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

Reference MG-MAMC/D/0002/001

File begins 11/09/1987

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exchange element of some (but not all) capital gains with no corresponding relief for losses on their borrowings. Removing these inconsistencies would allow companies more freedom to carry out a variety of transactions that make commercial sense but at present carry a tax penalty (eg currency swaps).

16. It would be idle to pretend that a comprehensive scheme would be universally welcomed. There are enough powerful companies with vested interests to ensure that this would not be so - as noted in paragraph 12 many can play the system very well. But were it not for the consideration of cost and of potential abuse (discussed below) we should feel that there was a lot to be said for a comprehensive scheme on the lines of that described in Appendix C.

Cost

17. It is extremely difficult to obtain any figures that would enable a firm estimate to be made of the potential revenue effects of a change in the law of the kind discussed in the preceding paragraphs. Neither Treasury or Bank of England officials nor the Group of 9 have been able to suggest any method that would provide a wholly reliable guide. This is partly because we lack the right sort of data and partly because a radical change in the law would be likely to trigger off significant behavioural changes as companies took advantage of a more liberal regime.

18. However, our latest estimates of the potential revenue effects of introducing a comprehensive scheme giving automatic and unlimited relief for losses on exchange differences are in the range of £50m - £100m for each percentage point that the pound falls against the dollar. There have been annual movements of the order of 10% in the dollar sterling rate in recent years

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(Footnote Continued)
tax purposes be 'matched' with an asset in the same currency so that differences on each side of the balance sheet cancel each other out regardless of whether they are on revenue or capital account.

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and even during calendar 1987 the pound has traded in the range US$1.6885 - 1.4710 (± 7%). On that basis it does not seem unreasonable to expect a net revenue effect (either way) of the order of £1/2 - 1 billion in any one year. We have considered ways in which this volatility might be controlled - for example, using some kind of smoothing or averaging formula - but these tend to breakdown in practice when an actual gain or loss is realised. Moreover, any such formula would add considerably to the complexity of any legislative scheme.

19. The starting point for our estimates has had to be the figures provided for Financial Statistics. The latest figures show that the "monetary sector" currently has foreign currency borrowings of (roughly) £500bn (five hundred billion) the vast bulk of which is undoubtedly on current account (with much of the balance - say £15bn - "covered" in some way for existing tax purposes). Of the non-bankprivate sector's borrowings (£50bn) (fifty billion) perhaps one third is on current account. The rest - some £30-35bn - might be expected to have been borrowed on "capital" account to finance inter alia overseas investment (totalling £160bn at the end of 1986). Part of this figure of £30-35bn will be "hedged" and a further part will be included in "matching" under the statement of practice but it could be that as much as £30bn represents the sort of borrowings on which relief for exchange differences is now sought (the Bank of England believes that virtually all these borrowings are in "hard" currencies - see paragraph 21 below - with 90% in dollars).

20. The revenue effects of recognising for tax purposes exchange differences on these enormous balances would depend upon the movement in exchange rates and upon whether "translation" or "conversion" were adopted. With translation there would be a full effect from the first year onwards; with conversion the effect would build up depending upon the maturity pattern of the loans, and the ability of borrowers to take advantage of favourable exchange movements to crystallise losses (and trigger tax relief). However, even if the level of foreign currency borrowing did not change, and if as much as £30bn is "at risk", a

1% change in the sterling exchange rate from one year to the next could cause revenue to rise or fall by about £100m a year. The figures are very uncertain but on a conservative view of the degree of exposure it seems reasonable to assume a range of £50m-£100m a year for each percentage point movement.

21. The Group of 9 paper purports to deal with the problem of cost by offering symmetry of treatment between gains and losses. As currencies fluctuated the Exchequer would recover on the swings what it had lost on the roundabouts. This sounds fine in theory but we remain to be convinced that taxable gains would ever in practice equal allowable losses claimed. There are three main (interlocking) reasons for this scepticism:

- first, most foreign borrowing is in "hard" currencies (traditionally the US Dollar, the Deutschmark, the Swiss Franc and, increasingly, the Yen). One factor is that borrowing in these hard currencies gives companies access to the lower interest rates available in the countries concerned;

- second, although UK government policy is towards greater currency stability the underlying strength of some of the other economies involved makes it likely that against some currencies at least the long-term trend will be for sterling to decline in value with the result that losses in some years will not be balanced in the long term by gains in others;

- third, if the UK introduces a tax regime which taxes and relieves exchange differences on a symmetrical basis there will be a built-in incentive for companies borrowing foreign currencies to ensure that any ostensible exposure is to hard currencies.

22. This last point (ostensible exposure) is especially important since there may be a sharp difference between the position shown in a company's balance sheet and economic reality. The tendency is to look exclusively at monetary items whereas

companies themselves look at both monetary and non-monetary items. For example, company A, a UK trading company acquiring an office block in New York for US$10 million may borrow US$10 million in order to cover any currency risk on its investment. However, the office block will appear in its balance sheet at the sterling equivalent of its dollar cost at the date it was acquired while the dollar borrowing will be translated into sterling at each balance sheet date. In economic terms company A is suffering neither gain nor loss but its business accounts will show a gain or loss depending on the way the dollar moves against sterling. If that same accounts treatment were followed for tax purposes - which it probably would be under a comprehensive scheme - then, assuming that the dollar was a 'hard' currency tax relief would be given for a 'loss' that might never materialise.

23. The full significance of this problem may be seen in an alternative scenario which would become much more attractive to multi-national groups if a symmetrical tax regime for exchange differences were introduced in the UK. Company B is a US corporation wanting to buy a US hotel chain for US$ 500 million at a time when it expects the dollar to rise against Sterling. It needs to borrow $500 million but instead of doing so directly it arranges for its associate company C, which is resident in the United Kingdom, to raise the money through a US dollar bond issue. Company C converts the $500 million into sterling and lends the pounds to company B. Company B sells the sterling for dollars and buys its hotel chain. As far as the Group is concerned there is economic matching. But company C's accounts will show it as exposed to a potential loss on its long-term dollar liability.

24. Many variations on this theme are possible and whatever technical safeguards were built into the legislation to try to prevent abuse it is certain that multi-nationals would be quick to exploit any system that gave automatic tax relief for "losses" on currency liabilities. This is not denied by Messrs Willingale and Co who acknowledge the difficulty of preventing abuse. (It might be argued that with a weaker dollar the chances of this

sort of procedure will reduce. However, the scenario holds good mutatis mutandis, for the Yen or whatever happens to be the str..g currency of the day). It is impossible to quantify this risk but the figures would certainly be very large, probably running into hundreds of millions of pounds. And, while there would be some benefits to be taken into account (notably in terms of the clarification of the law), and while a dollar appreciation would bring some advantages to the Exchequer through higher oil revenues etc it seems improbable that those benefits would be significant enough for Ministers to feel that they justified the increased uncertainty and potential loss of revenue involved in the introduction of this new element.

A more modest approach

25. If the problem of cost is, as we suspect, insoluble (or soluble only at the expense of numerous and complex restrictions) then the case for looking for something short of a comprehensive solution is strengthened. There are a number of less expensive measures that could be adopted to deal with some of the existing uncertainty and the worst of the current anomalies. For example, as already noted, dicta in Marine Midland have left the question of "timing" (ie annual translation or once-for-all realisation) very much up in the air. There is a case for legislating to prescribe the translation basis for all current trading assets and liabilities. However, something would need to be done at the same time to deal with at least some long-term items if companies were not to be worse off than under Marine Midland. This might involve allowing "matching" in certain limited circumstances (but not creating gains or losses on 'unmatched' long-term items). Ministers might justifiably argue that since nowadays companies were by and large matched in an economic sense there was no need to provide relief for such losses. Action should be confined to ensuring that the tax system did not tax non-existent gains. Again, (on the same lines) it is unsatisfactory that a capital asset (eg foreign currency) that has been taken into account in the matching procedure following Marine Midland to cancel otherwise allowable losses on a short-term borrowing should also attract a potential tax charge under the capital gains tax rules

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when it is disposed of (John Chown's 'tax trap', particularly important in relation to currency swaps). Legislation could be introduced to deal with these specific problems. While no figures are available, costs would be much less than those associated with a comprehensive reform.

26. However, this more modest approach would not necessarily satisfy the strongest advocates of radical reform who might dismiss it as 'tinkering'. They would almost certainly continue to press for relief for losses on long-term borrowings - the long-running saga of representations would go on. Nor would such an approach be a legislative "soft option". A lot of the issues raised with a comprehensive solution would also need to be confronted here and the legislation could be long and complex and present formidable drafting problems. For example: definitions would be needed of a range of terms such as "realisation," "accruals"; the interaction with capital gains tax would need to be resolved; the treatment of groups would be particularly problematic; the transition would pose especially complex problems.

27. These difficulties go far beyond the merely technical. There are pretty fundamental issues at stake where there would be no consensus as to the proper treatment. Contentious choices would be involved. For example, some trading companies have very significant capital assets and currency liabilities of a kind which in other groups are held in separate (non-trading) holding companies. Should therefore a distinction be made between trading companies and others, or between trade assets and liabilities and non-trade assets and liabilities? The answer might be very material for some major companies. The difficulty of the issues and the potential complexity of any legislation suggest that we should be hard pressed to produce a satisfactory solution in time for publication of the 1988 Finance Bill (? in April 1988).

More consultations?

28. These difficulties - and the possibility of considerable controversy - were recognised by the spokesmen for the Group of 9 who therefore proposed that we should work towards legislation in 1989 preceded by a more formal consultation based on a "very pale green" (eau-de-Nil) consultative paper setting out the Government's preferred solution to all these problems. This paper would not contain draft clauses but would describe (and discuss) the various measures proposed in some detail. Sufficient time should be allowed for comments and wide (wider than the group of 9) consultation.

29. Of course, this is not disinterested advice (although, as noted, we think the Finance Bill 1989 timescale is more realistic than legislation in 1988). The Group of 9, although nominees of their various bodies, feel themselves rather exposed as individuals (and representatives of companies) and hesitate to be seen to be parties to comprehensive legislation that could be to the disadvantage of some of their members for whom the current scheme provides a very comfortable regime. There are also those who are able to exploit the current system's asymmetry (see paragraph 13 above). It would be in the group of 9's interest for the Government to be seen to be making the running - any dissatisfaction with what was proposed would be directed at the Revenue and at Treasury Ministers rather than at them. So we think Ministers will want to think hard about the handling.

Our advice on handling

30. At first blush, notwithstanding what was said at paragraph 29 above, there is a lot to be said for the Group of 9's spokesmen's informal advice. A timetable involving the issue of a consultative document on Budget Day 1988 (perhaps discussed informally with some or all of the Group of 9 before publication) followed by public consultation until say July 1988 ought to give time for the preparation of a coherent and comprehensive legislative proposal for Finance Bill 1989. The technical issues would have been fully aired and, assuming that the general weight of opinion was in favour of what finally emerged, the legislation ought to be acceptable to Parliament without too much contentious

debate. From our point of view there would be some advantage in our consulting colleagues overseas, particularly in the USA, to see what they had to offer on the question of the containment of costs. We can also draw on work (in which we are participating) being done by OECD on international comparisons generally. (Incidentally, while some other countries, notably the USA and Australia, have recently legislated on this subject, we do not believe that there is any compelling need for the UK to follow that lead. This question is discussed more fully in Appendix E).

31. However, publication of proposals a full year ahead of their implementation would give scope for 'forestalling' on a spectacular scale. As noted at paragraph 19 above, capital borrowings in foreign currency by the non-financial sector alone are already in excess of £50bn. Even a relatively small readjustment of assets and liabilities could seriously affect the corporation tax yield. It is not inconceivable that we could devise ways of preventing or reducing forestalling (although this would in itself involve complex legislation) but the problem of potential cost (and particularly the volatility and unpredictability of that cost) seems inherent in any scheme that gives automatic relief for exchange differences (paragraph 24).

32. With this in mind it seems to us that there is a strong possibility that the outcome of a further round of public consultation would be a decision by Ministers against a comprehensive scheme. If that were so, unless this possibility were foreshadowed in the clearest possible terms at the outset of any further consultation, there is a risk that Ministers would be accused of having procrastinated and prevaricated in order to put off (the announcement of) a difficult decision.

33. If further consultation were not to take place what alternative courses would be open? It seems to us that there are really two options here. First, Ministers could announce (? on Budget Day 1988) that, notwithstanding the sincere efforts of all parties, the problem of cost remained insoluble and that therefore they had decided to leave the law unchanged (the "do nothing" option). Or, second, Ministers could announce that,

while a comprehensive scheme had to be ruled out, there were a number of relatively minor changes that could be made and that these would be contained in Finance Bill 1988. These options are discussed in the following paragraphs.

Do nothing

34. As already noted, the problem of cost is not only its potentially huge size but more particularly its unpredictable nature. And the scope for abuse seems virtually limitless. This may well ultimately kill any scheme for radical reform. However, while this may be conceded privately by the Group of 9 spokesmen it is by no means clear that all commentators would show such appreciation for Treasury Ministers' concerns. Some might argue that under the existing rules companies are subsidising the Exchequer because their genuine losses are going unrelieved. And again, other countries - notably the USA and Australia - have recently introduced symmetrical treatment for exchange differences on long-term borrowings, so why not the United Kingdom? There are perfectly good answers to these objections but it may be that more time would be needed to convince the Government's potential critics. While a consultative document followed by more or less public discussion might allow Ministers an opportunity to get their point across, a simple announcement of a decision not to legislate might provoke an acrimonious debate. The 'do nothing' option could be the most controversial.

'Modest' legislation in 1988?

35. The case for 'modest' legislation falling short of giving relief for losses on unmatched long-term borrowings is discussed at paragraph 25 above and it could be that at the end of the day Ministers will decide that that is their preferred solution. However, it is not clear that the best course would be to introduce this sort of limited measure, without further discussion, in 1988. As noted in paragraph 26 above, some critics would dismiss it as tinkering and in legislative terms it is very far from being a soft option. Moreover, critics, including possibly the Group of 9 spokesmen themselves, might

(perhaps ironically in view of this problem's long history) accuse the Government of acting precipitate when the viable alt[illegible]native of further consultation was available.

Conclusion

36. In this note we have explained why we think the "Group of 9" proposals submitted with their letter of 27 July do not form a satisfactory basis for legislation. However, it is not clear that any comprehensive scheme for reform can be devised which would not expose the Exchequer to an unjustifiable extent. More modest schemes would fail to satisfy critics but would still involve complex legislation.

37. Handling is a problem. On the one hand, there is advice (from the Group of 9) that the Government should consult widely on the basis of a (pale green) consultative document. On the other hand, if consultation leads nowhere, Ministers risk being accused of prevarication. So the alternative options of a decisive rejection of legislation or of limited legislation need to be considered.

38. On balance, we should recommend a further round of consultation on the basis of a document to be published at or around the time of the 1988 Budget. However, such a document should spell out categorically the Government's doubts over costs, warning that at the end of the day this factor might rule out legislation altogether. The document would describe and discuss a comprehensive scheme of reform including lesser matters such as the CGT problem referred to in paragraph 25 above. A section on international comparisons should be included and views should be invited not only on the prospects for a comprehensive change but on options if cost proves to be an insurmountable obstacle. This might pave the way for a modest reform while at the same time avoiding charges of "tinkering".

39. If you agree that this is the right way to proceed then you will want to consider how the next stages might best be handled. It might be helpful if we could consult some of the leading

figures in the Group of 9 on a confidential basis in the course of the preparation of the consultative document. That would ease the (potential) pressure for an early announcement on the outcome of this year's exercise and allow the Chancellor to announce the further consultative document in his 1988 Budget Speech.

40. You will no doubt want to hold a meeting to discuss all this and may see advantage in again involving representatives of the Bank of England.

P J A DRISCOLL

APPENDIX A

REPRESENTATIONS IN RESPONSE TO SP1/87

1. Mobil UK Group Tax 26 February 1987

   Request for solution to problem of fragmentation between the Case I Schedule D Income Tax and Capital Gains Tax rules.

2. Sedgwick Group plc 3 March 1987

   Request for information only, on the existing situation as applicable to the matching of assets and liabilities between different companies in the same group.

3. The Building Societies Association 1 May 1987

   Request that all profits, losses, fees and other payments under currency swap agreements should be treated in the same way as profits and losses on the underlying borrowing.

4. The "Group of Nine" 23/27 July 1987

   Proposals for legislative change

   There have been two representations in response to the Group of Nine paper. The first from Arthur Young Chartered Accountants in support of the proposals, and the second a personal letter from the representative of a major UK multi-national company expressing strong reservations about the proposals.

APPENDIX B

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Tel: 01-920-8262

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

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.

For further information contact:
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23rd July, 1987

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.

4. 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.

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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.

Companies Not Taxed As Trading Companies

17. Since there can be no adjustments to an existing Case I computation, and Case VI assessments are unacceptable to many groups of taxpayers, special consideration will need to be given to such categories as investment, investment holding, and life assurance companies. Alternative solutions exist, such as treating foreign exchange losses as additional management expenses, and gains (over otherwise allowable management expenses) as a species of taxable income, perhaps Case I. Another possibility is to allow such companies to fall entirely within the capital gains structure. The answer is not altogether clear at present, but is capable of resolution within the framework of the general solution finally adopted on exchange gains and losses.

Close Companies

18. Although close companies are in general no longer subject to apportionment on trading income, there are penalties on non-trading close companies which receive investment or Case VI income. Furthermore, Paragraph 3A Schedule 16 Finance Act 1972 provides that interest paid by a close company will be apportioned unless one of the exclusions of sub-paragraph 3A(2) applies. Case VI income does not qualify for exclusion under 3A(2)(c)(ii). It is particularly important for close companies to ensure that any reliefs or assessments do not have adverse effects on the computation of apportionment either of income or of interest expense.

Election for Matching

19. One key problem is that, whether an accrual or a realisation basis is adopted, there will be anomalies affecting any company that borrows, say, dollars to finance a dollar fixed asset which is then held as a permanent investment. If the dollar was strong the company might be able to claim relief on the loss on the liability while the corresponding gain on the asset is postponed indefinitely. Conversely, if the dollar (or other currency borrowed) was weak over an accounting period, the taxpayer would risk having a currently taxable profit which could not be offset, for tax purposes, against an unrealised loss. Unless there are special provisions, the tax charge could be distorted from one year to another.

20. We recognise that the Inland Revenue will want even-handed treatment in connection with any approach which looks forward. In particular we are not seeking to produce an option for the taxpayer which gives any ability to obtain a systematic advantage. We do want to enable taxpayers to elect for an administratively simple procedure so that they can find a practical solution to their own foreign exchange exposure problems in a manner which achieves certainty and consistency for both the taxpayer and the Revenue.

21. 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.

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