STATUTORY INSTRUMENTS

2004 No.

INCOME TAX

The Finance Act 2002, Schedule 26, Parts 2 and 9 (Amendment) (No. 2) Order 2004

Made - - - -	*2004*
Laid before House of Commons	*2004*
Coming into force - -	*2004*

The Treasury, in exercise of the powers conferred upon them by paragraph 13 of Schedule 26 to the Finance Act 2002(**a**) make the following Order:

PART 1

Introduction

Citation, commencement and effect

1.—(1) This Order may be cited as the Finance Act 2002, Schedule 26, Parts 2 and 9 (Amendment No. 2) Order 2004 and shall come into force on [xxx] August 2004.

(2) This Order has effect in relation to periods of account beginning on or after 1st January 2005.

PART 2

Amendment of Part 2 of Schedule 26 to the Finance Act 2002

2. Part 2 of Schedule 26 to the Finance Act 2002 is amended as follows.

3. In paragraph 4(2)—

(a) at the end of paragraph (d) add “and”;

(b) at the end of paragraph (e) omit “and”; and

(c) omit paragraph (f).

4. In paragraph 5—

(a) at the end of sub-paragraph (2)(b)(i) add “or”;

(b) at the end of sub-paragraph (2)(b)(ii) omit “, or” and

(**a**) 2002 c. 23. Paragraph 13 is amended by paragraph 2 of Schedule 9 to the Finance Act 2004.

(c) omit sub-paragraph (2)(b)(iii).

5. After paragraph 5 insert—

"**5A.**—(1) Paragraph 4 does not prevent a relevant contract to which this paragraph applies from being a derivative contract.

(2) This paragraph applies where a company is treated by section 94A(2)(b) of the Finance Act 1996 as a party to a relevant contract whose underlying subject matter is shares in a company.".

6. In paragraph 6—

(a) at the end of sub-paragraph (2)(a)(i) add "or";

(b) at the end of sub-paragraph (2)(a)(ii) omit ", or";

(c) omit sub-paragraph (2)(a)(iii);

(d) in sub-paragraph (3)(b)(i)—

(i) for "company," substitute "company or";

(ii) omit from "or assets" to "applies"; and

(iii) at the end add "and";

(e) for sub-paragraphs (3)(b)(ii) and (iii) substitute—

"(ii) one or more host contracts,".

7. In paragraph 7—

(a) at the end of sub-paragraph (2)(a)(i) add "or";

(b) at the end of sub-paragraph (2)(a)(ii) for ", or" substitute "and";

(c) omit sub-paragraph (2)(a)(iii);

(d) in sub-paragraph (3)(b)(i) for "company," substitute "company or";

(e) omit from "or assets" to "applies";

(f) at the end add "and"; and

(g) for sub-paragraphs 3(b)(ii) and (iii) substitute—

"(ii) one or more host contracts,".

8. In paragraph 8—

(a) at the end of sub-paragraph (2)(c)(i) add "or";

(b) at the end of sub-paragraph (2)(c)(ii) omit ", or" and

(c) omit sub-paragraph (2)(c)(iii).

9. In paragraph 9—

(a) in sub-paragraph (2)(a) for "paragraphs (c) to (f)" substitute "paragraphs (c) to (e)" and

(b) in sub-paragraph (4)(a) for "paragraphs (d) to (f)" substitute "paragraphs (d) and (e)".

10. In paragraph 12—

(a) in sub-paragraph (1) insert—

"(ca) an embedded derivative and related expressions;".

(b) After sub-paragraph (5) insert—

"(5A) An "embedded derivative" and "host contract" have the same meaning as in section 94A(1) of the Finance Act 1996.".

PART 3

Amendment of Part 9

11. Part 9 of Schedule 26 to the Finance Act 2002 is amended as follows.

12. In paragraph 46(2)(a) for "paragraphs (c) to (f)" substitute "paragraphs (c) to (e)".

13. After paragraph 45A (inserted by the Finance Act 2002, Schedule 26, Parts 2 and 9 (Amendment) Order 2004) insert—

"Embedded derivative contracts which are options

45B.—(1) This paragraph applies for an accounting period to a deemed contract where a company has a creditor relationship (within the meaning given by section 103(1) of the Finance Act 1996) to which section 94A Finance Act 1996 applies, and the derivative embedded in that relationship is treated by virtue of subsection (3) of that section as an option, but only if—

(a) the deemed contract does not fall within paragraphs 5 and 6 to 8 of Schedule 26 to the Finance Act 2002;

(b) the underlying subject matter at the time when the host contract came into existence is and at all times since then, has been, qualifying ordinary shares or mandatorily convertible preference shares; and

(c) it is not otherwise excluded.

(2) In sub-paragraph (1)—

"deemed contract" means a relevant contract to which the company is treated as a party under section 94A(2)(b) of the Finance Act 1996;

"mandatory convertible preference shares" means shares (other than qualifying ordinary shares) which are issued upon terms that stipulate that, by a time no more than 24 hours after their acquisition by a person who immediately before that acquisition had the creditor relationship represented by those shares, they must be converted into or exchanged for qualifying ordinary shares;

"qualifying ordinary shares" means shares in a company which satisfy the conditions in sub-paragraphs (3) and (4) below.

(3) The first condition is that the shares are shares representing some or all of the issued share capital (by whatever name called) of the company, other than—

(a) capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the profits of the company, or

(b) capital the holders of which have no right to a dividend of any description nor any other right to share in the profits of the company.

(4) The second condition is that the shares are—

(a) shares which are listed on a recognised stock exchange, or

(b) shares in a company which is a trading company or a holding company, and for this purpose "trading company" and "holding company" have the meaning given by paragraph 22(1) of Schedule A1 to the Taxation of Chargeable Gains Act 1992.

This is subject to paragraph 45C.

Embedded derivatives - exceptions

45C. Paragraph 45B does not apply to an embedded derivative if—

(a) the extent to which shares may be acquired under the contract for the asset (the loan relationship which consists of the host contract and the embedded derivative) is determined using a cash value which is specified in the provision included in the rights attached to that asset or which is or will be ascertainable by reference to the terms of that provision;

(b) the asset which includes the embedded derivative is one where, for the accounting period in which it came into existence, there is a connection between the company and the company which is the issuing company in relation to that asset within the meaning of section 87(3) of the Finance Act 1996.

Circumstances when embedded derivatives cease to be derivative contracts

45D.—(1) If, in a case to which paragraph 45B applies, the company and the company which is the issuing company in relation to the asset (the loan relationship which consists of the host contract and the embedded derivative) become companies between which, for any accounting period, there is a connection, then—

(a) the embedded derivative shall cease to be a derivative contract to which paragraph 45B applies, and

(b) it shall be treated as having ceased to be such a contract at the end of the accounting period immediately preceding the one in which the circumstances giving rise to that connection arose.

This is subject to the following qualification.

(2) Sub-paragraph (1) does not apply if section 73(5)(b) of the Finance Act 2002 applies to the asset.

Embedded derivatives which are contracts for differences

45E.—(1) This paragraph applies for an accounting period to an embedded derivative which is treated by virtue of section 94A(3) of the Finance Act 1996 as a contract for differences if—

(a) it does not fall within paragraphs 5 and 6 to 8 of Schedule 26 to the Finance Act 2002;

(b) the underlying subject matter at the time when the contract for the asset, (the loan relationship which consists of the host contract and the embedded derivative), came into existence, is and at all times since then, has been land or qualifying ordinary shares which are listed on a recognised stock exchange; and

(c) it is an exactly tracking contract.

(2) In this paragraph "an exactly tracking contract" means one where the amount that must be paid to discharge the contract for differences is equal to the amount determined by applying a relevant percentage change in the value of the underlying subject matter of the contract to the amount falling for the purposes of Chapter 2 of Part 4 of the Finance Act 1996 to be regarded in accordance with generally accepted accounting practice as the initial cost of the asset which included the embedded derivative.

(3) In sub-paragraph (2) the reference to a relevant percentage change in the value of chargeable assets is a reference to the amount of the percentage change (if any) over the relevant period in the value of chargeable assets of any particular description or in any index of the value of any such assets.

(4) In sub-paragraph (3) "the relevant period" means—

(a) the period between the date the asset came into existence and the discharge of the contract for differences; or

(b) any other period in which almost all of that period is comprised and which differs from that period exclusively for purposes connected with giving effect to a valuation in relation to rights or liabilities under the asset.

Indexed gilt-edged securities

45F.—(1) This paragraph applies for an accounting period to an embedded derivative which is treated by virtue of section 94A(3) of the Finance Act 1996 as a contract for differences if—

(a) the loan relationship mentioned in section 94A(1) of the Finance Act 1996 is an index-linked gilt edged security; and

(b) the credits and debits which fall to be brought into account for an accounting period for the purposes of Chapter 2 of Part 4 of the Finance Act 1996 in respect of the host contract are non-trading credits and debits.

(2) The credits and debits which fall to be brought into account under this Schedule for that accounting period in respect of the embedded derivative shall be disregarded.

(3) In this paragraph—

"index-linked gilt-edged security" means any gilt-edged security the amount of the payments under which are determined wholly or partly by reference to the retail prices index; and

"gilt-edged security" has the meaning given in section 103(1) of the Finance Act 1996.

Contracts treated as ones under which chargeable gains accrue

45G.—(1) This paragraph applies for an accounting period—

(a) to an embedded derivative which falls under paragraph 45B or 45E;

(b) where a company has a debtor relationship (within the meaning given by section 103(1) of the Finance Act 1996) to which section 94A of the Finance Act 1996 applies and the embedded derivative in that relationship is treated by virtue of subsection (3) as an option.

(2) Where this paragraph applies to a contract for an accounting period—

(a) paragraph 14(3) shall not apply to the credits and debits given in relation to the contract by paragraph 15, and

(b) sub-paragraph (3) shall apply.

(3) Where there is—

(a) a relevant excess of credits, a chargeable gain equal to the amount of the excess shall be treated as accruing in the accounting period in question to the company for the purposes of corporation tax;

(b) a relevant excess of debits, an allowable loss equal to the amount of that excess shall be treated as accruing in the accounting period in question to the company for the purposes of that tax.

(4) Where—

(a) there is a net amount of gains in one accounting period,

(b) there is a net amount of losses in the next following accounting period, and

(c) within 2 years after the end of the accounting period referred to in paragraph (b) the company makes a claim for the purpose in respect of the whole or part of net amount of losses for that period,

the amount of the gain for the earlier period and the amount of the loss for the later period shall be reduced by the amount in respect of which the claim is made.

(5) For the purposes of sub-paragraph (3) there is—

"a relevant excess of credits" where the amount by which the non-trading credits that are brought into account in respect of the contract for the period exceeds the amount of non-trading debits that are so brought; and "a relevant excess of debits" where the amount by which the non-trading debits that are brought into account in respect of the contract for the period exceeds the amount of non-trading credits that are so brought, and

(6) For the purposes of sub-paragraph (4)—

(a) there is a net amount of gains for a period where (A–B)–C is a positive value, and

(b) there is a net amount of losses for a period where A–B is a negative value.

(7) In sub-paragraph (6)—

A is the sum of the gains treated as accruing for the period under sub-paragraph (6)(a) ("sub-paragraph (6)(a) gains");

B is the sum of the losses treated as accruing for the period under sub-paragraph (6)(b); and

C is the amount of any allowable losses, not accruing in that period under sub-paragraph (6)(b), which, under section 8(1) of the Taxation of Chargeable Gains Act 1992(**a**), can only be deducted from sub-paragraph (6)(a) gains accruing in the period because of an insufficiency of other chargeable gains accruing in the period under paragraph 45A(6)(a).

(8) Sub-paragraph (3) does not apply if, were the embedded derivative an actual option, paragraph 2 of Schedule 7AC to that Act would apply to that option if it had been disposed of at the end of the accounting period.

(9) For the purposes of sub-paragraphs (8) and (9) the credits and debits which fall to be brought into account for that accounting period in respect of the embedded derivative under this Schedule shall be disregarded.".

Name
Two of the Lords Commissioners of Her Majesty's Treasury

EXPLANATORY NOTE

(This note is not part of the Order)

(**a**) 1992 c. 12.