
FOREIGN EXCHANGE LOSSES: TARGETED ANTI-AVOIDANCE RULE

Who is likely to be affected?

1. Companies that hold investments in “foreign operations” – subsidiaries or other business enterprises that operate in a different currency to the company.

General description of the measure

2. A number of tax avoidance schemes have been disclosed to HM Revenue & Customs that abuse the provisions for “foreign exchange (forex) matching”. Legislation will be introduced in Finance Bill 2009 to stop such schemes by providing that exchange gains or losses on borrowings or currency derivatives can only be “matched” if they do not arise from tax avoidance arrangements.
3. Two specific types of scheme are targeted. The first type – “one way bets” – involves arrangements that create an allowable foreign exchange loss if a foreign currency moves in one direction, but do not give rise to a taxable gain if the currency moves in the opposite direction. The second type tries to give a company a tax deduction for a forward premium on a forward currency contract – a loss dependent only on interest rates – without the counterparty being taxed on a corresponding profit.

Operative date

4. The measure will apply to company accounting periods beginning on or after 22 April 2009. Where an accounting period straddles 22 April 2009, it will apply only to exchange gains or losses arising between 22 April 2009 and the end of the period.

Current law and proposed revisions

5. Companies that have an investment in a foreign operation will normally hedge the resultant foreign exchange risk. For example, if a company which draws up its accounts in sterling holds shares in a US subsidiary, the value of its investment on its balance sheet will change if the US dollar weakens or strengthens against sterling. If it borrows in US dollars, or

enters into a US dollar currency derivative, the exchange gains or losses on the shares will be offset by corresponding losses or gains on the loan or derivative. But this creates a mismatch for tax purposes, because the exchange differences on the hedging instrument are taxable, whereas those on the shares are not. The distortion is eliminated by special “forex matching” rules that do not tax exchange differences on the loan or derivative until the shares are sold.

6. These forex matching rules have been exploited for avoidance purposes. Typical arrangements involve the use of options or similar instruments, such that an exchange gain is sheltered by forex matching, whereas if the foreign currency moves the other way, there is no such elimination of a forex loss. Some schemes of this type were countered by secondary legislation in 2006 (SI 2006/843), but new schemes circumvent these rules.
7. This measure revokes SI 2006/843 with effect from 22 April 2009, and replaces it with a more wide-ranging provision. Under this provision exchange gains or losses on derivative contracts are not eligible to be matched in two circumstances.
8. The first of these is if there is a “one-way exchange effect”. This is where an asymmetry exists between the exchange gains or losses to be brought into account by the “matching” company and companies connected with it, and those which would arise had the foreign currency moved in the other direction to the same extent. But the anti-avoidance rule will not apply if the asymmetry does not bring about any tax advantage, or if it does not result from forex matching.
9. The second restriction excludes from forex matching any element of an exchange gain or loss on a derivative that is not computed with respect to spot rates of exchange. This means that “forward points” on a currency contract, which depend only on the interest rate differential between the two currencies involved, are not eligible for matching.
10. There are provisions about forex matching both in primary legislation and in secondary legislation (SI 2004/3256 – the so-called “Disregard Regulations”). A Statutory Instrument to apply the new rules to matching under the Disregard Regulations will be laid after Finance Bill 2009 receives Royal Assent.

Further advice

11. If you have any questions about this change, please contact Sue Davies on 020 7147 2565 (email: sue.davies2@hmrc.gsi.gov.uk) or Aidan Reilly on 020 7147 2575 (email: aidan.reilly@hmrc.gsi.gov.uk). Information about Budget measures is available on the HM Revenue & Customs website at www.hmrc.gov.uk