

# **REGULATORY IMPACT ASSESSMENT FOR REFORM OF THE CORPORATE DEBT, FINANCIAL INSTRUMENTS AND FOREIGN EXCHANGE GAINS AND LOSSES REGIMES**

## **Introduction**

1. By the late 1990s, it was evident that the existing legislation on corporate debt, financial instruments and foreign exchange gains and losses, while in general working well, was suffering from a range of specific problems and was introducing distortions into business practice and decision making. A comprehensive review of the legislation was therefore announced in 2000.

## **Purpose and Intended Effect**

2. The reforms introduce a modernised and simplified regime for the taxation of loan relationships, derivative contracts and foreign exchange gains and losses which:

- extends the scope of the financial instruments regime to give certainty of tax treatment to most derivative contracts;
- enables companies to get relief for bad debts in a wider range of circumstances than presently possible; and
- merges the legislation on foreign exchange gains and losses into the loan relationships and derivative contracts rules.

3. The reforms eliminate over 200 pages of financial instruments and foreign exchange gains and losses legislation replacing them with approximately 70 pages of new legislation.

## **Risks**

4. An important aim of the proposals is that they should not restrict market freedom to develop innovative financial products. The consultation on the proper scope for this legislation addressed this concern and has also led to a set of rules which are more closely aligned with UK GAAP. Improving the alignment between accounting and tax rules will reduce the occasions where tax computations require a departure from the profit or loss shown in accounts, making it easier for business to meet its tax obligations than at present and so reducing compliance burdens and associated costs.

5. The reforms will impose compliance burdens on business as it comes to grips with the new rules. However, business currently has to cope with three separate and complex sets of legislation so any risk of avoidance, misunderstandings or simple non-compliance will be substantially reduced in the longer term by the simpler and more straightforward regime now being introduced.

## **Options**

6. There are essentially two options: do nothing and continue with the present regime; or introduce major reforms. This section summarises the reasons for rejecting the do nothing option and introducing reforms.

## **No Change**

7. Business has reported a range of problems experienced in complying with the requirements of the three existing regimes. In particular, the existing financial instruments legislation does not accommodate the range of new instruments the market has developed since the legislation was introduced in 1994 and the loan relationships rules create particular difficulties relating to bad debts where the debtor and creditor are connected.

8. Given the wide ranging nature of the problems being encountered and the extent to which the existing regimes are the target of avoidance schemes, a no-change option is not feasible.

## **Regulatory Reform**

9. The Government concluded that regulatory reform is essential in order to address the major problems within the existing regimes as well as a number of second order issues. The responses to the consultative documents make clear that the business community supports reform.

## **Benefits**

10. Current legislation requires companies to identify and make a variety of adjustments to their accounts figures when preparing their corporation tax return. This involves them in additional costs for administration and specialist advice. The proposals will significantly reduce this burden and make it easier for companies to pay the right amount of tax at the right time. There is no data currently available about the amount that taxpayers pay on either their own administration or for expert assistance. It has therefore not been possible to quantify the savings companies will make as a result of the reforms.

11. The limited scope of the financial instruments rules has caused problems for companies. It has created situations where companies have had to create unnecessarily complicated commercial arrangements to achieve certainty of tax treatment. The changes, in particular the much wider scope of derivative contracts, will enable business to enter into simpler arrangements thereby reducing costs and removing uncertainties.

## **Business Compliance Costs**

12. There are some 800,000 companies subject to the current regimes. However, we believe the majority of these companies will be unaffected by the proposed changes because they do not engage in transactions involving foreign currency or derivative financial instruments. The most significant impact will be on the larger companies and groups.

13. Those companies affected by the reforms will have to spend time and money ensuring that accounting and tax systems are modified where necessary, though

this will largely involve a simplification of existing systems. There will also be staff training costs and possibly a need to obtain specialist advice on the application and impact of the new regime in particular circumstances.

14. Statutory departures from the figures of profit and loss reported in accounts are kept to a minimum within the new regime. One departure is the non-elective matching regime. Whilst this will remove the need to make an election, groups were concerned at the possible compliance burden imposed in tracking matched assets to disposal. The Inland Revenue is developing a solution in consultation with representative bodies and tax professionals in order to provide a sensible and cost effective answer to the problem.

### **Inland Revenue Costs**

15. There is unlikely to be any major impact to Inland Revenue administration costs. There will be some costs for training and revised guidance material. The simplifications proposed should reduce the time taken to review individual company returns.

### **Impact on Small Business**

14. We believe the proposed changes will have little impact on small business in the normal course of their activities. Many small businesses will be sole traders or partnerships and so will not be affected by these measures which only apply to companies. Reform of the loan relationships regime includes measures which will facilitate the financial support and rescue of companies in financial difficulties and may therefore be of assistance to smaller companies.

### **Securing Compliance**

15. The main changes will take effect from 1 October 2002. This will give time to finalise guidance on the new regime as well as giving business time to modify their existing systems and in-house guidance and training. The Inland Revenue intends to published draft guidance in the summer and invite business to comment on its content.

### **Consultation**

16. The process of consultation was begun in 2000. Two Technical Notes and a Consultative Document have been published, the most recent being the Technical Note of 19 December 2001, entitled "Loan Relationships, Derivative Contracts and Foreign Exchange Gains and Losses", for which the consultation period closed on 15 February 2002. Responses were received from representative bodies, tax professionals and individual companies. They showed overwhelming support for the broad thrust of the reforms. In addition, the reforms have greatly benefited from a number of meetings and workshops held to discuss key issues and concerns.

## **Monitoring and Evaluation**

17. The Inland Revenue proposes to form a working group with representative bodies to monitor and review the impact of the reforms after implementation.

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## **REGULATORY IMPACT ASSESSMENT**

### **Reform of the Corporate debt, Financial Instruments and Foreign Exchange Gains and Losses regimes**

#### **Statement of Ministerial Approval**

I have read the regulatory impact assessment and I am satisfied that the benefits  
justify the costs.

Signed by the responsible Minister:

A handwritten signature in black ink, appearing to read 'Dawn Primarolo', written in a cursive style.

Dawn Primarolo  
Paymaster General

Date: 15 April 2002