



The Law Society

UK Resident Investment Companies: Currency for Tax Calculations

Response of the Corporation Tax Sub-Committee of the Tax Law Committee of the Law Society of England and Wales

Introduction

1. The Law Society is the representative body for over 140,000 solicitors in England and Wales. It negotiates on behalf of the profession, and lobbies regulators, Government and others.
2. We are pleased to have the opportunity to comment on the draft legislation dealing with UK resident investment companies: currency for tax calculations published on 9 December 2010.
3. This response has been prepared on behalf of the Law Society by members of the Corporation Tax Sub-Committee. The Sub-Committee is made up of senior and specialist tax lawyers from across the country.

Comments

4. We have the following comments.

Significant proportion

5. “Significant proportion” in the proposed sections 9A(2(a) and 9(A)(7) CTA 2010 is not currently defined in the draft legislation. We assume that its meaning will be clarified in guidance, in common with the use of that term in section 1010 CTA 2010 (see the guidance contained in 15503 of HMRC’s Company Taxation Manual).

Cliff edge test

6. Under the proposed section 9A(7)(a), an election will cease to have effect in an accounting period if “*at any time*” during that period a “significant proportion” of the assets and liabilities of the investment company cease to be denominated in the currency to which the election relates, and (broadly) another consolidated group company does not have that currency as its functional currency.
7. Notwithstanding the second limb (which will not be relevant at all to singleton investment companies), this seems a harsh and administratively burdensome test. Instead, we would suggest that the position is required to be considered at the balance sheet date or averaging is applied (c.f. section 262 TIOPA 2010 in the debt cap rules).

Anti-avoidance provisions

8. The proposed sections 328(2A) and 606(2A) CTA 2009 are intended to prevent “avoidance involving changes in the functional currency of an investment company” (see the HM Treasury document that announced the proposed legislation).
9. With that in mind, the provisions should only apply, in our view, to tax avoidance arrangements – and, more specifically, to arrangements which seek to exploit the loss relief that might otherwise result from a change in functional currency.
10. There are at least two good reasons for this, we believe.
11. First, under the provisions as currently drafted, a company may be taxed on an amount that does not reflect its true exchange gain.
12. For example, a company previously adopts Currency A as its functional currency in its accounting period beginning 1.1.2011 and acquires a loan asset during that accounting period which is denominated in Currency A. In the accounting period beginning 1.1.2012, the company designates Currency B as its functional currency under the new elective regime. It continues to own the loan asset until some point in the accounting period beginning 1.1.2014.
13. If the value of the loan asset in Currency B (the company’s new functional currency) is 155, 150 and 170 on 1.1.2012, 31.12.2012 and 31.12.2013 respectively, the company would recognise an exchange loss of 5 in its deemed accounts in the accounting period ending 31.12.2012 and an exchange gain of 20 in the accounting period ending 31.12.2013.
14. Importantly, however, the exchange loss of 5 would not have arisen “but for” the designation of the new functional currency and would apparently be denied tax relief under the anti-avoidance provisions mentioned above.
15. In contrast, the exchange gain of 20 would be brought into account in full in the next accounting period.
16. In other words, although the company’s aggregate exchange gain in these two accounting periods is only 15, it is taxed on 20. An investment company wishing to designate a functional currency for reasons unrelated to tax avoidance may be deterred from doing so as a result of these anti-avoidance provisions.
17. Our second reason for objecting to the absence of a tax avoidance filter in these provisions is that it will cut across the accounting/tax assimilation which the loan relationship and derivative contract rules are supposed to provide for (absent avoidance and other special circumstances).
18. In this regard, the proposed anti-avoidance provisions will not just apply where a functional currency is designated for tax purposes under the new regime. They will also apply where a “company with investment business” is required to adopt a new functional currency under accounting standards such as FRS 23 (see proposed sections 328(2A)(b) and 606(2A)(b) CTA 2009).
19. As a result of the application of these provisions, however, if such a company recognised exchange gains or losses under loan relationships and derivative contracts in the first accounting period in which the new functional currency was adopted, those exchange gains and losses would be ignored for tax purposes. It would not matter, moreover, whether the company had artificially manipulated the accounting rules in order to create a tax advantage.

20. This departure from the company's accounting treatment seems anomalous and potentially unfair. It is also likely to make the preparation of tax returns by affected companies more burdensome.

Company with investment business

21. The anti-avoidance provisions mentioned above and the legislation in general will apply to "investment companies" or "[companies] with investment business", which in both cases are defined under section 1218 CTA 2009 as companies whose business consists wholly *or* partly of making investments. Companies which predominantly carry on a trade but which also hold investments (for example shares in a subsidiary) could, therefore, fall within this definition.
22. In consequence, the proposed facility for "UK resident investment companies" to designate functional currencies for tax purposes may extend beyond what one would usually regard as investment companies, which we would not object to.
23. Equally, however, the anti-avoidance provisions mentioned in the preceding paragraphs will also have a wider ambit, including the provision that will apply on a mandatory adoption of a new functional currency (see 15 above). For this reason, it seems even more important to ensure that those provisions only apply to genuine avoidance arrangements.

Contact details

If you have any questions on these representations, please contact Chair of the Corporation Tax Sub-committee, Lydia Challen of Allen & Overy (tel: 020 3088 2753, e-mail: lydia.challen@allenoverly.com).

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