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SUBJECT 2 FOREIGN EXCHANGE ISSUES IN INTERNATIONAL TAXATION

The United Kingdom

Roger Muray and Vimal Tilakapala

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Introduction and summary

1. The UK tax system maintains a distinction between the taxation of companies and individuals.
2. Most substantial UK business are conducted through companies, one reason being the protection afforded to shareholders by limited liability. The main exceptions are large professional firms, notably accountants and lawyers, which usually carry on business as partnerships or as limited liability partnerships (LLPs) which are for most legal purposes treated as companies with limited liability but which are fiscally transparent so that individual members are subject to income tax and capital gains tax on their share of the firm's results.
3. Except in the section dealing with the historic development of the current regime, this report deals exclusively with the impact of foreign exchange issues for companies.
4. In many contexts accounting and accounting concepts have a very strong influence on the UK corporate tax system. One accounting distinction which is of fundamental importance to the taxation of exchange differences is that between monetary and non-monetary items. Exchange differences on monetary items are normally taxed as income, as recognised in a company's accounts. There is no explicit statutory rule or case law principle that provides for this and it is instead a consequence of the current architecture of the system, as described below.
5. Companies which carry on a trade (see 22 to 24) are generally taxed by reference to their accounting profit or loss from that trade.
6. Additionally there are specific statutory regimes which tax items within them by reference to a company's accounts, whether the company is trading or not. . Particularly pertinent to the taxation of exchange differences are the Loan Relationships and Derivative Contracts regimes (see 27 to 38), which deal with the major classes of monetary items (see 54).
7. Under these regimes the distinction established in case law between capital and revenue (see 26) has limited significance. This approach, first introduced by the Finance Act 1993 code has alleviated many of the problems encountered in the past, such as lack of relief for exchange losses on long term borrowings of a trade.
8. Legislative changes that introduced a closer link to GAAP accounts, dating back to FA 2002, have on balance achieved further simplification.
9. Where a company's tax position follows its accounts, whether because the company is trading or an item falls within one of the specific statutory codes, profits and losses including exchange differences are *prima facie* brought into account as they are reflected in those accounts.

10. Where tax does not follow the accounts, because the company is not trading and the items concerned fall outside the specific statutory codes, the position can be very different as the tax treatment will depend on general UK taxation principles. Here the tax result will depend on whether the relevant items are capital or income and if income, which Schedule and Case they fall within (see 18 - 21). The treatment of exchange differences will also depend on the nature of the items concerned and the circumstances in which they are held.
11. The inconsistency in the tax treatment of exchange differences can result in a company's tax position not reflecting its economic position and can make effective post tax hedging difficult.
12. There have been several attempts in the UK to mitigate some of the effects of these inconsistencies by creating special regimes for taxing exchange differences on certain types of assets or liabilities and also for better aligning the characterisation and timing of tax on hedges with that of the hedged item.
13. Thus, it is possible, for example, to "match" a foreign currency borrowing or short position on a currency with a shareholding of a company. Where matched, exchange differences (or fair value profit or loss arising from exchange movements) are initially left out of account for tax. When the matched shares are sold the untaxed exchange differences on the hedge are either taken into account as capital gains or losses or, where the substantial shareholdings exemption applies to the matched shares, never taxed.
14. A common theme in these attempts has been the increasing shift towards starting with the accounting treatment of exchange differences and modifying it as need be, rather than devising a free standing statutory code.
15. These provisions have been amended and repealed periodically and, following extensive consultations with the professions and with business, have evolved into a fairly comprehensive legislative framework which incorporates accounting concepts. The result has been to produce one of the world's most sophisticated regimes for taxing exchange differences, well-aligned to the needs of globalised business. The evolution is continuing at the time of writing this report. Other jurisdictions might reconsider their own regimes in the light of the UK experience

Characteristics of the UK tax system

Credit, rather than exemption for foreign profits

16. UK tax-resident companies are subject to UK corporation tax on their worldwide profits, with foreign tax credit relief available for foreign tax on foreign profits. This can extend to credit for underlying tax on profits out of which dividends are paid if the UK investor has at least a 10% voting stake. The profits of UK permanent establishments are subject to UK corporation tax on profits attributable to their UK activities. There is no exemption for the profits of foreign permanent establishments, nor is this likely to change in the near future. It is

possible that in the future some foreign dividends may be exempted from tax, but by 2008, the consultation process on this issue was making slow and irregular progress.

Companies and individuals

17. There are major differences between the taxation of individuals, subject to income tax and capital gains tax, and companies, subject to corporation tax on both income and capital gains. This report concentrates on the position of companies. Unless otherwise stated all comments relate to companies and corporation tax only. The position of individuals is covered only where this illustrates the historic position for companies (before 1995) and may provide an interesting comparison with the tax position in other countries.

Schedules and Cases

18. Historically income has for tax purposes been divided into a number of Schedules, some of which are further divided into Cases. Different computational rules apply to each Schedule and to each Case.
19. The Schedules relevant to corporation tax and the types of income they cover, in general terms, are, Schedule A (profit arising from a UK real estate business), Schedule D, Case I (profit arising from a trade), Schedule D Case III (profit on loan relationships and derivative contracts, and "annual payments"), Schedule D, Case V (income from foreign possessions and Schedule D, Case VI (miscellaneous income, not otherwise taxed).
20. The capital gains and losses of companies do not fall within any Schedule, and capital assets are instead taxed on a realisations basis
21. Dividends and other distributions paid between UK corporate taxpayers are also outside any Schedule and are not taxable, unless they are received as trading income or anti avoidance provisions apply.

Trading

22. A key distinction in UK tax is between merely carrying on a business and "trading".
23. The starting point in determining the taxable profits of a trade (taxable under Schedule D, Case I) are commercial profits as computed in accordance with GAAP,. This is subject to adjustment under various legislative provisions¹. GAAP for this purpose is defined as IFRS if that is applied in a company's single entity accounts or otherwise UK GAAP
24. Despite the importance of the trading/non trading distinction there is no useful statutory definition of "trade" and whether an activity amounts to a trade is a

¹ Section 42 FA 1998, which codified the principle established by case law over the years.

question of fact to be determined by reference to the circumstances. There is some guidance in case law as to indicators of whether a person is carrying on a trade and the question is from time to time still considered by the courts. Taking this guidance into account, some of the hallmarks of a trade include:

- Profit making-motive
- Frequency and degree of organisation of transactions
- Funding, at least in part, by debt.

25. Some of the adjustments that must be made to accounting results to arrive at the taxable profits of a trade reflect historical differences between the treatment afforded to fixed and circulating capital items. Circulating capital assets are those that are turned over or consumed in the course of a trade, such as inventory. Losses and expenses on such items are deductible as revenue and no adjustment is made. Fixed capital assets are those required to enable the trade to be carried on such as premises or plant and machinery. Losses on such items are capital and *prima facie* not tax-deductible. An example is depreciation of plant and machinery. This is not deductible but "capital allowances" may instead be claimed under a specific statutory regime.
26. The distinction between fixed and circulating capital items was also applied to the debt funding of a trade and a distinction was made between fixed and circulating capital (see 170 and 172). This was a source of much complexity, now largely removed by the accounts-based regime for Loan Relationships, see 29.

Accounts based statutory codes

27. There are a number of statutory codes which aim to tax a company on an accounts basis in respect of items within their scope, even if non-trading. The codes most relevant to exchange differences are those for Loan Relationships and Derivative Contracts.
28. These codes together cover most monetary items to which a company will be party. A monetary item is defined in IAS 21 as, "units of currency held and assets and liabilities to be received or paid in a fixed or determinable number of units of currency". The essence is that at some time a payment or payments become due or can be demanded and there is a mechanism to determine how much any payment will be.
29. The definition of a "**Loan Relationship**"² is broad enough to include virtually all types of corporate and government debt.

² The terms "Loan Relationship" and "Derivative Contract" are capitalised in this report to reflect their specific legal meaning in the Corporation Tax Acts.

30. Specifically, a company is party to a loan relationship if it is a creditor or debtor under a "money debt" which arises from "a transaction for the lending of money".
31. There are deeming rules that extend each of these definitions. A transaction is deemed to arise from the lending of money "where an instrument is issued by any person for the purpose of representing security for, or the rights of a creditor in respect of, any money debt". This would cover, for instance the issue of new debt as consideration for an acquisition of shares. A "money debt" is further defined as a debt which can be settled by the payment of money, the transfer of another money debt or by the issue or transfer of shares.
32. The Loan Relationship code also applies partially to money debts not arising from the lending of money, for instance trade debts. Here the code applies to determine the taxation of interest, exchange differences and impairment losses applying an accounts-based approach. Further, the code is extended in certain circumstances, by avoidance provisions, to cover items such as equities which are in substance debt.
33. The definition of a **Derivative Contract** is more complex. Here a derivative contract, which may be free-standing or embedded in another instrument or contract, must satisfy (a) a legal definition and be either an option, a future or a contract for differences and in most cases (b) an accounting requirement. The accounting requirement is that the contract is treated as a derivative or would be so treated but for the requirement that the initial investment is zero or small compared with what would be needed to invest in the underlying. This sweeps in some items actually accounted for as financial assets. Additionally some forms of underlying subject matter can prevent a contract from being within the Derivative Contracts code, whereas others can bring a contract within the code even if the accounting test is not satisfied..
34. Under each of these codes, a company's taxable profit or loss, including exchange differences, is computed broadly by reference to its accounts. No distinction is made between income and capital items; all amounts are brought into account as income. Profits are then taxed under Schedule D, Case 1 if they relate to a company's trade or Schedule D Case III if they do not. It follows that all exchange differences are swept into an income regime, whether they relate to fixed or circulating capital items.
35. Each of these codes also prescribes the nature of the "matters" which are to be taken into account. These extend to profits gains and losses (specifically including exchange gains and losses), expenses and charges and in the case of Loan Relationships, interest³. These may arise on the item itself or in consequence of a "related transaction", broadly defined to include any disposal, acquisition or variation of a Loan Relationship or Derivative Contract. Once such a matter is identified, the timing and measurement of amounts taken into

³ The key provisions are section 84(1) and section 84A FA 1996 (Loan Relationships), Paragraph 15(1) and 16 Schedule 26 FA 2002, Derivative Contracts.

account is determined by GAAP accounting – IFRS if applied otherwise UK GAAP.

36. In the absence of specific provision to the contrary, accounting credits and debits arising from other causes are not taxed. This allows established tax principles to place some limit on what is or is not taxable, although the principle that capital items are not taxed is explicitly overridden.
37. This is important because one point of difficulty is that these codes extend the definition of (accounting) profit or loss, to include amounts recognised in comprehensive income (in the STRGL under UK GAAP or Statement of Changes in Equity under IFRS) or even credits or debits taken directly to equity. However where the debit or credit relates to exchange differences, specifically included as taxable matters, the general rule is that it is only tax-effected if reflected in the profit and loss account (Income Statement under IFRS).
38. A significant feature of both codes is exclusivity – if a “matter” is dealt with under the Loan Relationships or Derivative Contracts codes it cannot otherwise be subject to corporation tax in the absence of specific provision to the contrary, the Loan Relationships provisions taking priority⁴. This is an important contributor to the simplicity and coherence of the UK taxation of exchange differences, as there is no need to consider two overlapping set of rules for capital items. Further, most Loan Relationships are specifically excluded from tax under the capital gains provisions⁵.
39. The effect of these rules is that virtually all exchange differences on monetary items are taxed as income, the quantum and timing of amounts being determined by their GAAP accounting treatment.
40. The other significant accounts-linked all-income code relates to “**Intangible Fixed Assets**”⁶ acquired or created since 2002. This is of lesser significance to the tax treatment of exchange differences.

Non-trading

41. The tax treatment of the non-trading activities of a company will not necessarily follow its accounts and will instead depend on the nature of its income and the Schedule or Case in which it falls.
42. As regards monetary items, the Loan Relationships and Derivative Contracts codes will, as outlined above, normally apply an accounts regime and the resulting profit or loss will be taxed or relieved under Schedule D case III.

⁴ Section 80(5) FA 1996, paragraph 1(2) Sch 26 FA 2002

⁵ A loan relationship is treated as a “Qualifying Corporate Bond” by section 117(A1) TCGA 1992 and an exemption from tax on capital gains applies under section 115(1).

⁶ The provisions of this regime are lengthy and it is complex, particularly where transitional effects arise. Further discussion is beyond the scope of this paper.

43. Other streams of income that, seen from an accounting perspective, are derived from non-monetary items (other than Intangible Fixed Assets) are taxed under a more “traditional” approach, not linked to accounts. Here items that might be regarded as “pure income” are taxed on a cash basis.
44. For instance, the taxation of dividends on shares of companies not resident in the UK⁷ is not linked to accounts but is on a cash basis. The dividend will be translated into sterling at the spot rate at the time of receipt. Credit is allowed for taxes directly suffered and where the holding is of 10% or more by vote it is also available to underlying tax on the profits out of which dividends are paid. These rules are complex.
45. Gains and losses in respect of capital items will usually be subject to corporation tax on chargeable gains which is charged on a realisations basis. For non-trading companies, shareholdings and real property are usually capital items.
46. Chargeable gains must be computed by reference to sterling and so acquisition costs, disposal proceeds and expenditure incurred on acquiring and enhancing a capital asset must be translated into sterling and the gain computed in sterling. The rate used to translate will be the spot rate at the time of acquisition or, if a disposal or acquisition is under a contract, the rate when the contract becomes unconditional.
47. If a disposal creates a money debt (because for example payment is on deferred terms), exchange difference on that debt do not form part of the calculation of the gain or loss on disposal, but are instead separately brought into tax as income in accordance with GAAP accounting under the Loan Relationships code.
48. Gains arising on the disposal of certain capital assets are not taxable. For example, the “substantial shareholdings exemption” operates in certain circumstances to exempt non-portfolio holdings from tax where the issuing company’s underlying operations are substantially trading. Where the holding is exempt, exchange gains and losses on it will not be taken into account for tax purposes.

Adminstration

49. Responsibility for the administration of corporation tax and most other UK direct and indirect taxes rests with “Her Majesty’s Revenue and Customs” (HMRC). UK companies are however required to “self assess” and to pay their corporation tax in quarterly instalments.

Foreign exchange controls

50. The UK removed all foreign exchange controls in 1979.

⁷ Where the dividend is from a UK company it is normally tax-exempt under s208 ICTA 1988.

Outline of the UK corporation tax treatment of exchange differences

51. There is no specific tax regime or set of principles for exchange differences. Exchange differences are not taxable as separate items but are a component taken into account in determining overall taxable gain or loss or wrapped up within the computation of the amount brought into account as income or capital gain.
52. The primary determinant of the manner in which exchange differences are taxed in the UK is context rather than the character of the gain or loss. Thus it is necessary to consider:
 - The nature of the operations or the use of the item that gives rise to the exchange difference (for instance, does it arise in the course of carrying on a trade, or in hedging exchange risk).’
 - The nature of the item (asset, liability, transaction, bookkeeping entry) that gives rise to the exchange difference
53. These determine which tax regime applies and, in consequence, the tax treatment in terms of characterisation, measurement and timing.
54. In practice the UK corporate tax system distinguishes, through the Loan Relationships and Derivative Contracts codes, between monetary and non-monetary items, as understood in an accounting context. Exchange differences on such *monetary* items will generally be taxed under those codes by reference to a company's accounts, although this treatment may be modified in the case of hedging arrangements.
55. For *non-monetary* items outside these codes the taxation of exchange differences will depend on a number of factors.
56. If the amounts arise in the course of a trade they are taken into account in computing the profit or loss within Schedule D, Case I and the measurement and timing of taxable amounts will be determined primarily by reference to the company's accounts – see 23. Amounts regarded as capital will normally be excluded from the computation of trading profit or loss.
57. Accounts-based treatment would also apply to post-2002 assets within the Intangible Fixed Assets Regime – see 40.
58. Where items of “pure” income, such as dividends, are taxed on a cash basis, any exchange difference simply influences the cash amount taxed, translated to sterling at the spot rate.
59. Exchange differences that alter the value of the source of such income, a non-monetary asset, are taken into account only on disposal as capital gains or losses. These are computed by reference to sterling amounts, see 46. If the

substantial shareholdings regime applies there is no gain or loss for tax purposes and thus exchange differences have no tax effect.

60. Where exchange risks on shareholdings are hedged, the UK tax system has a set of “matching” rules, designed to ensure that the tax treatment of exchange differences on the hedge is matched with that on the shareholding, whether taxed as a capital gain or exempt (see 145 to 153).

Accounting principles and tax

61. As discussed above, for most monetary items, accounting principles, or more particularly the actual accounting treatment afforded to a matter in GAAP accounts, is the primary determinant of the amount and timing of exchange differences taken into account for tax in respect of most monetary items. This is normally through the operation of the Loan Relationships or Derivative Contracts codes. Exceptionally where monetary items are not within the ambit of these regimes but are assets or liabilities of a trade or property business, any exchange difference recognised in profit or loss should be taxable..
62. In the case of a trade or property business, accounting is also relevant to the tax treatment of non-monetary items, as discussed at 75 to 80.
63. As of 2005, there are three different accounting sets of accounting standards that might be applied by a UK company in its single entity accounts.
64. Any UK company may choose to apply IFRS in its single entity accounts and if it does so this is respected for tax where relevant. No company is forced to apply IFRS in single entity accounts, but it must be applied in a group’s consolidated accounts if any group member has shares or debt listed on an EU stock exchange. Consolidated accounts are not used in computing tax, but differences between the standards applied in single entity and consolidated accounts can lead to deferred tax effects in the accounts.
65. Under “New UK GAAP”, some accounting standards are virtually identical to standards in IFRS, notably those dealing with exchange differences (FRS 23 = IAS 21) and “Financial Instruments” measurement (FRS 26 = IAS 39). Where a single company itself has listed shares or debt it must apply either IFRS or new UK GAAP in its single entity accounts. This requirement does not apply to other UK companies, even (subject to limited consistency requirements) subsidiaries in listed groups. For these companies, single entity accounts may be prepared under any of IFRS, New UK GAAP or Old UK GAAP. In practice, tax compliance tends to be simpler where Old UK GAAP is applied, so many groups restrict the application of New UK GAAP (or IFRS) to the single entity accounts of companies for which this obligatory. For instance, the taxation of FX hedges of anticipated transactions gives rise to greater complexity under IFRS or New UK GAAP than under Old UK GAAP – see 132 to 144.
66. The distinction between the various accounting standards is highly significant to the taxation of exchange differences and a source of complexity and

inconsistency. Old UK GAAP has virtually no codified requirements about in what circumstances and how hedge accounting should be applied, whereas IAS 39 / FRS 26 apply a *dirigiste* approach specifying how fair value, cash flow and net investment hedges should be accounted for and setting stringent requirements that must be satisfied before hedge accounting is allowed.

67. SSAP 20, the Old UK GAAP accounting standard for exchange differences dates back to the early 1980s. It permits what is described in IAS 39 as "net investment hedging". Under this approach (the "cover method"), exchange differences on hedges of exchange risk on foreign operations and shareholdings may be offset in reserves (shareholders equity in IFRS-speak) against exchange differences on the hedged item, thereby reducing P&L account volatility. Under IAS 39 net investment hedge accounting is restricted to hedges of exchange risk on foreign operations and the method used is subtly different in that although exchange differences on the hedges are reflected as a change in shareholders equity, bypassing the profit and loss account, there is no explicit offset.
68. Following changes in Finance Act 2002, tax matching, whereby exchange differences on hedges of exchange risk on shareholdings initially not taxed, but are in some circumstances taxed on disposal of the hedged item, had been driven by application of the SSAP 20 cover method accounting at single entity level. Once some companies were required to or could choose to apply new UK GAAP, regulations were made to allow tax matching for such companies. These are discussed in more detail at 145 to 153

Recognition principles

69. The foreign exchange elements of a transaction are not taxed as separate taxable objects.

Quantum and timing under the Loan Relationships and Derivative Contracts tax regimes

70. Where the Loan Relationships or Derivative Contracts codes apply, the actual accounting treatment afforded to a matter in GAAP accounts, is the primary determinant of the amount and timing of exchange differences taken into account for tax.
71. Two bases of accounting may apply under IFRS or New UK GAAP (see 65), the amortised cost basis (essentially the same as an Old UK GAAP accruals basis) or the fair value basis. The basis to be used will depend on the circumstances (for instance derivatives are always carried at fair value) and the purpose for which a company is party to the relevant instrument.
72. Under an amortised cost basis, the varying value reflects retranslation of foreign currency amounts at spot exchange rates. Under fair value accounting, the exchange difference is merely an economic component of fair value profit or loss.

73. As a general rule, where an amortised cost or accruals basis applies, exchange differences are taxed only if reflected in the profit and loss account. Amounts taken to equity are not taxed. This may be modified, notably in the context of hedging by the matching regulations⁸, see 140.
74. If a fair value basis applies the fundamental rule is that fair value profit or loss is taxable, even to the extent it relates to exchange differences and even if reflected in equity. Again, particularly in hedging scenarios, regulations may modify this by specifying how the exchange difference element in fair value profit or loss should be calculated⁹ and what special treatment should apply¹⁰.

Exchange differences on non-monetary items in the course of carrying on a trade

75. The starting point for determining trading profits is the GAAP accounts. Normally non-monetary items will not be retranslated in accounts until realisation, so no taxable amounts arise.
76. Where non-monetary items are assets and liabilities which relate to a “foreign operation” in accounting terms, there is retranslation of their carrying value, however as any gain or loss on retranslation is taken to equity rather than through profit and loss, it is not taxed. See 155 to 165 for more detail.
77. Whether exchange differences on non-monetary trading assets are eventually brought into account on realisation will depend on their nature. Broadly speaking, they will be if they are circulating capital items, for instance see 103 as regards inventory. The tax treatment simply flows from the accounting.
78. A different treatment is likely to apply to exchange differences on fixed capital non-monetary trading assets of a company. As mentioned these are likely to be subject to corporation tax on chargeable gains and here an exchange difference will only be a component of a capital gain or loss determined on realisation, say on most land and buildings.
79. The depreciation of such assets, as reflected in the accounts is capital expenditure and so not tax-deductible. For some classes of these assets, statutory capital allowances may be available. These will generally be computed in the functional currency of the company as a whole. See 90 to 95 for a discussion of which currency is used to compute taxable profits.
80. In all of these cases exchange risks may be hedged by a foreign currency liability or derivative. For the tax treatment of such hedges see 120 to 144.

⁸ Primarily SI 2004/3256

⁹ SI 2005/3422

¹⁰ Again primarily SI 2004/3256

Character of foreign exchange gains and losses

81. The characterisation of an exchange difference depends primarily on the nature of the item on which it arises.
82. Where the Loan Relationships or Derivative Contracts codes apply, all exchange gains and losses are normally treated as revenue (ordinary) items. Most monetary items will fall within the ambit of those regimes.
83. The exception to this is in relation to hedging transactions where special rules may apply to match the tax treatment of the hedge more closely with that of the hedged item. Both timing and characterisation may be altered. For further detail see 120 to 153.
84. If the item giving rise to the exchange difference is an asset subject to corporation tax on chargeable gains, the taxable event will be realisation and the exchange gain or loss wrapped up in the overall gain or loss on disposal by reference to the sterling equivalents of the acquisition cost and realisation proceeds.
85. For comments on the treatment of fixed and circulating capital non-monetary items in the context of trading, see 75 to 80.

Modification of character by other¹¹ transactions

86. There is no simple general principle whereby the characterisation of an exchange gain or loss may be influenced by the existence of other transactions or items.
87. The UK does not have a general anti-avoidance law, nor does the civil code "abuse of law" principle apply to UK domestic tax provisions. It is only in very limited circumstances that the courts have combined a number of transactions into a simpler transaction for tax purposes¹².
88. The presence of other transactions may tip the balance towards treating an activity as a trade rather than, say mere investment: for example a higher frequency and degree of organisation of transactions both point towards trading (see 22 to 24). These factors could lead to treatment of an activity as, say, trading in real estate, rather than mere investment. Real estate would then become circulating capital inventory rather than fixed capital investment. For the real estate investor, exchange differences will be wrapped up in a capital gain, on realisation. For the trader, gain or loss including that attributable to exchange differences is still recognised on realisation, or revaluation, but now

¹¹ The General Reporter's brief refers to "related transactions". This term had a specific and far from obvious technical meaning under the Loan Relationships and Derivative Contracts legislation encompassing any transfer termination or modification of a Loan Relationship or Derivative Contract. Accordingly, use of this term is avoided in this report.

¹² A review of the extensive case law is beyond the scope of this document

will be a revenue item, simply an element in computing the trading profit or loss taxable under Schedule D, Case I.

89. Specific rules relating to Loan Relationships and Derivative Contracts acting as hedges are discussed at 120 to 153. Hedging rules can apply in both trading and non-trading scenarios

Currency in which profits, gains and losses are computed

90. There are many circumstances in which taxable profits may, and must be computed in currencies other than sterling. The rules have changed over time and most unusually, in the context of UK tax, have become simpler. This has been achieved by tightening the linkage to actual accounts. The general rule is that sterling is used, unless provided otherwise¹³. This is also specifically required if a UK-resident company has a sterling functional currency, but presents its accounts in a different currency¹⁴.
91. Where a UK-resident prepares its accounts in a currency other than sterling, but its functional currency is different (and not sterling), the company must compute its profits in its functional currency and then translate those amounts into sterling¹⁵.
92. Otherwise, a UK resident company computes taxable profits in the currency in which it draws up its accounts¹⁶. A non-resident company computes taxable profits in the currency used for the accounts that back up the filing of the tax return for its permanent establishment.¹⁷ In computing the UK tax measure of the profits CFC the currency in which its accounts are drawn up will apply, as it is deemed to be UK-resident for the purposes of the computation.
93. By the standards of UK tax law these provisions, introduced with effect from 2005, despite their inclusion in FA 1993) are remarkably simple and straightforward. They could however be improved, for instance by referring explicitly to the presentation and functional currency as defined in IAS 21.
94. The Loan Relationships and Derivative Contracts codes require the debits and credits that are subject to tax to be based on those that would arise in “correct accounts”, that is accounts drawn up under IFRS, if applied, or otherwise UK GAAP. This would suggest that even if accounts are drawn up in accordance with different accounting standards – for instance in the case of a company resident in the UK but incorporated elsewhere - that computation should be made in the currency that would be the functional currency under UK GAAP. However where a company’s functional currency is not sterling, tax is generally

¹³ Section 92 FA 1993

¹⁴ Section 92A FA 1993

¹⁵ Section 92B FA 1993

¹⁶ Section 92C(1) 1993

¹⁷ Sections 92C(2) and 92E(2) FA 1993.

to be computed in the currency in which the accounts are prepared¹⁸, regardless of the accounting standards applied. This might potentially give rise to a conflict between the two tax rules. In the authors' view the debits and credits on Loan Relationships should be computed in the functional currency and then translated to sterling. This is consistent with the accounting approach under IFRS where exchange differences relative to functional currency are reflected in the income statement, but exchange differences between functional currency and presentation currency in shareholders' equity. The latter would be left out of account for tax under section 84A(3) FA 1996. In this way the exclusivity of the loan relationships provisions is not compromised (see 38).

95. The rules described do *not* apply to capital gains, which are always computed by reference to sterling disposal proceeds and base costs.

Change of accounting currency

96. Where there is a change of functional currency, under UK GAAP or IFRS, retained profits are recomputed as if the company had previously applied the new functional currency. However any resulting exchange differences should be left out of account for tax¹⁹.

Special rules for revaluation of the currency in which profits are computed

97. In recent years, the UK has not had a hyper-inflationary environment and there are no domestic rules to reduce tax because sterling has devalued relative to other currencies. This would be taken into account to the extent that consequential exchange differences affected the measurement of trading profits under GAAP or under the Loan Relationships or Derivative Contracts regime.

Source

98. The geographical source of an exchange difference is rarely relevant. The UK has no domestic statutory sourcing rules²⁰ and very little case law. A sourcing rule may, however be found in tax treaties. Typically, if the treaty party is permitted to tax the income under the terms of the treaty, then the income is sourced in that state and the UK is required to give tax credit relief, subject to UK computational rules (which broadly limit credit to UK tax on the foreign-sourced income). Under domestic unilateral tax credit rules, a common sense approach is usually applied. For instance, if a UK company had a US branch with a USD functional currency, which had an exchange difference by reference to a transaction denominated in euros, the exchange difference between the euro and the USD would be regarded as part of the income of the US branch.

¹⁸ Sections 92C(1) and 92E(1)(b) FA 1993

¹⁹ In the case of trading profits, because the starting point is the profit and loss account and amounts taken directly to equity are not taxed. In the case of Loan Relationships under Section 84A(4) FA 1996 and Derivative Contracts, Paragraph 16(3) Schedule 26 FA 2002.

²⁰ In 2007 HMRC announced that a statutory source rule might be introduced, but this initiative has not yet progressed

Given the way the UK tax credit rules operate, this might have no impact on the credit available.

99. Under the Loan Relationships and Derivative Contracts codes, no distinction is made between UK and foreign source items.

Transfer pricing

100. Fundamentally, the UK applies the arm's length approach. Accordingly, the manner in which related enterprises take into account exchange risk should reflect what independent parties acting at arm's length would be expected to do²¹. The transfer pricing provisions apply to domestic as well as cross border arrangements. Transfer pricing adjustments may be made to a UK company in respect of non-arm's length transactions with a between related UK company. Where transfer pricing adjustments are made to a UK company in respect of a domestic UK arrangement, to avoid double taxation in the UK the other company may claim a corresponding adjustment.
101. The interest rate on an intra-group loan should be consistent with arm's length rates for the currency in question. A loan denominated in a hyperinflationary currency might be disregarded and, say, treated as quasi-equity, if unrelated parties would not be expected to enter into such an arrangement.
102. In the context of thin capitalisation complexity may arise. In particular, where a company is thinly capitalised, interest relief may be disallowed and exchange gains and losses on excess debt disregarded. Under these rules borrowing capacity is determined on a company by company basis, taking into account subsidiaries, but not sister or parent companies. However if another company explicitly or implicitly guarantees the excess debt, it may claim to be treated for tax purposes as the borrower, subject to having sufficient borrowing capacity itself²². The guarantor will therefore get relief for excess interest and should bring into account exchange differences on the excess debt. If the guarantor has a different functional currency from the borrower it is unclear whether the taxable exchange differences should be computed by reference to its own currency, or if the deemed borrowing can be treated as if it had been made by a branch of the guarantor with the same functional currency as the actual borrower. Only the latter approach avoids the risk of double taxation or a double deduction.

Typical transactions

Purchase and sale of goods

103. The purchase and sale of goods will usually be an incident in carrying on a trade, taxed under Schedule D Case I (see 22 to 24) and the tax treatment of

²¹ The legislation is in Schedule 28AA ICTA 1988 which explicitly requires interpretation to be consistent with OECD transfer pricing guidelines

²² Paragraph 6D Schedule 28AA ICTA 1988

the transactions, including any economic impact of exchange differences are determined simply by following the IFRS or UK GAAP accounts of the trader. Inventory, a non-monetary asset, will be carried at the lower of cost or net realisable value, in the functional currency in which the trade (or branch thereof) is conducted. Thus foreign exchange differences would affect profit and loss only in the event of sale or of writing down inventory to a lower net realisable value. No attempt is made in tax law to further complicate the issue. For the impact of such hedging see 132 to 141.

104. The source of any exchange gain will be the trade itself. To the extent trading is carried on through a foreign permanent establishment, the geographical source will be that of the jurisdiction in which the permanent establishment is located. The currencies in question and the law under which contracts are made are of no direct consequence in determining source.

Measuring the cost of depreciable property (plant and equipment, not real estate)

105. The tax treatment of the depreciation and disposal of plant and machinery deviates from the accounting treatment. A statutory tax depreciation regime, "Capital Allowances" applies, computed normally by depreciating the residual balance of either the item in question or a pool of eligible items by 20% per full year²³. The computation will be made in the currency determined by the rules outlined at 90 to 95. Once the cost on which allowances are given is determined, exchange differences are ignored, except where they affect disposal proceeds brought into accounting in computing balancing charges and allowances. There are no explicit rules to determine the exchange rate used in computing cost and there is a lack of clarity. It is probable that the sterling cost on which allowances are based is determined by the spot rate for the date on which an unconditional obligation to make payment is established.
106. The tax impact of hedging such exchange risk is discussed at 142 to 144.

Measuring the cost of real estate

107. The depreciation of land and buildings in accounts is not deductible in computing trading profits and, except in relation to agricultural buildings, no "capital allowances" are available. Thus, where land or building is an investment or a fixed capital asset of a trade, foreign exchange effects are most relevant primarily to the computation of capital gains or losses where sterling base costs and disposal proceeds must be established²⁴. Following the rule that determines when a disposal takes place²⁵, it is considered that where a disposal takes place or expenditure is incurred under a contract, it is the spot rate at that date that should be used in computing disposal proceeds and base cost, including enhancement expenditure.

²³ The rules are somewhat intricate, as might be expected of the UK tax regime.

²⁴ This was put beyond doubt in the 1981 case of *Bentley v Pike*, 51 TC 590

²⁵ Section 28 TCGA 1992

108. In the case of a property trader, the land and buildings will be circulating capital assets. Exchange differences will be taxed as income on disposal or as an embedded economic component of property revaluation.

Measuring the cost of investments in securities

109. Debt securities and shares can be treated very differently UK tax purposes. Debt securities will usually be loan relationships (see 31) and here GAAP accounts determine the timing and quantum of exchange differences and the exchange rates applied should simply reflect the accounting treatment. If an amortised cost basis of accounting applies, exchange differences are taken into account by retranslation of principal. If a fair value basis applies, exchange differences are simply an economic component of fair value profit or loss.
110. Shareholdings, however, will normally be fixed capital assets to which capital gains treatment applies. Thus sterling base costs and disposal proceeds are computed as for real estate (see 107).
111. Where the substantial shareholdings regime applies, no capital gain or loss is taken into account for tax. The rules for this exemption are complex but the essential conditions for it to apply are that a 10% stake is held in the company in question and its underlying business is active.
112. For the tax treatment of hedges of exchange risk on shareholdings see 145 to 153.
113. Some shareholdings, or combinations of shareholdings with other transactions, may be deemed by anti avoidance rules to be Loan Relationships. This is the case, broadly speaking where the arrangements are engineered to produce an interest-like return²⁶. Where this is the case, an all-income approach is applied under a deemed fair value basis of accounting under which exchange gains and losses will be swept up into an annual revaluation.

Intangible property

114. A special regime applies to intangible fixed assets created or acquired since 2002 (see 40). Whether or not the intangible fixed assets are used in the course of trading, the GAAP accounts are followed and all amounts arising are taken into account as income items including, where relevant, exchange differences. Definitions are by reference to accounting concepts rather than legal form. No particular source rule applies.

Financing (borrowing and lending)

115. The tax treatment of loans (whether made or received) is governed by the Loan Relationships code, see 29 to 39, and the GAAP accounts are followed. Where

²⁶ Sections 91B to 91H FA 1996. The drafting is prescriptive and the phrase “interest-like return” is currently not used, but consultation is in course as to whether these provisions should be replaced by simpler rules targeted at interest-like returns with a “principles-based” drafting approach.

an amortised cost basis of accounting applies, as will almost always be the case, other than in relation to banks, financing debts denominated in a foreign currency of the borrower or lender are valued at the exchange rate for the date in question, in accordance with GAAP accounts. Where debt is between related parties, an amortised cost basis of accounting must be applied for tax purposes, even if fair value accounting is used in the accounts. Exchange differences recognised on retranslation are taxed or relieved as revenue items. For the treatment of hedging transactions see 128 to 131.

116. There is no question of regarding exchange differences as a discount or similar item. Exchange differences are recognised for tax year by year and are revenue items for tax irrespective of whether a debt or loan is on circulating or fixed capital account. Thus, complications encountered in some other tax jurisdictions, including the host nation, Canada, are no longer encountered in computing corporation tax liabilities.
117. Realisation of a foreign currency debt is normally an event of no special significance, other than as a time at which it will be retranslated under GAAP and an exchange gain or loss brought into account in accounts and so also for tax. It makes no difference whether or not the debt is replaced by equivalent debt funding.
118. There is normally no distinction for tax between exchange differences and other income, gains, losses, interest or expenses. However, to the extent exchange differences are taken to shareholders' equity they are not immediately taxed. This is most often encountered in the context of hedging, see 120 to 153.
119. The accrual of interest, discount or premium on foreign currency debt causes no particular problems; tax will follow the GAAP accounting treatment. Broadly, accruals will be translated into the functional currency of the company during the course of a year. Residual exchange differences on accrued amounts at year end or when paid are also taken into account for tax in the accounting period in which they are recognised in the accounts.

Hedging foreign exchange risk and tax

120. The UK has sophisticated and reasonably effective rules dealing with the corporation tax treatment of hedging transactions, particularly in relation to foreign exchange risk.
121. In some cases it is possible to follow accounts. Here no special rules are required.
122. However, in many cases there will be a mismatch of characterisation. A hedge of foreign exchange risk will almost always be a Loan Relationship or Derivative Contact, taxable as income on an accounts basis. The hedged item may however be subject to capital gains tax, as in the case of a shareholding. In these instances, specific rules act as a bridge between the two regimes to align better the tax treatment of the hedge and the hedged item.

123. There are essentially three objectives underlying the current hedging rules..
- (1) That, where the hedged item is such that it affects the computation of income (circulating capital such as inventory, or monetary items such as loans) and where hedge accounting applies, the tax treatment reflects the hedge accounting. This is essentially a question of timing.
 - (2) That, where there is an intention to hedge, and the hedged item is such that it affects the computation of income, the timing of taxation of hedge and hedged item is aligned, even if hedge accounting is not permitted, for instance because the stringent hedge effectiveness tests in IAS 39 are failed.
 - (3) That, where there is an intention to hedge, but gains and losses on the hedged item and the hedged item would be characterised differently for tax, the tax treatment of hedge and hedged item are matched. These rules may, for instance override treatment of gains and losses on the hedge as income and substitute taxation as a capital gain on realisation, or even no tax at all. In some cases this requires hedge accounting to be overridden.
124. These aims are ambitious and the rules (that emerged from a long and constructive process of consultation between taxpayers, their representatives and HMRC) are correspondingly complex. The process is also complicated by the concurrent application of two radically different approaches to hedge accounting under Old UK GAAP on the one hand and IFRS and New UK GAAP on the other (see 64 to 67).
125. Old UK GAAP had very little in the way of explicit rules in accounting standards. It was simply a collation of practice that had grown up of the years. There was a standard on disclosure of financial instruments, FRS 13, but none on measurement. Typical approaches were
- Leave hedges of anticipated transactions off balance sheet until the transaction takes place, then roll the gain or loss on the hedge into the measurement of the hedged item.
 - Carry foreign currency loans at the rate implied by a matching currency swap.
 - Offset exchange gains and losses on FX hedges of shareholdings against gains or losses in translation shareholdings (held at a foreign currency carrying amount) in reserves.
126. By contrast, IAS 39 and FRS 26 have explicit, albeit somewhat prescriptive, rules. Under these rules a hedge must always be designated as such before hedge accounting is permitted. Stringent prospective and retrospective hedge effectiveness tests also apply. Although complex, the rules do form a coherent pattern and where applicable reduce volatility in the profit and loss account.

However there are many circumstances where a derivative is acting as a hedge but hedge accounting is not possible. As a derivative must always be carried in the accounts at fair value, this leads inevitably to profit and loss account volatility.

127. Hedges of exchange risk will nearly always be taxable under the Loan Relationships or Derivative Contracts codes and the specific tax rules relating to designated or intended hedges alter the operation of these rules, sometimes radically.

FX hedges of monetary items

128. Where the hedged item is itself a monetary item, there is typically no need for hedge accounting. For instance a USD borrowing of \$100m at floating rates of interest may be hedged into sterling by a swap under which, on maturity, the company

- receives \$100m from its bank counterparty (so it can pay off the principal on the loan); and
- pays, say, £55m, reflecting the spot exchange rate on entry into the swap.

There are also “periodic payments”. Every 6 months the company

- receives 6 month USD LIBOR²⁷ on \$100m, reflecting the pattern of the interest payments it must make on the loan; and
- pays 6-month GBP LIBOR (plus margin) on the £55m notional principal.

129. Taking the borrowing and swap together, the company has a synthetic sterling borrowing of £55m at 6-months LIBOR (plus margin). One approach permitted under Old UK GAAP is to account for it as just that, accruing the net payments as sterling interest. Another is to carry the borrowing at \$100m translated at the year-end rate and carry the swap at the difference (positive or negative between that and £55m) in each case plus accrued interest or periodic payments. All interest and periodic payments are accrued through profit and loss. The net result is the same as using the synthetic accounting and for tax one simply follows the accounts.

130. Even under IFRS or new UK GAAP this scenario is not particularly troubling. The swap must be carried at fair value. But immediately after a reset date, ignoring the effects of creditworthiness, the present value of a stream of USD LIBOR payments on a notional principal of \$100m plus \$100m on maturity must be \$100m and similarly a stream of GBP LIBOR based payments on £55m, plus £55m on maturity must be £55m. Thus, the fair value of the swap at the end of the period of accounts will be very similar to the accruals basis carrying value

²⁷ The interest rate applicable to both borrowing and swap is set at the “reset date” at the beginning of the interest period, so the company knows exactly what it has to pay in 6 months.

(there is some “noise” caused by variations in short term interest rates between reset dates, but this is usually relatively small. It follows that no special hedge accounting or hedge designation is needed to achieve a satisfactory result – the swap is a natural hedge of the borrowing. Tax simply follows the accounts.

131. It does get somewhat more complex where the swap also hedges an interest rate exposure – say if floating rate dollars are swapped into fixed rate sterling. Accounting for interest rate hedges and the associated tax regulations are outside the scope of this paper. The regulations do, however, impact this simple scenario in that where IFRS or new GAAP applies, the company will have to adjust out the “noise” on the floating rate swap, so that the tax result is the same as under the accruals approach, unless it elects to follow its income statement for tax as regards interest rate and currency swaps and hedges of interest rate risk.

FX hedges of anticipated transactions

132. The key to understanding the tax treatment of hedges of exchange risk on anticipated trading transactions is the treatment of cash flow hedges under IAS 39.
133. Suppose 3 months before the end of a period of account a company (with a sterling functional currency) expects to buy some inventory for €100, 6 months later. It enters into a forward contract to buy €100 in 6 months for £81 (the 6-month forward rate) and designates it as a hedge of foreign exchange risk on the highly probable expected transactions. It is assumed all hedge effectiveness tests are passed.
134. At the year end the 3-month forward rate is €100 = £84. The swap is worth approximately £3, the amount the company would receive on settlement at that forward rate (the £3 would be discounted at a 3 month sterling interest rate to, say £2.95).
135. In its accounts the anticipated purchase does not feature at all – it is just a highly probable expected event. The forward contract is a derivative and must go on balance sheet at fair value. But, the profit of £2.95 is taken to a specific component of equity called the cash flow hedge reserve and does not impact the income statement (profit and loss account). (Under Old UK GAAP the forward does not feature on the balance sheet at all and recognition of the profit is suspended. The fair value of the forward is only reflected in a disclosure note).
136. When it buys the inventory at the expected time the spot rate is now €100 = £83. It has made a cumulative profit on the hedge of £2. It has two choices – it can (a) leave the profit of £2 in the cash flow hedge reserve and book the inventory at £83. Or (b) it can recycle the profit into the carrying value of the

inventory and carry it at £81²⁸. (Under old UK GAAP the inventory is booked at £81 reflecting the hedged rate).

137. Finally a year later it sells the inventory for £90. Under method (a) it has a profit of £7 (90-83) on the swap and the £2 is recycled from the cash flow hedge reserve to profit and loss – at the time the hedged item itself affects profit and loss. Under method (b) the profit is £9. Under either method the timing and amount reflected in profit and loss, credits totalling £9 is exactly the same, the only difference is in the balance sheet whilst the inventory is on the books. Under Old UK GAAP the profit is also £9.
138. Old UK GAAP companies simply follow their accounts for tax.
139. Where a company applies fair value accounting, the tax “Disregard” Regulations²⁹ are designed to replicate the IFRS accounting treatment if the company either
- (a) hedges with a forward contract which it designates as a cash flow hedge of exchange risk on the anticipated purchase; or
 - (b) simply intends the forward to act as a hedge of the risk.

This wide scope of the rules was a response to lobbying from companies that hedged exchange risk far into the future and where the hedged cash flows were not known with sufficient certainty to pass prospective hedge effectiveness tests. The tax rules are thus more generous than the accounting rules and cash tax may be less volatile than book profits.

140. The effect of the rules is first to override the statutory rule that exchange differences taken to equity are not taxed and then to base tax on rules that replicates the accounting that would apply in respect of an effective cash flow hedge, as described at 133 to 137.
141. This could, however, be an unwanted compliance burden for companies that have little difficulty satisfying hedge effectiveness tests or that can tolerate some cash tax volatility. Thus, companies are permitted to elect to follow their profit and loss account. Where accounting method (a) applies, amounts are taxed when recycled from the cash flow hedge reserve to profit and loss.
142. A similar approach applies to hedges of the cost of plant and machinery. Under the regulations, exchange differences are taxed as the plant or machinery is depreciated. This does not match the timing of capital allowances (statutory tax depreciation) but the timing difference is a result of the capital allowance regime, not the hedging regulations.

²⁸ These alternatives are at paragraphs 98(a) and (b), respectively of IAS 39 and FRS 26.

²⁹ Regulations 7 and 10 SI 2004/3256

143. The election to follow profit and loss is hampered here by a technical glitch in that if method (b) accounting is used, the exchange differences on the hedge are all taxed as soon as the plant and machinery is booked in the accounts and the profit or loss on the hedge is recycled to its carrying value. There is no problem under accounting method (a).
144. The regulations only work in this way in relation to expenses, whether revenue or capital, of trades and property business. Otherwise the regulations do no more than defer taxation of exchange differences on hedges beyond settlement of the forward contract.

Matching

145. There are circumstances where the normal tax treatment of a hedge is altered to achieve a better match between both characterisation and timing of recognition of gain or loss on the hedged item.
146. Where the hedged item is a foreign branch with a different functional currency – a “foreign operation” in accounting terms (see 156), a borrowing or swap may act as a hedge. Where Old UK GAAP applies, under SSAP 20, exchange differences on hedges of exchange risk on foreign operations are taken to reserves and offset against exchange differences on retranslation the net investment in the foreign operation (the cover method). Under IFRS or New UK GAAP, the hedge must be designated as a net investment hedge and to the extent the hedge is effective, the exchange differences, or fair value profit or loss on a swap, which will approximate to an exchange difference (see 130) is taken to a component of equity, much as under a cash flow hedge. (For more detail on the accounting and tax treatment of exchange differences on foreign operations, see 154 to 159).
147. In these circumstances statutory rules ensures that the exchange differences are not taxed³⁰ (even if branch assets or the entire branch is disposed of). The policy underlying this is first that tracking individual branch assets would impose an impossible compliance burden and second, disposals will typically be taxed by the jurisdiction in which the branch is located leaving little or no residual UK tax after credit for foreign tax. Thus, the best match of characterisation is achieved by non-taxation of the exchange differences on the hedge.
148. Under Old UK GAAP the cover method may also be applied to FX hedges of shareholdings. The shares may be carried at cost in foreign currency. This carrying value is retranslated at the end of each period of accounts and taken to reserves; the exchange differences on the hedge may be set off against this in reserves. Although not in the letter of the accounting standard, this approach has been extended to allow shareholdings to be carried at a “directors’ valuation”, reflecting the underlying net asset value of the subsidiary. This

³⁰ For Loan Relationships, section 84A(3) FA 1996; for Derivative Contracts, paragraph 16(3) Schedule 26 FA 2002.

allows the cover method to be applied where the value of a subsidiary exceeds historic cost and where there are underlying assets and hedges in more than one foreign currency. In this case, the statutory rules again ensure that exchange differences on the hedges taken to reserves are not immediately taxed.

149. IFRS and New UK GAAP do not allow shareholdings to be the subject matter of net investment hedges. However, in the parent's consolidated accounts, activities of the subsidiaries may then be "foreign operations" permitting net investment hedging. This does not help from a tax perspective, as tax is based on single entity accounts. But it does mean that the treasurer will wish exchange differences to be left out of account for tax. This is achieved through another part of the Disregard Regulations³¹.
150. Two mechanisms are possible. The company may designate a borrowing or swap as a *fair value* hedge of FX risk on the shares. The exchange difference or fair value profit and loss on the hedge remains in profit and loss, but the carrying value of the shares is adjusted to an equal and opposite extent. This does not directly help the tax position as the carrying value of the shares, a non-monetary, non-trading item, is irrelevant. But the regulations then require the exchange difference or fair value profit or loss on the hedge to be disregarded for tax, initially at least.
151. The alternative is matching by intention. Where the company intends that the borrowing or swap should hedge the exchange risk (and in practice can demonstrate that intention if challenged by HMRC), the exchange differences are again disregarded for tax. Where a swap is used, further regulations³² determine what element of fair value profit or loss is treated as an exchange difference. Normally, the limit to matching is that the principal of a borrowing or notional principal of a swap must not exceed the carrying value of the shares. But, the company may elect to have the limit for each currency the carrying value of the underlying net assets "denominated" in that currency in the group's consolidated accounts. The rules are intricate, but make it easier for the tax director and treasurer to ensure that the effect of net investment hedges in the consolidated accounts are not undermined by tax imposed at single entity level.
152. Typically, to avoid ambiguity as to what is intended to be matched, foreign subsidiaries will be held by a special UK "water's-edge" holding company whose only currency short positions will be those intended to act as hedges in the matching regime. However not all groups can do this. It might, for instance, cause unacceptable regulatory capital requirement for banks. This is one source of complexity in the regulations.
153. Matched exchange differences may not remain outside the scope of tax for ever; and further regulations apply where the matched assets are disposed of³³.

³¹ Paragraphs 3-5 SI 2004/3256

³² SI 2005/3422

³³ SI 2002/1970

If matched shares are sold and the sale is within the scope of tax on capital gains, previously matched exchange gains and losses arising on the hedging instrument are aggregated and brought into account as a component in the capital gains tax computation. As a result, if the hedged asset is exempt from capital gains tax (for example a shareholding within the “substantial shareholding exemption”) the tax treatment of the aggregated exchange gain or loss on the hedging instrument will follow. There are identification rules, that normally only need to be considered if there is a taxable disposal, designed to identify matched gains and losses on hedges first with the shares subject to the taxable disposal.

Foreign currency issues related to foreign branches or PEs of a UK-resident company and foreign-source pure income of a trader

154. The position in the UK is relatively straightforward, mainly as a result of the close link between the accounting and taxable profits of a trade. Typically a branch will be a foreign operation for accounting purposes and a foreign PE from a tax treaty perspective and little interference with the accounting treatment is needed. It is fair to say that from a UK perspective a foreign PE of an operation that falls short of being a trade is a somewhat alien perspective, so there are no clear rules for such cases.

UK trading companies with foreign branches – measurement of profits

155. The UK taxes the worldwide income of resident companies with no exemption for the profits of foreign permanent establishments. Tax credit relief is available for foreign tax suffered by the permanent establishment.
156. A “foreign operation” is defined in IAS 21 as “an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity”. A branch in this accounting context might be part of a UK business carried on the UK, say a division of a bank that deals in US securities and incurs significant expenses, such as employee bonuses in US, but it is more likely also to be a branch in a tax sense and a permanent establishment outside the UK.
157. The GAAP accounting methodology for dealing with exchange differences and consolidating the results of the branch in the single entity accounts of a company should be respected for tax.
158. The methods used under IAS 21 / FRS 23 (IFRS and New UK GAAP) and SSAP 20 (Old UK GAAP) are essentially similar. The essence of the accounting approach is that assets and liabilities at the balance sheet date are translated into the company’s presentation currency (which in most circumstances will also be the functional currency of its UK head office, typically sterling). Income and expenses arising from transactions are measured at the rate applicable at the date of the transaction (in practice the profit or loss for periods within the period of account are likely to be measured and translated at

an average rate for a period, as a reasonable approximation). Any resulting exchange differences are reflected directly in equity. Such exchange differences will reflect exchange differences on the opening net investment in the foreign operations, differences between the rates at which profits or losses are recorded during the year and the exchange rate at which assets or liabilities at which the resulting retained profits and losses are reflected at the balance sheet date and of remittances to head office or contributions from head office to the net assets of the branch.

159. In computing the UK taxable profits of a trade, the exchange differences taken to equity are left out of account. This is the case even where the net assets of the branch include Loan Relationships.
160. For the treatment of hedges of exchange risk of hedges of the branch see 146 and 147.
161. In the accounts any profits or losses on dealings between the UK head office and the foreign branch would be eliminated on consolidation and this would be respected for tax purposes. However there can be residual foreign exchange effects.
162. For instance within a bank part of the funding of a branch might be regarded as a loan from the head office to branch in the functional currency of the branch. There would be exchange differences in the head office divisional accounts, taken to profit and loss, but not those of the branch. On consolidation the intra-company loan eliminates but the exchange differences will remain in profit and loss. From a tax perspective the "loan" to the branch does not exist, so it cannot be a Loan Relationship. It is, however, possible to rationalise leaving the accounting treatment as it is and making no adjustment. The branch is likely to have loan relationship assets and liabilities and exchange differences on the net assets are taken to equity and therefore not taxed. But for tax purposes loan relationships assets matching the internal liability of the branch could be regarded as reallocated to head office and therefore taxable. Alternatively, and more generally, it is possible to see the accounting treatment as simply the methodology of measurement of the profit or loss. A deemed internal loan is simply a mechanical process for applying GAAP and determining which amounts are taken to equity and not taxed under the general principle of computing profits taxable under Schedule D Case I (see 23) by starting with the profit and loss account³⁴.
163. Where a company is trading, the measurement or source of foreign exchange effects is unaffected by the governing law of a transaction. The source of an exchange difference of a foreign permanent establishment will be the jurisdiction in which a branch is located.

³⁴ Section 42 FA 1998. There is not an explicit reference to the profit and loss account as distinguished from comprehensive income including amounts taken to equity, but this can be inferred from the context and the case law precedent that the section was intended to codify.

164. Until recently the limit to foreign tax credit relief was UK tax on the trading profits of a company as a whole, though the tax case which firmly established this³⁵ came as a surprise to some, including so it seems, HMRC. This case was perhaps a pyrrhic victory for the taxpayer, as new legislation was introduced in 2005 to limit the credit in effect to income of the branch³⁶. Gains or losses on derivatives that hedge specific branch assets may be treated as income of the branch for this purpose³⁷. This rule would not appear to cover the use of foreign currency debt as a net investment hedge of the foreign operation as a whole. There is, as yet, no case law.
165. For pure income the limit to credit is normally UK tax on the gross income, but more stringent limits apply where such income is part of the income of a financial trader or has been diverted from a financial trader³⁸.

Foreign currency issues relating to CFCs

166. The UK CFC rules are complex and work on a company by company basis. The effect of the rules, if applicable is that the “relevant profits” of the CFC are apportioned to UK-resident corporate shareholders unless, *inter alia*, the CFC distributes 90% of this amount within 18 months of its year-end. The “relevant profits” of the CFC are, in essence, the taxable profits it would have if it were a UK-resident company, though subject to some special computational rules. However if one of a number of escape tests are satisfied, as will be the case for most subsidiaries of a UK multinational, the rules have no effect.
167. The computation of the relevant profits of a CFC is made in the currency in which it draws up its accounts. To the extent the CFC is a party to Loan Relationships or Derivative Contracts – see 27 - 39, the amounts taken into account are those that would arise were UK GAAP used in preparing the accounts. There are no special rules applicable to CFCs as regards the treatment of exchange differences.

Historical development of the UK system

168. The UK corporation tax treatment of exchange differences can reasonably be described as modern, rational and user-friendly. This inevitably involves a degree of complexity, particularly as regards the special features designed to align the taxation of hedges with the hedged item. It could be seen as an appropriate model to assist other countries in improving their regimes. However, this has not always been the case and the modernisation has not extended into the field of income tax.
169. The stages through which the corporate system has passed may be instructive to other jurisdictions. In particular the system that applied from 1996³⁹ to 2001

³⁵ Legal and General Assurance Society Ltd v Thomas (no. 1) 2006 STC 1673

³⁶ Section 798A ICTA 1988

³⁷ In section 798B ICTA 1988

³⁸ Section 798 ICTA 1988

could be seen as a case study in how not to do it. With hindsight, this attempt to create statutory rules designed to mimic the tax treatment of exchange differences in accounts can only be described as a failure.

Before 1996: the traditional approach

170. Under the traditional approach, which still applies in computing trading profits of an individual, subject to income tax a distinction was made between revenue and capital items, even where monetary in nature. The starting point for computing taxable profits was the accounts. Revenue treatment on an accruals basis applied to circulating capital monetary items and exchange differences were included in taxable trading profits. However, exchange differences on fixed capital monetary items were taxed either, on realisation as capital gains (debts that had been transferred and “debts on a security”, broadly debt securities or other transferable debt) or not at all (simple debt or liabilities).
171. A number of tax cases reinforced this approach. Under *Beauchamp v Woolworth*⁴⁰ a company took on a 5-year Swiss Franc loan to fund its trade, hoping to benefit from low interest rates. Unfortunately the Swiss Franc strengthened markedly against sterling and the courts concluded that the exchange loss was non-deductible – a tax “nothing”.
172. This approach to taxation was not well-suited to dealing with the commercial world, once exchange controls were abolished. Considerable complexity arose. In one seminal court decision, *Marine Midland*⁴¹, exchange differences on foreign currency loans made by a bank were not taxed, to the extent they were matched by losses on the bank’s foreign currency capital liabilities, which would normally fall outside the ambit of tax. In simplified terms, the basis of this decision was that, taking the two together, there was no profit. For some years after that taxpayers and tax authorities tried to apply this concept on the basis of a convoluted non-statutory “Statement of Practice”. The resulting uncertainty was one of the factors that led to an extended consultation process on how exchange differences of companies should be taxed in the modern world.

The 1993 and 1994 Finance Acts: the failure of a prescriptive approach

173. The consultation was a protracted process. This was partly because different industries had different problems and there was initially no consensus within the “Group of Nine” bodies that took part in the consultation. Companies liked some features of the old regime. The lack of taxation of gains and losses on long term foreign currency borrowings made it easier for companies to hedge exchange differences arising from foreign operations through subsidiaries: this feature was preserved by means of the first version of the “matching” regime (see 145 to 153 for the current position).

³⁹ Strictly, accounting periods beginning on or after 23 March 1995 and before 1 October 2002.

⁴⁰ *Beauchamp v FW Woolworth plc*, 61 TC 542

⁴¹ *Pattison v Marine Midland Ltd*, 57 TC 219

174. The new legislation, in Finance Act 1993, was drafted in a very mechanistic style: an attempt was made to recreate the accounting treatment as a set of statutory rules. There were, for instance, definitions of “accrual periods”, over which exchange differences were to be measured, intricate rules to determine what exchange rates should be used, designed to cope with hedge accounting, and ponderous rules for dealing with debts that varied in amount. As is the way in the UK, the legislation was interspersed with a scattering of anti-avoidance rules. The legislation was supplemented with complex transitional regulations and regulations to deal with special issues, such as matching. The poorly-drafted regulations did not always do, in practice, what the parties had agreed in the consultation process.
175. To make things even more complex, Finance Act 1994 introduced a new body of law, coming into effect at the same time as the FA 1993 rules, dealing with “Financial Instruments”, mainly derivatives for dealing with interest rate and foreign exchange risk. Again, the drafting was mechanistic. A reference was made to accounts to decide whether an authorised accruals or authorised mark to market approach should be used, but statutory rules determined what payments should be brought into account and when. Currency forward contracts and swaps straddled both regimes, but with black holes through which taxable profits could mysteriously disappear. For example, if a foreign currency borrowing and swap were accounted for as a single item, the tax treatment of the final settlement could differ according to whether settlement was by means of a single net payment or by exchange of the gross notional principal amounts in the two currencies, notwithstanding the economic equivalence of the two methods of settlement.
176. These regimes created traps for the unwary taxpayer and opportunities for creative tax planners. A degree of hindsight was sometimes possible, particularly under the transitional rules, and for instance paying down a balance to near to zero just before the end of an accounting period and paying it off in full could have radically different tax effects. There has been some litigation and the lower courts have demonstrated a tendency to interpret the legislation in a less than literal manner⁴², as a means to defeat such tax planning.
177. Also coming into to effect at broadly the same time, was the Loan Relationships code. The drafting style was clear and uncluttered and this body of legislation had a well thought out and coherent structure. The link to real accounts was much closer and taxable amounts were based on debits and credits in real accounts. There was just one snag. Exchange difference were carved out and dealt with under the prescriptive FA 1993 regime.

⁴² See, for instance the case of *Prudential Plc v Revenue and Customs Commissioners 2008 STC 2820* (Chancery Court decision, under appeal) concerning a currency swap which from an economic perspective included an embedded loan, the principal amount of which was claimed to be tax-deductible, which is working its way through the courts.

Major reform in 2002: getting much closer to the accounts

178. It became evident over the years that the FA 1993 and 1994 caused significant compliance costs for companies. They were also the aggressive tax planners favourite playing ground, almost certainly also responsible for a noticeable short-fall in corporation tax revenues. There was a pressing need for reform. Also, although the drafting of Loan Relationships legislation was good, in some cases the legislation had inappropriate effects, especially in relation to bad debts and related party rules. A further consultation process ensued and out of this came the Derivative Contracts legislation in FA 2002, structured very much along the same lines of the Loan Relationships code, which was in turn refined. The link to accounts was strengthened further, especially as regards the treatment of exchange differences.

2004, to date, adaptations for IFRS and fair value accounting

179. Unfortunately, just as the tax provisions were aligned with accounts, the accounting standard setters decided that major reforms were due. It was decided that the consolidated financial statements of companies listed on an EU stock exchange would have to be drawn up under IFRS. The IFRS standards were tightened up so that rather than allowing a variety of approaches, a single set of principles and standards would apply. The standards dealing with financial instruments, IAS 32 and 39 and with exchange differences, IAS 21 were substantially reformed. At the same time the UK accounting standards setters were aligning UK GAAP more closely with IFRS and some companies were required to apply FRS 26 and 23 aligned with IAS 39 and 21 in their single entity accounts – see 63 to 66.
180. Members of the FA 2002 consultation group eventually persuaded HMRC that these changes would have a major tax impact and that significant legislative change would be required to protect companies from excessive volatility in their taxable profits. This was the genesis of the IAS 39 consulting group, from which emerged the Disregard Regulations⁴³, so important to the tax treatment of FX hedges (see 120 to 153).
181. HMRC initially underestimated the difficulty of the task and the accounting standards were very late in stabilising. As a result the original Disregard and Change of Accounting Standards⁴⁴ Regulations have been amended many times. The general pattern of transition to IFRS on 1 January was not determined until the Regulations were amended, with retrospective effect (this was specifically provided for in the primary enabling legislation) in early December 2005.
182. The original intention of the Disregard Regulations was to preserve old UK GAAP for tax, even where companies had to apply IFRS or New UK GAAP in single entity accounts. The group has since persuaded HMRC that there

⁴³ SI 2004/3256

⁴⁴ SI 2004/3271

should be an alternative approach, based on following the entries in the income statement, disregarding amounts taken to equity band taxing them when recycled at least if companies. The advantage is that this greatly simplifies compliance; the downside is that companies have to keep their single entity account hedge designations tightly controlled and will experience tax volatility if hedges fail accounting effectiveness tests.

183. The process is not complete; the consultation group is still working on refining the rules, making them more coherent and dealing with loose-end difficult scenarios, such as hedging partnership interests or the operations of investments of partnerships.
184. It is fair to say that the consultation process has not been fully democratic or open; essentially the members of the group are self-appointed and the drafts are not open for full public consultation. However the process does seem to work and from it has emerged what is could be regarded as the world's most sophisticated and commercially appropriate tax regime for hedges of exchange risk.