

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

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exchange gain or loss on the loan would be taxed at the same time and in the same way as the gain or loss on the investment which is financed by it (normally a capital gain or loss on disposal).

22. This is a very difficult area where it is not obvious what the "right" answer should be. Suppose that sterling has depreciated against the other currency (say, the dollar) - is the loss on the loan a real one? Even here, the answer is not clear. The investment will usually be shown in the balance sheet at historic cost, while the borrowings which finance it will be translated each year. There will therefore be an exchange loss on translating the loan and that loss, although unrealised, will reduce the profits available for distribution - but only because the unrealised gain on the investment caused by the depreciation of sterling is not recognised at all in the accounts.

The drawback of this accounting treatment is obvious. A board of directors which has made a sound dollar investment financed by dollar borrowings and which has seen the investment appreciate faster than the appreciation of the dollar against the £, would have every reason to feel satisfied. Yet the accounts will reveal only the loss on the loan; the dividend may have to be reduced accordingly; and the shareholders may be calling for the directors' heads on a plate.

For these reasons, the accounting rules allow an alternative treatment: the company may opt to treat an investment in equities (but not in anything else) as if it were foreign currency. If it does this, the shares will be translated each year in exactly the same way as the loan; the exchange gain on the shares will cancel out the exchange loss on the loan; and the profits available for distribution will therefore be unaffected by the movement in exchange rates.

23. What can we glean from all this? One thing can be stated with certainty: it would be wrong to give relief

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for the translation loss on the loan shown in the accounts when that loss is cancelled out by a translation gain on the investment (which may or may not be recognised in the accounts) which we cannot tax because gains on assets can be taxed only when the assets are disposed of.

24. To be fair to the G9, they do not ask for this. But their main approach (we will come to their optional one later) is not much better. Suppose that relief were to be given for exchange losses on borrowings on realisation basis, ie when the loans are repaid. This is what the G9 propose. The drawbacks are:-

- a. There is no real loss until currency is acquired with sterling to repay the loan. If the loan is renewed or rolled over, there is no real loss to the company at that time because the loans are repaid out of currency borrowed from someone else or possibly even from the same source. It follows that there is no economic cost until the last loan is repaid - and that often does not happen until the investment is sold, because the company will wish to reduce the risk that income from the investment will be affected by exchange rate fluctuations by paying interest in the same currency. Hence loans are often renewed.
- b. Loans may fall due for repayment at any time, and can often be repaid before they fall due. There will be an obvious danger that if the "realisation basis" were adopted companies would choose to repay them and borrow new ones, thus crystallising the apparent loss, when sterling is at its weakest.
- c. Relief on a realisation basis might encourage multi-national groups to hold investments through their UK subsidiaries against all economic sense. An example: US Corporation A wishes to acquire

US Corporation C. Instead of acquiring C itself, it gets its UK subsidiary (Company B) to do so out of dollars borrowed from A. If the £ then depreciates against the dollar, B would be able to claim relief for the loss each time the loan is repaid. The loan would only be repaid when sterling has depreciated against the dollar, thus giving rise to an apparent exchange loss. The corresponding gain on the investment - the shares in C - will not materialise until they are sold (and that may never happen). Distributions by C will not increase the flow of tax to the Exchequer, thanks to double taxation relief.

25. It follows that if any relief is to be given for the exchange loss on the borrowings, that relief should not be given until the corresponding asset is sold - which is the G9's optional treatment. At first sight, that treatment is right: as we have seen, the gain on the investment (including the exchange gain) is taxed; the exchange losses on the loans which have financed that investment must surely be allowed.

The trouble with this very sensible approach is that it does not take account of the capital gains indexation allowance. It would be asymmetrical to tax only the real gain on the investments (after indexation) while giving relief for the nominal loss on the loan. The alternatives are therefore:-

- a. scrap indexation for overseas assets; or
- b. index the loan as well as the asset; or
- c. do nothing.

Looking at these in turn, either of the first two alternatives could be made to work (although the legislation would be horrendously complex) but both would then give different tax treatment for overseas investments compared with domestic investments. In order to explain

this point, we need to look at what happens when a company acquires a domestic asset out of sterling borrowings. Suppose a company borrows £100 and uses it to buy an asset for £100; and the asset then increases in value in line with inflation of 5 per cent per annum. After a year the asset is sold for £105; £100 of the proceeds are applied to repay the loan; so that the company finishes up with a commercial profit of £5 on the deal. But for tax purposes, that profit is not taxed, because the cost of the investment is indexed, while the cost of borrowing is not.

Now let us suppose that the investment and the borrowing are in DM and that the company borrows DM300 and uses it to buy an asset for DM300 at a time when the exchange rate is DM3/£. As in the sterling example, the asset increases in line with inflation (but this time inflation in Germany - say 3 per cent per annum) and is sold after one year - for DM309. If exchange rates accurately track differential inflation rates, the lower rate of German inflation will push up the value of the DM against the £ to DM2.94/£. Consequently, the company has finished up with a commercial profit, after repaying the DM300 loan, of DM9 which converts to nearly £3. If the commercial profit were taxed, it would be right to tax that figure, which can be expressed as a gain of £5 on the asset (DM309 at DM2.94/£ = 105; less DM300 at DM3/£ = 100) less a loss of about £2 on the loan (DM300 at DM2.94/£ = 102; less DM300 at DM3/£ = 100). But as we have seen, the tax system does not tax the overall commercial profit on the deal, but instead taxes only the real gain on the investment. The real gain on the investment in this example - as in the sterling example above - is Nil, because in each case the sale proceeds (£105) is precisely equal to indexed cost.

The existing tax system therefore gets the "right" answer so long as by "right" we mean neutrality with UK investments; and so long as exchange rates do accurately track inflation differentials. Evidence produced by the Institute of Fiscal Studies indicates that over the longer term there is a strong correlation between exchange rates and inflation differentials (the so-called "purchasing

but they don't except in the long run

power parity"); over the shorter term there is not. So it can be said that the present rules do not get quite the right answer, but are - perhaps - a reasonable proxy for it.

26. It will not be easy to get a more precisely "right" answer. So far we have assumed that companies make specific borrowings to finance (or perhaps hedge) specific investments. But many companies' borrowings go into a common "pot" which finances their foreign currency investments generally. It would not be practicable to identify which loan finances which investment; and therefore (under the G9's optional treatment) which exchange differences on borrowings are to be taxed or relieved when the corresponding asset is disposed of. The G9 leave it to the company to make this allocation. That might not produce acceptable results. It is worth noting that under the US scheme either the taxpayer or the Secretary of the Treasury has the right to nominate which liabilities hedge which assets. We do not yet know how that works in practice, because the US Treasury has yet to publish regulations on the point. But it looks as if it might be a labour-intensive and perhaps contentious process.

27. This is an area where it is more difficult for the company to get relief for exchange losses under the present rules (contrast with paragraph 9 above). The company will either be an investment company; or a trading company for which the Exchange loss will either be treated as capital, or will fail the "purposes of the trade" test - and in all these cases the Exchange loss will be a "nothing". But that will often be the right result where the investment financed or hedged by the loan is retained indefinitely.

So what do the G9 proposals add up to?

28. The G9 proposals resemble a comprehensive scheme for legislation in much the same way as a primed canvas

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resembles a finished Rembrandt. As a starting point there is much that we can agree with. But they are only a starting point.

SOME WIDER ISSUES

29. Apart from the technical merits (or lack of them) of the G9 scheme, we think there are other points you will need to consider before deciding what to do next. They are:-

- the form and complexity of remedial legislation
- the need for legislation
- the cost of legislation.

These points are considered below.

The form and complexity of legislation

30. A comprehensive reform would start off by recognising all exchange differences for tax purposes. It would then exclude particular transactions where there is a danger that allowing relief for exchange losses would lead to the Exchequer being ripped off (for example, thin capitalisation:

see paragraph 11 above). The remaining exchange differences

would then be recognised either:-

- on a translation basis (for financial concerns and other traders which have frequent transactions in foreign currency); or
- on a realisation basis (where the loan is repaid and is not rolled over or renewed); or
- when the asset financed by the loan is disposed of.

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Detailed and probably arbitrary rules will be needed to define the dividing line between each of these categories.

31. For companies which are trading companies, exchange differences would be recognised as a component of their trading profits unless the loans are obtained for non-trading purposes or to finance or hedge assets - and where these loans go into a common "pot" detailed (and again probably arbitrary) rules will be needed to determine which asset is hedged by which liability (see paragraph 26 above). Exchange differences on these loans, together with all exchange differences of investment companies, would normally be brought within the capital gains net. As we have seen (paragraph 25 above) something would have to be done - and it would be fearsomely complicated - to ensure that we do not end up taxing real gains on assets while allowing nominal losses on loans.

32. A comprehensive scheme would therefore be complex in the extreme. Is it really necessary?

The need for legislation

33. We have already seen that there is an arguable case for doing nothing at all. The present rules are far from perfect - but they are flexible and dispense a measure of rough justice.

34. We just cannot say how many companies are "caught" by the present rules. We do have some statistics which show that a number of companies have claimed relief for exchange losses which have not been allowed - but all these do is to put a lower limit on the cost (say £m50 a year). We have looked at some of the bigger groups - and they make sure that they are not caught. They may incur extra costs in order to avoid losing relief - by setting up offshore companies which would otherwise be unnecessary, or by routing loans through more than one company - but they may regard that as a fact of life which adds no more than an irritating complication to their everyday transactions.

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35. We have seen, however, that companies which borrow to invest abroad - say the holding company of a large group - cannot get relief for exchange losses on loans which are applied to the acquisition of, or used to hedge, those investments. Paradoxically, this may not worry them too much because, as we have also seen, there is no real loss but rather a mismatch - or, perhaps more accurately, rough justice - when the investment is sold. Companies generally acquire investments in order to hang on to them, not to sell them, so that this eventual mismatch is unlikely to loom large in their day-to-day calculations. One piece of comforting evidence here is the increase in outward investment - particular in the United States - over the last few years, most of which will have been financed by dollar borrowings. The present tax rules have not discouraged that.

36. We have also seen that a similar mismatch occurs on swaps. Unlike loans used to finance investments, which are likely to be rolled over or renewed, foreign currency loans which are swapped into sterling have finite lives. The unpredictable effect of exchange rate fluctuations may discourage companies from entering into swaps, or force them into setting up offshore vehicles. This so-called "tax-fragmentation" or "tax trap" is something which makes people get hot under the collar. In this case at least the case for remedial legislation looks stronger. But with this one exception, it cannot be said that the case for legislation has been proven. Certainly the G9 has not made it out in their paper.

The cost of legislation

37. The revenue implications will depend upon:

- a. whether sterling depreciates or appreciates against foreign currencies and the extent of the fluctuations in any given period;
- b. the amount of the foreign currency borrowings

and monetary assets on which exchange differences will be relieved/charged for the first time;

- c. whether these exchange differences will be recognised on a translation, realisation or other basis.

The amount of data available to us to assess the impact of these factors is extremely limited and anyway could well be invalidated by changes in behaviour arising from legislation in this area. What data we have is set out below.

38. Under a. nearly all foreign currency borrowing is in currencies against which the £ is thought most likely to depreciate in the longer term. This means that the revenue effect will be a cost rather than a yield, although there will no doubt be periods when a hard currency goes soft as with the dollar at present.

39. Under b., some limited aggregate data is available from published sources. The latest figures show that the "monetary sector" has foreign currency borrowings amounting to £b500. All but £b15 is classified as current borrowing and has no revenue implications ie gains and losses in respect of current borrowing are already taxed/allowed under the existing rules. We are assuming that the £b15 capital borrowing is already covered by the banks through hedging etc and would therefore be unaffected by any changes in the law. Foreign currency borrowings by the non-bank private sector amount to over £b50. It is impossible to say to what extent exchange differences on this are already recognised. Where the borrowings are by trading companies a proportion will either be on current account or, if it is long-term capital borrowing, will have been turned into current borrowing in the way described above. Much of it, however, will have been borrowed to finance or hedge overseas investments which at the end of 1986 totalled £b160 and it is the Exchange differences on

this borrowing which is most likely to generate extra relief or tax.

40. It is impossible to say how much of this total borrowing would affect tax assessments in future, particularly as there could well be a behavioural change arising from legislation, but a figure of £30 billion is taken as illustrative of a possible order of magnitude. With this illustrative figure a change of 1 per cent in exchange rates would have a revenue effect of £50-100 million in a year depending upon the taxable capacity of the companies concerned. However if exchange differences on these borrowings are recognised only on disposal of the corresponding assets as suggested above, the profile of cost will be very uneven because it will depend entirely on when the assets are sold. Many will never be sold so the revenue implications would be much lower than the figures quoted above.

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41. Against the total cost - whatever it is - must be set some savings, in particular because it will no longer be necessary to use offshore subsidiaries to raise foreign currency borrowing; and tax on the "turn" expected by the host country will no longer represent a loss to the Exchequer. We cannot say what these savings will be, either - but they are not likely to be very great.

NEXT STEPS

42. The options for further action are:-

- A. legislate - either for a comprehensive scheme, or to do no more than remove the roughest of the rough edges in the present rules;
- B. issue a consultative document
- C. do nothing.

A. would be awkward presentationally. Even if you decide to go for a comprehensive scheme, the result would be entirely different from what the G9 want. It would be difficult to do that without explaining the reasons and inviting further comments. The same goes for C. - there is a case for doing nothing but it will have to be explained, and the only way of getting the message across, without becoming distorted in the telling, is by issuing a consultative document. The only realistic option is therefore B.

A consultative document

43. A consultative document would cover the same ground as this paper but in far more detail. The onus would be put on industry to show that comprehensive reform is really necessary. In particular, the document would invite companies to make the economic case for it - for example, do companies go in for unhedged borrowing and, if so, why? Do the present rules discourage overseas investment and, if so, what has been discouraged? In this area, the

consultative document would be dark green. But elsewhere it could be a lighter shade - perhaps in the area of swaps (paragraph 36 above); perhaps also in the question of whether exchange differences of trading companies should be recognised on translation or realisation.

The likely reaction to a consultative document

44. At the very least, the issue of a consultative document will be an indication of the Government's desire to get to grips with an issue which has been causing problems for many years. On the other hand, it will make it obvious that the Government has no intention of legislating for the G9 proposals. But the G9 proposals would bring most benefit at a time when sterling is depreciating against other currencies. The fact that the £ is now appreciating against the dollar and is steady against other currencies may well encourage companies to ditch their preconceived ideas, formed during the period when the £ was weak, and to recognise the weaknesses in the G9 approach.

CONCLUSION, NEXT STEPS AND TIMETABLE

45. The G9 approach is unacceptable: the issues are much more complex than they assume and the solution - whatever it turns out to be - will be very different from what they propose. But the G9 do not seriously expect the Government to legislate for their proposals anyway. They want the Government to issue a consultative document which will air the issues and give an indication of the Government's thinking. We see no alternative to giving them what they want - a consultative document - although the content may not be altogether to their liking.

46. It then remains to fix the timetable. You will be aware that our resource problems in this area are particularly acute. The three members of the team most actively involved in this subject have now resigned and it must inevitably take some time before their replacements are in a position to take the work forward. In the

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circumstances, and as Mr Painter has already explained, it seems most unlikely that we shall be able to prepare a comprehensive consultative document on this complex and controversial area of tax law in time for publication on Budget Day. However, by then we should be in a better position to give a firm date for publication; and we would certainly expect to get something out by June/July 1988 at the latest.

In the meantime, we see no reason for an announcement by Ministers and indeed we doubt whether the Group of Nine are expecting to hear anything substantive before Budget Day.

If you are content with the broad thrust of what we are suggesting above, we will set in hand the preparation of a consultative document and will report progress in the latter half of February so that Ministers can decide what, if anything, is to be said on this subject in the Budget speech.

We are at your disposal if you find it helpful to have a discussion on these technical and complex issues.

M D WHITEAR



Inland Revenue

copy
- see para 7
ANNEK 1
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20.7.87

From: P DRISCOLL
Ext: 6287
Date: 16 July 1987

OK 17/7

- 1. MR McGIVERN
- 2. FINANCIAL SECRETARY

EXCHANGE RATE FLUCTUATIONS

1. In my note of 19 February I said I should report back to you before the end of this month on progress with the "search for a legislative solution" to this problem.

2. Our "full" Statement of Practice under the existing law was issued on 17 February this year and at the same time you invited representations for a change in the law. To date, we have received just three, very minor, representations but we now understand that the "group of 9" representative bodies we met earlier this year propose to issue a press release early next week giving details of a joint representation.

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|---------------------------------|-------------|----------------|---------|
| cc: Principal Private Secretary | Mr Painter | Mr R K Miller |) |
| PS/Chief Secretary | Mr McGivern | Mr Newstead |) |
| PS/Economic Secretary | Mr Beighton | Mr J F Hall |) |
| Mr A Wilson | Mr Lawrance | Mr Fitzpatrick |) for |
| Mrs Lomax | Mr Hamilton | Mr Templeman |) info. |
| Mr Scholar | Mr Pattison | Mr D L Shaw |) |
| Mr M Hall | Mr Skinner | Miss Rhodes |) |
| Mr Ilett | Mr Whitear | Mr Michael |) |
| Mr Board | Mr Hamer | Mr J Evans |) |
| Mr Haigh | Mr Howlett | | |
| Mr Towers | Mr Robson | | |
| Mr Cropper | Mrs Smyth | | |
| Mr Mallett (Bank of England) | Mr Bolton | | |
| Mr Jenkins (Parly Counsel) | Mr Driscoll | | |
| | PS/IR | | |

3. The group of 9 consists of :

<u>Body</u>	<u>Representative</u>
CBI	Alan Willingale (Chairman)
Association of British Insurers	J E Brewster
Association of Corporate Treasurers	John Chown
Institute of Taxation	J Clark
Institute of Directors	W K Evans
International Chamber of Commerce	T L Halpern
The Law Society	M Mathews
Institute of Chartered Accountants	Roger White
British Bankers' Association	Paul Tipping

4. We have seen an advance copy of the proposed press release and a late draft of the proposal which is described as "minimalist" in its approach. We think that description is over-modest for a paper which seeks symmetrical treatment of gains and losses on all foreign currency-denominated liabilities but note that the group of 9 do not seek a comprehensive solution. They say informally that they are prepared to take the problem in stages, starting with what they see as the most important issues. Perhaps "selective" would be a better description than "minimalist".

5. We have not yet received a copy of the final text of the group of 9 proposals and it will obviously take us some time to digest and analyse what are in fact likely to be quite far reaching proposals. However, we take comfort in two facts :

- a. that a sufficient degree of consensus has been reached at least among the individual members of the group of 9 to enable them to put forward a single proposal; and

b. that that proposal stops short of asking for a wholesale recasting of the UK tax system (eg they do not advocate the abolition of the revenue/capital distinction).

6. While waiting for the proposals of the group of 9 we have done a certain amount of work of our own on two different approaches to the problem. Firstly, we have tried to describe a comprehensive regime for exchange differences. In some ways, this approach is similar to that adopted by the group of 9 although it goes further, we think, in addressing issues either avoided by them or left to taxpayers' options in their scheme. Secondly, we have looked (in less detail so far) at a truly "minimalist" approach that would do no more than cancel out some of the worst perceived inequities of the present system. More work remains to be done on each scheme.

Next steps

7. We do not believe there will be any need to react to the group of 9 press release. If asked, we shall confirm that we shall be considering the group of 9's representations along with others we have received with a view to reporting to Treasury Ministers in due course. Since it has taken the group of 9 five months to come up with their proposals they can scarcely expect an instant response. Tactically, however, we think it will be advisable for us to meet representatives of the group of 9 reasonably soon (say early in September) to indicate that the subject is still "active". These would be technical talks designed to clarify the group of 9's proposals and would not commit Treasury Ministers in any way.

8. When we have had a chance to consider the group of 9's paper and to discuss it with them we should then be in a position to report to you substantively on the prospects for legislation in 1988. As already indicated, we should have looked essentially at three policy options:

- a more or less comprehensive solution;
- the group of 9's more selective approach;
- a restrictive "minimalist" approach.

It is too soon to say which, if any, of these options would offer the best hope of a legislative solution.

9. The tentative timetable set out in my minute of 19 February will obviously need to be adapted but we anticipate being able to report to you in this way early in the Autumn (say October) and we should at the same time be in a position to make further recommendations on "handling". One obvious question that arises is whether further more or less formal consultation is needed. And, if so, at what stage and in what form? Should we aim for a discussion document or for draft clauses? Much will depend on our work over the next couple of months.

10. May we take it that you are content with these arrangements, please?


P DRISCOLL

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27th July 1987

Mr. N. Lamont MP,
Financial Secretary to the Treasury.
Treasury Chambers,
Parliament Street,
LONDON SW1P 3AG.

Dear

Financial Secretary

TAX TREATMENT OF EXCHANGE RATE FLUCTUATIONS

When on 17th February 1987 you announced publication of the new Inland Revenue Statement of Practice based on the Marine Midland case you added that Ministers had not ruled out the possibility of a legislative solution provided a scheme could be devised which could be effectively applied in practice, commanded a wide measure of support in industry and commerce and did not entail an unacceptable cost to the Exchequer.

We exchanged letters on the subject too (mine of 30th December 1986 and yours of 16th February 1987).

Following a meeting on 27th February 1987 with Peter Driscoll of the Inland Revenue nine leading representative bodies agreed that the best way forward was to produce a report that met your criteria.

We have therefore produced one a copy of which is attached. A copy has also been sent to Peter Driscoll with whom we now seek discussions on implementation.

Yours sincerely,

Alan Willingale

REPORT TO THE REPRESENTATIVE BODIES
FROM THE WORKING GROUP ON THE
TAXATION OF EXCHANGE RATE FLUCTUATIONS

PROPOSALS FOR LEGISLATIVE CHANGE

Terms of Reference

1. At a meeting on 27th February, 1987 the nine representative bodies listed below, were asked to explore the extent to which they could reach agreement on proposals to change the law on the tax treatment of foreign exchange differences.
2. This report represents a consensus reached by a working group of nine, each nominated by one of the representative bodies. The representative bodies have received and accepted the report and support its recommendations.

The members of the working group were:

Mr. A.E. Willingale (Chairman)	Confederation of British Industry
Mr. J.E. Brewster	Association of British Insurers
Mr. J.F. Chown	Association of Corporate Treasurers
Mr. P.R. Tipping	British Bankers' Association
Mr. R.J.G. White	Institute of Chartered Accountants in England and Wales
Mr. W.K. Evans	Institute of Directors
Mr. J. Clark	Institute of Taxation
Mr. T.L. Halpern	International Chamber of Commerce
Mr. M. Mathews	The Law Society
Mrs. S.M. Thornhill (Secretary)	British Bankers' Association

Minimalist Approach

3. The working group strongly recommend that urgent action be taken to deal with the serious anomaly that "capital" gains and losses on foreign currency borrowings are neither taxed nor relieved. Differing views as to the right approach technically have been subordinated to the need for an agreed solution. In accordance with the terms of reference, we examined, but rejected, several wider ranging approaches to the question and, in particular, do not recommend removing the distinction between 'capital gains' and Case I. Specifically, permanent investment denominated in a foreign currency would continue to be treated as chargeable assets. We have tried to keep the number of elections to the minimum: some remain in paragraphs 13, 16, and 21.

It is accepted that any new legislation must be symmetrical, i.e. gains on borrowings must be taxed on the same basis as losses on borrowings are relieved. It would also have to take account of, and give parity of treatment to, the differing requirements of investment holding companies, commercial trading companies, financial trading companies and close companies. We have not considered the position of sole traders and partnerships.

Matching

5. Matching, as an overall concept, seems to be of little interest to many taxpayers. The working group therefore recommends that, in general, gains and losses on foreign currency borrowings should be taxed or relieved without regard to the nature and tax treatment of the assets financed.
6. However, as outlined later (see paragraphs 19-21) there may be a significant problem for what we believe will be a small number of taxpayers: those for whom a currency borrowing is economically matched by that taxpayer with a foreign currency asset, which need not be a monetary asset. We therefore recommend that there should be an election for matching in prescribed circumstances.

Capital Gains or Case I

7. We have considered whether gains and losses on borrowings should be brought exclusively within the scope of capital gains tax legislation. This was rejected, and would probably have been rejected even without the Budget proposal to bring the rates into line.
8. We also considered whether it was practicable to assimilate foreign exchange gains and losses on borrowings to interest. The proposal had little support. Specifically, we considered and rejected the suggestion that we could amend Section 130 (f) to permit exchange losses on loans denominated in a currency other than sterling to be deducted as if they were interest. The complex special rules governing interest, particularly the distinction between short and long interest, could not, in our view, be adapted without undue complexity.
9. We therefore recommend that, in general, foreign currency gains and losses arising in respect of borrowings should be taxed or relieved under the provisions of Case I of Schedule D, subject to the limited exceptions set out in para 17.
10. Exceptionally, as outlined in paragraph 21, where a company has borrowed currency to fund fixed assets whose value is denominated in foreign currency, there may be an election for matching foreign exchange profits or losses on borrowings to be converted to chargeable gains.

Accruals or Realisation?

11. We have considered whether gains and losses should be taxed on an accruals or a realisation basis. There are strong practical arguments against taxing unrealised profits on capital assets, and these arguments would be equally valid against a proposal to tax the notional fall in value of a long-term borrowing in a 'weak' currency.
12. It is accepted that a tax imposed on a 'realisation' basis may give the taxpayer some scope for precipitating losses while running unrealised profits forward into a future period.
13. We recommend that gains and losses on borrowings should, in general, be taxed on a realisation basis. We accept that there will have to be exceptions to protect both the Revenue and the taxpayer and believe that taxpayers should have the right to elect for an accrual basis. We also recognise that the definition of what does, or does not, constitute a realisation will need to be drafted carefully.

Transitional Provisions

14. The working group accepts, reluctantly, that it is unrealistic to expect more than limited relief for the past. We therefore recommend that all existing borrowings should be translated at the exchange rate ruling on the effective date of the new legislation. On a realisation, or other taxable event, the gain or loss would be calculated with respect to this exchange rate. Pre "D day" gains or losses would remain as "nothings" in accordance with prior law.
15. This provision, strictly applied, could cause hardship to taxpayers who might subsequently be taxed on a post "D day" gain where there was an overall loss. Some transitional relief will be required. Several possibilities were considered, but our preferred solution is set out in paragraph 16.
16. We recommend that the relief could take the form of a limited "kink" provision to avoid tax being levied on a notional gain in excess of a real economic gain. Companies would be able to elect for this relief on an 'overall group' rather than a 'loan by loan' basis and would have to accept that the election applied equally to restrict, to real economic loss, any losses arising only by reference to the exchange rate applicable on the appointed day.

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1. We therefore recommend that there should be provisions enabling a company to designate borrowings in a foreign currency as qualifying for special treatment because the company regards these borrowings as being associated with capital assets whose value is determined by reference to that currency. Where this irrevocable election was in force, any gains or losses on the borrowing would be 'ring-fenced'. No tax would be levied on any gain or loss either on an accruals basis, or on what would otherwise be a realisation on reorganising or rolling over the borrowing, until such time as the asset was disposed of. On disposal of the asset the same tax treatment would be accorded to the gain or loss realised or accrued up to that date on the borrowing as would be applicable to the asset in respect of which the election is made.

Summary of Recommendations

22. -Urgent action should be taken to enable capital gains and losses on foreign currency borrowings to be taxed or relieved whilst leaving the distinction between capital gains and Case I.

-Any new legislation should allow parity of treatment between different groups of taxpayers and must be symmetrical in its treatment of gains and losses.

-In general, gains and losses on foreign currency borrowings should be taxed or relieved without regard to the nature and tax treatment of the assets financed. However, there should be provisions enabling matching in prescribed circumstances.

-Normally, foreign currency gains and losses arising in respect of borrowings should be taxed or relieved under the provisions of Case I of Schedule D on a realisation basis. However, special consideration will need to be given to companies not taxed as trading companies.

-All existing borrowing should be translated at the exchange rate ruling on the effective date of the new legislation. Transitional provisions would be required.

Issued jointly on behalf of:

Confederation of British Industry
Association of British Insurers
Association of Corporate Treasurers
British Bankers' Association
Institute of Chartered Accountants in England and Wales
Institute of Directors
Institute of Taxation
International Chamber of Commerce
The Law Society

TAXATION OF EXCHANGE RATE FLUCTUATIONS:
PROPOSALS FOR LEGISLATIVE CHANGE

Tax relief for foreign currency borrowing losses balanced by taxation of foreign currency borrowing gains is called for in a Working Group Report sent today by nine major trade and professional bodies to the Financial Secretary to the Treasury and the Inland Revenue. This is the main point in the Report which calls for legislative changes which might be included in the 1988 Finance Bill. The Report which has the full support of the sponsoring associations was prepared in response to an invitation from Treasury Ministers to consider possible changes to existing law on the tax treatment of exchange rate fluctuations.

The Report is seen by the representative bodies as providing pragmatic and practical solutions to the problems, based on the recognition that any new legislation should allow broad parity of treatment between different groups of taxpayers and must be symmetrical in its treatment of gains and losses; and that in general, gains and losses on foreign currency borrowings should be taxed or relieved without regard to the nature and tax treatment of the assets financed. However, there should be provisions enabling matching in prescribed circumstances.

The Report seeks to satisfy the main criteria set by the Financial Secretary to the Treasury in seeking responses that any proposals must be effective in practice, have a broad measure of agreement, and not be unduly complex.

ends

Copy of the report attached.

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THE US TREATMENT OF FOREIGN EXCHANGE GAINS AND LOSSES

The American treatment of FEGL is governed by specific provisions in the 1986 Tax Reform Act. The Act outlines the general framework but leaves nearly all the detail to be filled in by regulations, which have yet to be made by the Secretary to the Treasury.

The ^{bare} ~~best~~ framework in the Act is as follows:

- a. Foreign exchange gains will generally be taxed as income and foreign exchange losses allowed as deductions against taxable income. (Capital gains treatment may apply, by election, in some circumstances to FEGL in respect of forward and futures contracts.)
- b. The amount of the foreign exchange gains and losses is to be calculated against the taxpayer's "functional currency" which he chooses, once and for all, at the outset.
- c. FEGLs are to be recognised for tax purposes on realisation eg sale of foreign currency asset or repayment of foreign currency loan.
- d. Hedging transactions (for example, a foreign currency borrowing which finances an asset denominated in the same currency), identified by the taxpayer or the Treasury, are to be integrated with the item hedged and the whole treated as a single transaction.

Transactions entered into by individuals that are not investment or business related are specifically excluded from the Act.

THE AUSTRALIAN TREATMENT OF FOREIGN EXCHANGE GAINS AND LOSSES

The Australian treatment of FEGL was reformed by their Taxation Laws Amendment Act 1987.

The Act sweeps away the common law distinction between FEGLs on current and capital account. All business-related foreign exchange gains are treated as income and foreign exchange losses treated as an expense deductible in computing taxable income.

~~FEGLs~~ FEGLs are recognised on realisation.

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CURRENCY SWAP (See paragraphs 13 and 14)

Example:

X

Suppose, for example, that in 1978 a company borrowed SFm60 for 10 years when the exchange rate was SF3 = £1. Under an agreement with a bank the Swiss francs were swapped for £m20 and SFm60 were to be returned in 10 years' time in exchange for £m20. On reversal of the swap in 1988 the company repays its loan when the rate is SF2 = £1. The cost of the foreign currency, determined by the swap agreement, was £m20, but for tax purposes it must be treated as being disposed of when it is applied to the repayment of the original loan; and at the rate of exchange in force when that is done - so that the disposal is treated as £m30, which gives rise to a gain of £m10 (subject to the indexation allowance). That gain is balanced by an exchange loss of £m10 on the loan, the liability on which in sterling terms has increased from £m20 in 1978 to £m30 on repayment.