it left unanswered a number of important questions which would need to be tackled in any comprehensive reform.

---

CONFIDENTIAL

FROM: A C S ALLAN
DATE: 8 March 1989

BP 10/3

MR MOWL

cc Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Riley
Mr Sedgwick
Mr Gieve
Mr Pickford
Mrs Chaplin

DEBT REPAYMENT

The Chancellor would be grateful for advice on what proportion of total public sector debt will have been repaid as a result of the cumulative surpluses in 1987-88, 1988-89 and 1989-90. No doubt you will be able to advise on the appropriate definitions (and on points such as net and gross).

ACSA

A C S ALLAN

**COPY NO: 1 OF 16 COPIES**

**FROM: COLIN MOWL**
**DATE: 10 March 1989**

**CHANCELLOR**

cc Chief Secretary
Sir P Middleton
Sir T Burns
Mr Scholar
Mr Culpin
Mr Riley
Mr Sedgwick
Mr Peretz
Mr Gieve
Mr Pickford
Mr Patterson
Mrs Wright
Mrs Chaplin

**DEBT REPAYMENT**

You asked for advice on what proportion of total public sector debt will have been repaid as a result of the cumulative surpluses in 1987-88, 1988-89 and 1989-90 (Mr Allan's minute to me of 8 March).

2. Net public sector debt is the closest stock analogue to the PSBR/PSDR. But as you know changes in the outstanding stock of net public sector debt are not the same as the PSBR/PSDR for four main reasons:

(i) valuation changes as a result of changes in the exchange rate - the public sector has positive net foreign currency assets which rise in value, reducing net debt, if sterling falls and vice versa for a sterling appreciation;

(ii) the stock of debt is measured at nominal values but the PSBR/PSDR reflects the market prices at which transactions take place. If, for example, gilts are sold at a discount, the rise in the stock of debt is larger than the associated PSBR.

(iii) capital uplift on IGs increases their nominal value (and hence net public sector debt) but there is no associated cash (PSBR) transaction.

(iv) there is measurement discrepancy (ie. a balancing item) between changes in the stock of debt on the one hand and the PSBR/PSDR on the other.

£ billion

| | Stock of net public sector debt | | PSBR (+)/PSDR(-) |
|---|---|---|---|
| | End-year level | Change in year | |
| 1986-87 | 171.1 | | |
| 1987-88 | 171.3 | +0.2 | -3.5 |
| 1988-89 | 157 | -14½ | -13.9 |
| 1989-90 | 143 | -14 | -13.8 |

The main difficulty is that the stock of net debt rose in 1987-88 despite a PSDR of £3½ billion. Much of this difference is due to the statistical discrepancy. The change in debt in 1988-89 is our estimate, taking into account exchange rate movements etc, which will appear in chapter 6 of the FSBR. For 1989-90 we have assumed the change in stock of debt and PSDR to be the same.

3. There are, in one sense, competing estimates of the proportion of debt repaid over the three year period:

- the projected stock of net debt at end 1989-90 is £28 billion, or 16 per cent, lower than its end 1986-87 level;

- the cumulative PSDR over the three year period, £31.2 billion, is equivalent to 18 per cent of the outstanding stock of debt at the start of the period.

4. Earlier ministerial speeches have used the second approach in the context of debt repayment in 1987-88 and 1988-89. But in the context of a three year debt repayment, where the 1987-88 discrepancy between the PSDR and change in stock of debt is less important, I recommend the first approach. The Chancellor could say:-

"As a result of the cumulative surpluses in 1987-88, 1988-89 and 1989-90 some 16 per cent of (net) public sector debt will have been repaid."

Colin Mowl

COLIN MOWL

CONTENTS

SUMMARY

INTRODUCTION

PART ONE: NATURE OF FOREIGN EXCHANGE GAINS AND LOSSES

1. Currency Fluctuations
2. Economic Perspective

PART TWO: THE CURRENT REGIME

3. Accounting: Problems and Practice
4. The General Principles of UK Tax Treatment
5. Existing UK Tax Practice
6. Practical Difficulties with the Present Tax Regime

PART THREE: OPTIONS FOR CHANGE

7. Framework for Change
8. A Comprehensive Scheme: Timing - When Should Exchange Differences be Recognised?
9. A Comprehensive Scheme: How Should Gains and Losses be Recognised?
10. Risks to the Exchequer
11. Some Alternative Approaches
12. Review and Conclusion

ANNEX A Scale of the Issue

ANNEX B Effect of Marine Midland on UK Tax Treatment

ANNEX C International Comparisons

ANNEX D Specific Calls for Change

ANNEX E Glossary of Terms

**SUMMARY**

1. Under the present UK tax system, gains and losses resulting from currency fluctuations are not always taken into account for tax purposes in the same way, or even at all. For example, some may be treated as trading profits or losses, and some as capital gains or losses, while others fall outside the tax system altogether so that gains are neither taxed nor losses relieved.

2. This leads to difficulties, in particular:

- the absence of relief for exchange losses on capital borrowings (although, as a corollary, gains are not taxed);
- the hedging of currency exposures may be made ineffective because the hedge is treated differently from the underlying transaction;
- changes in the sterling value of foreign currency denominated share capital are not taken into account for tax purposes.

3. The document considers how these problems might best be tackled for the corporate sector within the broad framework of the existing tax system.

4. It considers:

- **when** exchange differences should be taxed or relieved - perhaps when a transaction is settled by cash payment; or when assets and liabilities are translated into sterling in the annual accounts; or some combination of these;
- **how** they should be recognised - perhaps as part of the trading profit or loss; or as capital gains or losses; or under new rules within the income tax system.

5. It also considers the kind of rules which would be needed to protect the Exchequer against potentially very high costs from:

- relief for exchange losses which in commercial terms are matched by corresponding untaxed gains so that there is no overall gain or loss within the company or group;
- repayment and renewal of foreign currency loans to crystallise accrued exchange losses while deferring accruing exchange gains;
- exploitation of timing and other differences on intra-group transactions, especially within multinationals.

6. These problems may be especially difficult to solve because of the complex financing arrangements used by large companies and groups in the normal course of their business. For example, it may not be easy to draft clear and objective rules to

establish whether a particular loss is in fact linked with a gain which may have been made elsewhere in the group; or whether a new loan can be said to replace another which has been repaid.

7. If an acceptable basis for comprehensive reform cannot be found, it may be possible to make important but more limited changes to deal with specific problems, for example, the need for symmetrical tax treatment of a hedge or exchange differences on share capital denominated in foreign currency. The document discusses some possible alternative approaches to these problems.

8. The Government recognise the importance which industry and its advisers attach to the need for change in this complex area of the business tax system. They would therefore welcome suggestions on how the particular problems which have been identified in the document might best be overcome.

## INTRODUCTION

1. Increasingly, business is conducted across national boundaries, so that many UK companies are exposed to currency fluctuations. Most of the foreign exchange gains and losses arising from these fluctuations are already taken into account for tax purposes, but significant problems remain in certain areas, particularly in the treatment of borrowings of a capital nature. This has led to calls for a major reform of the present tax regime.

2. The most recent proposals came from a group of nine major trade and professional bodies in July 1987. Their report was an important contribution to the debate on the need for a new scheme of relief, but as the group itself recognised, it left unanswered a number of important questions which would need to be tackled in any comprehensive reform.

3. To carry forward the search for a new scheme of tax relief, the Government have approved publication of this consultative document. The document examines the scope for comprehensive legislative reform and responds, in some detail, to the calls for change. It seeks to contribute to a full and informed discussion of what is widely recognised as one of the most complex and difficult aspects of the business tax system.

4. The Government's aim is to see whether solutions can be found to the various problems identified in the present regime which would command a broad measure of acceptance by business, would be workable in practice and would not involve unacceptable Exchequer costs.

THE CAPITAL/REVENUE DIVIDE

5. One of the areas which commentators have criticised is the distinction which the UK tax system draws between the treatment of capital and revenue items of expenditure and borrowing (see Chapter 6). This means that certain exchange gains and losses are not recognised for tax purposes; and that there is a lack of symmetry in the treatment of others. This has led some to argue that the distinction between income and capital generally is no longer relevant to many business transactions and that it should be abolished.

6. However, any system which sets out to measure and tax income and profits has in general to recognise a fundamental difference between revenue and capital flows - the difference, for example, between interest and a repayment of the investor's original capital. And indeed accounting principles reflect this difference at many points in a company's profit and loss accounts and balance sheet - to take another, more detailed, example, in the treatment of revenue expenditure and capital expenditure on plant and machinery and other fixed assets. The distinction is found in tax systems throughout the world. The abolition of the distinction would therefore raise wide-ranging issues which go well beyond the problems of exchange gains and losses - including perhaps a shift from the present system of taxes on income to an alternative system of taxing expenditure - and is not addressed in this consultative document. The document does however discuss

the question of whether the distinction between revenue and capital borrowing might be dropped in deciding how exchange gains and losses should be taxed or relieved (see Chapter 9).

## SCOPE AND CONTENT

7. The document focuses on foreign exchange gains and losses in the corporate sector. It is a discussion document and the Government will wish to consider the response to it before taking any decision whether to change the present legislation and, if so, the form that change might best take. Were any changes in tax treatment thought to be acceptable for the corporate sector, consideration could be given to some extension of this treatment to traders in the non-corporate sector.

8. The document does not consider the form of any transitional arrangements which might prove necessary were a new system of relief to be adopted. This would clearly be an important issue, but would depend on the precise nature of any change.

9. The first part of the document introduces the subject of currency fluctuations and also considers the wider economic perspective. Part two describes the general principles of the UK tax treatment of foreign exchange gains and losses and examines current Revenue and accounting problems and practice. The final part of the document considers alternative methods of tax treatment.

## REPRESENTATIONS

10. Representations are invited on the matters discussed. In particular, comments and suggestions would be welcome where the document identifies specific issues but not an immediately apparent solution and also where views are sought on the practicability and acceptability of possible ways forward.

11. Representations should be forwarded to:

The Board of Inland Revenue
Exchange Consultation
Room 69 New Wing
Somerset House
London
WC2R 1LB

If possible, to be received by 30 September 1989.

## PART 1 - NATURE OF FOREIGN EXCHANGE GAINS AND LOSSES

### CHAPTER 1 - CURRENCY FLUCTUATIONS

1.1 This Chapter introduces the discussion of currency fluctuations, by identifying some of the simplest situations in which they can affect a business's profits. At the same time, it introduces some elementary terminology.

1.2 Suppose a UK company purchases $10m for £10m when the exchange rate is £1 = $1. These dollars are then used in the company's US business. However, no profit or loss results; $10m remains. When the company comes to convert the dollars back into sterling, the pound has strengthened to £1 = $2. Thus the $10m can be exchanged for only £5m; the company has made an exchange loss of £5m.

1.3 This simple, though admittedly artificial, example illustrates some important points about currency fluctuations:

- **The measure of exchange gains and losses depends upon the base currency.**

  The UK company accounting in sterling, made a loss of £5m. Accounting in $US, it would have registered no exchange gain or loss. In dollar terms, the assets had a value of $10m at both start and finish.

- **Currency fluctuations affect cash flow in the base currency only when the foreign currency is exchanged with the base currency.**

  This is usually termed **conversion.** In the above example, the sterling/dollar exchange rate might have fluctuated substantially between the two conversion dates; however, there is no effect on the company's cash flow until the conversions actually take place.

- **However, where a company holds assets or liabilities denominated in a foreign currency, exchange rate fluctuations will continuously affect that company's wealth as measured in the base currency.**

  If in the above example the sterling/dollar exchange rate had fluctuated wildly, so too would the value of $10m assets as expressed in sterling terms. As discussed below, this may have an effect upon the company's business results as disclosed in its accounts.

1.4 Clearly businesses can be faced with a number of difficulties as a result of currency fluctuations. For example, dollar receipts for goods sold in the USA may need to be converted in order to cover sterling costs. If a UK trader issues a dollar price list, he is thereby exposed to losses should the pound strengthen. He could of course protect himself against that loss by quoting sterling prices. The American customers would

then bear the risk of a price which varies in dollar terms. However, in many cases in a competitive market this will not be commercially acceptable.

1.5 Similarly, delay between invoicing and payment (ie trade debts) exposes the trader to further currency risk. Even where a dollar price is appropriate when agreed, the pound may strengthen before the invoice is paid. In an extreme case, this could render a sale unprofitable. Conversely, of course, if the pound weakens, the trader stands to realise extra profits.

1.6 Exactly the same problems arise in respect of liabilities denominated in foreign currency such as bank borrowings, although the risks are the other way round: the trader loses if the pound weakens. In that event he has to find more pounds to buy the currency to discharge the debts and his sterling profit will, accordingly, be diminished. A strengthening pound will, of course, yield him additional gains, because it will cost him fewer pounds to repay the foreign currency debts.

1.7 The above examples are mainly concerned with the effects of actual conversions of currency. However, companies publish accounts covering fixed periods of time and for a UK company these will normally be in sterling. Consequently, foreign currency transactions and the resulting assets or liabilities have to be reported in sterling whether or not there has been a conversion into sterling. This raises the question of what exchange rate should be used.

1.8 Transactions are normally recorded in a company's accounts as at the date they occur. If the accounts are kept in sterling, foreign currency transactions will normally be recorded at the exchange rate prevailing when the transaction occurs (the **historic rate**), unless a different rate is agreed in the contract. However, a foreign branch or subsidiary may well keep its books in a foreign currency. In such a case, it would not be necessary to translate transactions into sterling until the foreign currency accounts were consolidated into sterling accounts. At that stage it may not be practicable to compute historic rates. Instead the rate prevailing at the balance sheet date (the **closing rate**) or an average rate might be used.

1.9 For balance sheet assets and liabilities resulting from foreign currency transactions, the choice will normally be between the historic and closing rates.

1.10 Exchange gains or losses will arise where a transaction is settled at an exchange rate different from that used when the transaction was originally recorded (or if appropriate at the previous balance sheet date). They will also arise on unsettled transactions if these are in the balance sheet at a different rate from the one used previously. These **translation** gains and losses may have a significant impact on the business results shown by the accounts, though there may have been no conversions into or out of sterling.

1.11 By far the vast majority of flows across the exchanges are transactions by businesses in the normal course of trading activities and the foreign exchange gains and losses arising in

respect of these transactions are already taken into account in the calculation of taxable profits under existing law. For example, where goods are sold in the course of the trade, gains or losses arising from exchange rate movements between the dates of sale and settlement are reflected in the trading profits. The main problems arise in the area of exchange fluctuations on capital borrowings which if not taken into account under the Marine Midland * matching doctrine (Chapter 5), are at present ignored for tax purposes. As a consequence, no relief is available in respect of losses on such transactions; and, as a corollary, exchange gains are not taxable. It is here that any change in the law could have Exchequer implications, whether in terms of volatility of the tax yield or in the scope for manipulation and abuse.

1.12 It is important to note that the risk to the UK Exchequer inherent in any tax changes in this area does not arise from any prior assumption about the longer-term movement of sterling against other world currencies. The issues involved and the related implications for the UK Exchequer are discussed in the following chapters and, in particular, in Chapter 10. In brief, there are potential difficulties or market distortions where:

- Only one side of a foreign currency loan transaction may be within the scope of the UK tax system. For example, a foreign exchange loss on borrowings by a UK company from a non-resident source could be relievable against the UK tax, whereas there could be no corresponding foreign exchange gain chargeable to UK tax in the hands of the lender. This could be true whether the borrowing was from a foreign, non-connected, bank or from a member of the same multi-national group. This could present an incentive for multi-national groups to channel borrowing for international investment through UK group companies (see paragraphs 10.23-10.31).

- But even where both parties to a foreign currency loan were within the UK tax system, the tax treatment of their exchange gains and losses could differ significantly. The lender might be an exempt institution, or a non-trading company in whose hands an exchange gain might be taxed as a capital gain when the loan is repaid. But the exchange loss might accrue - either genuinely in the normal course of business or by design - to a profitable trading company and be relieved annually as a trading expense (see Chapter 9).

- And even where the borrowings and the assets which they were used to acquire are both within the same UK company (eg shares in a foreign subsidiary), an accruing exchange loss on the borrowing might be recognised annually for tax, while the matching

* Pattison (HM Inspector of Taxes) v Marine Midland Ltd 57 TC 219.

gain on the shares would not normally be recognised until the shares were disposed of and would then be reduced by indexation. In other words, overall there would be no actual exchange gain or loss until the borrowing was repaid or the shares sold, but short-term fluctuations in the exchange rate could mean tax relief being given for a non-existent loss.

- There would also be possibilities for manipulation by means of almost circular transactions within a group and involving an offshore intermediary to crystallise exchange losses without creating a corresponding taxable gain.

- Finally, although exchange rates might be stable over the longer-term, short-term fluctuations could cause major volatility in the yield of business taxes.

1.13 Accounting practice is examined in Chapter 3. Chapter 5 goes on to consider areas where this conflicts with tax treatment. However, before considering the complex tax issues which exchange differences give rise to, it may be helpful to examine the economic background to the tax treatment of exchange movements. This is the subject of Chapter 2.

## PART 1 - NATURE OF FOREIGN EXCHANGE GAINS AND LOSSES

## CHAPTER 2 - ECONOMIC PERSPECTIVE

2.1 The objective of this Chapter is to provide an economic perspective on the issues discussed in this consultative document. It considers exchange rate volatility and the determination of exchange rates, the economic issues that arise when considering the tax treatment of foreign exchange gains and losses, the economics of hedging and the cost of recognising gains and losses for tax purposes. It would not be appropriate in a document of this nature to attempt a comprehensive analysis of all these issues. There are many business finance or economic text books that cover the ground in greater detail than is possible here. However, as a recent IFS paper persuasively argued, the determinants of exchange differences can be relevant to their proper tax treatment.

### EXCHANGE RATE VOLATILITY

2.2 Since the breakdown of the Bretton Woods system of fixed exchange rates in the early 1970s companies have operated in an environment of floating exchange rates and the volatility of currency movements can be sizeable. This has increased the likelihood that their profits will be affected by currency movements. It is not just UK companies that export to overseas markets or with operations based overseas that are exposed to risk: any company selling a product in the domestic market that has a significant import content is also exposed.

### THE DETERMINATION OF EXCHANGE RATES

2.3 Although in extreme cases the probable trend of a weak currency against a strong currency might be predicted with some confidence, forecasting the exchange rate is a notoriously fallible exercise. There are several reasons for this. First, there are a number of economic factors that can have a fundamental influence on exchange rates. The relative importance of these factors may be difficult to establish. Second, the behaviour of "players" in the exchange markets in the light of the expectations they hold about the future can lead exchange rates away from fundamentals, especially in the short term. Third, central banks may intervene in an attempt to smooth exchange rate fluctuations.

2.4 In the **longer term** relative inflation rates are important in determining exchange rate movements. The higher the rate of inflation in a given country, the more likely is its exchange rate to depreciate. This is consistent with the "purchasing power parity" theory that, if the prices of traded goods and services differ between countries, then current account pressures will tend to remove these differences - demand will lead to a shift of production to the cheaper location unless there is an offsetting exchange movement. There is empirical evidence which suggests that some correlation between relative inflation rates and exchange movements exists over the longer term, as one might expect if the supply performance of the economy takes time to adjust.

2.5 Other important influences in the longer term include the effects of the supply performance of the economy on non-price competitiveness, the ownership of natural resources (such as North Sea oil and gas), capital flows of a structural (rather than a short term) nature and the mix of monetary and fiscal policy.

2.6 In the **short term** expectations and the information or "news" on which they are based play a more important role. Short term capital movements and relative interest rates may have a dominating influence, increasingly so as capital markets worldwide become more closely integrated.

2.7 One important theory of exchange rate movements, "uncovered interest parity", assumes that such movements are dominated by short term capital flows. Such flows would be generated by arbitrage between different countries' asset markets, in response to differences in expected rates of return. In a world of perfect arbitrage such differences will be quickly eliminated and the **expected** capital gains/losses in one currency vis-a-vis another will exactly offset the interest rate differential between the two markets. Furthermore the premia/discounts on the spot rate in the various forward markets will also reflect interest rate differentials.

2.8 Interest rates will of course be affected by expectations for inflation, and by different expectations in different countries, for much the same reasons as exchange rates themselves. Indeed in a number of respects the debate on exchange differences raises echoes of the more general debate on the accounting and tax treatment of price changes generally, and a number of similar practical issues arise.

2.9 That having been said, actual exchange movements contain an **unexpected** as well as an expected element. In the short run the empirical evidence suggests that the unexpected element tends to dominate the expected movement. In the very short run, most statistical studies suggest that day-to-day movements in exchange rates follow a "random walk" ie there is an equal probability that prices will rise or fall tomorrow given today's price. But over the longer term a correlation is to be expected and can be found between price changes, exchange movements and interest rates.

2.10 One weakness of the "uncovered interest parity" theory in practice is that there is statistical evidence that interest differentials do not predict exchange rate movements correctly. There can be two main reasons for this; a risk premium and bias in market expectations.

2.11 Lenders may require a risk premium when holding foreign denominated assets because lending in a foreign currency means that the return on the lending when expressed in domestic currency is not certain. A risk premium may also be required, for example, when there is a possibility of foreign governments confiscating funds. Bias can occur because, although the market in a currency reflects the expectations of all those active in

the market, these perceptions will not always be realistic in the event, individually or taken together. Like risk, bias in market expectations can disturb the relationship between interest differentials and exchange rate movements even on average.

THE TAX TREATMENT OF EXCHANGE GAINS AND LOSSES

2.12 Virtually all companies are, to a greater or lesser extent, exposed to exchange movements. This is because directly or indirectly they supply foreign markets with exports, or purchase imports from abroad. However exchange differences on such transactions are normally recognised for UK tax purposes under the current regime. As this paper does not propose any changes in this respect, the consequences for tax purposes do not need to be considered in detail.

2.13 The main focus of this section is therefore on the capital assets and liabilities in a company's balance sheet, where most of the tax issues arise. The yield or rate of return on foreign currency denominated assets and liabilities is affected by exchange movements.

2.14 Suppose that, ignoring tax, a company can obtain 10% p.a. return on its capital in the UK but 12% p.a. is available if it invests abroad. In the absence of constraints such as exchange control and assuming no risk factor deterring investment in foreign assets, the company might be expected to buy the appropriate foreign currency and use it to invest in assets denominated in that currency. However, were the foreign currency to depreciate by more than 2% p.a. in sterling terms, the investor would be better off with the domestic investment, despite the superficial allure of higher interest rates abroad. Thus, the investor's decision will be influenced by his expectation of exchange rate movements.

2.15 Neutrality is only one of a number of desirable features of a tax regime (see Chapter 7) but if it is to be achieved, then returns on assets or liabilities of a similar type should be taxed in the same way. However, as Chapter 4 indicates, some exchange differences will be recognised as income, some as capital gains (subject to different rules) and some may not be recognised at all ("nothings"). To that extent commercial decision making may be affected because the return on a foreign asset/liability, including the exchange difference, may be taxed on a different basis from the return on its UK equivalent. Again the potential distortion has to be seen against a background in which inflation may also affect the pre- and post-tax treatment of both interest and capital generally.

2.16 One example, which is dealt with in Chapter 9, is the tax treatment of capital borrowings where, in many cases, exchange gains and losses are not recognised. This tax treatment in theory encourages companies to borrow in weak currencies because the capital gain arising on the exchange movement is untaxed - whilst they get tax relief for the full cost of nominal interest - but not strong currencies because the capital loss will not be relieved.

2.17 The nexus between inflation, interest and exchange differences has led some to argue that exchange differences should be treated as "interest". This argument, and the practical difficulties of adopting such treatment, are discussed further in Chapter 9. In theory it is of course only the "expected" element of exchange movements which is related to interest differentials and in practice the "unexpected" element is sizeable in the short run and tends to dominate the expected element.

2.18 Some have suggested that the theoretical distinction between "expected" and "unexpected" exchange differences should be carried through to the tax treatment of exchange differences. This suggestion was put forward in the US Administration's tax reform proposals of May 1985 (Treasury II) but, in the event, the reform that emerged in the 1986 Tax Reform Act was not based on this distinction. The approach adopted in the IFS report on the taxation of exchange gains and losses (Annex D) is similar but not identical to that of Treasury II.

2.19 In essence this approach assumes that uncovered interest parity holds so that information on premia or discounts from the forward market or interest rate differentials can be used to calculate the value of the expected element. This element would be recognised for tax purposes whereas the unexpected element would not be recognised at all (IFS) or only recognised on realisation (Treasury II). One basic question over this approach - on which the Government would need to be persuaded - is whether companies would be likely to support a basis of taxation which taxes gains or relieves losses which they might have been expected to make rather than those which they actually made. A second basic question concerns its practicalities: could it be made to work in a reasonably straightforward way in practice? This is discussed further in Annex D where a number of serious difficulties emerge. It is not considered further in this document.

THE ECONOMICS OF HEDGING

2.20 Companies can limit their exposure to exchange rate movements in a variety of ways collectively known as "hedging". Hedging involves establishing an offsetting currency position so that whatever is gained or lost on the original currency position is wholly (or partly) offset by a compensating loss or gain on the offsetting position.

2.21 Where a company has an excess of assets or liabilities in a particular currency, the offsetting position can be established by use of a financial instrument. The financial markets now supply a variety of hedging instruments including forward contracts, futures, options or currency swaps that allow companies to offset exposure of their cash flows to exchange risk.

2.22 Hedging of this kind does not eliminate all exchange movements. In essence the role of hedging is to limit the impact of the "unexpected" element of exchange movements discussed earlier. A forward contract will crystallise the sterling value of foreign currency available to a company on a future date and

limit the exchange movement to the market's "expectation" which will be reflected in the price of the forward contract as a premium/discount on the current spot rate. A foreign currency option can be used to set limits on the adverse effect of possible exchange rate movements but again the cost will to a large extent reflect the "expected" exchange movement.

2.23 A company can also hedge its exchange risk by ensuring that its assets and liabilities in the same currency are matched. If, for example, a company has portfolio assets denominated in a foreign currency, it can offset the exposure by borrowing in the same currency. With this kind of hedging, as long as the foreign currency values of the assets and the liability remain in line there is no exchange gain or loss (whether expected or unexpected) overall. However, in this case, if the market expects the two currencies to move relative to each other, the rate of interest paid on the foreign currency liability will differ from that which would have been payable on an equivalent sterling liability (if, for example, the foreign currency assets had been financed by sterling borrowings). This difference reflects the "expected" exchange movement; so the cost of this type of hedging is in effect similar to that of hedging via a financial instrument.

2.24 What is the optimum amount of hedging? Generally there is a trade-off between risk and reward. Some companies will hedge 100% as a matter of course. Others will seek to contain risk to acceptable levels. Given that hedging has a cost, as long as companies (and their shareholders) are not totally risk averse the amount hedged will usually be less than 100%.

2.25 The other major factors affecting the amount of hedging are, first, the availability of hedging instruments at a reasonable cost and, second, the degree of understanding by companies of how they can be used. In recent years there has been extensive innovation by financial markets and a wide range of instruments are now actively marketed. Major companies now place much greater emphasis on the treasury function, often treating it as a profit centre within the group.

2.26 Nevertheless there have been a number of well publicised instances of UK companies failing to hedge adequately and suffering large losses. Cost also probably remains something of a deterrent, particularly as it is easy to be wise after the event if an adverse currency movement does not materialise.

2.27 What significance does all of this have for the tax regime? Where foreign currency borrowing is itself being used as a hedging instrument (by portfolio investors say) then ideally all that is needed for the tax treatment to reflect the commercial reality is that the exchange differences on both the asset and the liability should be treated in the same way. But this raises practical and theoretical difficulties, which are discussed in Chapters 9 and 10.

2.28 Alternatively, suppose that the asset/liability acquired increases currency exposure so that hedging by means of a financial instrument is desirable in principle. The objective of the tax regime should then be to ensure that the tax treatment of

the integrated transaction reflects the true commercial cost and does not deter companies from using hedging instruments. This will not happen if different elements of the integrated transaction are dealt with in different ways for tax purposes. This issue of tax "fragmentation" is discussed below in Chapter 6.

THE COST OF RECOGNISING GAINS AND LOSSES FOR TAX PURPOSES

2.29 The full recognition of gains and losses on exchange movements that would result from a comprehensive scheme (see Chapter 9) implies that the Exchequer shares with companies the risk of adverse exchange movements on their capital assets and liabilities. If companies hedge 100% of their unmatched positions, then their exposure to exchange movements would effectively be limited to the "expected" element which, as noted earlier, will tend to reflect interest rate differentials but may also reflect other factors, including a risk premium and/or market bias. But if hedging is not 100%, the unhedged element is exposed to the full exchange risk. In principle this is no different to what happens elsewhere in the tax system: generally, unexpected upward or downward movements in profits or the capital gains on assets would be taxed or relieved, where the profits or gains are in principle chargeable to tax. But the potential revenue effects of comprehensive reform in this area are important.

2.30 Where hedging takes the form of matching capital assets and liabilities, the Exchequer exposure would be eliminated only if exchange differences on assets and liabilities were dealt with in the same way at the same time. For reasons discussed in Chapters 9 and 10 such symmetry may be difficult to achieve. In that event the Exchequer might be exposed to exchange risks - expected and unexpected - on liabilities which financed capital assets. Since they would be risks that companies themselves had eliminated, the cost here would be an even more important issue.

2.31 It is very difficult to provide precise estimates but some illustrative figuring may be helpful to provide an indication of the likely effects. Paragraph 10.2 suggests that, outside the banking sector, there is perhaps £30 billion of capital borrowing for which exchange differences are not recognised. More detail on the scale of the issue is to be found in Annex A. This is a very uncertain figure but, treated as an illustrative estimate, a change of one per cent in exchange rates could have a revenue effect of £50-£100 million in a particular year (paragraph 10.4).

2.32 This figure does not take account of cross-border transactions between companies/branches within multinational groups. As Chapter 10 indicates, without some protection such groups could exploit the recognition of gains and losses to their advantage - to the extent of course that exchange movements were reasonably predictable.

## PART 2 - THE CURRENT REGIME

## CHAPTER 3 - ACCOUNTING: PROBLEMS AND PRACTICE

3.1 This Chapter examines the consequences of currency fluctuations as represented in company accounts. In particular, it looks at the UK accounting standard on foreign currency translation.

3.2 There is no real problem in accounting for simple cash transactions settled within an accounting period. The difficulties arise with foreign exchange transactions not settled at the balance sheet date. Such items must appear in the company's reporting currency. Consequently, the company has to adopt a method of translation and decide how to account for resulting exchange gains and losses.

3.3 Further problems arise, for example, when branch results prepared in a foreign currency are consolidated into group accounts or where a transaction involves a contracted exchange rate different from that prevailing in the market.

3.4 Up until the 1970s there was no real uniformity in the UK accounting treatment of foreign exchange gains and losses but then various factors led to their having a much more prominent effect on company accounts. The ending of fixed exchange rates, the increase in the volume of world trade and the movement of international capital, the development of wide inflation differentials between major economies and the increasing importance of multi-national companies - each exerted an influence. Pressure grew for the adoption of a uniform accounting standard, and this coincided with a period of intense debate in the US on this subject. The UK accountancy bodies were closely involved in the decision by the Financial Accounting Standards Board to move in 1981 to the current US accounting standard FAS 52, and in April 1983 the UK Accounting Standards Committee issued the very similar UK standard, Statement of Standard Accounting Practice No 20 (SSAP 20).

3.5 Apart from exceptional cases, SSAP 20 is normally to be applied in the preparation of company accounts. However, the statement does not deal with accounting for profits or losses on a company's normal currency dealing operations and its relevance to financial concerns may therefore be limited.

3.6 The statement proceeds in two stages. First it sets out rules for producing the accounts of individual enterprises in their **local currency** - the currency of the primary economic environment in which they operate. It goes on, as a separate matter, to prescribe the method by which the resulting financial statements are then to be consolidated into the accounts of a home company or group prepared in a different currency.

3.7 The general rules for the accounts of single enterprises are as follows:

a each asset, liability, revenue or cost arising from transactions denominated in foreign currency should be translated into the company's local currency at the rate prevailing when the transaction occurs (ie an historic rate basis);

b once **non-monetary assets** (ie assets other than cash and debts) have been recorded in the company's local currency, no further translation is to be made. These items therefore continue to appear in the balance sheet at the historic rate for as long as they exist;

c monetary assets and liabilities should be translated at each balance sheet date using the exchange rate then prevailing;

d exchange gains and losses will arise on **settled transactions** when the rate at the date of settlement differs from that previously used; and on **unsettled transactions** when the rate at the balance sheet date differs from that previously used. In both cases the exchange differences are taken to profit and loss.

3.8 Exchange differences other than those arising on unsettled long-term (over one year) items are said by SSAP 20 to be realised; but even exchange differences resulting from the translation of long-term monetary items at closing rate should be included in the profit and loss account to show a true and fair view. The only restriction is where there are doubts as to the marketability or convertibility of the currency concerned.

3.9 There are exceptions to these general rules. The most important concerns foreign equity investments. These non-monetary assets would not normally be translated annually (paragraph 3.7b). However, where they are financed out of foreign currency borrowings (which are liabilities to be translated each year - paragraph 3.7c), the company may also value the assets at the closing exchange rate each year and carry the exchange difference to reserves. Exchange gains and losses on the related borrowings are then offset against those exchange differences as a reserve movement.

3.10 Other minor exceptions include transactions to be settled at a contracted exchange rate (where the contracted rate is used in making translations as in paragraphs 3.7a and c) and trading transactions covered by a forward currency contract (where, again the contracted rate may be used).

3.11 Having produced the accounts of a single entity, the problem of consolidation may arise. The method to be adopted depends on the facts of the individual case.

3.12 Where the affairs of the foreign enterprise are so closely interlinked with those of the home company that its results may be regarded as being more dependent on the economic environment of the home company's currency than its own reporting currency,

the **temporal method** of translation should be used. This provides that the financial statements of the foreign enterprise should be included in the consolidated financial statements as if all its transactions had been entered into by the home company in its own currency. The mechanics of the temporal method are identical to those used when preparing the accounts of an individual enterprise.

3.13 More commonly, however, a foreign enterprise operates as a separate business. In this case, all the items appearing in its **balance sheet** are to be translated into the reporting currency at the rate of exchange prevailing at the balance sheet date. In other words, the home company's net investment in the foreign entity is to be translated at the closing rate.

3.14 Amounts in the **profit and loss** account of the foreign enterprise are to be translated into the home company's currency at the closing rate or at an average rate for the accounting period and then simply entered into the home company's profit and loss account. Whichever rate is adopted, it is to be applied consistently from year to year.

3.15 Exchange differences in the home company's accounts arising from the re-translation of its net investment in the foreign enterprise at the closing rate should be recorded as a movement on reserves. If the profit and loss account of the overseas operation is translated at an average rate, the difference between the profit so translated and the result of applying the closing rate should also be recorded as a movement on reserves.

3.16 This method of consolidating the financial statements of a foreign enterprise is described as the **closing rate/net investment method.**

3.17 SSAP 20 provides examples of the factors to be taken into account in deciding whether the temporal or closing rate/net investment method is the more appropriate. Whichever is used, it should be applied consistently unless the relationship between the foreign enterprise and the home company changes.

3.18 In summary, SSAP 20 requires that exchange gains and losses should normally be recognised only on monetary items and that such gains and losses, whether realised or unrealised, should generally be recognised through the profit and loss account. However, in consolidating the accounts of foreign enterprises which operate as separate businesses, companies should recognise exchange gains and losses on both monetary and non-monetary items but should put all exchange differences to reserves rather than through profit and loss account.

## PART 2 - THE CURRENT REGIME

## CHAPTER 4 - THE GENERAL PRINCIPLES OF UK TAX TREATMENT

4.1 This Chapter explains the broad principles of the UK tax system as they affect foreign exchange gains and losses. (The tax treatment of exchange differences in other countries is discussed at Annex C). UK legislation is virtually silent on the tax consequences of exchange rate fluctuations. Only very few sections of the Taxes Acts refer to them specifically. Beyond this extremely limited guidance, the tax treatment of exchange differences derives from the application of general principles of tax law.

4.2 Corporation tax is levied on profits made up of income calculated according to income tax rules and capital gains calculated according to Capital Gains Tax (CGT) rules. It is assessed by reference to the profits of individual companies, not groups of companies. This means that the choice of method of consolidating the account of a subsidiary company into those of a group is not relevant for tax purposes. But the method which an individual company uses to consolidate foreign **branch** profits or losses is relevant since companies resident in the UK are chargeable to Corporation Tax on their worldwide profits.

### INCOME TAX

4.3 Under existing law, non-trading income (such as interest, dividends or rents) paid in foreign currency is simply translated into sterling at the exchange rate prevailing when the income arises for tax purposes. Likewise, statutory deductions such as capital allowances and interest paid are computed by translating foreign currency payments into sterling using the exchange rate prevailing when the expenditure is incurred for tax purposes or paid, as the case may be. Commercial accounting principles have little relevance in such situations.

4.4 Commercial accounting principles are, however, important in the computation of trading profits. If correct accounting practice recognises foreign exchange differences as part of the commercial trading profit, then those differences will generally be recognised in taxing trading income. There are, however, limitations to the application of commercial accounting practice, resulting both from specific statutory provisions and from case law. These limitations will in many cases exclude particular foreign exchange gains or losses from the computation of trading profits for income tax purposes (see paragraph 5.14 for the contrast between tax rules and SSAP 20).

### CAPITAL GAINS TAX

4.5 Receipts and expenditure not taken into account in computing income for income tax purposes may be recognised in CGT computations. Case law has established how chargeable gains on the disposal of assets denominated in foreign currency are to be calculated. Both cost and disposal proceeds must be translated into sterling at the exchange rates ruling at the dates of the transactions concerned. As a result, exchange movements against sterling will be fully recognised in the computation.

4.6 Due to significant differences between the two regimes (primarily indexation), exchange gains and losses reflected in CGT assessments can be very different from those recognised under income tax rules. They will also differ in most cases from the exchange differences appearing in accounts. Different gains and losses of the same company falling partly within one set of rules and partly within the other will not, because of the restricted right of set-off, always cancel each other out in tax computations as they might in the accounts.

"NOTHINGS"

4.7 Some exchange gains or losses will not be recognised at all for tax purposes, under either the income tax or the CGT rules. Items which are ignored by these rules are commonly referred to as "nothings".

4.8 A gain or loss outside the income tax regime is chargeable or allowable under the CGT rules only if it arises on the disposal of a chargeable asset. Although foreign currency is itself a chargeable asset, not all assets denominated in foreign currency are chargeable assets. The most important exception in the foreign exchange field is debts (ie loans made **to** other parties). A debt is not a chargeable asset unless the loan is made on such terms that it constitutes a **debt on a security** (ie broadly a debt which is marketable). Furthermore, exchange gains and losses of a capital nature may arise on foreign currency liabilities. However, there is no provision for recognition of gains or losses on liabilities (ie loans received **from** other parties) in the UK CGT system.

Overseas Net Earnings of UK Financial Institutions

£ million

| | 1977 | 1985 | 1986 | 1987 |
|---|---|---|---|---|
| Insurance | 917 | 3262 | 4913 | 4834 |
| Leasing | - | 66 | 50 | 40 |
| Investment Trusts | 51 | 183 | 189 | 171 |
| Unit Trusts | 12 | 113 | 178 | 218 |
| Pension Funds | 17 | 618 | 697 | 732 |
| Securities Dealers | - | 318 | 550 | 554 |
| Commodity Traders and Export Houses | 230 | 609 | 571 | 573 |
| Brokerage etc | 233 | 524 | 624 | 858 |
| Total excluding Banking | 1460 | 5693 | 7772 | 7980 |
| Banking | 61 | 1270 | 2176 | 1394 |
| Total | 1521 | 6963 | 9948 | 9374 |

Source: UK Balance of Payments - 1988 Edition.

## PART 2 - THE CURRENT REGIME

## CHAPTER 5 - EXISTING UK TAX PRACTICE

5.1 This Chapter sets out how the Revenue seeks to apply the law in practice. Following the House of Lords decision in the Marine Midland case in December 1983 (see Annex B), the Inland Revenue engaged in a lengthy period of consultation with interested parties. This process concluded with the issue of a Statement of Practice SP1/87 in February 1987, which replaced a provisional Statement of Practice issued earlier in the consultation process.

5.2 The Statement of Practice was presented as a practical guide to facilitate the preparation and agreement of tax computations of **trading taxpayers.** The Marine Midland decision and the practice described was not applicable to non-trading transactions.

### TIMING OF RECOGNITION OF EXCHANGE DIFFERENCES

5.3 SP1/87 confirmed that where business accounts (prepared in accordance with the Companies Acts and generally accepted accounting principles) take account of translation profits and losses in computing trading profits, those profits and losses should normally also be taken into account in computing trading income for tax purposes. This would not however be the case where there were particular reasons for taking a different view, eg where the gains or losses were in respect of capital items. It was pointed out that, apart from the requirements of accounting practice as laid down in SSAP 20, any attempt to deal with exchange profits and losses only where there was a conversion into sterling would, in many cases, present virtually insuperable problems of identification and follow up for both taxpayers and the Revenue alike. Nonetheless, the way was left open for a taxpayer to make out his case to the Inspector if he considered that the application of the relevant case law to his particular facts would result in a basis other than that set out in SSAP 20 - including a conversion basis.

### THE CAPITAL/REVENUE DISTINCTION

5.4 The Statement of Practice confirmed that the distinction between capital and current liabilities was between loans which could be said to add to the capital base of the business and loans providing temporary financial accommodation. This distinction is relevant particularly where foreign currency borrowings are converted into sterling for use in a trade conducted mainly in sterling so that there are no foreign currency assets to be matched against the liabilities. The dividing line is often difficult to draw and the answer in any individual case must turn on its particular facts. An important case (Beauchamp v F W Woolworth plc*) is proceeding through the Courts in which the Special Commissioners held that five year loans were raised for the general purposes of the company's trade and represented temporary facilities rather than a permanent addition to its capital.

* Beauchamp (HM Inspector of Taxes) v F W Woolworth plc (1987 STC 279 (High Court decision); 1988 STC 714 (Court of Appeal))

MATCHING

5.5 The Statement of Practice set out the way in which the Revenue interpreted the principle that all exchange gains and losses on assets and liabilities which are matched at any time in the accounting period should be ignored for tax purposes. It stated that:

- foreign currency liabilities could be regarded as matched only with assets in the same or a linked currency;
- in the Revenue's view the matching principle applied also where there were capital assets and current liabilities (the reverse of the situation in Marine Midland); and
- where, exceptionally, non-monetary capital assets were treated as foreign currency assets for accounting purposes, the tax treatment would be considered by reference to the particular facts.

5.6 In practice, companies are not generally matched in every currency throughout an entire accounting period. The Revenue confirmed that it is therefore necessary to consider both any entry in the profit and loss account (in order to disallow or exclude any unmatched exchange loss or gain relating to capital items) and any exchange differences on unmatched items taken to reserve (in order to bring any unmatched difference arising on current account into the tax computations).

5.7 It is for a company to demonstrate the matching of capital items but SP1/87 accepted that there could be practical difficulties in doing this since the extent to which capital and current items were matched might fluctuate on a day to day basis. A simplified practical method for calculating the effects of matching was proposed, as follows:

- For each currency, the aggregate exchange differences on capital assets and liabilities are compared with the net exchange difference taken to profit and loss account;

  then either

- if both items are losses or both are gains an adjustment is made in the tax computation, with the smaller amount being disallowed (if loss) or deducted (if gain);

  or

- if one of the figures is a profit and the other a loss no taxation adjustment is made at all.

This practical method may produce a result either more or less favourable to the taxpayer than would derive from a strict application of the matching principle. If adopted, the method must be applied on a consistent basis from year to year.

5.8 The Statement of Practice also discussed the consequences of matching in the context of hedging operations. This subject is discussed in greater detail in the later Chapters.

5.9 The Statement did not deal with the consequences of the matching of capital assets which are also chargeable assets for capital gains purposes. This will not normally arise, since most chargeable assets held by traders are non-monetary assets and are thus not normally matched. However, where such a situation does occur, the Revenue view is that since the consideration for the disposal is not taken into account in arriving at the trading profit or loss, the whole of the foreign currency consideration on disposal of the asset can be taken into account in computing the chargeable gain.

5.10 The Statement confirmed that the principles and practice relating to matching would apply only to individual trading companies. There would be no recognition of matching between assets and liabilities of different companies within a group.

OVERSEAS BRANCHES AND TRADES

5.11 The Statement of Practice indicated that the Revenue would normally expect accounts to be drawn up under the principles set out in SSAP 20. The Revenue would accept computations based on whichever method was appropriate under SSAP 20, so long as the method adopted was consistently applied.

5.12 The Statement did not address the issue of companies trading in the UK and preparing accounts in a foreign currency. This issue is considered in Chapter 11.

NON-TRADING ACTIVITIES

5.13 The Statement of Practice confirmed that the Marine Midland decision was considered to have no application to non-trading concerns. Exchange fluctuations experienced by such concerns would generally have no tax consequences outside the capital gains field.

CONTRAST BETWEEN TAX PRACTICE AND SSAP 20

5.14 This Chapter concludes by noting the reasons why the tax treatment of foreign exchange gains and losses diverges in several respects from the commercial accounting principles embodied in SSAP 20. This serves to highlight some of the major tax issues raised by exchange rate movements under existing law and practice.

- Profits have to be assessed in sterling. SSAP 20 is concerned only with the translation of foreign currency transactions or statements into a company's local currency, which may or may not be sterling.

- SSAP 20 provides for alternative treatment of exchange differences on foreign branch profits, depending upon whether the branch operates as a separate business with local finance or as an extension of the company's trade. This distinction may be difficult to make in practice and does not appear to be an appropriate consideration in determining the extent of the company's liability to UK tax.

- SSAP 20 is concerned with the effects of exchange rate fluctuations on commercial profits of all descriptions - not just trade profits. UK income tax takes no account of the exchange gains and losses relating to non-trading activities.

- Where trading income is concerned, some exchange differences will be subject to specific statutory prohibitions not reflected in SSAP 20, such as the restriction on expenditure not wholly and exclusively for the purposes of the trade.

- SSAP 20 contains no recognition of the tax rule that capital items must be distinguished from revenue items in calculating trading profits.

- Where capital gains and losses are recognised for CGT purposes, they are calculated differently and assessed under different rules from income. Indeed, because of indexation, chargeable gains will usually be smaller than the gains shown in the accounts and allowable losses will generally be larger.

- Certain gains and losses of a capital nature are recognised under SSAP 20 but are not taken into account for either income tax or CGT purposes, ie they are "nothings".

- There are also important differences in the timing of the recognition of exchange gains and losses for accounting and tax purposes.

5.15 As they stand, therefore, the accounting principles in SSAP 20 could not be adopted for tax purposes without major changes in the tax system, in particular to the different regimes for the taxation of income and capital. In considering the case for change in the present tax treatment, the following sections of this paper have regard both to general accounting practice (in this country and abroad) and also to the particular needs and objectives of the Exchequer.

## PART 2 - THE CURRENT REGIME

## CHAPTER 6 - PRACTICAL DIFFICULTIES WITH THE PRESENT TAX REGIME

6.1 This Chapter discusses the main difficulties which may arise in practice under the present tax regime.

CAPITAL BORROWING

6.2 As explained in Annex B, following the Marine Midland decision the Revenue accepted that where there are foreign currency borrowings and current trade assets in the same currency, exchange differences on the liabilities can be offset for tax purposes against those on the assets. The result is that exchange gains or losses on the liabilities will be taken into account for tax. However, this matching principle is of no assistance in certain situations.

**Unhedged foreign currency borrowing converted into sterling**

6.3 If a company borrows foreign currency which is converted into sterling for use in the business, it will have to purchase currency eventually in order to repay the loan. An exchange gain or loss will result if the sterling cost of the currency is more or less than the original sterling proceeds of the loan. In the accounts, exchange differences will be recognised annually on the translation basis over the period of the loan. For tax purposes, however, exchange gains or losses will not be recognised if the borrowing is on capital account.

6.4 In view of the range of financial instruments available to hedge against currency fluctuations it may be that many companies today do not undertake unhedged foreign currency borrowing. On the other hand, those instruments involve costs; and there may be other commercial reasons why a company chooses not to hedge.

6.5 This raises 3 questions -

- how far companies engage in unhedged foreign currency borrowing for conversion into sterling;
- to the extent that they do, what is the reason for accepting the exposure to exchange fluctuations;
- whether the non-recognition for tax purposes of exchange gains and losses on capital borrowings is a serious obstacle to commercial transactions in this area.

**Hedged foreign currency borrowing converted into sterling**

6.6 Where foreign currency liabilities are hedged in order to eliminate or reduce the risk of exchange losses, the tax treatment of the transactions can result in a capital gain or an allowable capital loss when overall there may be neither profit nor loss.

6.7 If a foreign currency loan is converted into sterling for use in the borrower's business, a forward contract, future, swap or option may be used to fix the cost of the currency required to repay the loan. In commercial terms the cost of repayment will not exceed the original proceeds of the loan plus the fee or premium paid for the particular financial instrument used. But under existing law the currency acquired to repay the loan is a chargeable asset (for CGT purposes) which is treated as having been disposed of for its sterling equivalent when the loan is repaid. There is therefore a potential capital gain or loss on the currency, whereas the corresponding loss or gain on the liability would not be recognised for tax purposes.

**Example: a currency swap agreement**

A company borrows SF60m for 10 years when the exchange rate is SF3 = £1. Under an agreement with a bank the Swiss francs are swapped for £20m; and the bank is to return SF60m in 10 years time in exchange for £20m. On reversal of the swap the loan is repaid when the rate is SF2 = £1.

| | | |
|---|---|---|
| Disposal of currency (ie sterling equivalent of SF60m when loan repaid) | £30m | |
| Cost (determined by the swap agreement) | £20m | |
| Capital gain | £10m | (subject to indexation) |
| Sterling value of loan on repayment | £30m | |
| Original value | £20m | |
| Exchange loss | £10m | |

The £10m exchange loss is not allowable because a 10 year loan is regarded as on capital account and exchange differences on it would not be taken into account in computing trading profits; and, not being an asset, the loan is outside the scope of CGT.

6.8 Fragmentation of what are essentially matched transactions is a much criticised aspect of the present regime. As the above example shows, the existing rules require that the transactions under the hedging operation and the transactions in the underlying asset or liability which is being hedged are dealt with separately under the appropriate parts of the tax code. This can mean that the results of the related transactions are dealt with differently as:

- income profit or loss;
  or
- capital gain or loss;
  or
- "nothings".

The tax due from the company may, therefore, bear no relation to the commercial results. At worst, this process can produce tax charges where an overall loss has in fact been incurred (or, for that matter, a tax loss when there has been an overall gain).

**Borrowing for investment in foreign currency**

6.9 A company which invests abroad - for example by acquiring shares in an overseas company - may finance or hedge that investment by borrowing in the currency in which the shares are denominated. If so, any change in the value of the investment or of the income produced by it as a consequence of exchange rate fluctuations will be offset by an opposite change in the cost of repaying the loan and of servicing it.

6.10 Under existing rules any exchange loss on the loan would not be allowable because the borrowing was either on capital account or not made for the purposes of the trade. Conversely an exchange gain would not be taxable. By contrast when the investment itself is disposed of the transaction would normally be dealt with under the capital gains code (there are exceptions such as the investments held on current account by banks and insurance companies). Any capital gain or allowable loss would include the exchange element (although this would not be identified separately) and would be subject to the indexation allowance. So in situations which showed no overall commercial gain or loss (eg a capital gain on the asset was offset by an equivalent loss on the borrowing), there would nevertheless be a CGT charge on disposal of the asset (if a gain, reduced by the indexation relief; if a loss, increased by it).

6.11 The results of applying the different rules (for CGT and income tax) to such transactions are another aspect of the present regime which attracts criticism. However, companies may overcome potential difficulties by arranging for the borrowing and the investment to be made indirectly by an overseas subsidiary. Where that is not possible, the non-recognition of exchange differences accruing on the loan is unlikely to be a matter of serious concern as long as the particular investment is retained. Even on the disposal of the investment the amount of the indexation allowance may be equivalent to a substantial part of any exchange loss on the borrowing and in some cases could exceed it. In that event a company would not be taxed on more than the actual overall gain. Conversely, the indexation allowance may create or enhance an allowable capital loss on the disposal of the investment although the company may have suffered no overall loss.

6.12 Outward investment has increased substantially over recent years. Direct investment, for instance, has been very buoyant with an average increase of 20% over the last three years to reach £4.5 billion in 1987. The Government would be interested in hearing views on whether the present tax treatment of exchange differences on capital borrowing has to any significant extent inhibited this flow, or significantly distorted the costs or pattern of financing investment.

CAPITAL LENDING

6.13 Exchange differences on capital lending are not recognised for tax purposes unless the loans are:

- debts on a security (broadly debts which are marketable);

or

- matched with current trade liabilities under the terms of SP1/87.

6.14 As with capital borrowing, capital lending can be hedged by selling forward, or acquiring an option to sell, the proceeds of repayment of the loan. Again, however, tax fragmentation may make the hedge partly ineffective. As explained above the currency sold is a chargeable asset and could give rise to a capital gain or loss, whereas the corresponding loss or gain on the loan would not be recognised unless the loan were a debt on a security.

6.15 Most lending in foreign currency is likely to be made in the course of a trade (for example, by banks), in which case exchange differences are already recognised for tax purposes. Otherwise, if the lending is financed by foreign currency borrowing, exchange differences on both borrowing and lending would normally be ignored for tax purposes and the tax treatment would therefore be consistent with the fact that there is no net exchange gain or loss. This raises the question therefore whether the non-recognition of exchange differences on debts which are not debts on a security does cause any difficulty in practice.

ACCOUNTING RECORDS KEPT IN FOREIGN CURRENCY

6.16 The Revenue accepts either method of translation allowed by SSAP20 - the closing rate/net investment or the temporal method - in determining the sterling measure of profits or losses attributable to an overseas branch of a UK company. Although problems can arise (for example, over the treatment of currency profits remitted to the UK or the measurement of branch profits for double taxation relief purposes), the acceptance of those methods appears to solve most of the main practical difficulties which companies with overseas operations might otherwise face.

6.17 For companies operating in the UK which keep their accounting records in foreign currency, the Revenue have not generally accepted that profits or losses for tax purposes may be determined by simply translating the balance of the profit and loss account into sterling. In general sterling is arguably the local or functional currency of businesses operating in the UK and their UK liability ought to be the same as it would have been had accounts been drawn up in sterling in accordance with correct accounting principles.

6.18 This may cause difficulty where there is foreign currency denominated share capital which has been used to acquire trade assets in that currency, since in the Revenue's view share capital cannot be taken into account in applying the Marine Midland matching principle. Exchange gains or losses on the currency assets would be taxed or allowed therefore, whereas the company may argue that from its viewpoint no profit or loss has arisen; and if the share capital were translated at closing rates no commercial profit or loss would be reflected in the accounts.

6.19 It is clear that this is becoming a significant problem for UK companies which may have to raise share capital in foreign currency for commercial reasons. It is a matter of particular concern to financial institutions and their supervisory authorities. This is because such institutions, for example banks, may have a considerable proportion of their assets denominated in foreign currency and, where appropriate, these assets must be covered for prudential reasons by a margin of capital resources above the minimum prescbied by the supervisors. This issue is discussed further in Chapters 7 and 11.

6.20 Difficulties may also arise where a company, although trading in the UK and preparing its accounts in sterling, carries on business to a material extent in a foreign currency, for example, an insurance company carrying on reinsurance or marine insurance business in US or Canadian dollars.

## PART 3 - OPTIONS FOR CHANGE

## CHAPTER 7 - FRAMEWORK FOR CHANGE

7.1 The criteria laid down by the Government for any new scheme are that it should:

- be workable in practice;
- reflect a broad measure of acceptability to taxpayers;
- not involve unacceptable costs to the Exchequer.

7.2 This Chapter sets out in broad terms some further criteria which should, ideally, be looked for in any major reform in this area. Chapters 8, 9 and 11 then go on to look at how different options would work in practice and Chapter 10 considers the Exchequer implications.

### EQUITY

7.3 The aim here would be to ensure that, so far as possible, any new regime charged gains and allowed losses on the same basis for all companies in broadly similar circumstances. This does not of course mean that the same rules would have to be applied across the board to all companies. Any new arrangements would need to reflect, for example, the different bases on which trading and non-trading companies are charged to tax.

7.4 But as the discussions in Chapters 8 to 11 bring out, full equity between companies may be very difficult to achieve and reconcile with other objectives. For example, if different companies were given different treatment as regards the timing of recognition of exchange differences or choice of functional currency or the matching of assets and liabilities, then this would not be equitable unless a reasonable, objective and workable basis for such differences in treatment could be devised to prevent unfair advantages or abuse. But as later Chapters explain, this might be difficult to devise and would involve considerable complexity in practice. On the other hand, a system that sought to apply the same rules to all companies could cause major practical difficulties and might be impossible for some to operate in practice.

### SYMMETRY

7.5 Reconciling the interests of the taxpayer and the Exchequer requires a system that is symmetrical, in the sense that it taxes exchange gains and allows relief for exchange losses on the same basis, as regards timing, method and amount. The symmetry should exist in practice as well as in theory, for example, a system which recognised exchange gains and losses only when realised by actual conversion of currency would be symmetrical in theory but would be asymmetrical in practice if taxpayers could in fact

realise losses at will and defer gains indefinitely. Such an asymmetry would arise if exchange differences were recognised whenever assets or liabilities were disposed of without regard to the fact that they might simply have been replaced by other similar assets or liabilities. This and other related issues are discussed further in Chapters 8 and 9.

NEUTRALITY

7.6 The objective here should be to ensure that any new arrangements for recognising exchange gains and losses should avoid distortions in company financing decisions. In principle the system should be neutral as it applies to sterling assets and liabilities and to those in foreign currency. In practice, however, the new regime would have to be incorporated within the existing system of business taxation and so might need to reflect the existing tax treatment of income and capital which is not of course neutral as between these kinds of receipts and payments.

7.7 As explained in the Introduction, the abolition of the different tax treatment of capital and revenue items generally raises wide-ranging issues which are outside the scope of this consultative document, although Chapter 9 discusses a possible new scheme for dealing with exchange differences which does not apply this distinction in one particular area. The main areas where the question of neutrality will be at its sharpest are the treatment of foreign currency borrowings compared with sterling borrowings and the treatment of foreign currency liabilities which finance certain monetary and non-monetary assets.

7.8 Some would argue that exchange gains and losses on foreign currency borrowings are akin to interest and that, in denying relief for exchange losses on capital borrowings, the existing system discriminates against non-sterling borrowings. But whatever the arguments of principle, there are significant differences between interest and exchange gains and losses. These, and the practicability of treating the two in the same way, are discussed at paragraphs 9.38-9.43.

7.9 In the case of balance sheet items other than foreign currency borrowings, it would again appear that the degree of neutrality which can be achieved in any reform must reflect the tax treatment of the items under existing tax law. And in some cases, the arguments for recognising the exchange differences appear less compelling than in the case of borrowings.

7.10 One such item is share capital. A UK company will have the choice of raising equity capital to finance its business by issuing shares denominated in sterling or in foreign currency. But as the discussion in Chapter 11 brings out, if the share capital were used to acquire foreign currency assets, recognition of the exchange differences on the foreign currency denominated share capital would not achieve neutrality, as it would produce a more or less favourable result - depending upon exchange movements - compared with the financing of such assets from sterling share capital.

7.11 Likewise recognition of exchange differences on general bad debt reserves denominated in foreign currency would offend against neutrality as increases or decreases in a sterling reserve of this kind, and indeed the reserve itself, are ignored for tax purposes.

7.12 Neutrality does not appear to provide any grounds for disturbing the existing CGT treatment of foreign exchange differences affecting non-monetary assets like buildings or machinery (see paragraph 4.5). Exchange gains and losses on these assets are currently taken into account as part of the overall gain or loss which is recognised for CGT purposes on disposal of the asset. This also accords by and large with accounting practice, which normally requires such assets to be carried in the accounts at their historic cost. Any tax treatment of the exchange element of the gain on disposal of a non-monetary asset which differed from the normal CGT treatment (for example, where a chargeable asset is financed by debt) would be difficult to justify as it is not clear why non-monetary assets acquired for foreign currency should be treated differently from those acquired for sterling.

CONSISTENCY WITH ACCOUNTING TREATMENT

7.13 There are a number of considerations which might suggest that this would be a desirable feature of any reform. Greater consistency between taxation and accounting profits would make for greater simplicity. In addition, it is sometimes argued that accounting practice as set out in SSAP 20 better reflects commercial reality than the present tax rules.

7.14 But there are various reasons why the accounting treatment would not always be appropriate for tax purposes and these are set out in paragraphs 5.14 and 5.15.

CLARITY AND CERTAINTY

7.15 Certain aspects of the existing regime are said to make sensible commercial planning more difficult. These fall into two main categories:

- **Timing** - when should foreign exchange gains be taxed or losses relieved?

- **Method** - how should foreign exchange gains and losses be taxed or relieved?

7.16 Within these categories there is particular difficulty in distinguishing between trade and non-trade items; identifying transactions as capital or revenue; establishing which assets and liabilities should be matched following the Marine Midland case; determining the interaction of the separate income tax and CGT regimes; and identifying the circumstances in which the "profit and loss" method of translating foreign currency accounts can be used for UK tax purposes.

7.17 A non legislative approach to these problems might involve -

- **Further Revenue guidance.** This would take the form of a further Statement of Practice explaining more fully than SP1/87 (see Chapter 5) the tax treatment Inspectors will accept. However, the scope for this approach is very limited. A statement of practice can only provide an interpretation of the law. It cannot be a substitute where the law is silent nor can it create certainty where the law is inherently unclear. And it would be subject to challenge by taxpayers who were adversely affected. Within these constraints, there are fairly narrow limits on the amount of further guidance which the Revenue could give, at least until it had much more experience of applying SP1/87 in practice.

- **Awaiting judicial clarification.** Apart from the inevitable delays inherent in such an evolutionary approach, there is no guarantee that future case law would give businesses the clarity they seek. In the meantime, taxpayers would have suffered continuing uncertainty and the costs of taking appeals to Court. Tax cases are, of course, decided on their particular facts and it can be difficult to elicit general principles from individual judgments.

7.18 Hence most observers argue that legislation is the only way to deal with these problems. The issues identified in paragraph 7.15 are discussed in more detail in Chapters 8 and 9, but whether legislation would in fact produce clarity and certainty would inevitably depend on the extent to which any new system was simple to understand and apply in practice.

SIMPLICITY

7.19 This is clearly an important objective in any tax reform, but there are two main reasons why it may be difficult to achieve in the taxation of foreign exchange differences.

- Foreign currency transactions are complicated - businesses engage in a wide range of different transactions some of which are highly sophisticated and complex and in some cases specifically tailored to the particular needs of the business. Providing a clear tax regime which removed all uncertainty would inevitably involve long and complicated legislation unless broad rules of universal application were acceptable. Such general rules (assuming they could in fact be devised) might well be inflexible and arbitrary in their impact on individual businesses.

- The business tax system itself is complicated - no tax regime for foreign exchange differences could stand alone; it would have to mesh in with the tax system which has to take account of the complexity and variety of business itself.

## OTHER CONSIDERATIONS

7.20 There are two further considerations which would need to be addressed in any reform of the existing scheme:

- **Should accrued but unrealised exchange gains and losses be taken into account for tax purposes?**

  It may often be difficult to define when an exchange profit is realised or an exchange loss incurred. The gain or loss may not affect cash flow until there is actual conversion from one currency to another; but there may never be conversions, for example, dollar sale proceeds might simply be reinvested in new dollar assets. And even where conversion takes place it may not be appropriate to regard a gain or loss as realised if the asset or liability is immediately renewed. This and related issues are examined in Chapter 8.

- **Avoidance of tax fragmentation of related transactions**

  "Tax fragmentation" is the term used to describe what happens when the overall net profit or loss for tax purposes on two or more different, but possibly related, transactions is different from the overall net commercial result because of the application of different tax rules to each of the individual transactions concerned. The most frequently quoted example is the foreign currency swap which paragraph 6.7 discusses. Another instance (discussed further in Chapter 9) would arise if, in the case of borrowings to finance foreign currency assets, exchange differences on the borrowings were recognised in a different way from those on the assets. But tax fragmentation is not confined to exchange gains and losses and can be to the taxpayer's advantage. A simple example is that tax relief is allowed for mortgage interest on a loan to acquire an owner-occupied house but there is no tax on the imputed rental or on a gain on disposal. Nevertheless, any reform of the existing arrangements for recognising exchange fluctuations would have to tackle the problems of asymmetry and inequity which arise at present on swap and other similar hedging transactions.

**PART 3 - OPTIONS FOR CHANGE**

## CHAPTER 8 - A COMPREHENSIVE SCHEME: TIMING - WHEN SHOULD EXCHANGE DIFFERENCES BE RECOGNISED?

8.1 This Chapter examines the timing of the recognition of foreign exchange gains and losses, ie:-

- when should foreign exchange gains be taxed?
- when should relief for foreign exchange losses be given?

8.2 These questions are closely linked with that of the method of recognition which is the subject of the next Chapter.

8.3 There are three broad choices on timing. A foreign exchange gain or loss could be recognised for tax:

- when the foreign currency proceeds are actually converted into sterling (the conversion basis);
- when the transaction is settled by cash payment (settled transaction basis); or
- when assets (eg debtors) and liabilities arising from the transaction are translated into sterling for accounts purposes (the translation basis).

THE CONVERSION BASIS

8.4 The advantage of the conversion basis is that foreign exchange gains and losses would not be taxed or relieved until they had actually been realised in cash terms by conversion of foreign currency into sterling or payment of foreign currency liabilities in sterling.

8.5 However, the conversion basis can give peculiar results even in simple situations.

**Example**

i. A company buys trading stock for £1.

ii. It contracts to sell the stock abroad for $2 when $1 = £1.

iii. It receives payment of $2 when $1 = £0.90. ($2 = £1.80).

iv. The dollars are **not** converted into sterling.

Under a strict conversion basis, the sterling expenditure would be deducted in calculating the company's profits but the dollar sale proceeds would be ignored. A £1 trading loss would therefore arise.

8.6 This odd result ignores the additional worth of the business arising from the sale and flies in the face of reality. It could be overcome, for example, by carrying forward the sterling expenditure to be set against the dollar sale proceeds if and when they were converted into sterling; or by recognising enough of the dollar receipts to eliminate the loss. Many more such artificial rules would be needed to deal with other situations.

8.7 There would seem to be no case for pursuing this conversion approach. In any case, it would present enormous practical difficulties for companies which engage in large numbers of foreign currency transactions. Each individual transaction would need to be traced in order to establish when currency was actually converted.

SETTLED TRANSACTION BASIS

8.8 A settled transaction basis would not tax foreign exchange gains (or relieve corresponding foreign exchange losses) until cash payment was made or received. At that stage the exchange gains and losses would be recognised for tax purposes even if there was no actual conversion of currency. (Similarly, any exchange gains or losses which then arose on the currency proceeds of a transaction would be recognised only when the currency was either converted into sterling or used to acquire another asset). This basis would be closer to the CGT regime where liability (or relief) only arises on the disposal of assets.

8.9 A settled transaction basis avoids the absurdities of a strict conversion basis without moving to a simple translation basis. But, there are several difficulties:-

- As already noted, a settled transaction basis would bear little resemblance to accounting practice.

- It would require the sterling value of each foreign currency transaction to be separately identified. This looks no less burdensome than the conversion basis for businesses which engage in large volumes of foreign currency transactions (eg banks).

- A settled transaction basis might yield commercially meaningless results. Why, for example, ignore translation gains and losses on a bank's year-end holdings of currency which, at least partly, relate to its currency dealing operations?

- Matched positions could become fragmented if the related transactions had different settlement dates. The foreign exchange gains on a repaid loan might be taxed, for example, even though corresponding foreign exchange losses were accruing on an asset originally financed with the loan but still being retained in the business.

- A settled transaction basis would recognise foreign exchange gains and losses on the repayment of a foreign currency loan even if the loan were immediately replaced by fresh borrowings in the same currency. Whether or not there were matching currency assets, it would be possible for companies to crystallise tax relief for a foreign exchange loss at little or no real cost to themselves. Conversely, should a foreign currency loan need to be renewed for commercial reasons, a taxable foreign exchange gain might arise even though there was no economic gain to the business. A settled transaction basis might therefore need to be accompanied by rules, probably complex and arbitrary, to prevent these problems arising.

8.10 It seems, therefore, that a settled transaction basis carries risks for both companies and the Exchequer. The following questions arise:

- To what extent would it be acceptable as a basis for recognising foreign exchange gains and losses which are currently outside the tax system?

- Would it still be acceptable if accompanied by complicated rules to prevent an asymmetrical system developing in practice (foreign exchange losses relieved on rolled over loans but gains taxed only on eventual repayment)? This problem is discussed more fully in Chapters 9 and 10.

TRANSLATION BASIS

8.11 A **full** translation basis would involve translating all assets and liabilities at each balance sheet date and bringing the resulting gains and losses into tax. Logically, this would need to be accompanied by annual revaluation of fixed assets. Although it would overcome the problems of matched assets and liabilities (paragraphs 10.6-10.12), it is assumed that such a radical approach would be unacceptable, if only because of the valuation problems it would give rise to in practice.

8.12 However, applying the translation basis adopted for accounting purposes in SSAP 20 would have many advantages. Foreign currency liabilities and monetary assets (eg cash deposits and debtors) would be translated each year at the balance sheet date with the resulting gains and losses brought into tax. Non-monetary assets would not be translated annually so leaving undisturbed the existing CGT treatment which generally applies to these items.

8.13 UK accounting practice (SSAP 20) specially provides for equity shares held by companies which are financed by foreign currency borrowing. These non-monetary assets may be translated annually but the resulting gains and losses are taken to reserves, not to the profit and loss account. There seems to be good reason to follow the accounting treatment here also by leaving the relevant translation gains and losses out of account for tax purposes. Equities would therefore remain within the normal CGT rules like other non-monetary assets.

8.14 It is, of course, implicit in any translation basis that some unrealised gains would be brought into tax and unrealised losses would be relieved. But there is the great advantage of avoiding at least some of the complicated rules which would almost certainly need to accompany a settled transaction basis.

8.15 Some problems would still remain, however. The translation basis would still produce mismatches in some circumstances. In particular, exchange differences on a foreign currency loan would be recognised on annual translation even where the loan financed a non-monetary asset. Gains and losses on the asset would not, of course, come into tax until the asset was sold. Special rules would almost certainly be needed to cope with the matched positions (see Chapter 10).

A COMBINATION OF BASES

8.16 There are a number of ways in which a settled transaction basis and a translation basis could operate side by side in a tax regime for foreign exchange gains and losses. These depend on identifying the circumstances in which the translation basis would be acceptable.

TRANSLATION BASIS FOR SHORT-TERM ITEMS

8.17 A settled transaction basis could be applied to "long-term" borrowings, for example, leaving foreign exchange gains and losses on "short-term" foreign currency liabilities and monetary assets to be recognised on a translation basis. "Short-term" items would need to be defined arbitrarily, perhaps (following SSAP 20) as those falling due within one year.

8.18 This approach has attractions.

- It avoids the existing difficult distinction between capital and revenue by adopting a simple rule of thumb.

- It brings into tax exchange gains (and relieves losses) which are realised for accounting purposes and therefore contribute to the company's distributable profits.

- A settled transaction basis would for most businesses be relatively easy to apply in practice to long-term monetary items.

- Applying a translation basis to short-term items is broadly consistent with the existing treatment of trade items on revenue account.

8.19 Its shortcomings are:

- The arbitrary short-term/long-term distinction may yield unfair results near the border-line.

- Mismatches would arise in the tax treatment of, say, a short-term liability which economically matched a long-term asset.

- Banks and other concerns which engage in currency dealing do not normally have regard to the duration of assets and liabilities denominated in foreign currency in determining their distributable profits. Consequently, for these businesses, the long-term/short-term distinction may be meaningless in commercial terms.

8.20 The simple but rough and ready short-term/long-term rule could be replaced by the existing distinction between revenue and capital. Foreign exchange gains and losses in respect of assets and liabilities on capital account would be recognised on a settled transaction basis. However, the capital/revenue distinction is often uncertain and can be difficult to apply in practice.

TRANSLATION BASIS FOR CERTAIN BUSINESSES

8.21 The translation basis might be applied to all the liabilities and monetary assets of specific categories of business (ie capital (or long-term) as well as revenue items), for example:-

- banks and other financial concerns;
- businesses with frequent and numerous foreign currency transactions;
- all traders.

A settled transaction basis would apply to the capital (or long-term) monetary items of other concerns.

8.22 The precise category of business to which the translation basis would apply could be difficult to define. There could thus be practical difficulties with this approach.

8.23 More generally, the distinction may be thought unfair. If traders were on a translation basis, they would get relief each year for accruing exchange losses on capital borrowings. An investment company, on the other hand, would have to wait until the loan was repaid. It might then have a large tax loss but have insufficient profits to absorb it. On the other hand, the investment company would benefit if foreign exchange gains were accruing.

ELECTION FOR TRANSLATION BASIS

8.24 Another approach might be to give companies the option to elect to have the translation basis applied to their capital (or long-term) liabilities and monetary assets. Companies might have difficulty in evaluating whether elections should be made but an election system would avoid the need to define categories of companies to which the translation basis is to be applied. However, there would have to be restrictions, for example:-

- The elections could only be available prospectively and would need to be irrevocable for transactions undertaken while it was in force. Otherwise companies could wait and see which way currency movements were going and choose accordingly.

- Revocation might be made available only when a major change in the business has occurred. Special rules would then be needed for those assets and liabilities held at the date of revocation for which exchange gains or losses had already been recognised for tax purposes.

8.25 Even so, many problems would remain, for example:-

- Where companies could predict currency movements with some confidence (for example, the continuing decline of a particularly weak currency), they would obviously elect accordingly, to the Exchequer's cost.

- Mismatches could arise within groups of companies if group members made different elections. Even if rules could be designed to enforce some kind of uniformity within the group, special rules would be required to cope with companies joining or leaving.

CONCLUSION

8.26 This Chapter has tried to identify the main options as to timing of the recognition of foreign exchange gains and losses for tax purposes. The translation basis following accounting practice would be relatively simple but it may be unacceptable to companies. A settled transaction basis might fail the other criteria set by the Government. Moreover, without restrictions any basis for the general recognition of exchange gains and losses may carry Exchequer risks (see Chapter 10). Such restrictions may be complex and burdensome, for businesses and the Revenue alike. There is no simple solution but comments are invited on which of of the approaches outlined above offers the best compromise between the conflicting objectives.

## PART 3 - OPTIONS FOR CHANGE

### CHAPTER 9 - A COMPREHENSIVE SCHEME - HOW SHOULD GAINS AND LOSSES BE RECOGNISED?

9.1 This Chapter examines the major questions which would arise in devising a comprehensive scheme for taxing and relieving all exchange gains and losses arising from business transactions. It concentrates on those exchange gains and losses which are at present outside the existing UK tax system, except where they figure in "Marine Midland matching" arrangements set out in SP1/87. The discussion proceeds on the assumption that SP1/87 would cease to apply if a comprehensive scheme of reform could be introduced.

9.2 As noted in Chapter 8, the questions of timing and method cannot be separated. To a large extent, the approach on timing depends on the method of relieving losses and taxing gains, and vice versa.

9.3 Four broad options are apparent. Foreign exchange gains and losses might be dealt with under:

- existing **income tax** rules, either as trading receipts or expenses, as interest received or paid or as profits or losses within Case VI of Schedule D;
- the **CGT** code as chargeable gains or allowable losses;
- **a new income tax regime** with special rules for measuring taxable profits and allowable losses;
- some combination of these.

9.4 Although income and chargeable gains are now taxed at the same rates, the UK tax system retains different computational rules for different categories of income and for capital gains. Indexation relief and the exclusion of pre 1982 gains significantly affect the measure of chargeable capital gains. There is no equivalent in the income tax system. Furthermore, there are different rules governing relief for trading losses and capital losses. Consequently, different results would flow from applying the various income tax regimes or the capital gains rules to foreign exchange gains and losses.

9.5 If acceptable arrangements could be found within one or more of the existing tax codes, there would seem to be little point in establishing a special regime for foreign exchange gains and losses. Indeed, to the extent that exchange gains and losses are already recognised in the existing system, either in the computation of Case I profits or in the computation of chargeable gains, there would seem to be little point in changing the existing regime. This Chapter therefore looks first at the scope for extending the current Case I or CGT treatment to those exchange gains and losses not currently recognised for tax purposes. It then goes on to look at alternative income tax treatments.

## TREATMENT AS TRADING RECEIPTS AND EXPENSES

9.6 The natural place to recognise foreign exchange gains and losses arising in the course of a trade would seem to be the computation of trading profits itself. One approach would be to continue to recognise exchange differences in respect of current trade assets and liabilities as forming part of the taxable trading results but to bring all exchange gains and losses in respect of capital borrowings and monetary capital assets either into the CGT regime along with gains and losses on non-monetary capital assets, or an alternative income tax regime.

9.7 However, these may not be attractive options. It is not always easy to determine the capital/revenue nature of a loan. Moreover, both CGT treatment and any alternative income tax treatment of exchange gains and losses on liabilities would raise difficult issues, which are discussed later in this Chapter. And if CGT treatment were adopted, trading companies might face the possibility of being unable to obtain effective relief for an exchange loss on a capital foreign currency loan raised to provide funds for use in the trade, since capital losses are available for set off only against capital gains. This would therefore resurrect the kind of problem faced by companies before the Marine Midland decision.

9.8 A simpler approach might therefore be to abandon the capital/revenue distinction for foreign exchange gains and losses arising in the course of the trade. Thus, such gains and losses would be taken into the Case I computation if they arose in respect of monetary assets held or liabilities incurred for the purposes of the trade.

9.9 At first sight, an annual translation basis might appear appropriate for these exchange gains and losses as this applies generally to foreign exchange differences which are already included in the computation of trading profits. But Chapter 8 also considered the possibility that exchange differences on long-term items (over one year) might be recognised on the settled transaction basis. Exchange differences in respect of current assets and liabilities would, of course, continue to be recognised as forming part of the taxable trading results. On the other hand, gains and losses on non-monetary capital assets would remain outside the Case I computation, falling generally under the CGT regime.

9.10 It might be argued that there is no need for a "purposes of the trade" test and that **any** exchange gains or losses of a company carrying on a trade should be taxed or relieved as part of its Case I profit or loss. On the other hand, it is questionable whether the measure of a company's taxable trading profits or losses should be affected by exchange gains or losses which have nothing to do with the trade. Where a trading company has foreign currency borrowings which finance, for example, a portfolio of shares there would seem to be no reason why exchange differences on those borrowings should be treated as trading items. At the other extreme there may be companies which are

primarily engaged in investment business but carry on a small trade as a subsidiary activity. For these reasons it might be difficult to justify giving a treatment different from (and, in the case of losses, potentially more generous than) that of a similar company which has no trade.

9.11 There are, however, some difficulties with the "purposes of the trade" approach. Although it is a familiar test within the business tax system it is nevertheless not always easy to apply in practice. Moreover, in order to determine whether a foreign currency loan was incurred for trade purposes it would be necessary to have regard to the nature of the assets financed by that borrowing. But, as the discussion in later paragraphs of this Chapter (and in Chapter 10) brings out, there are serious practical problems in identifying loans which are linked with particular assets.

9.12 The problems in this area - and on the matching of assets and liabilities generally - are essentially similar to those which were examined in detail in Chapter 13 of the 1982 Green Paper on Corporation Tax (Cmnd.8456). That chapter identified the difficulties which would arise in the treatment of monetary assets and liabilities within a tax system based on Current Cost Accounting. These were seen as particularly severe where a tax adjustment would have depended upon the purpose for which borrowings were made or on the different forms of monetary liabilities.

9.13 Where a foreign currency liability was incurred for trade purposes the further point arises that the borrowing may have financed the acquisition of, or hedged, a non-monetary asset of the trade, such as an overseas factory, which is a chargeable asset for CGT purposes. In that event, although exchange gains and losses on the loan might be recognised within the Case I computation on an annual translation basis, no account would be taken of corresponding exchange gains or losses on the factory until it was disposed of.

9.14 This mismatch would seem to suggest that in such circumstances exchange differences on the liability should not be recognised for tax purposes on the annual translation basis. And even if the settled transaction basis were generally adopted for long-term items there might be an argument for deferring recognition of the exchange differences on the liability until the asset was disposed of. But the need to treat differently those liabilities which financed non-monetary CGT assets would make much more acute the practical problems of identifying matched assets and liabilities.

9.15 It is for consideration whether it would be acceptable instead to adopt the Case I treatment so that exchange differences on the liability would be recognised on exactly the same basis as those on other borrowings for trade purposes, despite the timing mismatch. This would have the obvious attraction of simplicity. But if the currency concerned were to appreciate against sterling there could be a significant risk of

loss to the Exchequer because of the timing mismatch. Conversely, if sterling appreciated against the foreign currency, companies would be faced with the taxation of accrued and unrealised exchange gains on the liability with no offsetting relief for accrued (but unrealised) exchange losses on the asset.

9.16 In essence, therefore, the main point for decision would be whether inclusion in the Case I computation of trading profits would be the best way of bringing into the tax system those foreign exchange gains and losses which arise in the course of a trade but which are not currently recognised for tax purposes. If it would, then the further question arises whether it would be necessary to ensure that exchange differences on the liabilities were recognised at the same time as those on non-monetary trade assets which they may have financed or hedged.

9.17 Case I treatment cannot of course be the answer for non-traders who realise foreign exchange gains and losses. By itself, therefore, it would not satisfy the criterion of equity between different categories of business. Moreover, traders could have exchange differences on liabilities and monetary assets which are not incurred or held for the purposes of the trade. Consequently, it is necessary to explore what treatment might be appropriate for these items.

TREATMENT AS CAPITAL GAINS AND LOSSES

9.18 Foreign exchange gains and losses which do not arise in the course of a trade generally relate to investments which are subject to CGT and to foreign currency liabilities which finance or hedge those investments. This might suggest, therefore, that all such gains and losses should be brought within the CGT regime.

9.19 In the case of **traders** - if Case I treatment of exchange differences arising in the course of a trade were considered appropriate - this would mean that exchange gains and losses in respect of any foreign currency liabilities and monetary assets which failed the "purposes of the trade" test would be taxed or relieved under the CGT code. These would include, for instance, exchange differences on borrowings to finance or hedge investments in subsidiary companies and loans to subsidiaries (where they are not already included as debts on a security). For **non-traders**, exchange gains and losses on **all** foreign currency assets and liabilities would come into the CGT regime. In all these cases, in keeping with the CGT rules, the settled transaction basis would apply.

9.20 The main difficulty with CGT treatment would be its extension to liabilities. There are three major issues which would need to be addressed -

i. Determination of acquisition costs and disposal proceeds.

ii. Indexation.

iii. Renewal of loans.

**i. Determination of acquisition costs and disposal proceeds**

9.21 In order to calculate any capital gain or loss on the disposal of a foreign currency liability it would be necessary to determine the sterling equivalent of the loan both at the time it was raised and at the date of repayment. If, in the case of a trading company, a single loan could be identified as not satisfying "the purposes of the trade" test that calculation should be relatively straightforward.

9.22 But matters will rarely be as simple as that in practice. Borrowings frequently go into a pool which finances both trade and non-trade assets. The proportions attributable to each category may vary from year to year and even from day to day. In that case it would be necessary therefore to make an adjustment in capital gains computations for that element of gains and losses which had already been, or would be, taken into account for income tax. Otherwise there would be double taxation or double relief. The adjustment would need to be made separately for each borrowing, since the need to compute a gain or loss for CGT would arise only as and when an individual loan was repaid. In contrast, if exchange gains and losses on borrowings for the trade were recognised on the translation basis (paragraphs 8.11-8.15) the determination of what proportion of borrowings were for the trade would commonly be made not loan by loan but at a more aggregated level. In these circumstances, acute difficulty would arise in allocating the adjustments made each year between particular borrowings.

9.23 It is not obvious that rules could be devised to overcome this problem. But it is an issue which would have to be resolved if some liabilities were to be dealt with under the CGT code and comments and suggestions are invited.

**ii. Indexation**

9.24 At present CGT arises only on the disposal of chargeable assets. With exceptions for some particular categories of asset, indexation applies so as to exclude the inflationary element in capital gains. Indexation on assets thus takes account of the declining purchasing power of money in a time of inflation, and reduces chargeable gains, or contributes to capital losses.

9.25 Were foreign currency liabilities to be brought within CGT, the question arises whether they should be subject to an indexation adjustment. Such an adjustment would, as far as the borrower is concerned, work in the opposite way to indexation on assets: it would **enhance** exchange gains and **reduce** exchange losses in respect of loans. This is because in a time of inflation the declining purchasing power of money means that, where for example a loan is repayable at par, the cost of the repayment in **real** terms is less than the value of the loan at the

time it was taken out. So in real terms the borrower has a gain equal to the depreciation in the purchasing power of the sum borrowed. If there were an indexation adjustment, then, as far as the lender is concerned, indexation would operate in the same way as on other assets (reducing gains or increasing losses) unless the loan transaction was part of a trading activity (in which case income tax rules would apply): and indexation will already normally be due if the loan takes the form of a debt on a security.

9.26 In theory, there is an argument for saying that, without indexation of liabilities, looking at the treatment of the borrower the system would be unbalanced: nominal gains and losses would be recognised on liabilities but only real gains and losses on assets would come in for tax.

**Example**

- Suppose that the rate of inflation is 3% in the US and 6% in the UK.
- A UK company borrows $1000 and buys capital assets of $1000, when the exchange rate is £1=$1.77.
- One year later it sells the assets for $1030 and repays the loan.
- If, exceptionally, the exchange rate has followed the inflation rate differential (see Chapter 2), it will now be £1=$1.72.

The CGT computation on the assets is

| | |
|---|---|
| Disposal proceeds ($1030 @ 1.72) | = £ 599 |
| Acquisition price ($1000 @ 1.77) | = £ 565 |
| Gross gain | £ 34 |
| Indexation relief £565 @ 6% | £ 34 |
| Indexed gain | Nil |

The position on repayment of the loan is

| | |
|---|---|
| Repayment costs ($1000 @ 1.72) | = £ 581 |
| Original loan ($1000 @ 1.77) | = £ 565 |
| Nominal loss | £ 16 |

But the nominal exchange loss of £16 has not in fact been incurred by the company. This might suggest that a fairer result would be obtained by indexing the loan as well as the assets, so that the CGT computation on the repayment of the loan would give rise to a net gain of £18 (ie the actual surplus realised on the assets and the loan taken together ($30 @ 1.72)). Indexation of the loan would also result in taxation of the commercial profit where the exchange rate does not follow the inflation differential.

9.27 This example suggests that failure to index foreign currency liabilities brought into the CGT system could entail Exchequer costs in the form of relief for nominal exchange losses which, looking at the totality of the company's position, had not in fact occurred. A large proportion of the foreign currency borrowings which are currently outside the tax system will have been incurred to finance foreign currency assets; and therefore if sterling were to depreciate against particular currencies to any significant extent, substantial amounts could be involved.

9.28 Although the point it brings out about the cost to the Exchequer remains valid, the example is of course simplistic. It ignores interest on the loan which would normally be relieved for tax purposes. It also makes two critical assumptions: that the company is fully hedged, in the sense that its dollar denominated assets and borrowings are in balance, and that sale of the assets and repayment of the loan occur simultaneously. In reality this would rarely be the case. Moreover, there is the point made earlier in this Chapter that in practice and given the fungibility of finance it would usually be exceedingly difficult and often impossible to link particular borrowings to particular assets.

9.29 More generally, there is an argument for saying that:

- the benefit from indexation here is not essentially different in kind from, though perhaps more striking than, the benefit which is available under the existing rules where a company may borrow fixed rate sterling loan capital to finance sterling assets which it expects to appreciate in value. Under existing rules the capital gain on the assets may be within the charge to CGT and subject to indexation; the liability will not; but the company may receive tax relief on the full nominal interest payable on the liability;

- by contrast, there would be an equal and opposite new inequity, if CGT indexation were extended to liabilities generally, so as to create a gain or reduce a loss in the hands of the borrower, unless all loans (not just debts on a security) were similarly brought within the CGT charge, and given the benefit of indexation in the hands of the lender.

On this line of argument, to extend indexation to foreign exchange liabilities might in principle be expected to shift the margin at which market distortion takes place, but to give rise to new anomalies at the new margin. To extend indexation on a consistent basis for all assets and all liabilities would, of course, require a fully developed system of inflation adjustment for company accounts and that would take us well beyond the ambitions of the present paper.

9.30 An indexation adjustment for foreign currency, but not sterling, liabilities could also create distortions in patterns of lending. For example, as far as some borrowers were concerned, there would be an incentive for the foreign currency borrowing to be done in an offshore subsidiary which would then onlend into the UK group in sterling (and so side-step the indexation adjustment which would have taken place had the UK

company borrowed the foreign currency direct). In the hands of the lender - if indexation were extended to the lender - a foreign currency loan brought into the CGT system would attract indexation relief but a sterling one (unless it was a debt on a security) would not. Other things being equal, therefore, there would be an incentive to lend in foreign currency form. This would seem to conflict with the objective of securing a regime which would be neutral as between borrowings in different currencies.

9.31 It follows that indexation of loans could also carry significant risks of abuse. Special rules would be needed for borrowing within groups of companies, as there are now for intra-group lending, to exclude from indexation loans other than debts on a security. Outside of groups, more indexation adjustments might well be made for lenders than for borrowers. As long as both lender and borrower are within the UK tax net, in principle, the two adjustments should net off. But the symmetry breaks down if one is liable to UK tax and the other is not. For example, if the lender is a UK company and the borrower is outside the UK charge, indexation relief will be given to the lender without a corresponding adjustment for the borrower. Against this background, as mentioned in the preceding paragraph, there must be a possibility that some UK groups would obtain their foreign currency borrowing through non-resident subsidiaries (and hence unaffected by the UK rules on exchange gains and losses), while other companies within the UK tax net would make foreign currency loans which would attract indexation relief. The net result would be a loss of tax to the Exchequer.

9.32 Apart from avoiding the potential problems discussed in paragraphs 9.30 and 9.31, non-indexation of foreign currency liabilities would have the obvious attraction of simplicity and would achieve broad neutrality with the present treatment of borrowing in sterling. It would also ensure that companies would not face the possibility of being taxed on larger exchange gains on borrowings than they realised in cash terms.

9.33 There are strong arguments therefore both in favour of and against indexation of foreign currency liabilities. It is for consideration whether the balance of those arguments suggests that, if it were considered appropriate to deal with certain foreign exchange liabilities under the CGT code, they should be brought in on an unindexed basis.

### iii. Renewal of loans

9.34 If all exchange differences on foreign currency borrowings were recognised for tax purposes on a translation basis (following accounting practice), no particular difficulty would arise when loans were renewed or replaced. The tax computations for the accounting periods during which the old loan existed would have taken into account the exchange gain or loss on that loan as it accrued; and further gains or losses on the new loan would arise in subsequent accounting periods. But an annual translation basis is unlikely to be acceptable in all cases.

9.35 As noted in paragraph 9.19, any foreign currency borrowings for which CGT treatment was considered appropriate would be dealt with in effect on a settled transaction basis. The crystallisation of exchange gains or losses on the repayment of a loan could create problems for both companies and the Exchequer. On the one hand, a company might be taxed on an exchange gain when all that had happened in commercial terms was that one loan had come to the end of its life and an identical replacement loan had been negotiated; and companies might be inhibited by potential tax charges on exchange gains from making changes in their financing arrangements which market conditions might otherwise suggest. On the other hand, the Government would be particularly concerned to guard against "bed-and-breakfasting" - the repayment of loans in order to crystallise exchange losses followed immediately by replacement borrowing.

9.36 This appears to suggest that a deferral provision, on the lines of that already included in the CGT code for share exchanges, would be necessary in all cases where a foreign currency borrowing was repaid and renewed. Inevitably this would require some comprehensive rules and would be a major complication. For example, they would need to cover cases where frequent borrowings and repayments occur; where there was an interval between repayment and renewal; where the new loan was raised before the existing loan was repaid; and where the new loan was in a different currency from the old one. In practice therefore it would often be very difficult to distinguish situations where what had happened represented replacement or bed-and-breakfasting of an existing loan; but some means of doing so would have to be found if a deferral provision were to be included.

AN ALTERNATIVE INCOME TAX TREATMENT

9.37 Instead of CGT treatment, foreign exchange gains and losses unrelated to a trade could, in principle, be recognised in the computation of income, either as interest received or paid, or as profits or losses within Case VI of Schedule D, or within a new income tax regime with special rules for measuring taxable profits and allowable losses.

TREATMENT AS INTEREST

9.38 It might be argued that, in principle, there is a case for treating foreign exchange gains and losses as if they were interest paid and received. Thus, it can be argued that a foreign exchange loss on a borrowing in a strong currency is an additional cost of borrowing over and above the interest payable and should be treated accordingly. On this analysis, the loss can be seen as reflecting - in a very broad way - the difference between the actual rate of interest on the borrowing and the higher nominal interest rate which would have been payable if the same amount had been borrowed in the domestic market.

9.39 Likewise, a foreign exchange gain reduces the cost of the borrowing, suggesting that it should reduce the relief available

for the interest paid on the loan. And when the total gain exceeded the interest payments, the excess might be treated as an interest receipt.

9.40 Some would argue that giving tax relief on the nominal interest payments but not recognising gains or losses for tax is illogical and distorts financial decision making. But as Chapter 2 indicates, over the shorter term exchange rate movements bear no very clear relationship to differential interest rates.

9.41 It would not necessarily follow that, if the case in principle were established, the particular rules for taxing and relieving interest would be a sensible way of recognising exchange gains and losses as business costs or receipts. In the United Kingdom the interest regime is complex and the rules differ according to the nature of the borrowing. They are asymmetrical as between interest paid and interest received.

9.42 A further consideration would be the scope and relevance in a new regime for exchange gains and losses of the existing safeguards for the Exchequer in the arrangements for taxing and relieving interest. For example:

**Where the lender is resident in the UK**

- Interest relieved in the hands of borrowers will usually be taxed on the lender;
- Companies deduct tax from interest payments (unless the lender is UK bank);

**Where the lender is resident overseas**

- There is normally a requirement on the borrower to deduct tax from interest payments unless exemption is allowed under a double taxation agreement.
- Where the borrower and lender are associated no relief is given for the interest (which is treated instead as a distribution of profit) unless this is overridden by a double taxation agreement.
- Even where non deduction of tax and relief for interest paid to an associated person are allowed as a result of a double taxation agreement, restrictions may nevertheless be imposed if interest is paid at more than a commercial rate or the borrower is thinly capitalised.

9.43 This analysis appears to suggest that, whatever the arguments of principle, treating exchange gains and losses as interest would be difficult (and in some circumstances impossible) to apply in practice. This was the conclusion reached by the Group of Nine (see Annex D) and other commentators who have examined the issue. No other country appears to have adopted this approach in handling exchange gains and losses for

tax purposes; and although it was one of the proposals discussed at an early stage in the debate on tax reform in the United States (Treasury II) it was not in the event adopted.

## TREATMENT AS CASE VI PROFITS AND LOSSES

9.44 If exchange gains and losses were brought within Case VI of Schedule D, the main difficulty would be that Case VI losses are only available for set off against Case VI profits. This would mean that in practice companies would often be unable to obtain relief for exchange losses on their borrowing - either by set off against other income or by set off against capital gains on the assets financed by the borrowing. It seems doubtful therefore whether this option would be acceptable to companies.

## A NEW INCOME TAX REGIME

9.45 Instead of CGT treatment, foreign exchange gains and losses unrelated to a trade could, in principle, be dealt with under new rules within the income tax regime.

9.46 The essential difference between this approach and CGT treatment would lie in the scope for allowing relief for exchange losses against other profits - in contrast to the existing restrictions on relief for capital losses. The new rules would not necessarily have to mirror exactly those which apply elsewhere in the present income tax system. But if exchange losses were dealt with on the same basis as, for example, management expenses, they would be available for set off against both income and capital gains; and exchange gains could be reduced by deductions for such items as trade losses or charges on income.

9.47 As noted earlier, however, gains and losses which fail the "purposes of the trade" test generally reflect the change in value (in sterling terms) of assets within the CGT field and liabilities which finance them. It might be argued therefore that income tax treatment would be out of place for such items and would be inconsistent with the normal treatment of capital gains and losses.

9.48 A new income tax regime would, furthermore, give rise to difficulties similar to those identified earlier in this Chapter in connection with the possible extension of CGT treatment to liabilities. In some respects they might not be so great in practice but in others they might be more severe. Income tax treatment would, moreover, create additional difficulties that would not arise under a CGT regime.

9.49 The calculation of exchange gains and losses to be taxed or relieved in respect of loans would present the difficulties described in paragraphs 9.21-9.23. On the other hand, if the timing of recognition of exchange differences on both trade and non-trade liabilities were the same (for example, if the translation basis were applied to both) then it would merely be necessary to apportion total exchange differences on borrowings

rather than allocate amounts to particular loans. And if companies obtained a deduction against income in the computation of their corporation tax profits for exchange losses which were not taken into account in the computation of trading income, the application of the "purposes of the trade" test might be of less significance in practice.

9.50 If a settled transaction basis were adopted, the repayment and renewal of loans would give rise to the problems discussed at paragraphs 9.34-9.36. But it might be easier and more acceptable to adopt the translation basis in a new income tax regime than it would for CGT.

9.51 There could also be serious mismatches when a foreign currency loan financed a capital asset within the CGT regime. As the earlier discussion in paragraph 9.26 made clear, the recognition of **nominal** exchange losses on liabilities and **real** gains on assets could mean that less than the overall gain was taxed and might indeed result in relief for losses not incurred. Although the practical and other difficulties identified in paragraphs 9.25-9.33 may rule out indexation of foreign currency liabilities for CGT purposes, it might seem to be too generous to allow income tax relief for nominal exchange capital losses. Furthermore, timing mismatches would arise if the translation basis were adopted: this problem is discussed in greater detail at paragraphs 10.8-10.13.

9.52 Other problems could occur where there was an exchange gain on a borrowing matched by a loss on a capital asset financed by the borrowing. The loss on the asset would be enhanced by indexation whereas only the nominal gain on the loan would be taxed as income. Although in theory this would be in a company's favour, it would not be possible for the capital loss on the asset to be set against the exchange gain taxable within an income tax regime. Unless, therefore, the company had other capital gains against which the loss could be utilised, it would in effect be taxed on a gain when overall, in commercial terms, none had been made.

9.53 One approach to this particular problem might be to allow companies to elect for CGT treatment in relation to exchange gains and losses unrelated to a trade. Such an election would, however, have to be made at the outset and be irrevocable.

9.54 The mismatches caused by income tax treatment of exchange gains and losses on liabilities would be even greater if the company were exempt from CGT (for example, an investment trust). If a foreign currency asset appreciated in line with currency movements, the company would not be taxed on the real gain on the asset but would receive relief against its income for the exchange loss on the borrowing. Conversely, if the asset depreciated in line with currency movements, the company would be taxed on the exchange gain on the borrowing but with no relief for the capital loss on the asset.

CONCLUSION

9.55 This Chapter has examined various methods for bringing into the tax system those foreign exchange gains and losses which are currently ignored for tax. None of them is free from difficulties. A "purpose of the trade" test for deciding which items might be brought into the Case I computation of trading profits would introduce an element of uncertainty. And where borrowings financed fixed assets of a trade, simplicity could only be achieved at the expense of a lack of symmetry and the consequential risk of Exchequer losses or the taxation of unrealised gains. An extension of CGT treatment to non-trade liabilities would demand complex new rules for the computation of gains and losses and the renewal of loans. These may be difficult to devise but, without them, CGT treatment would be asymmetrical and unfair to some companies. Similar issues would arise with any alternative income tax regime for non-trade liabilities.

## PART 3 - OPTIONS FOR CHANGE

## CHAPTER 10 - RISKS TO THE EXCHEQUER

10.1 The Government has to ensure that, as well as commanding a broad measure of agreement from business and being administratively feasible, any scheme of taxation for foreign exchange gains and losses would not carry unacceptable risks for the Exchequer.

COST

10.2 Total foreign currency borrowings of UK businesses are at present estimated at £550 billion. Most (about £480 billion) of this debt has been incurred by the financial sector and exchange gains and losses on all but a very small proportion of those borrowings will already be recognised for tax purposes under the matching arrangements set out in SP1/87. It is impossible to say what proportion of the balance of about £70 billion* is capital borrowing and outside the tax system. As an illustrative figure, it might be assumed that, say, £30 billion, might be in this category. If these liabilities were now to be brought in, there would be a substantial loss to the Exchequer if sterling weakened. Conversely, the Exchequer would tend to benefit if sterling strengthened.

10.3 It is difficult to put a precise figure on the potential cost (or yield). Much would depend on future exchange fluctuations, behavioural changes of companies and the actual amount of foreign currency borrowings and monetary assets which would be recognised for tax for the first time. One possible behavioural change might be that companies would substitute low interest foreign currency borrowing for high interest sterling borrowing. This could produce an Exchequer yield under certain circumstances, for example, if over the life of the borrowing sterling outperformed market expectations at the time the loans were raised. This potential Exchequer yield would be the obverse of the benefit to companies under the present regime from borrowing in high interest foreign currencies.

10.4 Based on the illustrative figure of £30 billion (that is, excluding any behavioural effects), each 1% change in sterling against all other currencies could have a revenue effect of £50-£100 million in a particular year. The actual effect on tax receipts and hence business costs might be less than these figures suggest if ways were found to identify liabilities which finance or hedge specific non-monetary assets and to defer recognition of exchange differences on those liabilities until the assets were disposed of (see paragraphs 10.6-10.13). Even if

* This figure comprises borrowings from banks in foreign currencies by industrial and commercial companies, and direct borrowing overseas by other financial institutions. But it ignores industrial and commercial companies borrowing from the non-monetary sector and intra-group loans (see paragraph 3 of Annex A).

there was little absolute shift over the longer term, short term fluctuations could affect the total yield and volatility of tax receipts.

10.5 The remainder of this Chapter discusses certain other aspects of a comprehensive reform of the tax treatment of exchange gains and losses which would seem to require special rules to protect the Exchequer. The main areas of concern are:

- matched assets and liabilities;
- renewal of loans;
- groups of companies;
- multinational groups.

MATCHED ASSETS AND LIABILITIES

10.6 As already noted, the most important category of "nothings" to be brought into the tax system under a comprehensive reform would be exchange differences on capital borrowings. These will often have been raised in order to finance the acquisition of, or to hedge, specific assets (eg land and buildings, shares etc) which are chargeable assets for CGT purposes under existing law. Exchange gains in respect of such assets will be reduced and losses increased by indexation and will be recognised only when the assets themselves are disposed of. Without special provisions for matched assets and liabilities, the tax treatment of the gain or loss on the liability would be inconsistent with that on the asset as regards both timing and amount. If the treatment of the liability and the asset were not evenhanded, this would entail a potentially high Exchequer cost.

10.7 Substantial borrowings will also have been raised by financial concerns to finance assets the profits on the disposal of which are treated for tax purposes as receipts of their trade but which are not stock in trade. Such profits are assessable only when the assets are disposed of (the realisation basis). In the case of these matched assets and liabilities there would be no mismatch caused by indexation but there might be a timing mismatch.

10.8 Chapter 9 has already looked in some detail at the issues - including Exchequer costs - raised by the possibility of indexation of liabilities. This Chapter therefore concentrates on the question of timing mismatches. Such mismatches would arise if, for example, liabilities were dealt with on the translation basis (paragraphs 8.11-8.15). Accrued but unrealised exchange gains or losses would be taken into account annually throughout the life of the loan while corresponding gains or losses on a non-monetary asset financed by the loan would not be taken into account until it was disposed of. Similarly a timing difference would occur if the settled transaction basis (paragraphs 8.8-8.10) were adopted but the corresponding assets were not disposed of when the loan was repaid.

10.9 An approach to these difficulties might be to secure, if possible, that exchange gains and losses on matched assets and liabilities were taxed or relieved at the same time. If a loan matched a particular asset, exchange differences on the loan would not be recognised for tax purposes until the asset was sold.

10.10 This approach would, however, appear to present serious practical problems. Companies generally finance their operations from a single pool of capital, no part of which is earmarked against specific assets. At first sight, therefore, it would seem difficult to link a loan with a particular asset.

10.11 One approach might be to lay down a general rule that, where foreign currency borrowings finance particular assets, no foreign exchange gain or loss in respect of the loan would be recognised until the asset was disposed of. But on what basis would that match be established? There are three broad possibilities:

- The broad rule could be stated in legislation and left as a question of fact to be established either by agreement between companies and their Inspectors or, if necessary, on appeal before the Appeal Commissioners.

- Companies could be allowed to elect for matching. But it would not seem appropriate to leave the right of election completely at large: the onus ought to be on a company to demonstrate that there was a real commercial match.

- The Board of Inland Revenue could be given the power to direct that a particular loan was to be treated as matched with specific assets. Companies would clearly need to be given a right of appeal against such a direction.

10.12 But under any of these approaches there would seem to be no escape from the difficult and contentious task of establishing whether or not a commercial match actually exists. A broad rule would therefore present severe difficulties of interpretation and application. It would need to be applied in circumstances where, for example, a matched asset was disposed of and replaced, perhaps with an asset of a different kind, before the loan was repaid; or where loans were repaid and replaced with new borrowings in a different currency. On the other hand, legislation for detailed rules to cover all such circumstances would be likely to be formidably complex.

10.13 Comments would be welcome on the feasibility of hypothecating loans to particular assets and of the possible approaches outlined in the previous paragraphs. How should the test be applied, for instance, where all borrowings go into a general pool of finance; the company seeks to balance its foreign exchange exposure in each currency; and it is impossible to identify any particular asset with any particular borrowing? Would it be acceptable to treat a due proportion of total

borrowings in a particular currency as linked with any non-monetary assets held in that currency?

RENEWAL OF LOANS

10.14 In Chapter 9 reference was made to the implications for the Exchequer of the repayment and renewal of loans to crystallise losses, if CGT treatment were considered appropriate for certain foreign currency liabilities. Protection against the "bed-and-breakfasting" of loans would also be needed if liabilities were dealt with on a settled transaction basis outside the CGT code.

10.15 Without this protection the Exchequer would be exposed to losses whether sterling depreciated or appreciated against foreign currencies generally. Companies could crystallise losses that occurred over particular periods or against particular currencies while deferring gains that arose over other periods or against other currencies. If sterling depreciated companies could crystallise losses by repaying and renewing liabilities. If it appreciated they could recall and readvance loans to third parties. Would protection against the "bed-and-breakfasting" of loans be required? If so, what is the best solution to the difficulties discussed in Chapter 9 of devising appropriate rules?

GROUPS OF COMPANIES

10.16 Chapters 8 and 9 explored the possibility that different tax treatment may be appropriate for the foreign exchange gains and losses arising to different types of company. This might affect both the timing of recognition for tax purposes and the basis on which gains were taxed and losses relieved. Without some safeguards experience suggests that these differences might be open to exploitation at the expense of the Exchequer, particularly by groups of companies.

10.17 Thus, legislation was necessary in 1988 (Section 114, Finance Act 1988) to prevent exploitation of the CGT indexation relief in respect of certain intra-group lending. And intra-group loans might also be a particular difficulty in the present context. For example, a trading company A might borrow foreign currency from another company B in the same group. Exchange gains and losses on A's liability might be recognised within its Case I computation each year on a translation basis. But corresponding gains and losses on B's monetary asset might fall to be recognised only on repayment of the loan thus producing a mismatch within the group. The group would enjoy tax relief if foreign exchange losses arose on translation of A's liability even though, overall, there was no cost to the group. If the currency movements went the other way, A would be taxed on foreign exchange gains; but the loan could then be repaid so as to crystallise a loss in B's hands.

10.18 In theory, this kind of mismatch could arise under the present system if an intra-group loan were on capital account for one party to the loan but on revenue account for the other. But the dividing line between capital and revenue will often be a difficult one to draw in the case of loans, as mentioned in

earlier Chapters. In practice, therefore, any attempt by a group to create and exploit such a mismatch could well be unsuccessful and this probably reduces the scope for tax planning under the present system. But if a new regime were introduced for exchange differences, which provided different tax treatment according to the type of company concerned, it seems inevitable that the opportunities for exploitation would be substantially increased.

10.19 The question arises, therefore, whether uniformity of treatment of exchange differences should be required throughout a group of companies. There would of course be practical difficulties when companies joined or left a group and special rules would be needed to cater for these which would add to the length and complexity of the legislation. More fundamentally, it might be argued that it would be inequitable for a company to be taxed on a different basis from that of its competitors in respect of similar exchange transactions, merely because it was a member of a group. Any restrictions would clearly therefore have to reflect the difficult balance between the need to prevent abuse without penalising the competitiveness and genuine commercial transactions of group companies. One approach to this might be to give a choice of treatment, at the option of the group.

10.20 It would be for consideration whether uniformity of treatment might be confined to intra-group loans, instead of being applied to all exchange differences throughout a group. This should be sufficient to overcome the difficulties discussed in the previous paragraphs. But as it would be a relatively simple matter to circumvent the requirement by routing loans through a non-group intermediary, further rules would be needed to deal with "back to back" arrangements. These might not be easy to devise or operate in practice.

10.21 Moreover, uniformity of treatment for intra-group loans would still leave scope for mismatches where a foreign currency loan was raised outside the group and the borrower lent the currency proceeds to another company in the group. This may commonly occur, for instance, where one group member performs treasury functions for the group as a whole. In these circumstances, the special treatment of the intra-group loan might mean that exchange differences on the borrowing and lending were dealt with on a different basis.

10.22 There are obvious difficulties with the possible safeguards discussed in this Chapter. But without special rules of some kind any general reform which allowed different tax treatment of foreign exchange gains and losses for particular classes of company would be liable to offer unjustifiable advantages to groups of companies.

MULTINATIONAL GROUPS

10.23 The risks to the Exchequer identified in this Chapter would be particularly acute in the case of multinationals. Unrestricted relief for foreign exchange losses on intra-group borrowings (by whatever means) would offer multinationals an exceptionally favourable regime. The group as a whole might suffer no loss overall from an increase in the sterling value of

a UK member's foreign currency loan advanced by an overseas associate but, as paragraph 10.25 illustrates, the UK company's exchange loss would still qualify for tax relief.

10.24 Multinationals might be expected to take advantage of such a regime therefore to route their borrowings and non-UK investments through a UK group company, whether or not there was any economic reason to do so. This would be particularly advantageous if:

- exchange differences on currency borrowings were recognised on a settled transaction basis with no provisions for matched treatment of the loan and the investment;

- exchange losses on currency borrowings were available for set off against income.

10.25 For example, a US corporation A wanting to acquire another US corporation C, might lend dollars to its UK subsidiary B to make the acquisition on its behalf. If sterling weakened against the dollar, B could repay (and possibly renew subsequently) the dollar loan and obtain relief against its UK taxable income and gains for an exchange loss which the group as a whole had not suffered. Corresponding exchange gains on the shares in the US corporation C, would not be taxed until the shares were disposed of - which might of course never occur - and would be reduced in any event by indexation relief. If on the other hand sterling appreciated, the potential tax charge on the exchange gains on the loan could be deferred indefinitely by non-repayment.

10.26 To some extent the loss to the Exchequer in this example arises from the difficulties discussed in paragraphs 10.7-10.16. But the risk is increased in this instance because the exchange loss on the borrowing does not represent a real loss to the group and there is no exchange gain on the loan in dollar terms which would be subject to US taxation. There must be a strong possibility that multinational groups would take advantage of this lack of symmetry to make loans to UK group members so as to secure the non-taxation of part of their world profits. In theory of course they would run the risk of being taxed on any exchange gains on intra-group loans and, in consequence, because the gains were not real gains to the group, of suffering economic double taxation on part of their world profits. But this situation would be easy enough to avoid (ie by the UK subsidiary not repaying the loan).

10.27 A relatively simple solution to this problem might be to deny relief for exchange losses on intra-group loans where either the borrower or the lender is not within the charge to UK tax. This approach might be justified on the grounds that there would be no overall exchange loss to the group. As a corollary exchange gains on such loans would be excluded from taxation. The basic provision would again need to be accompanied by further rules to take account of "back to back" arrangements through non-group intermediaries.

10.28 But such an approach might be open to the objection that it discriminated unfairly against group companies, particularly

where the foreign currency borrowings from overseas associates were on ordinary commercial terms and indistinguishable from borrowings from unconnected overseas sources. If therefore relief were to be allowed for exchange losses on a borrowing from a non-group overseas company - despite the fact that there would be no corresponding exchange gain reflected in the lender's accounts - it could be argued that it should likewise be allowed where the losses arose on an intra-group loan. The funds advanced by the overseas associate might even have been borrowed on identical terms from an unconnected third party (as in the case of the company group which centralises its foreign currency borrowing in the hands of an offshore (eg Netherlands) subsidiary).

10.29 The non-recognition for tax purposes of all exchange differences on loans from overseas associates might also create difficulties in other circumstances. If, for example, a UK company borrowed foreign currency from its overseas parent and lent the funds to customers in the course of its trade, exchange differences on the loans to customers would be taken into account in computing taxable profits but those on the borrowing would not. This might suggest that an exception to the general rule would be needed in the case of borrowings from overseas associates for use in a UK company's trade.

10.30 In brief therefore the main issue for consideration is whether and, if so, in what circumstances exchange losses on capital loans to and from overseas associates could be allowed for UK tax purposes without creating opportunities for multinational groups to secure the non-taxation of a part of their worldwide profits at the expense of the UK Exchequer. Comments on the issues raised in the previous paragraphs are invited.

10.31 If it were accepted that in certain circumstances account should be taken of exchange differences on currency borrowings from overseas associates, a further point for consideration would be whether relief for losses on a particular loan should be denied to the same extent that relief for interest was restricted on grounds of "thin capitalisation". Without restriction of exchange losses "thin capitalisation" would retain a potential tax advantage notwithstanding the restriction of relief for interest.

CONCLUSION

10.32 It would appear that any scheme for the general recognition of foreign exchange gains and losses would need to be accompanied by complex and perhaps arbitrary rules to protect the Exchequer. These might be difficult to reconcile with the interests of companies. If, for instance, it were possible to devise a test for determining when liabilities were matched with particular assets so as to secure symmetry in the time at which gains or losses are taxed or relieved, the inevitable difficulty of applying it would introduce a significant degree of uncertainty into the system. In the area of groups we have seen that the broad but simple rules discussed could give rise to lack of symmetry and inequity in particular situations. This could

only be removed at the expense of highly complex legislation which would be difficult to operate in practice.

## PART 3 - OPTIONS FOR CHANGE

## CHAPTER 11 - SOME ALTERNATIVE APPROACHES

11.1 If a comprehensive scheme which satisfies the Government's criteria cannot be devised there may nevertheless be a case for action on particular features of the present regime which create significant difficulties. This Chapter discusses whether separate, and more limited, solutions are available for some of the problems identified in Chapter 6.

### HEDGED FOREIGN CURRENCY BORROWING

11.2 As noted at paragraphs 6.6 and 6.7 a mismatch can occur when for example a forward currency contract is acquired or a currency swap agreement is entered into in order to hedge a capital liability. This is because the acquisition and disposal of currency may result in a capital gain or loss on the unwinding of the arrangement. The discussion so far has focused on the tax treatment of exchange differences on the liability. An alternative approach is to consider the treatment of the hedging transaction itself.

11.3 One obvious option would be to remove all foreign currency from the scope of CGT. This would have the advantage of simplicity but it would go much wider than is either necessary or appropriate to deal with the tax fragmentation problem associated with hedging transactions. If, for example, an asset denominated in foreign currency and within the charge to CGT were being hedged, taking foreign currency itself out of the charge would introduce a new asymmetry. It must therefore be ruled out as a possible solution.

11.4 A more limited approach would be to remove from the charge to CGT foreign currency acquired under a forward contract to the extent that that currency served the purpose of meeting or hedging a liability. In those circumstances no capital gain or allowable capital loss would arise on disposal of the currency when the loan was repaid. A forward contract would include a currency swap agreement and a currency future of the appropriate amount. It is not clear that a suitable definition of hedging could be found to meet all relevant circumstances. It might therefore be necessary to leave the term at large for decision on the facts of the individual case but it would be for consideration whether some Revenue guidelines could be provided.

11.5 The question whether the foreign currency was in fact used to meet or hedge a capital liability would raise similar problems to those discussed in Chapter 10 in relation to the matching of currency borrowings with specific assets. But it seems likely that a company will normally enter into a forward contract to acquire currency with some particular purpose in mind and the linking of the proceeds of the contract with a capital liability or liabilities might not present the same degree of difficulty in practice. Bearing in mind the difficulties discussed earlier, however, comments would be welcome on whether this kind of

linking might be feasible in the more limited area of forward contracts. In addition, it would be helpful to know whether there are any other hedging instruments for which similar treatment might be appropriate; and, if so, whether in these cases a workable linking mechanism could be devised. Options, which involve a different technique from forward contracts, may be one example but may require different treatment.

CAPITAL LENDING

11.6 In theory, as discussed in paragraphs 6.13-6.15, tax fragmentation can also affect the hedging of certain capital lending although it is not clear whether significant difficulties do arise in practice in this area. It would be helpful to have comments on whether in fact they do. If a need for action were established, then the removal of foreign currency from the scope of CGT in specified circumstances again might afford a suitable alternative solution.

11.7 In this instance the hedge consists of a forward sale of the foreign currency proceeds of a loan. Where such arrangements are entered into, any gain or loss on the currency proceeds might be excluded from the charge to CGT to the extent that the currency served the purpose of hedging the lending. In other words there would be no capital gain or loss on the currency to the extent that there was a corresponding decrease or increase in the currency value of the debt.

ACCOUNTS PREPARED IN FOREIGN CURRENCY

11.8 As explained in paragraphs 6.16-6.19 the determination of sterling profits and losses for tax purposes can present practical difficulties for companies operating in the UK which prepare accounts in foreign currency. One approach to these difficulties would be to require all companies which are subject to UK tax to prepare their tax computations on a basis which reflects the sterling value of assets and liabilities. This would have the advantages of both simplicity and horizontal equity: computations would be prepared on the same basis for all UK-based operations over which the UK has a primary taxing right.

11.9 But there may be important commercial reasons for preparing accounts in a foreign currency. An alternative approach for consideration would be to legislate to permit the use of a non-sterling functional currency only in certain circumstances. It would clearly be unrealistic and inconsistent with accounting practice for the profits of UK based businesses in general to be measured in a foreign currency and the net result translated into sterling for tax purposes. It would also be unsatisfactory from the Exchequer point of view if such a basis were widely available. Actual exchange fluctuations against sterling would not be reflected in companies' accounts and there would be scope for companies with different functional currencies to arrange transactions in such a way that one party to a transaction obtained relief for an exchange loss without the other being taxed on the corresponding gain.

11.10 The adoption of a non-sterling functional currency would therefore have to be exceptional and subject to closely defined conditions. The conditions might be:

- the greater part of the issued share capital is denominated in that currency;
- expenses and receipts are generated primarily in that currency;
- the greater part of the company's loan capital is in that currency; and
- the company is controlled by non-UK residents.

It would also be necessary to require a degree of continuity of all these factors.

11.11 The functional currency approach might also be thought appropriate for UK insurance business transacted in foreign currencies.

11.12 Representations are invited on the need for and possible nature of any changes in the tax treatment of companies which prepare accounts in foreign currency in respect of UK business operations or which conduct UK business operations in a foreign currency but prepare accounts in sterling.

FOREIGN CURRENCY DENOMINATED SHARE CAPITAL

11.13 As discussed in Chapter 6 companies may issue share capital denominated in foreign currency. Where they prepare accounts in that currency, exchange gains and losses on the issued shares and on any assets in the foreign currency acquired with the share capital will not arise; nor will they be reflected in the taxable profit if the profit and loss method is used. But if the profit and loss method is not used or if the accounts are prepared in sterling there will be exchange differences on both the foreign currency issued share capital and on the foreign currency assets. In the company's sterling accounts however such exchange differences would cancel each other out.

11.14 If the exchange gain or loss on the assets were taken into account for tax purposes but the change in the sterling value of the share capital ignored, the profit for tax purposes would diverge from the profit shown by the accounts. Even quite modest currency fluctuations in percentage terms could lead to taxation adjustments which exceeded the entire commercial profit.

11.15 The application of current tax law in this area is extremely uncertain. A possible solution to the problem would be to legislate to allow share capital denominated in foreign currency to be matched with foreign currency assets in the same way as capital borrowings under the terms of SP1/87. In other words there would never be any charge to tax on gains or relief for losses in respect of exchange fluctuations on the foreign

currency assets to the extent that these were matched by an equal value of share capital. The matching here would not be of specific assets and liabilities, but rather of an amount of foreign currency assets and the value of share capital. If on the other hand a comprehensive reform of the tax treatment of exchange gains and losses were proposed in the light of these consultations, then this approach would mean recognising exchange differences on share capital on the same basis as, in effect, those on capital borrowings.

11.16 But a major objection to such an approach is that it results in a lack of neutrality between sterling and foreign currency share capital. From the investors point of view, the company with foreign currency share capital would be able to acquire foreign currency assets and subsequently distribute them to the investor or repay share capital without itself paying tax on any increase in the sterling value of those assets resulting from exchange rate movements. A company with sterling share capital on the other hand would not be able to do this. Furthermore, as noted in paragraph 10.31, it might be considered necessary to deny relief for exchange losses on a loan to the same extent that interest was disallowable on account of thin capitalisation. But it might seem somewhat inconsistent to make such a restriction, essentially on the grounds that a loan was a substitute for share capital, and yet recognise exchange differences on share capital itself.

11.17 An alternative approach to the recognition of exchange differences on share capital might be merely to **defer** the taxation of exchange gains and losses on foreign currency assets matched by foreign currency share capital. In the case of non-monetary assets, gains and losses would be taxed on disposal under the CGT code in the ordinary way. In the case of monetary assets, gains and losses would not be recognised for tax purposes until those assets were either converted into another currency or were distributed or repaid to shareholders. Cessation of business or of UK residence might also be events that would trigger tax recognition.

11.18 There would of course still be the problem of devising rules to establish which foreign currency assets were matched by share capital. It would probably be necessary to lay down some general rule of the kind suggested in paragraph 10.12 for matched borrowings and assets. However, the difficulties of applying such a rule in practice might not be so great where share capital was concerned since share capital would not normally fluctuate in the same way as borrowings.

11.19 The rule might simply provide that to the extent that share capital was denominated in foreign currency, monetary assets in that currency would be matched with the share capital. If subsequently the monetary assets fell below the level of the share capital that had been matched, the exchange gain or loss realised on the previously matched assets would have to be computed and taken into account.

11.20 A modified approach of this kind would not entirely restore neutrality between sterling and foreign currency share capital since there would still be a timing difference, particularly if exchange differences on monetary assets were normally recognised on the translation basis. But there would be neutrality in the sense that gains and losses on assets would ultimately be taxed in the same amount irrespective of the currency in which share capital was denominated.

11.21 Comments are invited on the need for any change in the tax treatment of share capital denominated in foreign currency. In particular, views would be welcome on whether a deferral system of the kind outlined in paragraphs 11.17-11.19 could be operated in practice.

## CHAPTER 12 - REVIEW AND CONCLUSION

12.1 As the discussion in earlier Chapters brings out, the application of the present tax regime to foreign exchange gains and losses is widely held to be unsatifactory in a number of respects. The most significant of these are:

- there is no relief for exchange losses on capital borrowings (the corollary being that corresponding gains are free of tax), except where the borrowings are matched by current assets in the same currency so that the principle established by the Marine Midland case (described in SP1/87) applies;

- "fragmentation" of related transactions such as currency swaps undertaken for hedging purposes, so that different tax treatments apply to them, making the hedge ineffective.

- changes in the sterling value of share capital denominated in foreign currency are not taken into account for tax purposes.

Running through the criticisms of the existing rules is a strong desire for greater certainty and symmetry of treatment in this highly complex area.

COMPREHENSIVE REFORM

12.2 Any comprehensive reform which aimed to bring into the tax system most (if not all) foreign exchange gains and losses which are currently excluded would have to meet the criteria laid down by the Government, namely that it should be workable in practice, be generally acceptable to industry and its advisers and should not involve unacceptable Exchequer cost. Applying these tests, the preceding Chapters consider:

- whether foreign exchange gains and losses arising on monetary assets held and liabilities incurred for the purpose of a trade might best be taken into account for tax purposes in the computation of trading profits or losses (paragraphs 9.6-9.16). If so, the question arises whether the gains and losses should be taxed or relieved when assets and liabilities are translated into sterling in the annual accounts (paragraphs 8.11-8.15), or by taking some into account on that basis and others only when they are realised on settlement of the particular transaction (paragraphs 8.16-8.25);

- all other foreign exchange gains and losses which are not already recognised for tax purposes might then be treated as capital gains or losses within the CGT code (paragraphs 9.18-9.36); or

- as an alternative to CGT treatment, exchange gains and losses which are not related to a trade might be dealt with within the income tax system (paragraphs 9.37-9.54), either as though they were interest paid or

received, or under the rules of Case VI of Schedule D, or under completely new rules within the income tax regime.

12.3 However, any scheme of reform based on these lines would have to include special rules to ensure that the tax treatment adequately reflected the commercial reality of the situation, in particular where:

- assets and liabilities were commercially matched (paragraphs 10.6-10.13);
- foreign currency loans were repaid and renewed immediately or soon afterwards (paragraphs 10.14 and 10.15);
- intra-group transactions were involved, especially in multinational groups (paragraphs 10.16-10.31).

As the earlier discussion brings out, such rules would be essential to protect the Exchequer against potentially very large costs.

12.4 Chapters 9 and 10 discuss the difficulties of devising rules which would satisfactorily meet these requirements in the light of the borrowing and financial management arrangements of larger companies and within groups of companies. It seems likely that similar problems would arise in deciding whether or not a loan was raised for the purposes of a trade, although possibly to a lesser degree. The complexity of financing arrangements may well mean that it would be very much the exception rather than the rule that a particular borrowing was, or could be, identified as being made to finance or hedge a particular asset; or that a particular loan could be identified as a replacement of another. But it could be a matter of critical importance to the acceptability of any scheme of comprehensive reform that such links could be established.

MORE LIMITED REFORM

12.5 Chapter 11 considers the possiblity of separate solutions to at least some of the problems presented by particular features of the present regime. In particular it examines the scope for and possible nature of more limited legislative changes to deal specifically with tax fragmentation on the hedging of capital borrowings and, if it were shown to be necessary, capital lendings. It also looks at possible ways to cater for companies operating in the UK which either have foreign currency denominated share capital or prepare their accounts in foreign currency.

12.6 It is not possible to estimate the Exchequer cost of a more limited reform of this kind. Much would depend on the final shape of the scheme itself, future exchange fluctuations and possible behavioural changes.

**CONCLUSION**

12.7 Any reform of the tax treatment of foreign exchange gains and losses inevitably raises a number of difficult questions.

Also inevitably, it would add to the length and complexity of existing legislation. In its report entitled "Taxing Currency Fluctuations", the IFS described the issue as "a complex one for which there are only imperfect solutions". That thought has been echoed in a recent report of the OECD which explored the implications of exchange fluctuations for the taxation of companies in an international context.

12.8 This consultative document dicusses in some detail those aspects of the present regime which are widely seen as unsatisfactory, and considers the difficulties which would have to be tackled in devising a new scheme of tax treatment. Representations are invited on the issues discussed, especially on those topics where views are sought on the practicability and acceptability of possible ways forward, as well as any further ideas for reform not already identified. In particular, comments and suggestions would be welcome on:

- the extent to which companies do undertake unhedged borrowing in foreign currency for conversion into sterling (paragraph 6.5); whether the present tax treatment of exchange fluctuations on capital borrowing is seriously inhibiting overseas investment by UK companies (paragraph 6.12); and whether tax fragmentation does create difficulties in relation to capital lending (paragraph 6.15);

- whether the approaches outlined in paragraph 12.2 meet the first two of the Government's criteria (practicability and acceptability to taxpayers);

- the kind of rules which would be necessary to cope with the difficulties summarised in paragraph 12.4; and

- the extent to which special rules, of the kind examined in Chapter 10, for protecting the Exchequer could be made to work in practice and at an acceptable compliance cost to UK businesses and the Revenue.

**ANNEX A - SCALE OF THE ISSUE**

1. This Annex considers whether quantification of the effects of currency fluctuations is possible. It concludes that there is great difficulty in assessing the degree of exposure of UK tax revenue to exchange movements. This will clearly have implications for any attempt to predict the effects and costs of any tax reform.

2. Nevertheless, it is important to identify in broad terms the areas where currency fluctuations may have a sizeable impact on UK tax liabilities. The rest of this Annex looks at seven separate, but in practice often inter-related, areas of interest. Of course, the extent to which any change considered in this paper would affect Exchequer revenue will vary very much from area to area. The preliminary conclusion to be drawn is that profits from inward investment, borrowings to fund overseas portfolio investment and foreign currency borrowings generally are the main areas of interest in terms of the possible tax consequences of the options considered in this document.

3. Much of the discussion in the main body of the paper deals with the tax treatment of capital borrowings. The figure of £70 billion quoted in paragraph 10.2 for the total borrowings of UK businesses (except the banks) is derived from the figures quoted in paragraphs 13 and 16 below; borrowings from banks in foreign currencies by industrial and commercial companies (£24 billion), borrowing by other financial institutions from banks (£28 billion) and from abroad (£16 billion).

4. What fraction of the figure of £70 billion is capital borrowing is not known, so an illustrative figure of £30 billion is used in Chapter 10. The Revenue has no reliable data for the UK economy as a whole on the split between current and capital items, although this distinction is important in terms of the present UK systems of income and corporation tax. If borrowing abroad takes place, it is often not clear from published figures whether the borrowing is in sterling or in foreign currency, let alone precisely which currency although most foreign currency borrowing appears to be in US dollars.

PROFITS FROM DIRECT INVESTMENT OVERSEAS

5. Net earnings by UK companies on their overseas direct investments were £7.7 billion in 1986. This consisted mainly of earnings of overseas subsidiaries, which are normally subject to UK tax only when remitted to the UK as dividends (this figure is in fact net of foreign tax). Earnings of branches overseas (which are normally subject to UK tax) are comparatively low, at about £300 million. Dividends remitted to the UK from subsidiaries were about £3 billion, about 40% of the above earnings figure and a percentage that has risen in recent years.

6. In a number of cases, very little UK tax is charged on dividends from overseas subsidiaries or on overseas branch profits remitted to the UK. This is because such income is likely

to be taxed at a higher rate overseas than in the UK (unless exceptionally profits are earned in low tax countries), with the result that double taxation relief will eliminate or significantly reduce the UK tax charge. Exchange differences will not generally enter into the calculation of dividend income for tax purposes and, where overseas branches are concerned, if the amount of overseas income were increased or reduced by recognising the effects of currency fluctuations on branch assets and liabilities, this is likely to have little effect on the UK tax charge. Currency fluctuations are not, therefore, likely to expose the Exchequer to any major potential loss of tax revenue in this area.

PROFITS FROM INWARD INVESTMENT

7. Earnings net of tax from inward investment were £5.3 billion in 1986. Most will fall within the UK tax net. However, the exposure to foreign currency movements is unknown. It is possible that in many cases capital borrowings, on which exchange differences are ignored for tax purposes under the present system, are in the currency of the foreign parent. Furthermore, the foreign parent may decide that only exchange movements relative to its own base currency (in which it reports to its shareholders) should be hedged by companies in the group. This will not normally be sterling, and the UK subsidiary measuring its profits in sterling for UK tax purposes may therefore be left with a substantial exposure to that currency.

8. These general arguments suggest that any change in the tax treatment of exchange differences could have a considerable effect on taxable profits in this area.

FOREIGN CURRENCY BORROWINGS USED TO FUND INWARD AND OUTWARD DIRECT INVESTMENT

9. Profits are normally calculated net of interest paid to suppliers of loan finance. Much of this finance will come from third parties, such as banks or the corporate bond market. However, parents of overseas subsidiaries may fund them in part by direct loan rather than by equity. Equally, subsidiaries can lend to their parents - these are known as "upstream" loans.

10. In the case of **outward investment**, the Department of Trade and Industry's estimate of "interest received by UK companies" has been negative since 1982 and has been running at about £150 million per annum. This figure is the difference between interest paid to and interest received from subsidiaries and the negative figure simply indicates that "upstream" loans now exceed loans extended by parents.

11. The main reason for this has been that UK parents have preferred to raise cash through overseas finance subsidiaries (commonly in the Netherlands) in order to pay interest gross to Eurobond holders. However, it is not clear what proportion of this borrowing is in foreign currencies, though it seems likely that most will be.

12. In the case of **inward investment**, interest paid to overseas parents was running at about £229 million in 1986, a sharp increase on earlier years. Again, the currency is not known.

FOREIGN CURRENCY BORROWING TO FUND DOMESTIC INVESTMENT

13. Figures from Financial Statistics indicate that "industrial and commercial companies" (ICCs) were, at June 1988, borrowing about £24 billion from banks in foreign currencies. However, non-bank lending to ICCs in foreign currencies, which would tend to increase the £24 billion figure, is not separately identified and it is not known how much of the bank lending is used to purchase overseas, rather than domestic, assets or what proportion would count as 'current' or 'capital'. This is clearly an important channel by which exchange movements may be influencing Exchequer revenue.

INCOME AND CAPITAL GAINS FROM PORTFOLIO ASSETS

14. Figures of overseas income for the major types of institutional investor are given in the attached table. The investment income of pension funds is tax exempt. The other institutions are subject to UK corporation tax on their foreign income, less credit for any foreign witholding taxes paid. Excluding banks, about £7 billion of foreign source income may be subject to UK tax. This figure has shown considerable growth over the last decade but the rate of growth has fluctuated from year to year.

15. Ultimately, capital gains arising from overseas assets will normally be subject to UK tax when they are realised, apart from those of pension funds. Normally the gains will be exempt from tax in the country of origin. Potentially, this is an important source of future UK revenue but this liability has not yet crystallised, indeed the timing of disposal itself may be influenced by exchange fluctuations. At the end of 1987 total portfolio holdings of overseas assets by institutions (excluding banks, ICCs and pension funds) amounted to £45 billion.

FOREIGN CURRENCY BORROWINGS AND PORTFOLIO INVESTMENT

16. Figures from Financial Statistics suggest that at June 1988 "other financial institutions" (OFIs) were borrowing about £28 billion in foreign currencies from banks. As with ICCs, the level of non-bank lending is not identified, but OFIs had a further £16 billion of "overseas liabilities". It seems likely that most of this is 'capital' borrowing, intended to hedge foreign portfolio assets. Hedging policies of investment trusts vary considerably.

THE BANKS

17. It is estimated that UK banks' total net income from external transactions was about £1.4 billion in 1987. However, the main element of this figure is the difference between two very large flows of interest received and interest paid (which

can result in large fluctuations in the net figure). It also reflects income from a variety of activities: branch earnings overseas, income from the bank's own portfolio investments and foreign currency lending both to foreigners and to UK residents.

18. In the case of banks, foreign exchange gains and losses on loans will normally be recognised for tax purposes apart from borrowings on capital account (although even these will normally be matched in accordance with Marine Midland principles). Therefore, although the sums involved are very large (about £480 billion at June 1988), it is unlikely that any changes contemplated in this document will have very much direct effect on Exchequer revenue from the banking sector.

## ANNEX B - THE EFFECT OF MARINE MIDLAND ON UK TAX TREATMENT

1. Despite the absence of specific guidance on exchange matters in the Taxes Acts (see paragraph 4.1), only a small number of cases have reached the Courts on the subject. These have generally concerned the question of whether particular exchange differences have arisen in the course of trade, ie whether they were on capital or revenue account (if the former, they were excluded from the Case I computation).

2. Other issues have given rise to disagreements between the Revenue and taxpayers. These have included questions such as when exchange differences should be regarded as realised (normally the translation basis would be used for accounting purposes and this would be followed for tax) and how the profits of overseas trades conducted in foreign currency should be translated into sterling for tax purposes (normally the balance sheet method would be preferred, although considerable latitude would be allowed in practice and in particular fields the profit and loss method might be the normal method if it had been consistantly adopted in the past).

3. The judgements in the Marine Midland case touched on all these issues. This case concerned a UK resident bank carrying on business in international commercial banking. For the purpose of making dollar loans and advances in the course of its banking business, it borrowed US $15 million in the form of subordinated loan stock, redeemable in 10 years. As a result of exchange rate fluctuations, the sterling value of the loans to customers increased, as did the liability in sterling terms of the loan stock. The bank's general aim was to remain matched in each foreign currency and for the most part the dollar borrowing remained invested in dollar assets. After 5 years the bank received repayment from its customers of the US $15 million it had lent to them, itself repaying the loan stock. At no time was any of the US $15 million converted into sterling.

4. Each year in the accounts the monetary assets and liabilities denominated in foreign currency were valued in sterling at the exchange rate prevailing at the balance sheet date. To the extent that currency liabilities were matched by currency assets, no profit or loss appeared in the profit and loss account. The Revenue argued that exchange gains on the assets should be taxed as trading income but that no deduction should be allowed for exchange losses on the liabilities as these were on capital account. The Court of Appeal and the House of Lords held that in these circumstances no profit or loss arose for tax purposes on the matched assets and liabilities; they did not find it necessary to decide whether the borrowings were capital or revenue transactions.

5. On the other hand, the company brought into its profit and loss account any increase or decrease in the sterling value of excess dollars - that is, to the extent that it was in an unmatched position - and this had been accepted as a profit or loss for tax purposes. Lord Templeman said that this practice "reflected the success or failure of the company in acquiring and

holding excess dollars which could be converted into sterling". He noted without disapproval the Revenue's acceptance of the practice and said that it was "not inconsistent with the company's submission that no profit or loss was attributable to dollar assets equal in dollar terms to dollar liabilities".

6. Various conclusions have been drawn from the judgements. Some commentators have argued that certain dicta in the case establish that no exchange profit or loss is realised for taxation purposes until currency assets and liabilities are converted into sterling. Some have argued that other dicta in the case provide general support for the use of the profit and loss method in translating foreign currency accounts and transactions.

7. Marine Midland did, however, prepare its accounts in sterling in such a way as to bring into the profit and loss account exchange differences - calculated by reference to sterling - arising on its unmatched currency positions; and those differences were based on valuation of the currency at closing rate rather than on actual conversions. The accounting practice was in fact not essentially different from that now set out in SSAP 20. Since the Courts did not disturb this treatment for tax purposes, the Revenue has been reluctant to accept conclusions drawn from the case which would produce different profits from those which were actually computed by Marine Midland in accordance with normal accounting practice.

8. The Revenue therefore does not accept as a general proposition that translation profits and losses recognised in accounts drawn up under generally accepted accounting practice should be ignored for tax purposes. Nor does it accept that the profit and loss method of translation is universally correct. For an individual company which enters direct (rather than through a branch or a subsidiary) into foreign currency transactions, the use of this method would not be in accordance with generally accepted accounting practice.

9. The principle which the Revenue did draw from the case was simply that where trade assets and liabilities in the same currency are matched and no profit or loss is taken into the profit and loss account, no adjustment can be made for tax purposes regardless of the capital or revenue nature of the assets and liabilities. Beyond this, the Revenue's view is that Marine Midland provides no justification for any change in the interpretation of the law in relation to domestic businesses. The main concern has been how the matching principle should be interpreted and applied in practice. For overseas trades conducted in foreign currency the Revenue has now more generally accepted that local currency accounts can be translated by the profit or loss method or its equivalent closing rate/net investment method, so long as it is consistently applied.

10. Turning to CGT, the Revenue's line has always been that gains or losses on foreign currency assets should be measured against sterling. Thus an asset purchased for $100 when £1 = $2 and then sold for $100 when £1 = $1 would give rise to a chargeable gain of £50 (there would of course have been no chargeable gain, had the measure been in dollar terms). The

decision in Bentley v Pike * confirmed that the cost of acquiring a chargeable asset in foreign currency has to be expressed in sterling at the exchange rate prevailing at the date of acquisition, while the foreign currency consideration received must be expressed in sterling at the exchange rate ruling on the date of disposal.

11. The Marine Midland Case (decided in the House of Lords) was heard after Bentley v Pike (decided in the High Court). Some commentators have argued that Marine Midland overrules Bentley v Pike, at least where foreign currency assets are matched by liabilities, but the Revenue has not accepted that argument on the grounds that the decision concerned only the computation of trading income.

12. The Marine Midland decision has also raised questions about the calculation of capital gains on the disposal of chargeable assets, where those assets are matched for the purposes of computing trade income against current liabilities. This issue is discussed in detail in Chapter 5.

* Bentley v Pike (HM Inspector of Taxes) 53 TC 590

**ANNEX C - INTERNATIONAL COMPARISONS**

1. This Annex considers the tax treatment of foreign exchange gains and losses in the national systems of other major trading countries. In particular it summarises the position for companies carrying on business in five countries - Australia, Canada, France, Germany and the USA.

2. In its report "Tax Consequences of Foreign Exchange Gains and Losses" (published September 1988) the OECD set out to examine the extent to which tax administrations can and should improve international compatibility in this field as well as providing equitable and internally consistent national systems. The report suggested that "unnecessary international variations in ways and means of dealing with these problems within member countries" should be minimised (paragraph 151 of the report). But, in drawing its broad conclusion, the report said that

> "Although it is apparent that national solutions to the problem of fitting exchange gains and losses equitably and effectively into the tax system may well have international implications, it seems clear that the problems and their solutions are, in the main, matters of domestic rather than international policy" (paragraph 150).

3. That cautious conclusion may reflect the fact that although exchange gains and losses arise, by definition, in an international context, their treatment under national tax systems must be consistent with the scope and structure of those systems and with the requirements of the country's fisc.

4. In addition, there is the familiar point that international comparisons of tax systems - and especially of particular parts of them - is often difficult and misleading, if not seen in their wider context. Account needs to be taken of, amongst other factors, the fiscal and general economic policies of the Governments concerned and the commercial and legal regimes, as well as the administrative traditions, in which the tax systems must operate. The fact that a particular item of expenditure or profit may be treated less generously in the tax laws in one country than another does not by itself establish that businesses in the former may be at a competitive disadvantage internationally. It is necessary to see how far there is a difference in practice in the treatment of that particular item, when the tax laws are applied in their appropriate economic, legal, political and administrative environments. And, even where there is a difference in the tax treatment of a specific item, the balance of advantage may be reversed on other matters, for example on rates of tax or, more generally, as regards other business costs.

5. The European Commission has not published any proposals for harmonisation of the tax treatment of exchange differences within the European Community. It is not known whether the issue will be examined as part of the Commission's work on proposals for

harmonisation of the tax base (ie the rules for determining the taxable profits of business undertakings).

6. The summaries at paragraphs 11-38 are based on information available in London at end-November 1988. They outline how and when exchange gains and losses are recognised for both trade and non-trade items and describe the circumstances in which a non-domestic "functional currency" can be used. They also look at the position on forward currency contracts and similar financial instruments and foreign branches. In addition they briefly indicate the accounting treatment adopted and the extent to which it is followed for tax purposes in each of the five countries.

7. It can be seen that, other than in France, at least some exchange differences arising from business transactions are recognised on a form of realisation basis. In Australia and the United States this basis appears to be similar to the "settled transaction" basis discussed in Chapter 8. It is not known how burdensome the need to identify and value separately each foreign currency transaction is in practice.

8. Two countries, Australia and Canada, maintain a capital/revenue distinction on the lines of the UK with the result that exchange gains and losses on assets and liabilities on capital account are normally excluded from the computation of income. But, relief for exchange losses on capital borrowings against a company's income is effectively allowed in four of the countries. None of those countries appears to require a "purposes of the trade" test to be satisfied before relief is allowed.

9. It is not clear to what extent these regimes include special measures to guard against the risks to the Exchequer which have been identified in Chapter 10, for example:

- the use of intra-group loans to obtain relief for exchange losses, where the group as a whole may not in fact incur any overall loss; and

- the repayment and immediate replacement of foreign currency loans to crystallise exchange losses.

In the United States, for example, the Courts hold themselves able in appropriate circumstances to have regard to the substance rather than the form of transactions and this may protect the fisc in this area. In other countries, general anti-avoidance provisions which enable certain kinds of transactions to be set aside for tax purposes may give the protection required.

10. An important further consideration in making comparisons in this area is that the potential cost of recognising exchange losses on capital borrowings may be significantly greater for some countries than others. Much might depend, for example, on the size of the capital flows across the exchanges, the extent of

currency fluctuations and the scope of the national tax charge which might exclude certain kinds of foreign income and hence the losses and expenditure associated with it.

AUSTRALIA

11. Australian accounting standards make a distinction between foreign exchange gains and losses on short-term (defined as having a life of 12 months or less) monetary items (generally cash, receivables and payables) and long-term monetary items. Both realised and unrealised (translation) gains and losses on the former are usually recognised as income of the period in which they arise, whereas unrealised (translation) gains and losses on the latter are normally taken to reserves and then amortised to the income statement over the remaining life of the long-term monetary item.

12. The tax treatment distinguishes between exchange differences of a capital nature and those of a revenue nature. Exchange gains and losses on revenue account are recognised as income when realised. For example, goods and services purchased or sold in foreign currency are recorded in Australian dollars at the contract date; and later payments or receipts in the same tax year are recorded as adjustments to the contract price. If payment or receipt is outstanding at the balance sheet date, the realisation basis applies and the exchange gain or loss is not recognised until the following year when payment is actually made or received.

13. Until 18 February 1986 exchange differences on capital account, whether arising on the purchase and sale of a capital asset or on settlement of a capital liability, were generally excluded from income. Thereafter, the capital/revenue distinction was removed in relation to gains and losses on new business borrowings which are treated as income when realised, ie on repayment. Capital assets remain within the CGT code and exchange differences are recognised only on the disposal of the assets. Capital gains are computed on the same basis as in the UK with costs and disposal proceeds translated into Australian dollars at the rates ruling on the dates of the transactions, with an indexation adjustment to costs.

14. In the case of forward exchange contracts or options, the treatment of exchange differences for many years followed that of the underlying transaction. Thus, gains and losses on instruments taken out to hedge trading transactions were taken into account in computing income but those on instruments which hedged capital transactions were ignored for tax purposes. Under the 1986 legislation gains and losses under any hedging contract are normally included in the income statement. An anti-avoidance measure denies relief for exchange losses which are covered by a hedging contract or similar arrangement where the hedging contract itself produces a gain which is not assessable as income of an Australian resident taxpayer.

15. For 1987/88 onwards foreign branch profits of an Australian resident are subject to Australian tax with credit relief for foreign tax. Such profits have to be expressed in Australian currency at the average exchange rate for the relevant period.

CANADA

16. Under Canadian accounting principles, exchange differences arising in the course of trading activities are usually taken into the calculation of profits, whether or not they have been realised. The accounting treatment can only be followed for tax purposes in respect of gains and losses which are on income account. But income items can be recognised on a realisation basis, provided that method is adopted consistently for both accounting and tax purposes. Where gains and losses are on capital account, they are recognised for tax purposes only on realisation (eg when a capital borrowing is repaid).

17. The whole of any exchange gain or loss on income account is taken into account in computing income. Exchange differences on capital transactions are treated as capital gains or losses and a fraction (2/3 for 1988 and 1989; 3/4 for 1990 onwards) of the gain or loss is taxed or relieved. Capital losses may not be set against income.

18. General tax principles are applied in determining whether exchange gains and losses are on income or capital account. This is dependent on the nature of the underlying transactions on which they arise or, in the case of foreign currency borrowings, the use of the funds. Generally where a gain or loss arises from goods or services relating to the business operations, it will be ordinary income. If it arises as a direct consequence of the purchase or sale of capital assets it will be a capital gain or loss.

19. Where foreign currency borrowings are used in the ordinary course of business, exchange differences are regarded as income items. Where they form part of the fixed capital, CGT treatment applies. The income or capital nature of a loan is determined by consideration of all the facts and the period of the loan is not conclusive.

20. An important exception to the normal treatment of borrowings is made in the case of a thinly capitalised company. To the extent that the loan represents a deficiency of paid-in capital, its repayment is regarded as on capital account regardless of the use of the funds. Trade accounts payable to a parent or affiliate may also attract the same treatment.

21. The treatment of forward contracts is governed by the general income/capital principles and exchange gains or losses on business account are reflected in ordinary income. Transactions not on business account are evaluated by reference to the purpose and intention of the taxpayer. Where forward currency contracts are used to hedge general currency risks, the tax treatment is determined by looking through the hedging operation to the nature of the underlying asset or liability.

22. Foreign branch results may be translated into Canadian dollars by the transaction (temporal) method, the profit and loss method or the balance sheet method. The transaction method applies where the branch financial records are in Canadian dollars. Where the branch accounts are kept in foreign currency, either of the other two methods may be adopted provided it is used consistently.

FRANCE

23. Under French accounting principles receivables and payables denominated in foreign currencies are translated into French francs at the exchange rate prevailing when they are booked. When receivables are collected or payables are settled in the same accounting period, the exchange rates ruling on those dates are applied and the resulting exchange gains and losses are regarded as realised and immediately reflected in the profit and loss account, as are gains and losses arising from cash and other like assets (funds available and funds due on demand). When receivables and payables are outstanding at the balance sheet date, they are re-valued by reference to the exchange rate ruling on that date and the resulting unrealised exchange difference is generally taken to reserve. It is, however, permissible for unrealised losses on long-term debts to be charged to profit and loss account over the period of the debt. When realised losses are reflected in the profit and loss account, prior reserves for unrealised losses are written back.

24. The tax treatment differs from the accounting treatment in that normally both realised and unrealised exchange gains and losses on loans, receivables, debts and payables are recognised in the income statement, ie exchange differences taken to reserve as well as to profit and loss account, are taxed or allowed. No distinction is made between capital or revenue items. When a fixed asset is acquired with foreign currency, the purchase price is translated into francs at the exchange rate ruling on the date of the transaction. An exchange gain or loss would be accounted for only on the disposal of the asset and it would be taxed or allowed as ordinary business income or expense at that time.

25. Companies have to include in their tax computations unrealised exchange gains and losses on payables and receivables denominated in foreign currencies, even if they are hedged in the same currency by a forward exchange contract with a similar maturity date. The accounting profit has to be adjusted therefore.

26. For domestic businesses functional currency will have no relevance. Where foreign branches are concerned profits are not taxable under French tax territorial rules. No currency translation of the branch assets and liabilities is therefore required for tax purposes and any exchange gain or loss with respect to the foreign branch generally has no tax effect.

GERMANY

27. The tax treatment of exchange gains and losses generally follows accepted accounting principles. All financial statements (balance sheet and profit and loss accounts) must be prepared in deutsche marks (DM) and so transactions denominated in foreign currencies have to be translated into DM for accounts purposes. The functional currency issue does not therefore arise.

28. Assets and liabilities denominated in foreign currencies - including, for example, trade debtors and creditors, lendings and borrowings, fixed assets, trading stock and assets held as investments, such as shares - are recorded at the exchange rate prevailing at the date on which they are acquired or incurred. At a subsequent balance sheet date they have to be revalued at the rate prevailing on that date. If this produces an exchange loss, it is recognised in the accounts. But, if there is an exchange gain, it is not recognised and the value of the asset or liability remains unchanged in the accounts.

29. As the tax treatment follows the accounting treatment, this means that exchange gains are not taxed until actual realisation, whereas exchange losses are deductible whether realised or unrealised. In the case of assets, realisation occurs when the assets become due (eg loans) or are sold, while for liabilities it is when they are repaid. In general, foreign exchange gains and losses are regarded for tax purposes as business income and expenses irrespective of their capital or revenue nature.

30. Although foreign currency assets and liabilities are normally separately valued, there is an exception where assets and liabilities in the same currency are equal in amount. In such a "closed position" no account is taken of any exchange loss on either an asset or a liability, which otherwise would have been recognised on translation. In cases where a foreign currency asset and a liability, while equal in amount, do not have the same maturity date, a closed position may still exist to the extent that the difference in maturity is hedged. Where, for example, a liability (eg a loan) is settled before disposal of the asset, it appears that no exchange gain or loss would be recognised on repayment of the loan if it is replaced by another currency loan of equivalent amount or if a forward contract is entered into to purchase the same amount of foreign currency. Fixed assets are excluded from this treatment because they cannot be realised at a certain date. The "closed position" principle is also followed for tax purposes and thus limits the application of the realisation basis.

31. Where a foreign branch is located in a country with which Germany has a double taxation agreement, the agreement usually provides for exemption of the branch income from corporation tax. In other cases the branch income is included in income subject to corporation tax. The accounting treatment normally used to determine the branch profit or loss is very similar to the temporal method required by SSAP20 for a foreign branch which is regarded as merely an extension of a UK company.

## UNITED STATES

32. The US Tax Reform Act 1986 provides new rules for the tax treatment of exchange gains and losses. These rules generally follow the financial accounting concept of "functional currency" - defined as the currency of the primary economic environment in which a particular entity operates - laid down in 1981 by the Statement of Financial Accounting Standards No. 52 (FAS 52).

33. As a general rule the US dollar will be the functional currency of all US taxpayers for tax purposes. Where, however, a "qualified business unit" - broadly a self-contained foreign operation such as a foreign branch of a US corporation - maintains separate books and records in a foreign currency and a significant part of its business activities are conducted in that currency, its functional currency will be that foreign currency.

34. Exchange gains and losses are normally determined on a "separate transaction" basis for transactions involving financial assets and liabilities denominated in a currency other than the taxpayer's functional currency (referred to as Section 988 transactions). Gains or losses arise if the exchange rate changes between the date an asset or liability is taken into account for tax purposes (the booking date) and the date it is disposed of or settled. They are recognised therefore only when a transaction is closed or completed (for example, the actual payment of a trade debt or the repayment of a borrowing or lending). This contrasts with the accounting treatment of these transactions under which exchange differences on unsettled transactions are reflected in net income along with realised gains and losses. With certain exceptions, exchange gains and losses on such transactions are treated as ordinary income or loss for tax purposes with no account being taken of their capital or revenue nature.

35. In the treatment of forward currency contracts, options and similar financial instruments a distinction is drawn between those instruments which are subject to "mark to market" rules and others which are Section 988 transactions. The former cover instruments traded on a qualified Exchange or in the interbank market and which are not part of a hedging transaction. Where such instruments are held at the year end, they are revalued at market value and taxable gains or losses are recognised. The other instruments within Section 988 are dealt with generally on the "separate transaction" basis.

36. An exception to the separate transaction principle is made for certain fully hedged foreign currency transactions. A hedging transaction involving a transaction within Section 988, if identified as a hedge by the taxpayer or the US Treasury, will be integrated with the asset or liability hedged and treated as a single transaction or otherwise dealt with on a consistent basis. Regulations governing the extent of this treatment and the transactions concerned have not yet been published.

37. It is understood that fixed and other non-financial assets are subject to capital gains treatment and exchange differences are recognised on disposal of the assets. Costs and sale proceeds are translated into dollars at the rates ruling on the dates of acquisition and disposal. There are restrictions on relief for capital losses in certain circumstances.

38. Where the accounts of a foreign branch are prepared in functional (non-dollar) currency, the profit or loss must be translated into dollars using a weighted average rate, ie the profit and loss method. The resulting figure is then included in taxable income without reduction for remittances from the branch during the year.

## ANNEX D - SPECIFIC SUGGESTIONS FOR CHANGE

1. There have been two important contributions in recent years to the public debate on the need for reform of the UK tax treatment of foreign exchange gains and losses. First, in 1985, the Institute for Fiscal Studies (IFS) published a report, entitled "Taxing Currency Fluctuations?", on the results of a study of the existing regime after the Marine Midland decision. Second, in July 1987, proposals for legislative change were presented to the Government by a group of nine representative bodies (Group of Nine)* in response to the invitation from the Financial Secretary to the Treasury at the time of publication of the Revenue's statement of practice (SP1/87).

IFS REPORT

2. The IFS study examined in depth two methods of dealing with exchange gains and losses on monetary assets and liabilities. Under a comprehensive method, all gains and losses would be brought into tax as they accrue (ie on an annual translation basis). The study suggested that this comprehensive method appeared, at first sight, to be relatively straightforward in application and had the advantage of corresponding reasonably closely to accounting practice. It also considered the treatment of non-monetary items but identified many of the difficulties with a comprehensive scheme which are discussed in this consultative document, such as the asymmetry of treatment that would arise where a foreign currency liability matched a non-monetary asset within the CGT code. The report concluded that major difficulties would arise with a comprehensive reform when a company had fixed assets denominated in a foreign currency but that any change to the existing treatment of non-monetary assets, to take account of these difficulties, would produce anomalies and distortions of its own.

3. While not rejecting the comprehensive method altogether, the report favoured an alternative approach - the "interest margin method" - based on a distinction between the permanent and transitory components of exchange rate fluctuations. Permanent movements represent the underlying strengths and weaknesses of particular currencies which are mirrored in and influenced by differences in the relevant rates of inflation and interest. This expected element in exchange fluctuations on monetary items would be recognised for tax purposes as it accrued. Transitory movements, on the other hand, represent the volatile short-term fluctuations characteristic of speculative markets and, after examining various options for dealing with this element, the study concluded that it should be disregarded for tax, except in the hands of a currency dealer. The existing

* The nine bodies were: The Association of British Insurers, The Association of Corporate Treasurers, The British Bankers Association, Confederation of British Industry, The Institute of Chartered Accountants in England and Wales, International Chamber of Commerce, Institute of Directors, Institute of Taxation, The Law Society.

treatment of non-monetary assets would remain, with the exception of trading stocks which would be dealt with in the same way as monetary assets.

4. The report suggested that the practical difficulty of determining the permanent element in exchange gains or losses would not be as great as it might appear. It would be necessary to apply an "interest adjustment factor" - based on interest rate differentials or, where major currencies were concerned, on premia and discounts in the forward exchange market - to the net figure of monetary assets less liabilities in each currency held by a company, on average, during its accounting period.

5. The report envisaged the Inland Revenue publishing appropriate adjustment factors for each currency and for each period, rather like the monthly publication of CGT indexation factors. The calculation, dissemination and application of these adjustment factors would be a major undertaking covering at least 15-20 (and probably many more) currencies. For the UK's major trading partners, forward currency rates are readily available; but, apart from the US$, these rates are usually on a short-term basis. For other currencies, as the study recognised, interest rate differentials would presumably have to be used. Inevitably, to keep calculations manageable an element of rough justice would be required.

6. The adjustment factors would need to measure the average interest rate differential over the preceding year but, because companies can freely choose their accounting periods, they would have to be available on a monthly basis. It is also not obvious precisely which interest rates would be used. For example, if a company had a net asset position, differential lending rates would seem appropriate; but with a net liability position, it is arguable that differential borrowing rates should be used.

7. Non-recognition for tax of the transitory element would give some protection to both companies and the Exchequer against volatility of tax payments and receipts which might otherwise result from recognising the whole of the gain or loss arising from currency fluctuations. But, as the report recognised, it might not be considered appropriate for companies to escape taxation on large unexpected exchange gains. Such windfall gains do add to the taxable capacity of companies. Conversely, companies which suffer real exchange losses would feel that they had justifiable cause for concern at a system which denied relief for that part of a loss which was unexpected. Moreover, the application of this distinction to transactions on revenue account would result in partial withdrawal of relief allowed under the present regime.

8. These objections and the high compliance and operational costs for companies and the Revenue in calculating permanent exchange movements in each currency, suggest that this alternative approach would not meet two of the Government's three criteria for reform, ie acceptability to companies and practicability.

## GROUP OF NINE REPORT

9. The report of the nine representative bodies called for early action to be taken in relation to foreign currency borrowings on capital account and proposed a framework for change in that particular area. It recommended that, in general, exchange gains and losses on capital borrowings should be taken into account on a realisation basis in the computation of trading profits and losses under Case I of Schedule D.

10. Although a realisation basis was proposed, the report acknowledged that this might give companies some scope to crystallise exchange losses but to defer gains. It accepted a need therefore for some, unspecified, exceptions to protect both the Exchequer and companies; and suggested that companies should have a right of election to adopt the accruals (ie annual translation) basis.

11. The report also recognised the lack of symmetry where a foreign currency borrowing finances a non-monetary asset. To overcome this problem it recommended that companies should be able to designate specific borrowings as matching particular assets in the same currency. Where such an election was in force exchange differences on the borrowing would not be recognised until the asset was disposed of; and on the disposal, exchange differences on both the asset and the borrowing would be dealt with in the same way.

12. The report identified some other important points which it said would need further consideration in the context of a comprehensive scheme of reform. And there are other issues which it did not address. For example, the report concluded that special consideration would need to be given to non-trading companies, where there is no Case I computation; and it made no mention of the treatment of exchange differences on capital monetary assets which may also not be recognised under the present regime. These and other related issues are discussed in Chapters 8-10.

**ANNEX E - GLOSSARY**

| Term | | Definition |
|---|---|---|
| BALANCE SHEET METHOD | - | Method of translating accounts prepared in a foreign currency into sterling for tax purposes. Broadly, taxable profit is based upon the change, over the accounting period, in the sterling value of the foreign currency current assets and liabilities. Produces essentially the same result as the "Temporal" method described in SSAP 20 but with exchange differences on capital items excluded. |
| BASE CURRENCY | - | The currency of measurement in which, for example, value, profits and income are measured. |
| CLOSING RATE | - | The exchange rate prevailing at the balance sheet date. |
| CLOSING RATE/NET INVESTMENT METHOD | - | Method described in SSAP 20 of consolidating accounts prepared in a foreign currency. Broadly, the net investment in the foreign enterprise is revalued at closing rate each year and exchange differences carried to reserve; its profit is simply translated (eg into sterling) using the average or closing rate of exchange (on a consistent basis). |
| CONVERSION BASIS | - | Basis on which foreign exchange differences are recognised for tax purposes at the time the foreign currency proceeds are actually converted into sterling. |
| EFFECTIVE EXCHANGE RATE | - | See "Trade Weighted Exchange Rate". |
| FORWARD CONTRACT | - | An agreement to exchange different currencies at a specified future date at a rate of exchange agreed now. |
| FUNCTIONAL CURRENCY | - | In general terms, the currency in which a business conducts its business. |
| HEDGING | - | Any transaction (eg a forward contract) designed to reduce exposure to adverse price movements. |

| | |
|---|---|
| HISTORIC RATE | The exchange rate prevailing at the date on which a foreign currency transaction is undertaken. |
| MONETARY ITEMS | Money held and amounts to be paid or received in money (eg cash, deposits, creditors and debtors). |
| NON-MONETARY ITEMS | Assets and liabilities which do not qualify as monetary items under the above definition (eg shares, land, buildings). |
| NOTHINGS | Items not recognised for tax purposes as either revenue or capital items. |
| OPTION | An agreement giving the purchaser a right, but not an obligation, to buy (a 'call' option) or sell (a 'put' option) or both (a 'double' option) something, eg a block of currency, at a pre-determined price during a specific period or on a specific day. |
| PURCHASING POWER PARITY | This is said to hold when the cost of purchasing a basket of goods in one country is the same as the cost of purchasing the same goods in a different country at the prevailing exchange rate. |
| PROFIT & LOSS METHOD | Method of translating accounts prepared in a foreign currency into sterling for tax purposes. Broadly, Case I trading profit is calculated in the foreign currency and then simply translated using the average or closing rate of exchange (on a consistent basis). |
| SETTLED TRANSACTION BASIS | Basis on which exchange differences are recognised for tax purposes at the date cash payment is made or received, whether or not proceeds are actually converted into sterling. |
| SP1/87 | Inland Revenue Statement of Practice on the tax treatment of the consequences of currency fluctuations. |
| SSAP 20 | The Statement of Standard Accounting Practice on foreign currency translation. |

| | | |
|---|---|---|
| STRONG CURRENCY | - | A currency is said to be strong, when, over the long term, its price in terms of other currencies rises. |
| SWAPS | - | Fixed-term agreement designed to exploit the complementary positions of two parties. Under a currency swap, a sum in one currency is exchanged for a second currency, with an agreement to re-exchange at a later date for the same amount, regardless of any currency fluctuations during the intervening time. Can be used as a hedging device. |
| TEMPORAL METHOD | - | Method of translating (eg into sterling) accounts prepared in a foreign currency described in SSAP 20. Broadly, transactions are recorded at the rate prevailing when they occur but liabilities and monetary assets are translated at each balance sheet date using the rate then prevailing. The resulting exchange differences are taken to profit and loss account. |
| THIN CAPITALISATION | - | The use of loans as a substitute for equity capital in the financing of companies for the purpose of obtaining a tax advantage. |
| TRADE WEIGHTED EXCHANGE RATE | - | An index that reflects the relative movements of a currency against a basket of other currencies. The basket of other currencies is chosen and weighted according to their relative importance in the trade flows of that country. |
| TRANSLATION BASIS | - | Basis on which foreign exchange differences are recognised for tax at the time assets and liabilities arising from a transaction are translated into sterling for accounts purposes. |
| WEAK CURRENCY | - | A currency is said to be weak, when, over the long term, its price in terms of other currencies falls. |