

File- Monetary Policy Issues-Exchange Rate
Intervention – Part C

Reference MG-MAMC/D/0002/001

File begins 11/09/1987

File ends 23/12/1987

Pages 60-78

A COMPREHENSIVE SCHEME

Outline and Open Points1. Introduction - The Aims of a Comprehensive Scheme

A comprehensive scheme of taxation for foreign exchange gains and losses (FEGL's) aims to provide a coherent set of rules which produce clear and "sensible" results when applied to the great variety of foreign currency items and transactions.

Ideally, the scheme should yield parity of treatment for profits and losses (ie if a profit on a foreign currency item is taxed in a particular way and recognised for tax at a particular time, an equivalent loss should be relieved in a corresponding way and be recognised for tax at the same moment.) The scheme should be as neutral as possible enabling business decisions to be made on commercial grounds without undue regard to tax considerations. The scheme should be reasonably consistent with the rest of the tax system so that foreign currency transactions are not afforded treatment significantly better or worse than sterling transactions. Indeed, it should reflect commercial reality as far as possible and restrict divergence from accountancy practice to the minimum. Clearly, it must not be wide open to abuse.

2. Clearing the Decks - Removing Marine Midland

Any comprehensive scheme would have to override the Marine Midland decision. Following this House of Lords judgement on the current law, it is necessary to look simultaneously at both sides of the balance sheet to see if assets and liabilities need to be 'matched'. A comprehensive scheme would proceed on an entirely different basis, examining each item separately. Consequently, the Marine Midland principle will need to be swept away before a new comprehensive scheme can be constructed.

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3. Scope of the Scheme

There are two main questions here,

- a. should the scheme apply to all taxpayers or just companies?

and

- b. should it cover all assets, liabilities and transactions or only a restricted category?

A. Range of Taxpayers

While, in principle, it is difficult to justify discriminating between companies on the one hand and all other taxpayers, including individuals, on the other, there are formidable practical difficulties in providing a workable scheme for the taxation of foreign exchange gains and losses (FEGL's) made by individuals generally. It is relatively easy to deal with companies because all their activities are reflected in a single set of accounts and they are taxed by means of a single assessment incorporating all their income and gains.

The scheme outlined below would therefore apply only to companies.

B. Range of Items and Transactions

The scheme is designed to deal with gains and losses arising from exchange rate fluctuations. The value of any asset or liability can in theory be denominated in a foreign currency. However, exchange rate fluctuations have little significance in relation to long term assets like property or shares in subsidiaries. In reality, currency fluctuations only matter when money changes hands or money is owed. For this reason, the scheme is designed only to affect "monetary items" ie cash, debts and borrowings. In any case, most non-monetary items will be capital assets dealt with under the existing CGT code.

4. The Basic Framework

The scheme's rules fall into two broad categories:

- a. the treatment of FEGL's which arise in the course of trading; and
- b. the treatment of other FEGL's.

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5. Trading FEGL's

The scheme's basic rule is that FEGL's arising in the course of a trade will be taken into account in computing the profits or losses of that trade. In other words, these FEGL's are assimilated into the Case I Schedule D system.

In general, the normal Case I tests will be applied. A foreign exchange loss on a foreign currency borrowing, for instance, will be deductible in computing trading profits only if the loan was raised for the purposes of the trade. Similarly, a foreign exchange gain will be added to the trading profit only if it arises on a trade item.

The novel feature of this scheme is that FEGL's on foreign currency borrowings would be recognised in the Case I computation even if the loan forms part of the trader's capital base. Under the present rules, FEGL's on such loans are excluded from Case I. Indeed, since losses on such liabilities are not recognised for CGT purposes either, differences on these foreign currency capital borrowings are "nothings".

The normal practice in taxing traders is to "translate" foreign currency denominated assets and liabilities into sterling at each balance sheet date and recognise the resulting translation gains and losses for tax. This will be the normal rule also for items newly brought into Case I under this scheme. However, the question of timing (when are profits and losses to be recognised for tax?) is perhaps the most difficult single issue - see Section 6 below.

In summary the scheme for trade FEGL's enlarges the scope of Case I of Schedule D. Items already dealt with there (eg FEGL's on trade debtors) are unaffected. But items currently excluded on the grounds that they are on capital account are to be brought in. The most important of these are foreign currency capital borrowings. However, some assets will also come into Case I for the first time.

6. Trade FEGL's - Timing

As already noted, the normal rule for traders will be that foreign currency denominated items are translated into Sterling at each balance sheet date and the resulting gains and losses included in the computation of trading profits and losses. This follows the existing practice for most traders and accords with the accountancy practice. However, it will not be possible to apply this translation basis across the board to all trading items. It makes perfect sense to apply a translation basis where there are frequent transactions in the foreign currency for example in the case of a bank. However, a company which raises a foreign

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currency loan but has few (if any) other transactions in the relevant currency would justifiably feel aggrieved if it had to pay tax on unrealised "paper" gains thrown up by annual translation of the loan at the balance sheet dates. In this type of case, it only makes sense to recognise the real gain or loss arising on eventual repayment of the loan. Between these two extremes of course there lies a whole spectrum of cases. A practical solution would be to adopt translation as the norm for traders but allow them to elect for realisation either generally or in specified circumstances.

There are many possibilities here and even more difficulties. One course is to allow the trader to "match" a foreign currency borrowing with a particular asset. So long as the asset was retained, no account would be taken of translation FEGL's in respect of the borrowing even though it would come within the Case I net under the general rule. Alternatively, the company could be allowed to opt for a realisation basis across the board.

Some kind of option is probably unavoidable but it does increase the scope for taxpayers to "play the system". There are also problems if companies join or leave groups; and "matching" breaks down if the asset and borrowing are not liquidated simultaneously.

7. Non-Trade FEGL's

This part of the scheme handles the residue of FEGL's on monetary items which are not assimilated into the computation of trading profits under paragraph 5 above. They are carried to a special account in the tax computation and netted off against one another. If there is an overall gain, that is added to the company's profits for tax purposes. A net loss is deducted from total profits.

This treatment will apply broadly to two categories of FEGL's: first, those FEGL's realised by companies which do not conduct a trade and, second, in the case of a trading company, those FEGL's which do not qualify for inclusion in the computation of trading profits because they do not arise on trading items.

On timing, the general rule will be to recognise these non-trade FEGL's only on realisation ie at the time of liquidation of the relevant asset or liability.

8. Relieving Foreign Exchange Losses

Foreign exchange losses arising in the course of trading (paragraph 5) above are assimilated into the computation of trading profits and losses. Consequently, if they contribute to an overall trading loss, all the usual reliefs for trading losses will be available. Losses can be set against other profits of the year or the previous year, surrendered as group relief to other companies in the group or carried forward to set against future trading profits.

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Special rules will be needed to govern tax relief for other (non-trade) foreign exchange losses thrown up by the special account described in paragraph 7 above. Primarily, such losses will be allowed against the company's other profits of the year or be surrendered as group relief. Further flexibility, for example the carrying forward of excess losses would arguably be over generous in relation to some other non-trading reliefs available to companies.

9. Interaction with capital gains tax

The general principle is that nothing which is taxed or allowed under the income tax rules should also come within the CGT system. Clearly, this should apply to FEGL's as to anything else. However, the present law, following *Marine Midland*, violates this principle (see paragraphs 11 and 25 of the main note). The proposed comprehensive scheme does restore the position and marginally shifts the boundary line between income tax and CGT. Foreign exchange gains and losses on monetary assets will all be dealt with in the income computation and therefore removed from the CGT net if that is where they currently fall. However, most CG items, being non-monetary assets, will be unaffected.

10. ? Changing the CGT Rules

Although the current CG rules for FEGL's are relatively clear (certainly much clearer than their income tax counterparts), there may be a case for changing them (ie make the comprehensive scheme even more comprehensive).

There are three areas of possible change. First, the current basic rule is that acquisition and disposal costs are translated for CGT purposes at the time of acquisition and disposal respectively (the "*Bentley v Pike*" decision). This may not always be the logical way to proceed.

Second, there are some assets (eg debts not on a security) which are not currently recognised by the CGT code. If FEGL's on any of these items remain outside the income tax scheme, they could be brought within CGT. Otherwise they would be 'nothings'.

Thirdly, indexation often produces illogical results when applied to capital-certain assets like debts. The problems are compounded if the foreign exchange element in the capital gain is dealt with separately under a special scheme.

A comprehensive scheme ought to deal with all three.

11. Currency Hedging

One of the major shortcomings of the current system is that it does not deal logically with hedging arrangements like currency swaps. The comprehensive scheme outlined here aims to produce sensible treatment for the FEGL's arising on the hedging transactions themselves. However, separate action will be required in relation to the costs of acquiring hedging instruments eg premiums paid on the grant of

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currency options. If foreign exchange gains, and losses on the underlying hedging transactions are to be brought within the income tax system, so logically should the costs of acquiring the hedging instruments in the first place.

The Finance Act 1980 legislation granting relief for the incidental costs of obtaining loan finance contains a specific bar on certain such costs which would need to be removed.

12. Open Points

The following items will need to be dealt with in the comprehensive scheme:

a. Transition

The legislation will have to contain rules ensuring a workable transition from the current system to the new. Any simple rule is bound to be rough and ready. However, the Group of Nine have concluded that a single "D day" will be the best way to proceed. On that day, all foreign currency items would be translated at the then-prevailing exchange rates. FEGL's up to that date would be dealt with under the existing system and the new rules would apply only to subsequent gains and losses calculated by reference to the D day base point. There is something to be said for this approach but special rules to deal with hard cases would probably be unavoidable.

b. Special Cases

There are several categories of taxpayers for which special provisions would almost certainly be required. These include insurance companies, banks, Unit Trusts and investment trusts, building societies and other financial concerns.

c. Functional Currency

All the above discussion assumes that taxpayers produce sterling accounts. However, businesses which operate substantially in a different currency will produce accounts for their own purposes in that currency. Consideration needs to be given to the possibility of recognising such accounts for UK tax purposes, notably in the case of foreign branches.

d. Knock-on Effects

Clear and logical rules for taxing FEGL's may throw the spotlight on areas of uncertainty in the general tax system. This is particularly true over the question of timing. Should profits be recognised only when actually realised or is annual valuation at the balance sheet date appropriate?

APPENDIX D

	Existing Situation (As SPI/87 17.2.87)	Comprehensive Scheme	GROUP OF NINE
Matching & Earmarking	Based on Marine Midland allow same currency matching regardless of capital/current nature of borrowing.	Earmarking as an option	Generally against a system based on matching, but recommend possibility of election in prescribed circumstances ie borrowings for capital assets.
Recognition	Translation except in exceptional cases Realisation for CGT.	Different approaches for different classes Further thought required	Realisation generally. Option of accruals basis.
More than one currency	One currency only. Except in case of swaps.	[One currency only]	No comment [no limit]
Capital Gains/ Case 1	Distinction strictly applied. Except in case of matching as a	Maintain distinction. Allow earmarking	Maintain distinction. Allow election for matching.
Scope (Type of taxpayers)	All.	Corporate traders. Corporate non-traders. Not sole traders, partnerships etc.	Corporate traders. Corporate non-traders. Not sole traders, partnerships etc.
Symmetry	Gains and losses treated on same basis	Gains and losses treated on same basis	Gains and losses treated on same basis. [Options could lead to breakdown on this.]
Non-trading companies.	Generally no tax consequences outside CGT except where profits subject to Case VI Schedule D.	Charges treatment	A. FEGL subject to CGT or B. Adjustment to management expenses.
Non-trading activities of trading companies	As above	As above	As above.
Transition	N/A (Transition from SP3/85 to SP1/87 by negotiation with Inspectors).	Further thought required	Sharp "D Day" cut off with option of group (not loan by loan) limited kink election.
Functional currency/ Reference to sterling.	Functional currency allowed to the extent outlined in SP1/87 paragraph 25 on trades conducted wholly abroad.	[Reference to sterling]	Not mentioned.
Coverage (Types of FEGLs)	FEGLs, on foreign currency borrowings of capital nature are nothings. Except where matchings possible.	Monetary assets and liabilities	All

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APPENDIX E

INTERNATIONAL COMPARISONS

Introduction

1. The OECD reported on the "Tax Consequences of Foreign Exchange Gains and Losses" on 3 September 1987. This report was based on answers given to a questionnaire in 1985, reflecting the situation at 1 July 1984, with a certain amount of updating in 1986 and 1987 (particularly concerning changes in legislation in both the United States and Australia in 1986).

2. The main conclusion to be drawn from the report is nicely understated by the report when it suggests that "member countries display, in fact, quite a variety of different actual and theoretical approaches". This is compounded by the fact that a number of countries such as Ireland, Norway and Germany are reported as having the problem under examination. Also Japan is reviewing its rules for the accounting of foreign currency assets and liabilities, including studying the possibility of introducing multi-currency accounting to replace the present system of translating all foreign currency assets and liabilities into yen.

National legislation, case law, etc

3. Only a few countries (Australia, Denmark, France and the United States) have any substantial legislation specifically covering these matters. Italy also, however, makes some legislative provisions. A small number of countries without such legislation, eg the Netherlands, like the United Kingdom can look to a certain amount of case law for guidance. Most countries whether they have specific legislation or not, look for guidance, in the first place, to the rules of recognised accountancy practice. These are sometimes modified by specific tax rules, for example, in some countries, treating FEGL on capital items differently from those on income (or revenue) items.

Relevance of general accountancy principles

4. In following general accountancy principles tax authorities normally deal in terms of historic cost. Commonly too, following a generally observed accountancy principle of commercial prudence, foreign exchange gains are not recognised before they are realised while potential foreign exchange losses or decreases in the value of foreign currency denominated assets are recognised at the end of an accounting period, when the balance sheet is drawn up, even though the losses have not been realised. Nevertheless this practice of recognising unrealised losses while not

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recognising unrealised gains or profits, sometimes called the "imparity principle", though common, is not universally adopted.

5. A payment due in foreign currency would normally be entered into the accounts as an amount in domestic currency arrived at by translating the foreign currency at the rate prevailing at the date when the transaction was entered into. If the payment was actually made or received during that accounting period at a time when the exchange rate had altered, some countries would accept a single entry calculated by using the rate prevailing at the date of payment or receipt. Others would expect a sequence of entries showing the amount due translated at the rate prevailing at the date when the transaction was entered into, followed by a credit or debit reflecting the foreign exchange gain or loss arising when the payment was actually made or was otherwise to be taken into account.

6. The proper accounting treatment of FEGLs has in recent years been studied by a number of national and international bodies. Other than a modification to the US system, in general it does not seem that these studies have significantly changed the various national approaches in essentials. The general feeling of OECD Member countries is, however, that insofar as any national or international accounting standards affect generally accepted accountancy principles or sound business practice, then they might broadly be followed for tax purposes to the extent that tax laws or principles do not specifically provide for some other approach.

Base Currency

7. Where an establishment of an enterprise uses foreign currencies in its business the question arises as to what is the currency with reference to which, from the taxation point of view, FEGL arise for the establishment. In the case of an enterprise buying or selling directly abroad without the intervention of a permanent establishment this "base currency" would normally be the domestic currency of the enterprise. However, if the enterprise is operating through a permanent establishment abroad the answer may not be so simple.

8. In most situations the base currency is likely to be the domestic currency of the taxing country. This is the case in practice even in the United States which has adopted the "functional currency" (ie the currency of the primary economic environment in which the establishment operates) as the base currency.

9. Most of the countries responding to the OECD questionnaire would require a taxpayer's profit and loss account or balance sheet, or both, to be reported for tax purposes in the currency of the taxing country. Some countries would, in fact, require an enterprise operating in

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the country to keep all its books and records in the domestic currency of that country. As an exception to this rule, Switzerland would allow some establishments of foreign enterprises, if their importance is relatively small, to keep their accounts in a foreign currency where that was the functional currency of the enterprise and would require only the net results to be translated into domestic currency for tax purposes. Several countries, however, would impose no obligation on taxpayers to keep their books and records in any particular currency. Nevertheless, it seems that, in general, the profits and losses of a foreign permanent establishment would be required to be computed for the tax purposes of the head office country according to the rules of the head office country, even though they were computed in a foreign currency.

Recognition

10. Although not the universal practice, it is common (as mentioned in paragraph 4) to recognise foreign exchange gains for tax purposes only when they are realised, but to recognise foreign exchange losses as they accrue at the end of an accounting period (ie on the "balance sheet date"). This principle of imparity is followed by, in particular, Austria, Belgium, Germany, Sweden, Switzerland and, in certain circumstances, Japan. In the Netherlands, it is followed where long-term assets or liabilities are concerned, but FEGL arising in connection with short-term assets or liabilities (stock or inventory items) are often both recognised at balance sheet date. In Norway the imparity principle has been followed hitherto, but recently it has been modified to provide for the recognition of unrealised long-term gains which offset previously recognised (but unrealised) long-term losses. At present, however, this modification applies only in relation to income taxable according to the special rules of the Petroleum Tax Act.

11. Some countries would ordinarily expect a foreign exchange loss to be recognised if, at the balance sheet date, the market price of a foreign currency denominated asset is lower than its cost, whether or not the potential loss is likely to be realised, but in other countries, eg Germany, the loss would not be recognised if there was a good possibility that the price might recover (a point of particular importance in the case of volatile currency markets). Where decreases of value have been recognised before realisation of any loss, it is usually the case that the assets may be revalued in the next accounting period and additional losses allowed or the earlier losses offset by some or all of the amount of any gain. In France, however, unrealised foreign exchange gains and unrealised foreign exchange losses are as a general rule both recognised at balance sheet date, although there are exceptions to this general rule.

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12. Some countries, however, would not recognise for tax purposes unrealised foreign exchange losses or gains at all, eg Australia and the United States, or would recognise only limited categories of unrealised losses or gains of this type (for example, recognising unrealised gains when they seemed likely to be quickly realised). Commonly, unrealised foreign exchange losses which were recognised would be allowed immediately as deductions in arriving at taxation profits or capital gains. But in France certain unrealised foreign exchange losses, though recognised, may be charged to a reserve account for long term depreciation and, in Sweden, deductions for unrealised foreign exchange losses relating to long term assets or liabilities may similarly be spread over a period of years.

Borrowing and Lending in a Foreign Currency

13. In the context of the timing of recognition of FEGL where borrowing and lending in foreign currency is concerned, a common practice is to record the borrowing and lending of funds on the transaction date, using the exchange rate of the date when the transaction is entered into, and to retranslate the asset or liability into the base currency at the exchange rate prevailing on the balance sheet date. Commonly too, but again not universally, any FEGL recognised either on a balance sheet date or on discharge of the obligation is recognised as ordinary income or expense. In some countries, however, such FEGL may be exempt or disallowed or deferred or specially treated, depending on the character (ordinary income or capital) which is attributed to them.

14. Belgium uses a modified imparity system for balance sheet date translation: recognised but unrealised foreign exchange gains on assets or liabilities are not subject to tax except to the extent they set off losses previously recognised on the same assets or liabilities (each asset and liability being considered separately) and deducted in arriving at taxable profits. In Canada, where it can be determined that a gain or loss on foreign exchange arose as a direct consequence of the purchase or sale of goods abroad, or the rendering of services abroad, and such goods or services are used in the business operations of the taxpayer, such gain or loss is brought into income account. Where it can be determined that a gain or loss on foreign exchange arose as a direct consequence of the purchase or sale of capital assets, this gain is either a capital gains or capital loss. Generally where borrowed funds are used in the ordinary course of a taxpayer's business operations, any foreign exchange gain realised on the repayment of the loan is considered to be an income gain, and any foreign exchange loss incurred on repayment of the loan is considered to be an income loss. However, where it is obvious that the capitalisation of a company is insufficient, to the extent that funds can be shown to have been borrowed in a foreign currency to offset this deficiency, any gain or loss as a result of repayment of such fund will be on account of

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capital, regardless of the use of the funds. A Danish enterprise can elect to recognise FEGL on long-term loans at balance sheet date or to leave recognition until realisation. In Finland, although FEGL are recognised on the repayment of the loan, and unrealised foreign exchange gains need not be included in taxable income, the taxpayer may choose to have foreign exchange gains or losses recognised at balance sheet date (or not, as the case may be) or to spread them over a period of years.

15. The tax treatment of capital gains often varies from the tax treatment of ordinary income. In some countries such gains may simply not be taxed at all. In others only certain types of gains may be taxed. In countries where they are taxed, they may be taxed as ordinary income without differentiation, or they may be taxed in the same general way as ordinary income but at a different rate of rates. In other countries they may be taxed under a separate code of rules. It might be expected therefore that it would be generally important for countries to distinguish between FEGL on capital account from FEGL on ordinary income or revenue account. This distinction might be expected to depend on the character of underlying or related transactions.

16. In practice, however, it appears that this distinction is not generally regarded as important. Denmark, France, Germany (with some exceptions), Greece, Italy, the Netherlands and Switzerland would treat them all as ordinary business income or losses. Turkey would treat them all as ordinary income and so, with some exceptions, would Sweden. Japan would not distinguish between capital and revenue type FEGL, nor, normally would Luxembourg. Austria would treat them all as capital gains (but in Austria all capital gains are taxed as income). The United States would treat them as ordinary income generally but FEGL attributable to an unhedged capital asset such as a forward contract, futures contract, or option are treated as capital income if, on the date of acquisition, the taxpayer identified the asset as unhedged, not part of a straddle, and not marked to market. (Under the new United States law, FEGL are not treated as interest income or expense except in special circumstances.) Ireland would treat the gain or loss under the income tax code if the creditor had advanced the loan in the ordinary course of a business which included the lending of money, but otherwise would treat it under the capital gains tax code. Similarly to the UK, Belgium would make a distinction between capital FEGL and income FEGL; so would Finland, Norway, Sweden and in some circumstances, Germany.

The nature of particular FEGL

17. The nature of the income, eg whether it is trading profit, interest, rent, etc will determine the rules by which it is taxed. The question arises accordingly whether FEGL should be taxed in the same way as the income or losses arising on the transaction giving rise to the foreign

currency denominated asset or liability in relation to which the FEGL is recognised as arising, or whether they should be taxed in some other way.

18. There seems not to be any very consistent international practice. One group of countries (Norway, Ireland, Finland and Canada) would, like the UK, attribute the same nature to FEGL as that of income etc arising from the underlying transactions. So would Sweden (normally) and Belgium (though unrealised foreign exchange losses thrown up by a revaluation in a balance sheet would not, in Belgium, be attributed to particular operations, but would be attributed generally to the profits or losses of the enterprise). Germany and Switzerland would treat foreign exchange gains as business receipts where they are related to business transactions. Denmark and Italy would not necessarily regard FEGL as of the same nature as the gains and losses on the underlying transactions but would simply treat them as part of the total gains or losses of the enterprise, whatever their nature. Under the Netherlands net worth system of ascertaining profits and losses it is not necessary to attribute a particular nature to FEGL, they simply emerge as part of the gains and losses of the enterprise on comparing its net worth at the beginning and end of the accounting period. Japan and Luxembourg would also regard the nature of FEGL as irrelevant for tax purposes. Other countries which would not treat them in the same way as gains and losses on the underlying transactions include Austria, France, Greece (except, at the taxpayer's option, in the case of depreciation of fixed assets), Turkey and the United States. Austria would treat them all as capital gains or losses on the disposal of movable property. France and Turkey would treat them as business profits or losses in all cases. The new United States system treats FEGL in general as ordinary income or loss unless they are clearly capital and unless they are clearly interest (and thus to be treated as interest), their nature is not important for United States tax purposes.

Source of FEGL

19. The attribution of a foreign or a domestic source to FEGL may be a matter of importance in some countries, such as Denmark, Switzerland and particularly the United States. Some countries, such as Switzerland, Japan, Greece and Turkey, would treat most FEGL as arising from domestic sources; the exceptions would be different in each case quoted (there are none in the case of Turkey). Some countries make no distinction between FEGL from foreign or domestic sources (and in effect therefore treat them as from domestic sources). Canada, France, the Netherlands, Luxembourg and Portugal fall into this category. However, the Netherlands and France would exempt FEGL attributed to a foreign permanent establishment; although in the case of France this practice might be overruled by provisions in tax treaties. Other countries including Ireland, Sweden, Norway, Finland and Italy would, like the UK, tend to look

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at the circumstance of the underlying transaction to determine the source of the FEGL. The United States, under its new law, would normally attribute the FEGL to a foreign or domestic source by reference to the residence of the relevant business unit whose books reflect the asset, liability, income or expense giving rise to the FEGL. Austria would relate FEGL arising from the valuation of a financial asset to the situs of the asset. Germany would, in general, determine the source of FEGL by reference to the source of the underlying business even giving rise to it.

20. Most countries would apply the same rules as those employed for sourcing other FEGL where it is necessary to decide the source of FEGL arising to a debtor or to a creditor on the repayment of a foreign currency denominated loan. Variations do, however, occur, for example, in the Netherlands, Germany and Ireland.

Hedging etc

21. Countries vary in the way they deal with hedging arrangements for tax purposes. Most countries appear (one way or another) to regard a FEGL arising on the fulfilment of a "Forward Currency Contract" as a taxable event (ie an amount to be taken into account for tax purposes at that stage). Exceptions to this rule include the Netherlands and Greece who would not necessarily recognise all such gains or losses, and Italy who would not regard such FEGL as taxable events in any case.

22. The tax treatment of other financial instruments such as "Currency Options" and "Currency Swaps" is, in general, still being developed. The problems arising being problems of the domestic law of each country involved.

Foreign Base Currency

23. As already noted, an establishment operating abroad will normally keep its accounts in the currency of the country in which it is situated, and for that country's taxation, its base currency will be normally the taxing country's currency. If it carries out transactions in a third country's currency, making or receiving payments in that third country's currency, then the tax problems of dealing with any FEGL arising in relation to the currency of the country in which it is situated will be, for the tax of that country, the same sort of problems as those already mentioned. When it comes to the taxation of that establishment's profits by the country of its Head Office, a number of additional problems may arise related to the translation of one currency into another. There are a variety of ways of arriving at the net income of an establishment in one currency by translation from accounts kept in another currency. All these methods require the use to some extent of conventional or more or less approximate rates of exchange for at least some items (that is to say, rates of exchange which are not necessarily those current

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when the relevant transaction took place or the relevant asset or liability was acquired or incurred, etc). The type of exchange rate utilised will vary from country to country.

Conclusion

24. The OECD report concluded that:

"It is clear that the tax treatment of FEGL presents considerable problems for both taxpayers and tax administrations. However, it is also clear that although solutions to these problems may have international implications, they are, in the main, matters of domestic rather than international policy."

25. The report went on to make policy suggestions that were essentially a matter of common sense. There seems to be no clear guiding light to follow.

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FROM: A C S ALLAN

DATE: 21 October

MR PERETZ

cc PS/Financial Secretary
 PS/Economic Secretary
 Sir P Middleton
 Sir T Burns
 Sir G Littler
 Mr Cassell
 Mr C W Kelly
 Mr R I G Allen
 Ms Goodman
 Mr Cropper

END-MONTH RESERVE FIGURE

The Chancellor was grateful for your minute of 21 October. He would be grateful if you could liaise with the Financial Secretary about the possibility of giving BP underwriters until, say, Monday 2 November to pay up.

2. On the number to publish, he would like a figure bigger than May's record but - as of now - still slightly below \$5 billion. He would be grateful if you could procede accordingly.

ACSA

A C S ALLAN

✓ Mr D Mave

MCA/fob

558/87

D3
Mr POLINFROM: M RICHARDSON
DATE: 30 October 1987~~Mr Richardson~~ ^{cc Mr Peretz}
Mr Kelly.Do you think you might
desist from sending minutes
written in such an aggressive
tone of voice to people 3cc Mr Peretz
Mr Grice
Mr Kelly
Mr Pickford
Ms Goodman

THE RESERVES IN OCTOBER (or is it now 4?) grades below you?

Mr Goodman 30/x

I attach (not for all) some manuscript comments on your draft Q/A briefing.

2. There are a couple of further points that you might address. The first is the ubiquitous reference to "stability" in the foreign exchange markets (see, for example, Q25). I realise that we need to emphasise the advantages of stability, especially in the post-Louvre era. But this needs delicate handling; we must not be so mesmerised by the £/DM rate that we are blind to other movements in the foreign exchange markets. To anybody focussing on the dollar over recent days, the brief's excessive emphasis on stability could look complacent or unrealistic.

3. Second, the brief pays very little attention to the size and cost of reserves expenditure this year. Again, I recognise that we have now become so anaesthetised by ^{huge} daily movements that we may think them unworthy of comment. But to the person on the privatised bus service, these are massive sums by any measure; and it may seem extraordinary that the Government is happy to spend £3 billion in a month (£100m a day, including weekends!) on greenbacks, when we have insufficient money to spend on the arts, child benefits, schoolbooks or nurses' pay. Although this point has general application, it will be all the more pertinent on the day of the Autumn Statement, when any number of lobbies will be disappointed and critical of the Government's expenditure plans. Why is it prudent and responsible to inflate spending on dollars, when it would be imprudent and irresponsible to finance additional spending on supply side infrastructure? Why cannot the Government abstain for a day from buying dollars, and spend £100m on hurricane relief instead?

4. The allied point here is the profit or loss incurred in FY 1987-88 to date on the dollar assets in which this money has been invested. Some critics might suggest that reserves spending this year (which is the size of a major public expenditure programme) has largely been on assets that have declined in value. You might like to provide IDT with material to meet the supplementary "What has been the profit/loss on foreign exchange intervention so far this financial year?"



M RICHARDSON