EXPLANATORY MEMORANDUM TO

THE EXCHANGE GAINS AND LOSSES (BRINGING INTO ACCOUNT GAINS OR LOSSES)(AMENDMENT) REGULATIONS 2010

2010 No. 809

1. This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs ('HMRC') and is laid before the House of Commons by Command of Her Majesty.

2. Purpose of the instrument

2.1 The Regulations amend The Exchange Gains and Losses (Bringing into Account Gains or Losses) Regulations 2002, SI 2002/1970 ("the principal Regulations"). The principal Regulations provide for exchange gains or losses on loans or derivatives which hedge foreign exchange risk from a company's investment in a foreign enterprise, and which have previously been disregarded for corporation tax purposes, to be brought back into account in specified circumstances. These amendments change the way in which this is achieved. The purpose of so doing is to eliminate anomalies in the interaction between the principal Regulations and the Taxation of Chargeable Gains Act 1992 ("TCGA 1992")

3. Matters of special interest to the Select Committee on Statutory Instruments

3.1 Please see paragraphs 4.5 and 4.6 below about the limited retrospective effect of the Regulations in a particular case.

4. Legislative Context

4.1 The Regulations are made under powers conferred by sections 328(5)-(7) of the Corporation Tax Act 2009 in relation to loans, and sections 605(5)-(7) of the same Act in relation to derivatives, supplemented by section 151E TCGA 1992 and paragraph 26(5) Schedule 23 Finance Act 2002.

4.2 Where a company makes an investment in a "foreign operation" (a subsidiary, branch or other entity that conducts its business in a different currency) it is common for the company to hedge the resulting foreign exchange risk by borrowing, or becoming party to a derivative, in the same currency. For corporation tax purposes, exchange differences on the hedging instrument are brought into account only when the company disposes of the hedged item, which may be shares or a long-term loan.

4.3 Under the principal Regulations, the aggregate amount of exchange differences that have previously been disregarded are brought back into account as an income gain or loss where the investment takes the form of a loan, or as a chargeable gain or allowable loss where the company holds shares. In this latter case, the gain or loss is "free standing" – although it is triggered by the disposal of an asset, it does not arise from that disposal. Since

the capital gains code is, in very broad terms, about the disposal of assets, the interaction of this provision with the main TCGA 1992 rules can create difficulties.

4.4 These amending Regulations do not affect the quantum of exchange gains or losses that are brought back into account. They do, however, change the method of so doing. Where, overall, an exchange gain has previously been left out of account, it is brought back into account by being added to the disposal consideration for the shares (and not as a free-standing chargeable gain). Similarly, an exchange loss is subtracted from the disposal consideration (and does not give rise to a free-standing allowable loss).

4.5 Where shares are transferred to another group company there are, however, no tax consequences: the transfer is, under chargeable gains rules, at "no gain/no loss". Under the principal Regulations, a chargeable gain or allowable loss crystallised on such a no gain/no loss disposal, but was not brought into account until there was a disposal of the shares to an external party. The changed treatment under these Regulations applies to such gains or losses which have already crystallised, but have not yet been taxed or relieved. The operation of the Regulations is therefore retrospective to this limited extent.

4.6 For the most part, this will either benefit companies or be neutral, but in a minority of cases a company could be disadvantaged (because of the interaction of these "bringing into account" rules with capital gains indexation allowance). For this reason, the Regulations provide for a company to be able to elect to continue to apply the old rules to gains or losses that have already crystallised as a result of a previous no gain/no loss disposal of shares.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

- ***What is being done and why***

7.1 Schedule 12 of the Finance Act 2009 changed and extended the TCGA 1992 provision allowing groups of companies to reallocate chargeable gains or losses to another company in a group. Reallocation under the new rule is, however, only possible where the gain or loss arises from a disposal of an asset. It did not apply to the "free-standing" chargeable gains or allowable losses that arose under the principal Regulations. This meant that some groups of companies might, on making a disposal of shares, have less flexibility in allocating gains or losses than had previously been the case.

7.2 These Regulations have effect in a case where a company makes a disposal of shares, and exchange gains or losses relating to a hedging instrument fall to be brought into account under the principal Regulations. The amendments mean that these exchange differences are brought back into account by adjusting the amount treated for chargeable gains purposes as disposal consideration for the shares. In effect, the shares and the hedging instrument are treated as if they were a single instrument. This reflects the underlying commercial and economic reality.

7.3 The change in treatment means that various provisions of TCGA 1992 work more fairly and logically in relation to such share disposals. This applies particularly to the new group reallocation rule mentioned above, but it also applies to the computation of indexation allowance. An additional consequence of the change is that it eliminates the need for the principal Regulations to contain special rules to deal with cases where the shares are exchanged for shares or securities as part of a reorganisation of share capital. This makes the principal Regulations significantly simpler.

7.4 There are no current plans to consolidate these Regulations.

8. Consultation outcome

8.1 HMRC and HM Treasury have a consultative group (the "IAS 39 Working Group) that looks at the tax treatment of financial instruments generally, particularly at the interaction with accountancy rules. A sub-group of accountants, lawyers and tax managers has given in-depth consideration to the tax rules relating to the hedging of investment in a foreign operation. The proposed amendments to the principal Regulations were discussed at an early stage with this sub-group. In addition, these Regulations were circulated in draft to members of the IAS 39 Working Group for comment.

8.2 All consultees welcomed the amendments being made and the method of making them. No change has therefore been made to the underlying policy, and only minor changes have been made to the drafting of the Regulations as a result of the consultation.

9. Guidance

9.1 HMRC will amend the existing guidance on principal Regulations to reflect the changes made by these Regulations.

10. Impact

10.1 The impact on business is limited since the Regulations will only have an effect where a company disposes of shares in a subsdiary; the investment in the subsidiary has given rise to foreign exchange risk, which has been hedged; and Substantial Shareholding Exemption does not apply to the disposal. Such transactions are not frequent. Where they do occur, however, the effect of the Regulations is positive since they eliminate anomalies in the capital gains

treatment of such disposals and make the “bringing into account” rules simpler to apply.

10.2 There is no impact on the public sector, or on charities or voluntary organisations.

10.3 For these reasons, no Impact Assessment has been prepared.

11. Regulating small business

11.1 The legislation will not in practice apply to small business, since the circumstances described at 10.2 above do not arise in the context of small companies.

12. Monitoring & review

12.1 HMRC will continue to consult the Working Group referred to above in order to identify any difficulties in the operation of these Regulations.

13. Contact

Sue Davies at HM Revenue and Customs (Tel: 020 7147 2565 or email: sue.davies2@hmrc.gsi.gov.uk) can answer any queries regarding the instrument.