

## **Changes to the loan relationships and derivative contracts rules on amounts not fully recognised for accounting purposes**

1. Legislation was published on 6 December 2010 amending the anti-avoidance provisions in sections 311 and 312, and sections 599A and 599B, and inserting new sections 455A and 698A of the Corporation Tax Act 2009 (CTA 2009). The Technical Notes of 6 July 2010 and 9 December 2010 have more information on the background to these changes.
2. The paragraphs below summarise the changes that have been made, or not made, in the legislation published in [Finance Bill 2011](#), in response to comments received on the clauses published in December 2010.
3. Draft guidance for the HM Revenue & Customs (HMRC) Corporate Finance Manual is also set out below.

### **The breadth of the legislation**

4. Concern has been expressed that the drafting of section 311(7) and section 599A(7) is too broad. In particular, in view of the fact that 'arrangements' has a wide meaning, clarification has been sought on whether the reference to 'any party to the arrangements' will include a company (Company A) that is party to a loan relationship or derivative contract in respect of which it does not fully recognise amounts, in circumstances where the counterparty (Company B) has an avoidance purpose but Company A does not. Hence the question is whether the legislation would require Company A to recognise a profit that it innocently derecognises.
5. HMRC consider that the legislation cannot apply in these circumstances. Sections 311(7)/599A(7) remain as published on 6 December 2010. For the legislation to apply, the derecognition must have occurred **as a result** of tax avoidance arrangements to which Company A is party.
6. Section 311(2)/599A(2) require that the company is both party to a creditor loan relationship or derivative contract, and also party to tax avoidance arrangements as a result of which that company does not recognise amounts in respect of the loan or derivative.
7. If Company A innocently enters into a loan or derivative that forms part of Company B's tax avoidance arrangements, and in consequence does not fully recognise amounts in respect of that loan or derivative (or another loan or derivative), then its non-recognition of amounts is not the result of its being party to tax avoidance arrangements. While Company A will be party to a loan or derivative pursuant to Company B's tax avoidance arrangements, that does not make it party to Company B's tax avoidance arrangements, since a loan or derivative is not, on its own, an avoidance arrangement. Company A would have to have the purpose of obtaining a tax advantage for itself or another company, and the result of entering into the avoidance arrangements would have to be that amounts are not fully recognised by Company A, before the legislation could apply.

8. For this reason, HMRC does not consider that the legislation will require a company to bring in, for tax purposes, cash flows on instruments entered into as part of a normal commercial transactions, including complex transactions such as those where a derivative forms part of a synthetic secured loan.

#### **No debits brought in by section 312/599B**

9. Sections 312 and 599B have been changed from the legislation published in December 2010 by the insertion of new subsections 312(3) and 599B(2A). These state: ‘...no debits are, as a result of this section, to be brought into account by the company in respect of the creditor relationship/derivative contract...’
10. Experience with anti-avoidance provisions in former section 91B FA 1996 was that there can be cases where an avoider seeks to get within the anti-avoidance rule in order to create debits as part of avoidance arrangements. The amendments in sections 312(3)/599B(2A) aim to remove the Exchequer’s exposure to such a risk.
11. This change to the December 2010 version of the legislation has effect for avoidance arrangements entered into on or after Budget Day 23 March 2011

#### **Sections 455A/698A not to apply to outright disposals**

12. Concern was expressed that the rules in new sections 455A and 698A as published on 6 December could apply to actual disposals of a loan or derivative, as well as what may be termed ‘technical derecognition’, and that the proposed interaction with the unallowable purposes rule was unclear.
13. Sections 455A and 698A have therefore been amended by the inclusion of the requirement in new subsections 455A(1)(c) and 598A(1)(c) that the company continues to be party to the loan relationship or derivative contract immediately after it is derecognised. In essence, sections 455A and 698A apply to the types of transaction that fall within sections 311/599A.
14. The company will continue to be treated as party to the creditor relationship or derivative even though it has disposed of its rights under a repo, stock lending arrangement, or under a transaction not involving a disposal under section 26 TCGA 1992.
15. The provisions giving priority to the unallowable purposes rule (sections 455A(3)/698A(3)) have been removed.

#### **Derivative contracts: fair value profits from a previous accounting period**

16. Continuing avoidance disclosures suggest that the requirement in CTA09/S599B to use fair value accounting could be used where an in-the-money, off-balance sheet, derivative is transferred as part of avoidance arrangements, without recognition of an accounting profit, in a later period. It is argued that fair value profits from a period before the avoidance arrangements are entered into could go untaxed, as a result of the fair value at which the derivative is recognised in accordance with CTA09/S599B at the start of the later period.

17. New section 599B(4) includes a requirement that where the fair value of a derivative exceeds the accounts carrying value at the start of the accounting period in which avoidance arrangements are entered into, the difference is to be brought into account as a credit in that period, in essence as if it arose from a change of accounting policy.
18. This change to the December 2010 version of the legislation has effect for avoidance arrangements entered into on or after Budget Day 23 March 2011.

For further information contact [Tony Sadler](#) or [Richard Rogers](#)

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## **Draft amendments to Corporate Finance Manual: amounts not fully recognised for accounting purposes**

### **Existing CFM33120**

New banner – ‘This guidance applies for accounting periods beginning before 6 December 2010’

### **New CFM33122 – Loan relationships: computational rules: GAAP: amounts not fully recognised for accounting purposes: Conditions A to D**

This guidance applies for accounting periods beginning before 6 December 2010

CFM33120 describes the anti-avoidance rule that applies with effect from 6 March 2006 to arrangements in which derecognition arises as a result of a loan relationship being matched with preference shares that have equivalent cash flows.

Further avoidance schemes were devised in which a loan relationship is not fully recognised as a consequence of its cash flows being matched with those arising on other financial instruments. In the example described in CFM33120, instead of paying preference share dividends to the parent, the subsidiary might make payments in respect of a capital contribution from the parent. Or in return for additional shares or an increased interest in a fellow group company it may undertake to make payments equal to the cash flows it receives in respect of the loan.

As with the original derecognition avoidance schemes, the effect of not fully recognising the cash flows relating to the matching financial arrangements is that credits are said not to be taxable on the creditor loan relationship not recognised in the accounts, while amounts not recognised in respect of the liability would not be deductible.

Accordingly, further amendments were made to the legislation to deal with such schemes, and as a result, for periods beginning before 6 December 2010, the rule applies where either Condition A, B, C or D is met.

Condition A is where a creditor loan relationship is derecognised as a result of its cash flows being matched with a debtor loan relationship. This is the basic derecognition scheme described in CFM33120. Condition A applies for periods ending on or after 22 March 2006.

Condition B is where a creditor loan relationship is derecognised as a result of its cash flows being matched with a capital contribution. It applies for periods ending on or after 9 May 2007, in respect of amounts relating to any time after 9 May 2007.

Condition C is where a creditor loan relationship is derecognised as a result of its cash flows being matched with securities forming part of the company's capital. It applies for periods ending on or after 22 April 2009, in respect of amounts relating to any time after 22 April 2009.

Condition D is where a creditor loan relationship is derecognised as a result of its cash flows being matched with an interest in another company's shares, or a partnership's profits or capital, or a trust. It applies for periods ending on or after 22 June 2010, in respect of amounts relating to any time after 22 June 2010.

For periods beginning on or after 6 December 2010, the derecognition rule was amended so that it applies as a generic rule wherever a company is party to tax avoidance arrangements. See CFM33124.

**New CFM33124 – Loan relationships: computational rules: GAAP: amounts not fully recognised for accounting purposes: periods beginning on or after 6 December 2010**

For periods beginning before 6 December 2010, the rule in CTA09/S311 and S312 applies where specific conditions are met (CFM33122). For periods beginning on or after 6 December 2010, the derecognition anti-avoidance legislation operates as a general rule, wherever an amount is not fully recognised, as a result of the company being party to tax avoidance arrangements. This change to the legislation was made by FA11/S?? and FA11/Sch??. See CFM33127 for more on commencement provisions.

The changes made with effect from that date are as follows.

- Conditions A to D are repealed.
- Instead, CTA09/S311 and S312 apply wherever a company is party to a creditor relationship, and as a consequence of its being party to tax avoidance arrangements amounts are not fully recognised in respect of the creditor relationship.
- Where section 311 applies, section 312 requires amounts to be brought into account for tax purposes as if the creditor relationship had been fully recognised in the accounts, but these amounts do not include debits (CTA09/S312(3)(a)).
- A new section CTA09/S455A is inserted, to deny a debit arising from the derecognition of a creditor relationship (CFM33126).

For periods beginning on or after 6 December 2010, CTA09/S311 and S312 will apply to a wider range of avoidance schemes based on derecognition than those previously addressed by Conditions A to D, and will come into play where the company is party to 'tax avoidance arrangements'. These are arrangements to which a company is party if the main purpose, or one of the main purposes of entering them is to obtain a 'tax advantage'. 'Tax advantage' takes its meaning from CTA10/S1139,

and 'arrangements' includes arrangements, schemes and understandings of any kind.

CFM33125 has more on the application of this rule.

**New CFM33125 – Loan relationships: computational rules: GAAP: amounts not fully recognised for accounting purposes: periods beginning on or after 6 December 2010: meaning of 'as a result of tax avoidance arrangements'**

A company must be party to tax avoidance arrangements for the anti-avoidance rule in CTA09/S311 and S312 to bite. It will not override the accounting treatment for tax purposes in normal commercial situations where generally accepted accounting practice does not require recognition.

An arrangement will generally involve a number of parties. It is possible that some will have an avoidance purpose while others do not. Although the term 'arrangements' has a wide meaning, and includes arrangements entered into by any party whose purpose is to obtain a tax advantage (whether for itself or another company), the reference to 'any party to the arrangements' in CTA09/S311(7) will not require a counterparty (Company A) to a company that has an avoidance purpose (Company B) to recognise an amount that company A innocently derecognises.

Section 311(2) require that the company is both party to a creditor loan relationship and also party to tax avoidance arrangements as a result of which that company does not recognise amounts in respect of the loan.

If Company A innocently enters into a loan that forms part of Company B's tax avoidance arrangements, and in consequence does not fully recognise amounts in respect of that loan (or another loan), then its non-recognition of amounts is not the result of its being party to tax avoidance arrangements. While Company A will be party to a loan pursuant to Company B's tax avoidance arrangements, that does not make it party to Company B's tax avoidance arrangements, since a loan is not, on its own, an avoidance arrangement.

Company A would have to have the purpose of obtaining a tax advantage for itself or another company, and the result of entering into the avoidance arrangements would have to be that amounts are not fully recognised by Company A, before the legislation could apply.

**New CFM33126 – Loan relationships: computational rules: GAAP: amounts not fully recognised for accounting purposes: periods beginning on or after 6 December 2010: no debits for derecognition**

CTA09/S311 addresses the case where, in accordance with generally accepted accounting practice, amounts are not fully recognised in the accounts. In such circumstances the cash flows on a creditor relationship (a loan relationship asset) will not be recognised in accounts and may escape taxation under the loan relationships rules.

An act of derecognition may also give rise to a debit in one of the accounting statements in CTA09/S308 - the profit and loss account or income statement, statement of total recognised gains and losses, statement of changes in equity, or any other statement of items taken into account in computing the company's profits and losses (see CFM33100). In some instances the act of derecognition may result in an amount being debited in the company's balance sheet.

CTA09/S455A denies a deduction for such a debit where the company is party to tax avoidance arrangements and continues to be party to the derivative contract after its derecognition. 'Tax avoidance arrangements' means the same as it means in CTA09/S311 (CFM33124). It does not matter whether the amount in respect of the derecognition arises in P&L or elsewhere in the accounts, or is claimed as a computational deduction (for example under CTA09/S320 or under CTA09/S316 if a loan is derecognised under a change of accounting policy).

Section 455A applies only where the company continues to be party to the loan relationship immediately after the act of derecognition. It will not, therefore, apply to derecognition that follows from an actual disposal of the asset by the company.

### **Example**

ABC Ltd is party to a valuable loan asset. It enters into a subscription agreement to acquire shares in XYZ Ltd, so that its loan asset is derecognised and replaced by another financial asset. The accounting entries are a credit in the loan asset account (which eliminates it from the balance sheet), and a debit creating the new asset. This debit is claimed as a deduction under CTA09/S320. CTA09/S455A denies a tax deduction for the purposes of the loan relationship rules in respect of an amount derecognised, where the company is party to tax avoidance arrangements.

### **New CFM33127 – Loan relationships: computational rules: GAAP: amounts not fully recognised for accounting purposes: periods beginning on or after 6 December 2010: commencement**

CFM33124 to CFM33126 explain that for periods of account beginning on or after 6 December 2010, the derecognition anti-avoidance legislation operates as a general rule, wherever an amount is not fully recognised, as a result of the company being party to tax avoidance arrangements.

Periods straddling this date are treated as two separate periods of account, so in effect the new rules apply to credits and debits relating to amounts not fully recognised on or after 6 December 2010.

However, CTA09/S312(3)(a) (the rule that denies debits where amounts are required to be fully recognised) only has effect in relation to avoidance arrangements to which the company became party on or after 23 March 2011.

### **Existing CFM56110**

New banner - 'This guidance applies for accounting periods beginning before 6 December 2010'

### **New CFM56112 – Derivative contracts: tax avoidance: amounts not fully recognised for accounting purposes: Conditions A to C**

This guidance applies for accounting periods beginning before 6 December 2010

CFM56110 describes the anti-avoidance rule that applies for periods beginning on or after 22 April 2009. Because further avoidance schemes were devised in which a derivative contract is not fully recognised as a consequence of its cash flows being matched with those arising on other financial instruments, this rule was amended for periods ending on or after 22 June 2010, in respect of amounts relating to any time

after that date. Accordingly, for periods beginning before 6 December 2010, the rule applies where either Condition A, B, or C is met.

Condition A is where a derivative contract is derecognised as a result of its cash flows being matched with a capital contribution, and applies to periods of account ending on or after 22 April 2009, in respect of amounts relating to any time after 22 April 2009.

Condition B is where a derivative contract is derecognised as a result of its cash flows being matched with securities forming part of the company's capital, and applies to periods of account ending on or after 22 April 2009, in respect of amounts relating to any time after 22 April 2009.

Condition C is where a derivative contract is derecognised as a result of its cash flows being matched with an interest in another company's shares, or a partnership's profits or capital, or a trust capital contribution, and applies for periods ending on or after 22 June 2010, in respect of amounts relating to any time after 22 June 2009.

For periods beginning on or after 6 December 2010, the derecognition rule was amended so that it applies as a generic rule wherever a company is party to tax avoidance arrangements. See CFM56114.

#### **New CFM56114 – Derivative contracts: tax avoidance: amounts not fully recognised for accounting purposes: periods beginning on or after 6 December 2010**

For periods beginning before 6 December 2010, the rule in CTA09/S599A and S599B applies where specific conditions are met (CFM56112). For period beginning on or after 6 December 2010, the derecognition anti-avoidance legislation operates as a general rule, wherever an amount is not fully recognised, as a result of the company being party to tax avoidance arrangements. This change to the legislation was made by FA11/S?? and FA11/Sch??. See CFM56117 for more on commencement provisions.

The changes made with effect from that date are as follows.

- Conditions A to C are repealed.
- Instead, CTA09/S599A and S599B apply wherever a company is party to a derivative contract, and as a consequence of its being party to tax avoidance arrangements amounts are not fully recognised in respect of the creditor relationship.
- Where section 599A applies, section 599B requires amounts to be brought into account for tax purposes as if the creditor relationship had been fully recognised in the accounts, but these amounts do not include debits (CTA09/S599B(2A)).
- A new section CTA09/S698A is inserted, to deny a debit arising from the derecognition of a creditor relationship (CFM56116).
- Section 599B(4) includes a requirement that where the fair value of a derivative exceeds the accounts carrying value at the start of the accounting

period in which avoidance arrangements are entered into, the difference is to be brought into account as a credit in that period. It is aimed at schemes in which it may be argued that fair value profits of an earlier period where an in-the-money, off-balance sheet derivative, is transferred as part of avoidance arrangements, without recognition of an accounting profit, in a later period.

For periods beginning on or after 6 December 2010, CTA09/S599A and S599B will apply to a wider range of avoidance schemes based on derecognition than those previously addressed by Conditions A to C, and will come into play where the company is party to 'tax avoidance arrangements'. These are arrangements to which a company is party if the main purpose, or one of the main purposes of entering them is to obtain a 'tax advantage'. 'Tax advantage' takes its meaning from CTA10/S1139, and 'arrangements' includes arrangements, schemes and understandings of any kind.

These anti-avoidance provisions operate in the same way as the equivalent rules for loan relationships. See CFM33125 for more guidance on the application of this rule to a company that is an innocent counterparty to another company with an avoidance purpose.

**New CFM56116 – Derivative contracts: tax avoidance: amounts not fully recognised for accounting purposes: periods beginning on or after 6 December 2010: no debits for derecognition**

CTA09/S599A addresses the case where, in accordance with generally accepted accounting practice, amounts are not fully recognised in the accounts. In such circumstances the cash flows on a derivative contract will not be recognised in accounts and may escape taxation under the derivative contracts rules.

An act of derecognition may also give rise to a debit in one of the accounting statements in CTA09/S597 - the profit and loss account or income statement, the statement of total recognised gains and losses or statement of changes in equity, or any other statement of items taken into account in computing the company's profits and losses. In some instances the act of derecognition may result in an amount being debited in the company's balance sheet.

CTA09/S698A denies a deduction for such a debit where the company is party to tax avoidance arrangements and continues to be party to the derivative contract after its derecognition. This rule operates in the same way as CTA09/S455A in relation to loan relationships (CFM32116).

**New CFM56117 – Derivative contracts: tax avoidance: amounts not fully recognised for accounting purposes: periods beginning on or after 6 December 2010: commencement**

CFM56114 to CFM56116 explain that for periods of account beginning on or after 6 December 2010, the derecognition anti-avoidance legislation operates as a general rule, wherever an amount is not fully recognised, as a result of the company being party to tax avoidance arrangements.

Periods straddling this date are treated as two separate periods of account, so in effect the new rules apply to credits and debits relating to amounts not fully recognised on or after 6 December 2010.

However,

- CTA09/S599B(2A) (the rule that denies debits where amounts are required to be fully recognised), and
- CTA09/S599B(4) (the rule that requires a credit to be brought in where the fair value of the contract exceeds the carrying value in the period in which avoidance arrangements are entered into)

only have effect in relation to avoidance arrangements to which the company became party on or after 23 March 2011.

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Draft