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By post and by email (ellen.milner@hmrc.gsi.gov.uk)

Dear Madam

Revenue Law Committee response to 20 July 2012 Consultation Document on Foreign Currency Assets and Chargeable Gains

The City of London Law Society ("CLLS") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response has been prepared by the CLLS Revenue Law Committee.

We are grateful for the opportunity to respond to the Consultation Document. Members of the committee did not feel in a position to answer every question posed by the Consultation Document, and we have therefore only covered certain areas.

In general, we support this proposal. Our members have experience of a number of scenarios where clients have been prevented from winding-up dormant non-sterling functional currency subsidiaries because of latent sterling denominated chargeable gains which do not reflect real economic gains.

Consideration 2: which assets should any change cover?

We agree that this change should apply to shares.

However, we also consider that there are certain other types of assets in relation to which similar problems arise - in particular, ships and aircraft. Ships and aircraft are commonly held through special purpose companies which have a US dollar functional currency. This is because ships and aircraft are generally valued in US dollars and often generate US dollar denominated income streams. We note that ships and aircraft (along with shares) benefit from special treatment in relation to hedges of foreign exchange risk under regulations 3 and 4 of the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004.

Applying this rule to ships and aircraft would not only mean that chargeable gains and allowable losses arising in relation to ships and aircraft would reflect real economic losses and gains, but would also resolve an inconsistency between the basis upon which chargeable gains and capital allowances are computed. Under current law, chargeable gains are computed in sterling whereas capital allowances are computed in the company's functional currency. For a sterling functional currency company, the chargeable gains and capital allowance computations interact in a broadly coherent manner: to the extent that sale proceeds exceed tax written down value then the tax relief already claimed (representing the difference between original cost and tax written down value) will be clawed back through the capital allowances computation and any excess of sale proceeds over original cost will give rise to a chargeable gain.

However, this interaction is not coherent for a US dollar functional currency company because the claw-back of capital allowances will be capped at the US dollar denominated original cost whereas chargeable gains will be computed by reference to a sterling base cost. If sterling has depreciated against the US dollar (such that the US dollar denominated original cost for capital allowance purposes exceeds the sterling denominated base cost for chargeable gains purposes) then both a chargeable gain and a balancing charge could arise in relation to the excess of the US dollar denominated original cost over the sterling denominated base cost. Similarly, if sterling has appreciated against the US dollar (such that the sterling denominated base cost for chargeable gains purposes exceeds the US dollar denominated original cost for capital allowance purposes) then neither a chargeable gain nor a balancing charge would arise in relation to the excess of the sterling denominated base cost over the US dollar denominated original cost.

We can see some merit in this rule applying not only to shares but also to ships and aircraft, and perhaps more generally to all assets in respect of which capital allowances can be or have been claimed.

Consideration 3: should any new rule be mandatory for all companies brought within the rule or should the regime be elective?

We consider that a distinction should be drawn between assets acquired before the date on which this rule change takes effect and assets acquired thereafter.

In terms of assets acquired after the date on which this rule change takes effect, we have no strong preference between a mandatory or an elective regime; although we would note that since one of the professed aims of this change is the simplification of the chargeable gains rules a mandatory regime may be preferable. There may be some merit in avoiding the scenario where some companies use sterling to compute chargeable gains while others use their functional currency.

In terms of assets acquired before the date on which this rule change takes effect, our concern with a mandatory regime would be that the rule change could create or increase uncrystallised chargeable gains which do not currently exist. For example, suppose a

company holds US dollar denominated shares which were acquired for US$100 and currently have a US dollar denominated value of US$110, but the sterling denominated base cost is £65 and the current sterling denominated value is also £65. Under current rules the company could dispose of those shares at market value without triggering a chargeable gain, whereas if these new rules were introduced mandatorily then a disposal at market value would trigger a US$10 chargeable gain.

We would accept that a mandatory regime for new assets and an elective regime for existing assets may over-complicate matters and not achieve the simplification which is intended for tax-payers. Perhaps this over-complication could be resolved by introducing a mandatory regime, but permitting groups to elect that their sterling base costs for assets acquired before the date on which the rule change takes effect should be converted into the relevant functional currency using the spot rate as at the date on which the rule change takes effect, as opposed to using the spot rate as at the date the relevant expenditure was incurred. Using the example set out in the previous paragraph, if the company were to make this election then the base cost of the US dollar denominated shares would be converted from £65 to US$110 rather than from £65 to US$100 – the rule change would not create an uncrystallised chargeable gain where previously there had been none, and going forward chargeable gains and allowable losses would be computed in US dollars rather than sterling. We accept that it may be necessary for such an election to be made on a group-wide basis in respect of all assets held by the group.

Consideration 4: what rules are required if a company's functional currency changes?

Paragraph 3.18 of the Consultation Document provides that:

> *"from the date of the functional currency change, the Government proposes that the new functional currency should be used to compute chargeable gains and losses on shares."*

It was not clear to us from the Consultation Document the precise basis upon which the Government envisages that the new functional currency would be used to compute chargeable gains and losses. We have considered two different bases upon which the new functional currency could be used to compute chargeable gains and losses.

By way of example, suppose a company has a euro functional currency and acquires certain sterling denominated shares for £100 which, at all relevant times, have a market value of £100. Suppose further that the company changes its functional currency to US dollars and then disposes of the shares for £100. The following table sets out illustrative sterling, euro and US dollar values of the shares as at the date of acquisition, as at the date on which the company's functional currency changes and as at the date of disposal.

	Acquisition	**Functional currency change**	**Disposal**
Sterling value	£100	£100	£100
Euro value	€150	€160	€170
US dollar value	$170	$160	$150

The first basis would be to use the US dollar denominated acquisition cost and disposal proceeds, resulting in an allowable loss of US$20. We would note that this basis would in effect mean that an allowable loss of US$10 would be attributable to the period between acquisition and change of functional currency notwithstanding that during that

period the company operated in a euro economic environment and the shares stood at a €10 economic gain. This basis, if taken to extremes, could give rise to anomalous results. Taking a different example, suppose that a sterling functional currency company had held sterling denominated shares worth £100 for a significant period, say 20 years, and that during that 20 year period the shares stood at neither a gain nor a loss. Suppose further that the company changes its functional currency into a currency which during those 20 years had been through a period of hyper-inflation, such that £100 was worth 100 units of that currency 20 years ago but 1 million units of that currency today. If the company were to sell those shares even a day after it changes its functional currency it would crystallise a gain of 999,900 units of the new currency. This should be contrasted with the position where the company had sold the shares the day before it changes its functional currency; in which the case the disposal would give rise to neither a gain nor a loss.

The second basis reflects the fact that the shares stand at a gain of €10 as at the date on which the company changes its functional currency and that going forward the chargeable gains and allowable losses should be computed in the new US dollar functional currency. This could be achieved by either (i) converting the €150 base cost into US dollars at the spot rate as at the date on which the company changes its functional currency (i.e. giving a base cost of US$150) or (ii) holding over a US$10 gain and deeming the company to have a base cost equal to the US dollar market value of the shares as at the date on which the functional currency changes (i.e. a base cost of US$160). Either way, the US$10 gain attributable to the period up to the date on which the functional currency changes would match the US$10 loss attributable to the subsequent period leaving a net position of neither a loss nor a gain.

On the basis of the anomalous results which could arise from the first basis, we would have a preference for the second basis.

One point we would note is that the basis upon which indexation allowance is currently computed for chargeable gains purposes would not obviously be appropriate for non-sterling functional currency companies. The UK retail prices index would not necessarily reflect the extent to which changes in the value of an asset denominated in a non-sterling currency are attributable to inflationary gains as opposed to real gains. This point may be particularly relevant where a company has a functional currency the real value of which depreciates significantly during hyper-inflationary periods, giving rise to large nominal gains where there is only a small or no real gain.

Another point to consider is the interaction between this new rule, the Exchange Gains and Losses (Bringing into Account Gains or Losses) Regulations 2002 and the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004. By way of example, suppose a sterling functional currency has hedged its foreign exchange exposure to its US subsidiary by entering into a currency derivative. If it were to change its functional currency to US dollars it may well want to close-out the derivative. It seems to us that under the Exchange Gains and Losses (Bringing into Account Gains or Losses) Regulations 2002 the disregarded gains or losses made on the derivative would be denominated in sterling and as currently drafted would be carried forward as a sterling amount. However, the mirror uncrystallised losses or gains made on the shares in the subsidiary as at the date of the functional currency change would in effect be converted into a US dollar amount. Movements in the sterling/US dollar exchange rate between the date of the change in functional currency and the date of disposal of the shares would therefore mean that carried forward sterling gains or losses made on the derivative and the uncrystallised US dollar losses or gains made on the shares in the subsidiary may not match when the shares are disposed of. This problem could be resolved by including a provision in the

Exchange Gains and Losses (Bringing into Account Gains or Losses) Regulations 2002 to the effect that disregarded loan relationship or derivative contract foreign exchange gains and losses should, at the time the company changes its functional currency, be converted into the new functional currency at the spot rate as at that time.

Consideration 5: are special rules required for groups?

We agree with paragraphs 3.19 to 3.21 of the Consultation Document in relation to the basis upon which this rule should apply to transfers within a group.

However, we do not see how (if an elective regime were used) these rules could be manipulated by transferring assets between group members who continue to calculate their chargeable gains in sterling and group members who have elected to calculate their chargeable gains in their functional currency. The position should be the same as would subsist where (under a mandatory regime) assets are transferred between group members with a sterling functional currency and group members with non-sterling functional currencies.

In terms of whether or not a targeted anti-avoidance rule would be needed, our view is that this would not be necessary given the anti-avoidance rules already included in the Taxation of Chargeable Gains Act 1992 (for example, at section 16A) and given the proposal for a new general anti-abuse rule. If, notwithstanding this, a targeted anti-avoidance rule were considered to be appropriate, we consider that a significant amount of care would need to be taken to ensure that such a rule were properly targeted. In particular, we would envisage that groups may well look to transfer assets denominated in a particular currency to group members with the same functional currency specifically for the purpose of managing their exposure to tax arising from foreign exchange movements. A broad anti-avoidance rule which, for example, applies whenever one of the main purposes of an intra-group transfer is to avoid a potential chargeable gain would arguably apply in relation to this sort of reasonable tax planning.

We hope that the above responses are helpful.

Yours faithfully,

Bradley Phillips
Chair
The City of London Law Society Revenue Law Committee

THE CITY OF LONDON LAW SOCIETY
REVENUE LAW COMMITTEE

Individuals and firms represented on this committee are as follows.

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