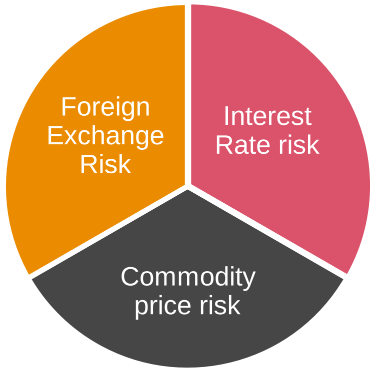
International Tax and Treasury
Finance and Treasury Tax

Derivative Hedging Transactions

What are typical Derivative Hedging Transactions ?

- Company predicts it will buy a certain amount of stock from overseas suppliers in foreign currencies.
- Company enters into a currency contract to fix the sterling price of forecast purchases

- Company predicts a certain level of sales to overseas customers in foreign currencies.
- Company enters into a currency contract to fix the price of those forecast sales.



- Company predicts it will need to purchase large quantities of raw materials (e.g. steel, aluminium).
- The company fixes the price by entering into a commodity derivative.

- Company predicts it will use a significant amount of fuel e.g. gas, electricity, petrol or coal.
- The company fixes the price by entering into a commodity derivative.

- Company borrows externally from a bank at a variable rate of interest.
- Company enters into an interest rate swap to fix amount of interest it will pay.

- Company borrows externally in USD at a fixed rate of interest.
- Company enters into a cross-currency interest rate swap, which operates to convert the loan into a GBP Sterling loan with a fixed rate of interest.

Why now?

- Markets have been particularly volatile over recent months and are likely to remain so.
- Continuing economic uncertainty as a result of COVID-19 has made currencies more volatile.
- Oil and gas prices have risen dramatically affecting energy costs and certain currencies.
- Commodity prices continue to be volatile.
- This is an area which continues to be hard to tackle.
- Tax teams often struggle to understand the transactions and related accounting.
- Treasury teams tend to focus on the group position.
- It is often unclear who is responsible for entity accounting.
- The application of Pillar 2 can create some unexpected results – and is complex to assess and understand.

What are the risks if you get this wrong?

- Cash tax volatility relating to tax on volatile fair value movements.
- These tax liabilities are often unfunded as the fair market value movements may not be realised.
- Tax elections may be available to reduce volatility. It could be costly if an election is missed or made inappropriately. This is an area which could lead to reputational damage for both the groups tax team and their advisors if simple strategies are overlooked.
- This volatility can lead not only to cash tax volatility but also to unexpected reserves blocks, which could affect a group's ability to repatriate profits and ultimately to pay dividends.

What are the benefits of getting this right?

- Mitigate potential unexpected taxable gains in the UK or overseas.
- Mitigate unexpected hits to distributable reserves.
- More robust cashflow forecasting, including tax.
- Possibility to reduce the cost of expensive external hedges.

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Our approach

Understand	Review	Action Plan	Implement	Operate
Work with the tax team and their colleagues to understand the legal, accounting, UK and overseas tax constraints.	Consider the tax treatment of existing arrangements, and availability of appropriate tax elections. If relevant consider restructuring to ensure hedges are efficient from an accounting and tax perspective.	Prepare an action plan, and if necessary design a bespoke solution to fit individual clients objectives.	Assist clients with implementing the solution (where necessary working with our legal and accounting colleagues) Consider relevant elections / documentation.	Ensure all interested parties (e.g. tax, treasury, accounting) understand how the solution operates.

Examples

Advising FTSE 100 company on the tax treatment and availability of elections for complex (cross-currency) interest rate hedging (undertaken on a portfolio basis)	Annual review for large utility group of derivative hedging transactions for year end accounts	Advising an inbound manufacturing group with autonomous UK treasury function on hedging currency sales and purchases with options and complex derivatives	Advising a number of energy businesses in relation to commodity (own use v hedging) contracts and the availability of elections & tax transition rules.
Advising a number of groups on the tax treatment of complex intra group hedging transactions	Working with several utility groups to consider the tax treatment of RPI and interest rate swaps	Working with a number of UK groups to consider the tax treatment of interest rate swaps in a different company from external debt being hedged	Advising groups generally on interaction between hedging transactions and other rules e.g. the corporate interest restriction
Advising a group considering a European central procurement function and the impact on current hedges and hedging arrangements going forwards	Advising on amending and extending out of the money interest rate swaps (e.g. on M&A deals). Advising on early termination of swaps.	Advising a PE group on the tax treatment of an interest rate swap, resulting in realising a loss earlier to eliminate cash tax in an earlier period (resulting in NPV benefit)	Numerous examples of general advice on the tax treatment of hedging derivatives. Many examples of working with clients to obtain necessary figures for the tax returns

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