Jill C Pagan

TAXATION ASPECTS OF CURRENCY FLUCTUATIONS

Second Edition

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Taxation aspects of currency fluctuations

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Preface

It is now twenty years since August 1971 when the US Treasury terminated the link of the US dollar to gold, thus signalling the end of the Bretton Woods Agreement which had fixed exchange rates from 1948. By 1973, floating exchange rates were a fait accompli. No tax system had been designed with floating exchange rates in mind, and international businesses had to cope not only with the trials of operating with floating exchange rates, but also with the (often unappreciated) problem that the tax treatment did not necessarily follow the economic reality.

Nowhere was the divergence between economic reality and the basis of taxation more marked than in the United Kingdom, which operates an Anglo-Saxon style tax system with the capital/revenue divide enshrined for both corporate and individual taxation. Other countries using an Anglo-Saxon style system, including the United States and Australia, subsequently introduced amendments to their tax systems so as to reflect the economic reality of floating exchange rates on international corporate activity. Today, the United Kingdom stands alone as the one major trading nation with a tax system that does not recognise the commercial and economic realities of foreign exchange risk.

While the first edition of this book was in preparation, the *Marine Midland* case was wending its way through the courts and it was generally accepted that discussions on reform of the United Kingdom tax system would not be progressed until after the House of Lords had had its say. There was a need to set out the difficulties inherent in the tax system.

In the event, it has taken eight years since the final judgment in the *Marine Midland* case for proposals for a new tax system for corporate taxation of exchange gains and losses to emerge. It seems clear that, even if the proposals are adopted, the new system will not apply before some time in 1993 and, given the forthcoming General Election, this could be even later. International businesses must therefore continue not only to cope with the difficulties of the present tax system, but to keep an eye on progress towards a new tax system, for there will be a number of special problems associated with the changeover. Flexibility is the keynote.

The purpose of this second edition is threefold. First, to update the previous edition to take account of general changes to the tax system since 1983. Second, to include analysis of the foreign exchange products and techniques which have since developed in the light of floating exchange rates. Third, to highlight the thrust of the proposals for a new system of taxation and to identify areas which may be candidates for problems at changeover date.

I would like to thank all my clients over the years who have kept me interested in this subject by bringing a varied set of problems. A thank you also to that small band of fellow professionals who have contributed to the consultations and discussions in this area. It is appropriate to single out for mention my old friend and now colleague John Chown who has been ever ready to contribute an economist's point of view, and Roger White who has brought a lively mind and an accountant's expertise to our discussions. Special thanks are due to Ian Marsh who cheerfully constructed numerous models on exchange rate movements, explained clearly the implications of the European Exchange Rate Mechanism and produced the charts for Chapter 1. Nevertheless, the views expressed and the conclusions drawn in this book are entirely my own.

Finally my thanks go to my husband, Hugh, and two sons, Robert and Thomas, who continue to give much appreciated moral support.

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October 1991

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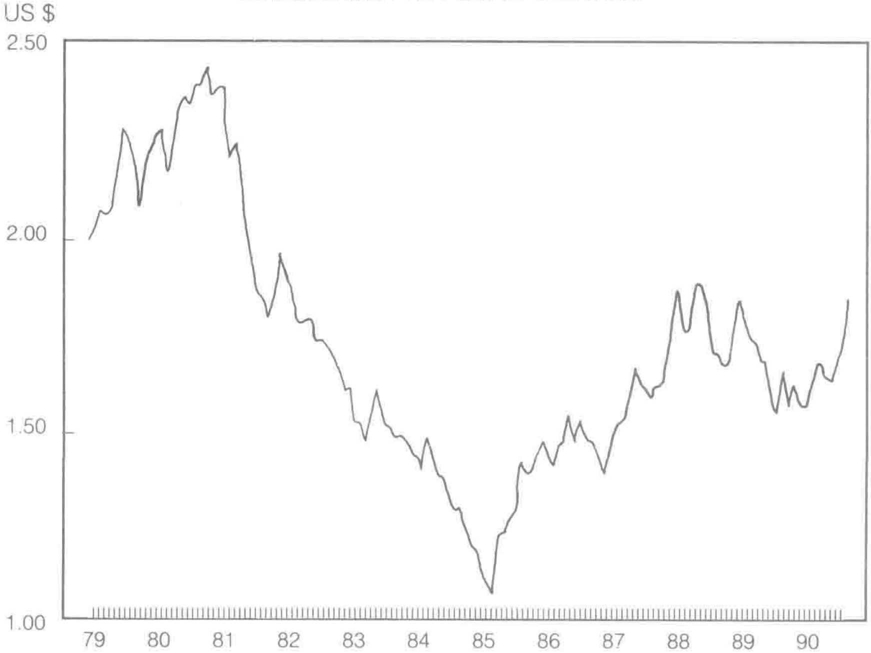
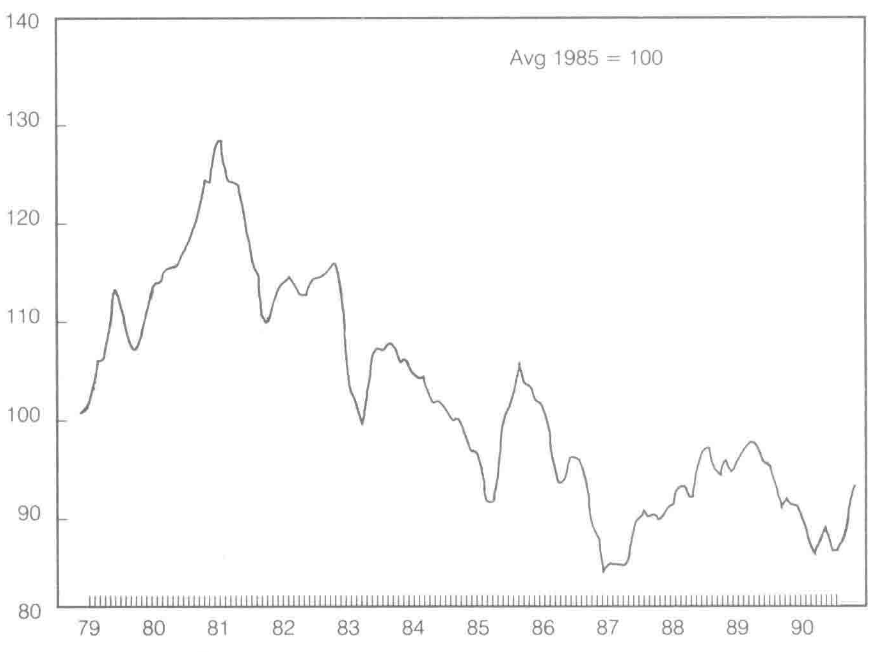
FIGURE 1

US DOLLARS PER POUND STERLING



STERLING TRADE WEIGHTED INDEX



Compiled by: Ian W Marsh BA(Hons) MSc, J F Chown & Company Limited

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CHAPTER 1
Basic elements

1.1 Background to currency fluctuations

Fluctuations by major currencies are a phenomenon of the twentieth century. Until 1914 and the First World War they were almost unheard of and certainly not a worry to the major developed countries. The pound sterling was on the gold standard, which meant that it was agreed to be worth an agreed weight in gold and anyone holding a pound note could go along to the Bank of England and swap it for an equivalent amount of gold. People worldwide had confidence in gold and would have confidence in paper money as long as it had a fixed exchange rate in relation to gold. Hence the saying 'as good as gold'.

The gold standard was suspended during the First World War and then reintroduced in a modified form in 1925. The modified form did not work and in 1931 the United Kingdom abandoned the gold standard for good. The 1930s saw a period of free floating currencies with all the attendant problems. The advent of the Second World War turned the major powers' minds to other things, and it was not until the end of that war that the goverments of the trading nations of the free world decided that the problems of currency exchange rates had to be tackled.

It was against this background that the leading monetary experts came together in 1945 at Bretton Woods in the United States to seek a solution and stabilise the external values of the world's main currencies. The Bretton Woods Agreement turned out to be an incredible success and, for a period of almost twenty years from 1948, the external values of the currencies of the leading nations remained remarkably stable. The basis of the Agreement was to replace the pure gold standard with a dollar gold standard and the International Monetary Fund (IMF) was established to administer the system. All forty-three countries setting up the IMF agreed a fixed exchange rate between their currency and the US dollar.

In the late 1960s several of the major currencies had to break away from the limits agreed with the IMF (the United Kingdom devalued the pound in 1967) and in 1971 the US Treasury decided to break the link between the dollar and gold. Once again the world's leading countries came together to try and hammer out a new agreement; this time they met at the Smithsonian

Institute in Washington. Unfortunately, the Smithsonian Agreement met with little success and in 1973 the major international currencies one by one floated freely on the world's money markets.

Throughout the 1970s there were several attempts to stabilise external exchange rates of the major currencies, none of which enjoyed any measure of success. By the 1980s the European Economic Community (EEC) had established the Exchange Rate Mechanism (ERM) within the European Monetary System (EMS) which worked on the basis of the currencies of EEC member states floating within a narrow range against a defined basket of EEC currencies (see **1.2**). Attempts to find a solution for all major currencies seem to have been put on the back burner, though one school of thought is that the twenty-first century will see the international trading community copying an international system on EMS/ERM lines centring around three major currency blocks, the US dollar, the EMS and the Japanese yen. For those who want to read further on the reasons for and mechanics of currency fluctuations, *All you need to know about Exchange Rates* by Howard Flight and Bonita Lee-Swan (Sidgwick & Jackson 1988) provides a readable and useful account for the non-specialist.

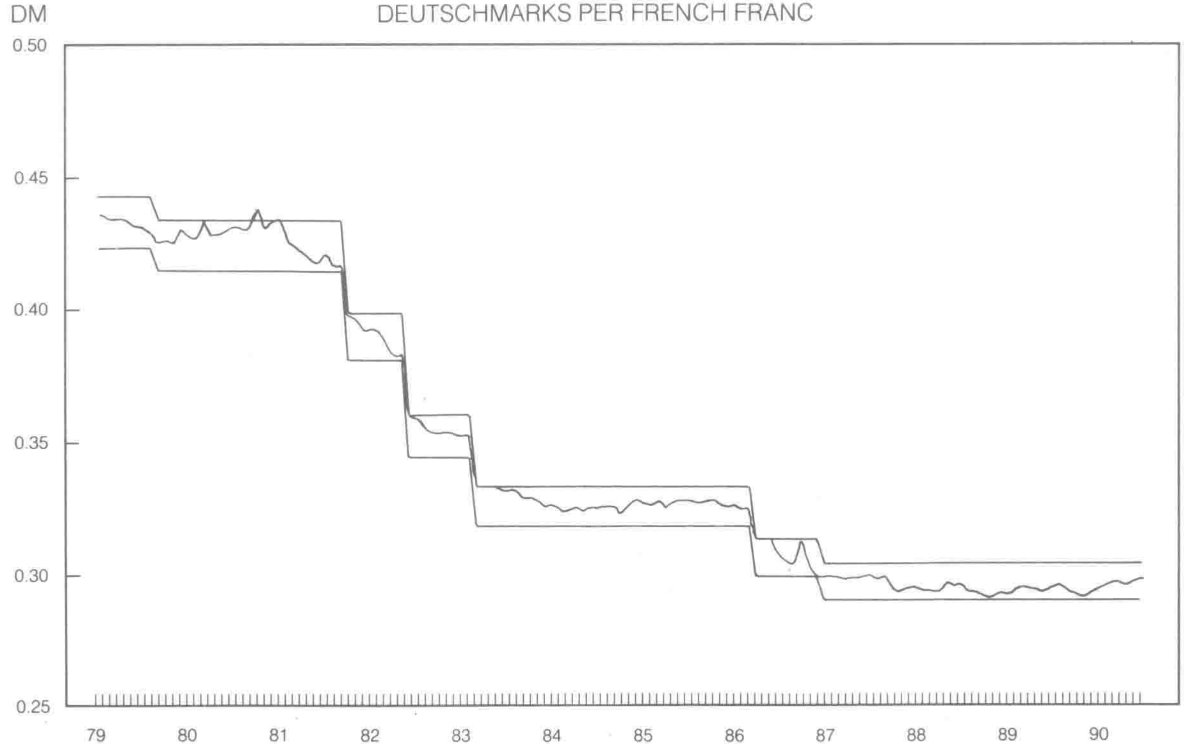
The fact is that currency fluctuations have become a way of life and need to be understood and taken into account in all commercial and investment decisions. A movement of a few percentage points can have a disastrous result on profit forecasts or on cash-flow needs. While currency fluctuations are necessarily about gains as well as losses, experience has shown that a weakening pound sterling does not go hand in hand with a strengthening economy and therefore currency losses are likely to arise at a particularly difficult time.

The problems of dealing with currency fluctations are not helped by the goverments of the major trading nations failing to think through and amend their taxation provisions in relation to exchange gains and losses. On the whole the Continental style system of taxation (eg as used by Germany, France and the Netherlands) which uses a net annual revaluation basis to determine corporate profit recognises the economic realities of exchange gains and losses more efficiently than the Anglo-Saxon style taxation system which proceeds on an ingrained capital/revenue distinction and gives rise to tax fragmentation of an otherwise commercially matched transaction. The United Kingdom is the forerunner of countries using the Anglo Saxon system, which is also used by the United States, Canada and Australia. In 1986 both the United States and Australia introduced legislation to counteract the main cause of tax fragmentation and provided that currency losses or gains on foreign currency borrowings would be tax deductible/taxable.

It was not until March 1991 that proposals for changes to the United Kingdom tax system to cope with currency gains and losses were put forward (see **1.6**) so UK resident companies have had to cope with eighteen years of currency fluctuations in the teeth of a tax system which does not follow economic reality. Why proposals for reform have taken so long can probably be explained by the fact that politically it has not been an attractive option. It is not a reform which would attract votes, and Ministers seemed preoccupied with what they perceived as an overall downward trend of sterling against

FIGURE 2

DEUTSCHMARKS PER FRENCH FRANC



Key: ERM bands

Compiled by: Ian W Marsh BA(Hons) MSc, J F Chown & Company Limited major world currencies since 1967 (at some stages up to 50% against the US dollar and Swiss franc and 70% against the Deutschmark) seeing reform as only giving relief for losses rather than for what it is, in an era of floating exchange rates, taxing gains as well as relieving losses. No doubt the United Kingdom's entry into the ERM in October 1990 has given Ministers the hope of more stability in sterling and this, combined with a growing sense of isolation in relation to other developed countries tax systems and gradual realisation that sterling did strengthen as well as weaken throughout the 1980s, has allowed proposals to emerge. The question now is whether, and if so when, these proposals will become law.

1.2 The Exchange Rate Mechanism

The Exchange Rate Mechanism (ERM) is the aspect of the European Monetary System (EMS) which manages exchange rates of the currencies of the countries which are members of the European Economic Community (EEC). The ERM does not fix exchange rates, but fixes bands within which member currencies should actively try to stay. Established members of the ERM work within a 2.25% margin of the central rate which effectively gives a band of around 4% after bank intervention. Newer members will take a 6% margin from central rate which in practice would give a band of around 11% taking bank intervention into account. If a currency gets close to the upward or downward limit of its particular band, then the country may itself take economic steps (eg the raising or lowering of interest rates) which will keep its currency within its band, and the central banks of other countries in the ERM may possibly also intervene to help stabilise the exchange rates. If country action combined with bank intervention cannot hold the line, then a revaluation may take place.

The United Kingdom did not join the ERM until October 1990 and its central rate, as against the Deutschmark which had been the strong currency of the ERM throughout the 1980s, was DM 2.95 to the £1; as a new member the United Kingdom would have a 6% margin, giving an effective band of 11%. The actual reasons for the entry of sterling as an ERM currency were political and varied; possibly a combination of closer relationships with fellow member countries of the EEC, recognition of it being a useful tool to fight inflation and an excuse to start to bring interest rates down. By contrast, the advantage of the ERM to inter-community trade is said to be that it produces greater stability of exchange rates between member countries of the EEC, discourages speculation, and that it will provide warning of when a currency may be close to devaluation. All these factors are said to make it easier for businessmen to operate. However, for the following three reasons, this seems to be an inaccurate claim.

(a) The US dollar, which is the major world trading currency, is not in the ERM, so the risk of sterling against the dollar remains the same as it always has been, although it is hoped that sterling may have a little greater general stability. Many other important world currencies, including the Japanese yen, are also outside the ERM.