

PART 8

DERIVATIVE CONTRACTS

1. This Part provides for the taxation of profits and losses arising to a company from its derivative contracts. It is based on Schedule 26 to FA 2002 (“Schedule 26” in these notes).

2. Derivative contracts take many forms, from a simple option or future, such as a commodities option to buy goods at a future date at a price fixed now, to a sophisticated contract for differences embedded within a financial instrument which is not itself a derivative contract, say where a long-term lease contains terms for contingent rental rates.

3. In most cases, the accounts treatment under generally accepted accounting practice is followed in identifying and quantifying the credits and debits which go to make up the profits and losses for tax purposes. This Part does not itself contain a tax charge. Broadly, if the contract is held for the purposes of a company’s trade, credits and debits arising from it are included in calculating the profits of the trade. If it is not so held, the credits and debits are included with credits and debits from the company’s loan relationships and taxed under the provisions for loan relationships (Chapter 2 of Part 4 of FA 1996). But, in a number of cases (primarily if the item whose value is the subject of the derivative contract is land or shares), credits and debits are instead treated as giving rise to chargeable gains or allowable losses within TCGA.

4. There are considerable similarities between many of the core rules for derivative contracts and those for loan relationships. There are also rules for the interaction of the two regimes if a loan relationship is divided in accordance with generally accepted accounting practice between the derivative contract “embedded” in the loan relationship and the rest of the rights and liabilities under the loan relationship (the “host contract”).

5. Schedule 26 to FA 2002 replaced more limited rules for derivative contracts in FA 1993 and (in particular) FA 1994, which themselves overtook the application of Case I of Schedule D (section 18 of ICTA) and TCGA to profits and losses arising from such contracts. Schedule 26 was modelled closely on the FA 1996 provisions for loan relationships (as amended extensively themselves by FA 2002). But it has been amended substantially, usually under the powers in paragraph 13 of Schedule 26, for two main reasons. First, the provisions have been amended as a result of the considerable recent developments in accounting standards, whether under financial reporting standards which represent United Kingdom generally accepted accounting practice (for example, Financial Reporting Standards 25 and 26) or under international accounting standards (see International Accounting Standards 32 and 39). Second, the provisions also recognise developments in the market use of derivative contracts and the needs of certain users of derivative contracts. See in particular the rules added by paragraphs 45A to 45M of Schedule 26.

6. The draft clauses do not reflect any changes to the source legislation proposed by or by virtue of Finance Bill 2007 or changes proposed by earlier legislation which have not yet come into effect. In particular, they do not reflect the prospective repeal of paragraph 16 of Schedule 26 (exchange gains and losses from derivative contracts).

7. The clauses do not yet contain the consequential or transitional provisions that will be needed as a result of the rewrite of the source legislation for these clauses.

8. There are some modifications of the effect of the source legislation for these clauses in secondary legislation. See in particular the Exchange Gains and Losses (Bringing into Account Gains or Losses) Regulations 2002 (SI 2002/1970), as amended, the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004 (SI 2004/3256), as amended, and the Loan Relationships and Derivative Contracts (Change of Accounting Practice) Regulations 2004 (SI 2004/3271), as amended. The modifications in this secondary legislation have not been rewritten in these clauses.

9. Some clauses refer to provisions in “Part [6] (loan relationships)” or “Part [7] (relationships treated as loan relationships etc)”. These Parts contain the draft clauses for loan relationships, rewriting Chapter 2 of Part 4 of FA 1996, which were published for consultation on 2 May 2007. If there is a reference to a specific clause in one of those Parts, the commentary identifies that clause by the number it has in the those draft clauses (described in these notes as the “May 2007 draft clauses”). There are occasional references to other prospective Parts of the Bill in which the derivative contracts clauses will be located, but these notes refer in such cases to the current legislation.

10. Although the core provisions in Chapter 2 of Part 4 of FA 1996 and Schedule 26 are often similar, there are differences of wording and effect. The clauses rewriting Schedule 26 have been modelled on those rewriting Chapter 2 of Part 4 of FA 1996, but there are some drafting differences. Later work will consider further harmonisation of the material common to both sets of clauses.

11. The commentary uses a number of abbreviations. They are listed below.

FA 2002	Finance Act 2002 (and similarly for other Finance Acts)
F(No 2)A	Finance (No. 2) Act
FISMA	the Financial Services and Markets Act 2000
HMRC	Her Majesty’s Revenue and Customs
ICTA	the Income and Corporation Taxes Act 1988
ITA	the Income Tax Act 2007

TCGA the Taxation of Chargeable Gains Act 1992

TMA the Taxes Management Act 1970

Chapter 1: Introduction

Clause 1: Overview of Part

12. This clause sets the scene for the rest of the Part with a brief description of what it is about and a signpost to the key definition for the Part, that of “derivative contract”. It is based on paragraphs 1(1) and 15(1) of Schedule 26.

13. The material in the Part is ordered as follows:

- This Chapter contains the core rules for the tax treatment of credits and debits from derivative contracts
- Chapter 2 sets out the contracts to which the Part applies
- Chapters 3 to 5 contain the rules for identifying and quantifying credits and debits
- Chapters 6 and 7 deal with the circumstances in which credits and debits give rise to a chargeable gain or allowable loss instead of income
- Chapters 8 to 11 deal with a number of special circumstances, particularly relating to certain types of company who are party to derivative contracts
- Chapter 12 contains definitions as well as the power to amend parts of the legislation by statutory instrument.

14. This Part refers to “profits and losses” arising from derivative contracts whereas the clauses rewriting the loan relationships provisions say “gains and losses”. The difference of approach reflects differences in the source legislation (that for derivative contracts says “profits”, that for loan relationships “profits or gains”). Other than differences necessarily arising from the context of each set of provisions, no distinction is intended to be read into the use of different expressions in rules which are common to both regimes.

Q1. We welcome comments on the use of “profits and losses” in this Part.

15. For what is meant in *subsection (1)* by “its derivative contracts” in relation to a company, see clause 12(5).

Clause 2: General rule that profits arising from derivative contracts chargeable as income

16. This clause provides a general rule that profits arising to a company from its derivative contracts are chargeable as income. Profits are so chargeable “in accordance with this Part”. That is, the Part contains the necessary rules for identifying and quantifying the amount to be charged to tax. This clause is based on paragraph 1(1) of Schedule 26.

17. Before amendments to Schedule 26 provided for some amounts to be charged as chargeable gains under TCGA, all profits arising from derivative contracts were chargeable as income.

18. *Subsection (3)* contains a signpost to the main exception (but not the only exception) to this general rule.

Clause 3: Profits and losses from derivative contracts to be calculated using credits and debits given by this Part

19. This clause provides that profits and losses for the purposes of this Part are found by reference to the credits and debits identified and quantified by the Part. The terms “credit” and “debit” are used in accounting practice and therefore reflect the operation of the Part by reference to generally accepted accounting practice (see clause 36). This clause is based on paragraph 14(1) of Schedule 26.

20. Chapter 3 contains the main rules for finding credits and debits.

Clause 4: Trading credits and debits brought into account under Part [3]

21. This clause provides that credits and debits are treated as receipts and expenses of a company’s trade if the company is party to the derivative contract for the purposes of that trade. If this clause applies, the charge to tax is under Part [3] (trading income). This clause is based on paragraph 14(2) and (4) of Schedule 26.

22. *Subsection (4)* ensures that any debit found under this Part is deductible notwithstanding any rule in section 74 of ICTA which would otherwise prevent it being taken into account as an expense of the trade. (The reference to “section 74 of ICTA” will be replaced by the appropriate reference to the clause or clauses in Part [3] (trading income) that rewrite this provision.)

23. *Subsection (5)* contains signposts to provisions which disapply this clause, either because the contract in question is taken outside the scope of this Part or because credits and debits are taken into account instead in computing chargeable gains.

Clause 5: Non-trading credits and debits brought into account under Part [6]

24. This clause provides that credits and debits are treated as non-trading credits and debits, and brought into account in calculating gains charged or losses relieved under Part [6] (loan relationships), if clause 4 does not apply to those credits and

debits. If this clause applies, the charge to tax is under Part [6] (loan relationships). This clause is based on paragraph 14(3) of Schedule 26.

25. *Subsection (3)* performs the same function for non-trading credits and debits as does clause 4(5) for trading credits and debits.

26. The reference to “section [j061080]” is to clause 17 in the May 2007 draft clauses.

Clause 6: Exception to the general rule: derivative contracts giving rise to chargeable gains

27. This clause introduces Chapter 6 (chargeable gains arising in relation to derivative contracts). It is new.

28. Chapter 6 has two main functions. The first is to disapply clauses 4 and 5 and instead to use the credits and debits to calculate a chargeable gain or allowable loss under TCGA. The other is to add or modify the application of some TCGA rules in relation to derivative contracts.

Clause 7: Overview of remaining provisions of this Part

29. This clause briefly introduces the contents of the rest of the Part. It is new.

30. The major part of these chapters is concerned with identifying and quantifying the credits and debits that are taken into account under clauses 4 or 5 or under Chapter 6.

Clause 8: Priority of rules under this Part for corporation tax

31. This clause provides that this Part has priority, for amounts brought into account in accordance with it in respect of any matter, over any other corporation tax provision that would otherwise apply. It is based on paragraph 1(2) of Schedule 26.

32. This rule covers not only the case where an amount is dealt with under clauses 4 or 5 or under Chapter 6, but also a case such as clause 43 (index-linked gilt-edged securities with embedded contracts for differences) where the amount is not chargeable to tax at all.

33. *Subsection (2)* indicates the rule is occasionally disregarded. *Subsection (3)* lists particular cases where this is so (but there may be others).

34. Clause 9 deals with the case where Part [6] (loan relationships) has priority over this Part. Where that clause applies to any amounts, those amounts are not in fact brought into account in accordance with this Part and so this clause cannot apply.

Clause 9: Relationship of this Part to Part [6]: loan relationships

35. This clause gives priority to Part [6] (loan relationships) if the amount that would otherwise be brought into account under this Part, or (if different) the profit or

loss accruing to the company on the derivative contract, is brought into account under that Part. This clause is based on section 101 of FA 1996.

36. This rule covers, for example, the case where a loan relationship arises from the conduct of a derivative contract (say, if one party defaults on a payment in the course of an interest rate swap and so owes money to the other). A payment due in respect of the loan relationship is dealt with under Part [6] and not under this Part.

37. *Subsection (3)* sets out the one significant exception to the general rule. It applies if a loan relationship is divided in accordance with generally accepted accounting practice between rights and liabilities of an embedded derivative and the remaining rights and liabilities. In such a case, clause 21 (loan relationships with embedded derivatives) applies. The embedded derivative is treated as a relevant contract that may constitute a derivative contract. This Part continues to apply to profits and losses in respect of the embedded derivative that is a derivative contract.

Chapter 2: Contracts to which this Part applies

Clause 10: Meaning of “derivative contract”

38. This clause sets out the three conditions to be satisfied for a contract of a company to be a derivative contract. It is based on paragraph 2(1) of Schedule 26.

39. The first condition, that it is a “relevant contract” (defined in clause 11), limits the application of the term to contracts that derive their value from underlying subject matter which is subject to changes in market prices or other factors.

40. The second condition, that it meets the “accounting conditions” in clause 14, means that the contract either:

- is treated by the relevant accounting standards as a derivative or as a financial asset or liability; or
- has underlying subject matter (defined in clause 18) within certain categories.

41. The third condition, that clause 24 or another provision of the Corporation Tax Acts does not prevent it being a derivative contract, cuts down the scope of this Part, particularly in relation to contracts whose underlying subject matter is land or shares.

42. *Subsection (2)* draws attention to provisions that *treat* certain rights and liabilities under some contracts as derivative contracts where the conditions in this clause would not be met. See also clauses 19 to 21, under which some of the rights and liabilities under a contract are *treated* as relevant contracts which are then derivative contracts if they meet the conditions in this clause. This subsection also refers to the powers in clause 125 that allow the meaning of “derivative contract” for the purposes of this Part to be amended by statutory order.

Clause 11: Meaning of “relevant contract”

43. This clause defines the umbrella term “relevant contract”. It is based on paragraph 2(2) of Schedule 26.

44. The term is used in this Part to refer generically to a contract falling within one of the three categories of contract listed here. In many contexts it is immaterial whether the relevant contract is an option, a future or a contract for differences. A relevant contract is a derivative contract if it satisfies the conditions in clause 10 or is treated as a derivative contract under another provision.

Clause 12: Derivative and relevant contracts of a person and being party to such contracts

45. This Part refers commonly to a company’s or a person’s derivative contracts or relevant contracts or to a company or person being party to such a contract. This clause explains what those references mean. It is based on paragraphs 2(2A) and 53(1), (2) and (6) of Schedule 26.

46. A relevant contract is “of” a company or person if that company or person has entered into or acquired the contract. A reference to a company or person being party to a contract means the company or person who has entered into or acquired the contract. (“Person” includes “company”, but “person” is used for cases where one of the parties to the contract may not be a company within the meaning of section 832 of ICTA. That will be the case if that person is a partnership or an overseas entity that would not be a company under United Kingdom tax law).

47. *Subsection (4)* explains what “acquires” means in relation to a contract for the purposes of this Part. The words “whether by assignment or otherwise” in the source legislation have not been reproduced as they add nothing.

Clause 13: Meaning of “plain vanilla contract”

48. This clause defines “plain vanilla contract”. It is based on paragraph 2(2B) of Schedule 26.

49. The term means any relevant contract except those to which a company is treated as party under clauses 19, 20 or 21. Those clauses apply when the rights and liabilities under a non-financial contract, a hybrid derivative or a loan relationship are treated as divided between rights and liabilities of one or more embedded derivatives and the remaining rights and liabilities of the contract.

50. For use of this term, see clauses 26, 97, 98 and 106.

Clause 14: The accounting conditions

51. This clause sets out the conditions referred to in clause 10(1)(b). If it meets any one of these conditions, a relevant contract is a derivative contract, subject to any rule that prevents it being a derivative contract. It is based on paragraph 3 of Schedule 26.

52. The first of the conditions in *subsection (1)* is that the relevant contract is treated for accounting purposes as a derivative. *Subsection (3)* explains that this means the contract is so treated for the purposes of the “relevant accounting standard” used by the company (or would be so treated if the company used that standard). The applicable standard is that mentioned in *subsection (5)*. Financial Reporting Standard 25 deals with presentation in accounts for financial instruments.

53. The second of the conditions is that, if the first condition is not met solely because of a particular requirement of the accounting standard, the contract is nevertheless treated for accounting purposes as a financial asset or financial liability. Section 9(b) of Financial Reporting Standard 26 (measurement in accounts of financial instruments) states that the “financial instrument or other contract within the scope of this Standard... requires no initial net investment or an initial net investment that is smaller than would be required for other types of contract that would be expected to have a similar response to changes in market factors”. This requirement is to be satisfied for the contract in question to be treated as a derivative under Financial Reporting Standard 25. It reflects some of the advantages of a derivative contract. For example, a derivative contract is usually a cheap way of covering the risk of adverse price movements compared to other ways of achieving the same effect. A derivative contract may also allow a company to defer the cost of covering the risk until the end of the term of the contract.

54. The third condition is that neither the first nor second condition is met but the underlying subject matter of the contract falls within one of the categories prescribed in *subsection (2)*. If the underlying subject matter is commodities, it does not matter what category of relevant contract the contract falls into. But only a contract for differences can meet the condition by reference to the other prescribed categories of underlying subject matter. So an option or future whose underlying subject matter is one or more of those other categories is only a derivative contract if it meets one of the other two accounting conditions.

55. *Subsection (4)* has the same function in relation to the second condition as has *subsection (3)* in relation to the first condition (and *subsection (5)* applies again to prescribe the relevant accounting standard).

Clause 15: Meaning of “option”

56. This clause defines an “option” in this Part. It is based on paragraph 12(1), (8) and (10) of Schedule 26.

57. Subject to the non-exhaustive definition in *subsection (1)* and the limitation in *subsection (2)* (itself limited by *subsection (3)*), the word takes its ordinary meaning. “Warrant”, in *subsection (1)*, is defined in clause 134.

58. The limitation in *subsection (2)* excludes cash-settled options from the meaning of “option”. Contracts so excluded will be contracts for differences and subject to the rules applying to relevant contracts generally and specifically to

contracts for differences. A number of provisions dispense with this limitation and so do not exclude cash-settled options from the meaning of “option” in that context.

Clause 16: Meaning of “future”

59. This clause defines a “future” in this Part. It is based on paragraph 12(1), (6), (7) and (10) of Schedule 26.

60. *Subsections (4) and (5)* exclude cash-settled futures from the scope of the definition in the same way that clause 15(2) and (3) does for cash-settled options in relation to the meaning of “option”. Contracts excluded from the definition of a “future” by subsection (4) will be contracts for differences.

Clause 17: Meaning of “contract for differences”

61. This clause defines a “contract for differences” in this Part. It is based on paragraph 12(1), (3), (4) and (5) of Schedule 26.

62. This is the broadest category of relevant contract and the definition is expressed in wide-ranging terms. *Subsection (2)* therefore excludes a number of categories of contract from the scope of the definition, in particular an option and a future, but also a loan relationship and a number of other types of financial instrument. Clause 134 has definitions of “contract of insurance” and “capital redemption policy”.

63. *Subsection (3)* emphasises the wide-ranging nature of the indices or factors that may be designated in a contract for differences (a point already made in the list of categories of underlying subject matter in clause 14(2)). The words “and, for those purposes, a numerical value may be attributed to any variation in a matter”, in the source legislation for this subsection, have not been rewritten as they add nothing. It is of the essence of any index or factor used in a contract for differences that it has such a numerical value.

Clause 18: Meaning of “underlying subject matter”

64. This clause provides the meaning in this Part of the “underlying subject matter” of a relevant contract. It is based on paragraph 11 of Schedule 26.

65. *Subsections (2), (3) and (4)* give the meaning for, respectively, an option, a future and a contract for differences. If, in the case of an option or future, the property that would fall to be delivered on the exercise of the option or when the future runs to delivery is itself a derivative contract, the underlying subject matter of the option or future is taken to be the underlying subject matter of that contract.

66. *Subsection (5)* echoes clause 14(2) in permitting certain factors to be the underlying subject matter of a contract for differences. One of those factors is interest rates. *Subsection (6)* provides that interest rates are not regarded as the underlying subject matter of a contract for differences if such rates are only used incidentally in

determining the variable amount of a payment due under the contract at a variable date.

67. *Subsection (7)* applies to all categories of relevant contract. It stops certain types of property from being regarded as the underlying subject matter of the contract. It applies if that property would only be regarded as the underlying subject matter of the contract because *income* from that property forms part of that underlying subject matter.

Clauses 19 to 21: Cases where companies treated as parties to relevant contracts

Overview

68. These three clauses treat certain rights and liabilities under a contract as themselves constituting a derivative contract independent of the remaining rights and liabilities under the main contract.

Clause 19: Non-financial contracts with embedded derivatives

69. This clause deals with non-financial contracts. It applies if, in accordance with generally accepted accounting practice, the contract is treated as divided between rights and liabilities under one or more derivatives (“embedded derivatives”) and the remaining rights and liabilities. Each embedded derivative is treated under this clause as a relevant contract. A non-financial contract is defined in *subsection (4)* as a contract which is neither a loan relationship nor a “hybrid derivative” (see clause 20), for example a property lease. This clause is based on paragraph 2A of Schedule 26.

70. If generally accepted accounting practice would so divide a non-financial contract, the company is treated under *subsection (2)* as party to one or more relevant contracts. Each such relevant contract is treated under *subsection (3)* as an option, future or contract for differences depending on what a contract consisting only of its rights and liabilities would be. Any such relevant contract is a derivative contract for the purposes of this Part if it meets the conditions in clause 10 and is not prevented by any provision from being a derivative contract.

71. Rights and liabilities treated as a relevant contract under *subsection (2)* are labelled a “non-financial embedded derivative” by *subsection (4)*. That term is used in clause 29 (as is the term “non-financial contract”). But references in this Part to a relevant contract or to an option, future or contract for differences, as the case may be, apply also to a “non-financial embedded derivative” if the context permits.

72. *Subsection (2)(b)*, in dealing with the case where there is more than one embedded derivative, refers to a contract “whose rights and liabilities consist only of those of one of the embedded derivatives”. But the source legislation refers at the equivalent point to a contract “whose rights and liabilities consist only of one of the *non-financial* embedded derivatives”. “Non-financial” is part of the label “non-financial embedded derivative”, which applies to the relevant contract to which the company is deemed to be party under this provision. It is not appropriate to the embedded derivative itself by virtue of which the company is treated as party to a

relevant contract. “Non-financial” has therefore not been rewritten in subsection (2)(b).

Clause 20: Hybrid derivatives

73. This clause deals with certain relevant contracts (“hybrid derivatives”). It applies if, in accordance with generally accepted accounting practice, the contract is treated as divided between rights and liabilities under one or more derivatives (“embedded derivatives”) and the remaining rights and liabilities which by themselves would amount to a relevant contract (“the host contract”). Each embedded derivative is treated under this clause as a relevant contract. The host contract is also treated under this clause as a relevant contract. “Hybrid derivative” is defined in *subsection (4)* by reference to a relevant contract within *subsection (1)*. This clause is based on paragraph 2B of Schedule 26.

74. The relevant contracts to which this clause applies are those that meet the second or third accounting condition in clause 14(1). But it does not apply to a relevant contract that meets the first accounting condition. So it does not apply to contracts that are treated as a derivative under generally accepted accounting practice.

75. If generally accepted accounting practice would so divide a hybrid derivative, the company is treated under *subsection (2)* as party to relevant contracts consisting of the rights and liabilities under the host contract and under each embedded derivative. As in the case of clause 19, each such relevant contract is treated under *subsection (3)* as an option, future or contract for differences depending on what a contract consisting only of its rights and liabilities would be. Similarly, any such relevant contract is a derivative contract if it meets the conditions in clause 10 and is not prevented by any provision from being a derivative contract.

76. Rights and liabilities treated as a relevant contract under subsection (2)(a) or (b) are labelled respectively a “nested derivative” and “quasi-derivative host contract” by subsection (4). Those terms are used in clause 27 (as is the term “hybrid derivative”). “Hybrid derivative” is also used in clauses 19 and 29 (and “nested derivative” is used in the latter). As in the case of clause 19, references in this Part to a relevant contract or to an option, future or contract for differences will, if the context permits, apply also to a “nested derivative” and “quasi-derivative host contract”.

Clause 21: Loan relationships with embedded derivatives

77. This clause deals with the case where, in accordance with generally accepted accounting practice, a company treats a loan relationship as divided between rights and liabilities under one or more derivative financial instruments or equity instruments (“embedded derivatives”) and the remaining rights and liabilities which by themselves constitute a loan relationship. Each embedded derivative is treated under this clause as a relevant contract. This clause is based on section 94A of FA 1996.

78. The definition of “loan relationship” in section 834(1) of ICTA applies. For the meaning of “financial instrument” and “equity instrument”, see clause 134 (that is, these terms have the meaning they have for accounting purposes).

79. If a company divides a loan relationship as mentioned in *subsection (1)*, the company is treated under *subsection (2)* as party to a relevant contract consisting of the rights and liabilities under the embedded derivative (or under each of the embedded derivatives). As in the case of clause 19, each such relevant contract is treated under *subsection (3)* as an option, future or contract for differences according to what a contract consisting only of its rights and liabilities would be. Similarly, any such relevant contract is a derivative contract if it meets the conditions in clause 10 and is not prevented by any provision from being a derivative contract.

80. Rights and liabilities which are treated as a relevant contract under subsection (2) are labelled a “section 21 embedded derivative” for the purposes of this Part (see clause 133). That term is used extensively in the Part. See, in particular, clauses 26, 43, 70, 73, 80, 85 and 95. As in the case of clause 19, references in this Part to a relevant contract or to an option, future or contract for differences will, if the context permits, apply also to a “section 21 embedded derivative”.

81. *Subsection (4)* contains a signpost to the provision in Part [6] (loan relationships) dealing with the remaining rights and liabilities which by themselves constitute a loan relationship. (“Section [j061094Aaa]”, clause 116 in the May 2007 draft clauses, rewrites section 94A of FA 1996 to the extent that section applies to the loan relationship which contained the embedded derivative(s).)

Clause 22: Contracts relating to holdings in unit trusts, OEICs or offshore funds

82. This clause treats a relevant contract that is not otherwise a derivative contract as such a contract if its underlying subject matter consists wholly or partly of a holding in a collective investment scheme that scheme fails to meet a “qualifying investments test”. It is based on paragraph 36(1), (2), (3) and (4) of Schedule 26.

83. If *subsection (2)* applies to treat the relevant contract as a derivative contract in a particular accounting period, that treatment persists for so long as the contract is a relevant contract of the company.

84. *Subsection (3)* describes what a “relevant holding” is for the purposes of the section. It is drafted in terms of the underlying subject matter of the contract rather than referring to a relevant holding of a “person”. This corrects an incongruity in the source legislation that arose from following a similar provision for loan relationships (see paragraph 4(1) of Schedule 10 to FA 1996). See *Change 1* in Annex 1. (This Change also applies to clause 47; see the signpost to that clause in *subsection (6)*.)

<p>Q2. We welcome comments on the proposal to omit the reference to a “person” holding a relevant holding in setting out when the underlying subject matter of a relevant contract consists of such a holding.</p>

85. The meaning of “interest in an offshore fund” in subsection (3)(a)(iii) is provided by reference to section 759 of ICTA rather than, as in the source legislation, paragraph 7 of Schedule 10 to FA 1996. By doing so, the phrase includes a narrower meaning of “offshore fund”. See *Change 2* in Annex 1 (an earlier version of which was published with the May 2007 draft clauses).

Q3. We welcome comments on the proposal to adopt the narrower meaning of “offshore fund” in construing the meaning of a “relevant interest in an offshore fund”.

86. *Subsection (4)* sets out what “meeting the qualifying investments test” means by reference to the meaning of that phrase in the rewritten loan relationships provisions. The reference to “section [j0696108e]” is to clause 165 in the May 2007 draft clauses.

87. *Subsection (5)* refers to the power to amend the definition of “relevant holding”, by regulations under section 17 of F(No 2)A 2005, in relation to the source legislation for both this clause and its loan relationships equivalent (clause [j0696104] in the rewritten loan relationships provisions, clause 163 in the May 2007 draft clauses). The power has not yet been exercised.

88. The provisions mentioned in *subsections (6) and (7)* are those that deal specifically with contracts to which this section applies. But a contract treated as a derivative contract by this clause will be subject to other provisions that operate on derivative contracts so far as the context permits.

Clause 23: Non-qualifying shares where the associated transactions condition is met

89. This clause treats an “associated transaction” in respect of shares held by an “investing company” as either a derivative contract or a transaction in respect of a derivative contract, if it would not already be such a contract or transaction. Where it does so, credits and debits arising from the associated transaction are then brought into account under this Part under clause 49. It is based on section 91B(5) of FA 1996.

90. Sections 91A to 91G of FA 1996 deal with certain shares which in substance are equivalent to loan relationships. They provide that the same consequences follow for tax purposes as if the company’s holding of shares were a loan relationship. Those provisions are rewritten as Chapter [6] of Part [7] (relationships treated as loan relationships etc).

91. Section 91B of FA 1996 applies to “non-qualifying shares” of an “investing company”.

92. A company which holds a share in another company is an “investing company”. A share is “non-qualifying” if one of various conditions is met. One of those conditions (section 91E of FA 1996) is that there is a scheme or arrangement

under which the share and “one or more associated transactions” are designed to equate to an investment yielding a commercial rate of interest. An “associated transaction” is one of entering into, or acquiring rights and liabilities under, a derivative contract or contracts having some similarity to a derivative contract or a contract of insurance or indemnity.

93. Section 91B(5) applies if there is such an associated transaction (the “associated transactions condition” mentioned in *subsection (1)*). *Subsection (2)* of this clause provides that the associated transaction is treated as a derivative contract or as a transaction in respect of a derivative contract if it is not already such a contract or transaction.

94. *Subsections (4)* and *(5)* provide for the interpretation of this clause in accordance with the rewritten loan relationships provisions in Chapter [6] of Part [7] (relationships treated as loan relationships etc).

95. The references to “section [j061091M]”, “section [jsharesover]” and “section [j06191E]” are to clauses 188, 187 and 197 respectively in the May 2007 draft clauses.

Clause 24: Contracts excluded because of underlying subject matter: general

96. This clause, supplemented by the next four, provides that a relevant contract is not a derivative contract if its underlying subject matter falls wholly into certain categories (or is treated as doing so) and one or more conditions applies. It is based on paragraph 4(1), (2), (2ZA) and (4) of Schedule 26.

97. Profits and losses arising in relation to such contracts are therefore not brought into account under this Part but are taxed as appropriate under other provisions, primarily as chargeable gains.

98. *Subsection (1)* introduces the term “excluded property” to describe underlying subject matter that causes the relevant contract not to be a derivative contract. *Subsections (2)* and *(3)* define the term, with further detail appearing in clauses 25 to 27.

99. Intangible fixed assets are excluded property, but only in the case of an option or future. Profits and losses in respect of such a contract will be dealt with primarily under Schedule 29 to FA 2002.

100. The major categories of excluded property, in relation to any type of relevant contract, are (a) shares in a company and (b) rights of a unit holder under a unit trust scheme. But the relevant contract must satisfy one of the conditions in clause 26.

101. *Subsection (4)* takes certain types of share out of the excluded category. These are, first, shares dealt with by the loan relationships provisions in rewriting sections 91A and 91B of FA 1996. Second, it takes out shares in an open-ended

investment company if that company fails to meet the qualifying investments test for the purposes of the loan relationships provisions. For more on the qualifying investments test, see the commentary on clause 22.

102. Clause 25 deals with the case where a relevant contract has both excluded property and other but minor underlying subject matter.

103. The references to “section [j0696104]”, “section [j061091A]” and “section [j061091B]” are to clauses 163, 189 and 191 respectively in the May 2007 draft clauses.

Clause 25: Disregard of subordinate or small value underlying subject matter

104. This clause provides that the parts of a relevant contract’s underlying subject matter that are subordinate or of small value are ignored in determining whether its underlying subject matter consists wholly of excluded property for the purposes of clause 24 . It is based on paragraph 9 of Schedule 26.

105. A relevant contract may contain a number of minor elements in addition to its main purpose. For example, there may also be an option to settle the contract in one or more currencies by reference to a particular exchange rate or there may be some minor leeway as to the settlement date.

106. If part of the underlying subject matter is not itself within the meaning of “excluded property” in clause 24, but the rest is, and the part that is not within that meaning is either:

- “subordinate” in relation to that part of the underlying subject matter which is excluded property, or
- of “small value” compared to the value of the totality of the underlying subject matter,

the underlying subject matter of the contract is treated as consisting wholly of excluded property.

107. *Subsection (3)* provides that any question of whether part of the underlying subject matter is “subordinate” or of “small value” is determined by reference to the time the company enters into or acquires the contract. But the clause does not otherwise provide any definition of “subordinate” or “small value” (and it would not necessarily be helpful to a particular case to attempt further definition).

108. See also clause 28 which deals with the cases of an option or future where the part of the underlying subject matter that is not excluded property is more than subordinate or of small value.

Clause 26: Conditions A to E mentioned in section 24(3)

109. This clause provides the conditions which govern whether shares in a company or rights of a unit holder under a unit trust scheme are excluded property under clause 24(3). It is based on paragraph 4(2A), (2B), (2C), (2CA) and (2D) of Schedule 26.

110. Condition A applies to certain relevant contracts entered into or acquired by life insurers that are an “approved derivative” within the meaning of Rule 3.2.5 of the Insurance Prudential Sourcebook issued by the Financial Services Authority on 25 October 2006 or, in the case of an overseas life insurance company which is a European Economic Area firm or a “treaty firm”, are derivative instruments falling within article 23.3 of the EC Consolidated Life Directive (EC/2002/83).

111. The source legislation for condition A applies only to cases where the contract is “entered into” by the company. But the source legislation for conditions B to D in this clause applies where the company enters into *or acquires* the contract. This condition has been brought into line with those conditions. See *Change 3* in Annex 1.

Q4. We welcome comments on the proposal to extend condition A to cases where a company acquires a plain vanilla contract as well as cases where it enters into such a contract.

112. Rule 3.2.5 of the Insurance Prudential Sourcebook sets out a number of conditions to do with the purposes for which the derivative is held, how the risk under the derivative is managed and the circumstances in which it is entered into or acquired.

113. The reference to Rule 3.2.5 of the Insurance Prudential Sourcebook follows the substitution of that reference by the Insurance Companies (Corporation Tax Acts) (Miscellaneous Amendments) Order 2006 (SI 2006/3270) for the former reference in paragraph 4(2A) of Schedule 26 to “Rule 4.3.5 of the Integrated Prudential Sourcebook”. See also the definition of “Insurance Prudential Sourcebook” in clause 134.

114. Condition A does not apply to a relevant contract that meets the condition in clause 14(1)(b) (one that is treated by accounting standards as a financial asset or liability, but is not treated not as a derivative by accounting standards because of the size of the initial outlay).

115. See also clause 27 which extends the application of condition A to certain rights and liabilities that are treated as a “nested derivative” by clause 20.

116. Condition B applies if the company is not party to the relevant contract for the purposes of its trade and there is a “hedging relationship” (defined in clause 130) between the relevant contract and either (a) shares or rights of a unit holder in a unit trust scheme or (b) the company’s share capital or related liability.

117. Condition B does not apply if the relevant contract is one treated as such by clause 21 (that is, an embedded derivative in a loan relationship).

118. Condition C applies if the company is not party to the relevant contract for the purposes of its trade and the contract is a quoted option to subscribe for shares.

119. Condition D deals with a relevant contract that relates to the acquisition by company A of a major investment in the share capital of company B other than for the purposes of core activities of company A's trade. The reference to "activities forming an integral part of a trade" ensures that the condition is not disapplied in the case of, say, a financial trader. For a financial trader, the particular contract may be relevant to its structural assets, which might be regarded as held in the course of its trade, but may not be actually relevant to its core trading activities. The contract must be an option or future for the acquisition or delivery of shares. As with condition B, condition D does not apply if the relevant contract is one treated as such by clause 21.

120. Condition E applies if there is a hedging relationship between the relevant contract and an asset or liability representing a loan relationship which is treated under clause 21 as divided between one or more embedded derivatives and a loan relationship consisting of the remaining rights and liabilities. The second leg of condition E is that each of those embedded derivatives is a derivative contract to which one of the clauses specified in paragraph (b) of *subsection (6)* applies. Under those provisions, credits and debits are brought into account in calculating chargeable gains rather than as income.

121. *Subsection (9)* is the first of a number of signposts to rules in Chapter 11 of this Part that modify the application of various provisions in the case of mutual trading companies or insurance companies.

Clause 27: Nested derivatives treated as meeting condition in section 26 etc

122. This clause extends the application of condition A in clause 26 to certain "nested derivatives" within the meaning of clause 20. Where it applies, the underlying subject matter of the nested derivative may meet the test for "excluded property" in clause 24(3). The nested derivative may thereby not be a derivative contract for the purposes of this Part. The clause is based on paragraph 45M of Schedule 26.

123. The clause applies only if the "hybrid derivative" (within the meaning of clause 20) is a relevant contract within clause 14(1)(b). That is one that is treated by accounting standards as a financial asset or liability, but not as a derivative because of the size of the initial outlay, for example, a prepaid equity forward). The "quasi-derivative host contract" (within the meaning of clause 20) must be treated for accounting purposes as (or as part of) a financial asset.

124. The nested derivative must itself satisfy clause 14(1)(a) (a relevant contract that is treated for accounting purposes as a derivative). And its underlying subject matter must be wholly shares in a company or rights of a unit holder in a unit trust

scheme. *Subsection (4)* indicates that clause 25 applies if appropriate to determine whether the “wholly” test in paragraph (c) of *subsection (1)* is met.

125. If the clause applies, the nested derivative is treated as satisfying condition A in clause 26, and therefore meets one element of the meaning of “excluded property” in clause 24(3). It would be sufficient to deem the nested derivative to meet any one of the conditions in that clause for the purposes of 24(3). But this clause is expected to be relevant primarily (although not exclusively) to insurance companies. And condition A specifically applies to such companies.

126. The clause does two more things. First, it treats the nested derivative (which in all likelihood is not now a derivative contract, because of clause 24) as a “chargeable asset” for the purposes of this Part and TCGA. See the definition of that term in clause 127.

127. Second, the quasi-derivative host contract is treated as a “creditor relationship” of the company for the purposes of the Corporation Tax Acts. That primarily affects the operation of the Parts rewriting the loan relationships provisions. But it will also affect those clauses in this Part that operate by reference to a creditor relationship (for example, clause 112). See the definition of “creditor relationship” in clause 128.

Clause 28: Contracts where part of underlying subject matter is excluded property

128. This clause provides for an option or future to be treated in certain cases as divided between a relevant contract whose underlying subject matter consists wholly of excluded property within the meaning of clause 24 and one whose underlying subject matter consists wholly of property other than excluded property. It is based on paragraph 46 of Schedule 26.

129. The clause applies only to options and futures, and the relevant contract must meet one of the accounting conditions in clause 14(1). It does not apply to a relevant contract which is treated as consisting wholly of excluded property by virtue of clause 25.

130. In determining the underlying subject matter of each relevant contract treated as a separate contract under *subsection (3)*, *subsection (4)* provides that any necessary apportionment shall be made so far as just and reasonable.

131. See the commentary on clause 24 for the significance of the underlying subject matter of a contract being or not being “excluded property”.

Clause 29: Derivatives not embedded in a loan relationship

132. This clause reverses the effect of clauses 19 and 20 if certain conditions are met by reference to the non-financial embedded derivative or nested derivative identified by either clause. It disapplies clauses 4 and 5 to that derivative. It also sets aside fair value accounting as an accounting basis in calculating profits and losses on

the non-financial contract or hybrid derivative in question. For contracts to which this clause applies, splitting of the contract under clause 19 or 20, or the use of fair value accounting, may produce unacceptably volatile results for tax purposes. The clause is based on paragraph 45L(1), (1B), (1C), (2) and (3) of Schedule 26.

133. *Subsection (1)* sets out that the clause applies if a non-financial embedded derivative or nested derivative within clause 19 or 20 is a derivative contract because it is recognised for accounting purposes as a derivative.

134. But the clause does not apply to a nested derivative within clause 20 that comes within clause 27 (so that it may meet the “excluded property” conditions in clause 24). Nor does it apply if regulation 9 of the Disregard applies (defined in *subsection (6)* to mean the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004, SI 2004/3256). That regulation prescribes credits and debits for the purposes of paragraph 17B of Schedule 26 in the case of derivative contracts that are interest rate contracts. That paragraph is rewritten in clause 36

135. Nor does the clause apply if an election is made under clause 30 for this clause not to apply.

136. *Subsections (3) and (4)* treat the relevant contract that was divided under clause 19 as not so divided. The contract is therefore outside the scope of this Part. It will be dealt with for tax purposes according to what sort of non-financial contract it is. *Subsection (4)* also provides that section 42 of FA 1998 (computation of trade etc profits in accordance with generally accepted accounting practice) applies as if fair value accounting was not generally accepted accounting practice for that company. *Subsections (3) and (4)* apply to the “original contract” rather than (as in the source legislation) the “contract” to avoid confusion with the contract referred to in *subsection (1)(a)*.

137. *Subsection (5)* treats the relevant contract that was divided under clause 20 as not so divided. It is therefore treated as a single derivative contract for the purposes of this Part. But again the contract is treated as one to which fair value accounting does not apply.

Clause 30: Election for section 29 not to apply

138. This clause allows a company to elect that clause 29 does not apply to any of its contracts. For some companies the benefit afforded by that clause may be disproportionate to the administrative and accounting burden of distinguishing and tracking affected contracts. Or the degree of volatility in the tax consequences of splitting the contract or using fair value accounting may be acceptable to the company holding the contract. This clause is based on paragraph 45L(2A), (2B) and (2C) of Schedule 26.

139. An election under this clause applies to all of a company's contracts. Clause 31 contains further provisions modifying or extending the effect of an election made by a member of a group of companies.

140. *Subsection (1)* excludes two types of contract from an election. They are, first, a "contract of long-term insurance" (a term defined in clause 134) and, second, a contract where the embedded derivative identified by clause 19 or 20 has commodities as its underlying subject matter.

141. *Subsections (2) and (3)* provide a time limit for making an election, by reference to the end of the first accounting period of the company in which the conditions for the application of clause 29 are met. Such an election is irrevocable. The clause does not specify how the election must be made. See *Change 4* in Annex 1.

Q5. We welcome comments on the proposal to drop the requirement that an election under this clause be made in writing to HMRC.

Clause 31: Elections under section 30: groups of companies

142. This clause applies or disapplies the effect of an election under clause 30 in a number of cases where a party to a contract is a member of a group of companies (within the meaning of section 170 of TCGA). It is based on paragraph 45LA of Schedule 26.

143. The first case is if:

- one member of a group ("A") has made such an election in respect of its contracts; and
- another member of the group ("B") is the counterparty to one of those contracts or otherwise is also party to the contract.

144. *Subsection (1)* treats B as having made an election in relation to that contract. This rule ensures parity of treatment of the contract within the group.

145. The second case is if:

- B becomes party in place of A to a non-financial contract to which clause 19 applies, at a time when they are members of the same group; and
- A has made or makes an election in respect of its contracts.

146. *Subsection (2)* provides that B is treated as having made an election in relation to that contract. This rule applies even if A makes the election at a time after B has succeeded A as party to the contract or at a time when A and B are no longer

members of the same group. This rule ensures that a company cannot exclude some of its contracts from the effect of an election by transferring them to another group member.

147. The reference in subsection (2) to a contract “to which section 19 applies” corrects a missed consequential amendment to paragraph 45LA(3)(b) of Schedule 26. The reference there to “paragraph 2(3)” is otiose following the replacement of that provision by paragraph 2(2A) of Schedule 26 (replaced by article 3 of the Finance Act 2002, Schedule 26, (Parts 2 and 9) (Amendment) Order 2006, SI 2006/3269) and the insertion of paragraph 2A of Schedule 26 (by article 4 of that Order).

148. The third case is if:

- B becomes party in place of A to a relevant contract treated as such by clause 19 or 20, at a time when they are members of the same group;
- that contract was within clause 29 in A’s hands (that is, A had not made an election); and
- B’s other contracts are outside clause 29 by virtue of an election B has made (whether an election made before B has succeeded A as party to the contract or one made later).

149. *Subsection (4)* ring-fences the contract in question, so that any existing or later election by B is ineffective in relation to that contract. This rule ensures that a contract cannot be selected for preferential treatment under another group member’s election if the member who is the original party to the contract does not otherwise wish to make an election. This rule is however disapplied if A makes an election in respect of its contracts subsequent to B becoming party to the contract in place of A.

Chapter 3: Credits and debits to be brought into account: general

Overview

150. This Chapter contains the main rules for identifying and calculating the credits and debits to be brought into account in calculating the profits and losses arising to a company from its derivative contracts, as mentioned in clause 3. It provides in particular for the application of generally accepted accounting practice, or for departure from generally accepted accounting practice, for that purpose. Chapter 4 contains further provisions about credits and debits for a number of special situations.

Clause 32: Credits and debits to be brought into account

151. This clause provides that the credits and debits to be brought into account under this Part are the amounts that fairly represent profits and losses arising from a company’s derivative contracts. It is based on paragraph 15(1), (4) and (9) of Schedule 26.

152. *Subsection (4)* provides that expenses are disregarded in determining under *subsections (1) and (2)* any profits or losses in respect of the derivative contract. However, paragraph (b) of subsection (2) adds expenses incurred for certain purposes and in certain ways (as listed in *subsection (3)*) to the amount to be brought into account as debits under this clause. Such expenses are limited to those incurred directly in the acquisition of the derivative contract and in performance of the rights and liabilities under the contract.

153. Subsections (1) and (2) also include as credits and debits any profits, losses or eligible expenses in connection with “related transactions” in respect of the derivative contract. Clause 33 defines “related transaction”.

154. *Subsection (5)* contains a signpost to a clause 34 which adds certain other expenses to those allowed as debits under subsection (2).

Clause 33: Meaning of “related transaction”

155. This clause provides the meaning of “related transaction” for the purposes of this Part. It is based on paragraph 15(7) and (8) of Schedule 26.

156. A related transaction is any disposal or acquisition of rights or liabilities under a derivative contract. *Subsection (2)* has a non-exhaustive list of what a disposal or acquisition includes for this purpose.

157. The term is used extensively in this Part in provisions which may apply to or involve consideration of the acquisition or disposal of a derivative contract. For later use, see clauses 34, 42, 44, 46, 55, 56, 57, 59 and 108.

Clause 34: Pre-contract expenses where contract not entered into

158. This clause extends the category of expenses that are treated under clause 32 as debits to be brought into account under this Part. It applies to equivalent expenses incurred for purposes connected with entering into a derivative contract or related transaction that has not been entered into. It also applies to expenditure on giving effect to any obligation that might arise under that contract or transaction not yet entered into. The clause is based on paragraph 15(5) of Schedule 26.

159. The clause effectively provides a relief for abortive expenditure, or where there is delay in entering into the derivative contract. But the relief is limited under *subsection (2)* to expenses equivalent to those that would have been allowed had the contract been entered into or the related transaction of acquisition or disposal carried out.

Clause 35: Exchange gains and losses from derivative contracts

160. This clause makes clear that exchange gains and losses are included in the profits and losses mentioned in clause 32(1) and (2). For the meaning of “exchange gains” and “exchange losses” in this Part, see clause 129. The clause also provides

powers for regulations that exclude certain exchange gains and losses from the scope of this clause. It is based on paragraph 16 of Schedule 26.

161. *Subsection (1)* does not rewrite the words “and related transactions” in paragraph 16(1) of Schedule 26 as it is not considered that exchange gains and losses arise in respect of such transactions. Exchange gains and losses arise in this context from comparing the translated value of the derivative contract at different times, so they arise from the derivative contract itself.

162. *Subsection (3)* excludes exchange gains and losses arising in two circumstances from the basic rule in subsection (1) if those gains and losses are recognised in the company’s “statement of total recognised gains and losses” or “statement of changes in equity”. Those terms are defined in clause 134 as having the meaning they have for accounting purposes. The former is taken from United Kingdom generally accepted accounting practice and the latter from international accounting standards, but are otherwise equivalent terms. Amounts recognised in such a statement will fall to be taken into account by virtue of clause 32, so there is no need for the rule in this clause to apply. This subsection is subject to the effect of any regulations made under the power in *subsection (5)*.

163. The clause contains two regulatory powers. The first is in *subsection (4)*. It concerns exchange gains and losses from a derivative contract whose underlying subject matter is wholly or partly currency. Regulations may exclude such gains from the scope of subsection (1). For regulations made under this power, see the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004 (SI 2004/3256), as amended by SI 2005/2012, SI 2005/3374, SI 2006/843, SI 2006/936, SI 2006/3236 and SI 2007/948.

164. The second is in subsection (5). Regulations may countermand the effect of the rule in subsection (3) or of regulations made under subsection (4). Where the regulations apply, the affected amounts are brought into account under this Part as credits or debits arising from a company’s derivative contracts or for the purposes of corporation tax on chargeable gains.

165. (The Exchange Gains and Losses (Bringing into Account Gains or Losses) Regulations 2002 (SI 2002/1970), as amended by SI 2004/3259 and SI 2005/2013, are made partly under the power rewritten in subsection (5). As amended by regulation 5 of SI 2005/2013, SI 2002/1970 has no direct impact on the source legislation for this clause.)

166. The source legislation for this clause has been prospectively repealed by paragraph 9 of Schedule 6 to F(No 2)A 2005, subject to the making of an order for the repeal to have effect. No such order has yet been made.

Clause 36: Generally accepted accounting practice and recognised amounts

167. This clause provides that amounts to be brought into account as credits and debits for the purposes of this Part are those recognised for a period of account in accordance with generally accepted accounting practice. The clause also explains what “recognised” means for this purpose. Finally, it deals with the treatment of prior period adjustments. The clause is based on paragraph 17A(1) and paragraph 17B(2) of Schedule 26.

168. *Subsection (2)* sets out the overall primacy of generally accepted accounting practice in determining the credits and debits relevant to this Part. “Generally accepted accounting practice” is defined by section 832(1) of ICTA by reference to section 50(1) of FA 2004. If a company prepares accounts in accordance with international accounting standards, those standards constitute generally accepted accounting practice. Otherwise United Kingdom generally accepted accounting practice applies.

169. Similarly to clause 32(5), *subsection (3)* makes clear that this general rule is subject to the rest of this Part. It mentions in particular clause 32(1) to (4) which determine the credits and debits to be brought into account under this Part.

170. *Subsection (4)* set out what an amount “recognised” in determining a company’s profit or loss means by reference to the various parts of a company’s accounts, whether under United Kingdom generally accepted accounting practice or under international accounting standards, in which amounts are recognised. “Income statement”, in paragraph (a), is defined in clause 134 as having the meaning it has for accounting purposes (in this case, international accounting standards).

171. *Subsection (5)* provides that a “prior period adjustment”, that is an amount brought into account because of a review of the adequacy or correctness of the accounts for an earlier period of account, is to be taken into account for the purposes of this clause. But *subsection (6)* excludes any amount which corrects a “fundamental error” from this rule. It is not the practice under United Kingdom generally accepted accounting practice for a correction of a fundamental error to be shown as a prior period adjustment.

172. See also clauses 54 and 55 for the treatment of adjustments shown in accounts on a change of accounting policy.

Clause 37: Companies without GAAP-compliant accounts: meaning of “amounts recognised for accounting purposes”

173. This clause provides that, in a case where a company has not prepared accounts in accordance with generally accepted accounting practice, amounts brought into account as profits or losses under this Part are nevertheless calculated on the basis that it had done so. It is based on paragraph 17A(2), (3) and (4) of Schedule 26.

174. See the commentary on clause 36(2) for the meaning of “generally accepted accounting practice”. Where this clause applies, it means in effect United Kingdom generally accepted accounting practice (as defined in section 50(4) of FA 2004). Unless a company uses international accounting standards for a period, the default meaning of generally accepted accounting practice is UK generally accepted accounting practice.

Clause 38: Power to make regulations about accounts

175. This clause provides powers for regulations which amend the amounts regarded as “recognised” in one or other of the various statements mentioned in clause 36(4). It is based on paragraph 17C of Schedule 26 and paragraph 52(1) and (2) of Schedule 4 to FA 2005.

176. The regulations may allow amounts to be excluded from clause 36(4) and may require amounts to be brought into account (and may provide how they are to be brought into account) in determining a company’s profit or loss for a period. *Subsection (2)* makes clear that regulations requiring amounts to be brought into account may reverse the effect of any use of the power to exclude amounts from clause 36(4). And *subsection (3)* provides that the regulations may take into account amounts derived from or related to an earlier period.

177. For regulations made under this power, see the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004 (SI 2004/3256), as amended by SI 2005/2012, SI 2005/3374, SI 2006/843, SI 2006/936, SI 2006/3236 and SI 2007/948 and the Loan Relationships and Derivative Contracts (Change of Accounting Practice) Regulations 2004 (SI 2004/3271), as amended by SI 2005/3383, SI 2006/3238 and SI 2007/950.

Clause 39: Credits and debits treated as relating to capital expenditure

178. This clause provides that, if a credit or debit in respect of a derivative contract is used in presenting the value of a fixed capital asset or project in accounts, it is to be brought into account under this Part in the same way as a credit or debit brought into account in determining the company’s profit or loss. It is based on paragraph 25 of Schedule 26.

179. Generally accepted accounting practice may permit a credit or debit of an income nature to be included in the value of a fixed capital asset or project. This clause effectively overrides that treatment. The credit or debit (whether arising from the derivative contract itself or a related transaction in relation to that contract) is used to determine the income or gains chargeable by virtue of this Part.

180. *Subsection (3)* excludes a debit taken into account for the purposes of “Part [9] (intangible fixed assets)”. That Part rewrites Schedule 29 to FA 2002 (draft clauses for this Part have not yet been published).

181. *Subsections (5) and (6)* prevent any debit being taken into account by virtue of this clause so far as it represents the writing down of the value of the asset or project in question or the writing off of the interest component of the asset in an amount of amortisation or depreciation.

Clause 40: Credits and debits recognised in equity or shareholders' funds

182. This clause provides that, if a credit or debit in respect of a derivative contract would be recognised in equity or shareholders' funds, rather than in one of the statements mentioned in clause 36(4), it is to be taken into account for the purposes of this Part in the same way as a credit or debit to which clause 36 applies. It is based on paragraph 25A of Schedule 26.

183. As in the case of clause 39, this clause effectively overrides the accounts treatment. The credit or debit (whether arising from the derivative contract itself or a related transaction in relation to that contract) is used to determine the income or gains chargeable by virtue of this Part.

Clause 41: Release of liability under derivative contract under statutory insolvency arrangement

184. This clause exempts from the scope of this Part an amount arising on the release of a company's liability to pay an amount under a derivative contract, if the release is part of a statutory insolvency arrangement. It is based on paragraph 22(5) of Schedule 26.

185. A "statutory insolvency arrangement" is defined in section 834(1) of ICTA by reference to the Insolvency Act 1986 and other provisions having a similar effect.

Chapter 4: Further provision about credits and debits to be brought into account etc

Overview

186. This Chapter provides rules governing the credits and debits to be brought into account in a miscellany of special situations.

Clause 42: Contracts ceasing to be derivative contracts

187. This clause provides that, if a contract to which the company continues to be party ceases to be a derivative contract, there is a deemed disposal of the contract at the time of that cessation. It is based on paragraphs 43A(5) and 43B of Schedule 26.

188. *Subsection (2)* deems the company to have disposed of the contract in a "related transaction" (see the definition of that term in clause 33). Depending on the amount of the consideration attributed to that disposal, a credit or debit will arise to be brought into account under this Part. That credit or debit is additional to any other credit or debit that arises in relation to the contract, while it was a derivative contract, for the accounting period in which the deemed disposal occurs.

189. The disposal is deemed to be for a consideration equal to the “notional carrying value” of the contract at the time it ceases to be a derivative contract. That value is defined in *subsection (4)* as the carrying value the contract would have had in the books of the company had a period of account ended immediately before the deemed disposal. “Carrying value” is defined in clause 126.

190. The source legislation for subsection (4) refers to the amount that would have been the carrying value of the contract in the accounts of the company “if an accounting period had ended immediately before that time”. But the source legislation for the equivalent definition in clause 107(6), paragraph 28(3) of Schedule 26, refers to the value found “if a period of account had ended immediately before” the requisite time. But, if a period of account comes to an end, that will be the end of an accounting period under section 12(3) of ICTA. So there is no distinction of substance in this context between the end of a period of account and the end of an accounting period. The two definitions have been brought into line using “period of account”.

191. After the contract ceases to be a derivative contract, it is likely to be a chargeable asset for the purposes of corporation tax on chargeable gains. *Subsection (5)* therefore contains a signpost to clause 92 which sets out the acquisition cost of the contract for that purpose.

Clause 43: Index-linked gilt-edged securities with embedded contracts for differences

192. This clause provides that credits and debits arising in respect of an embedded derivative in an index-linked gilt-edged security are not brought into account under this Part if conditions are met. It is based on paragraph 45I of Schedule 26.

193. This clause applies if:

- an index-linked gilt-edged security which is a creditor relationship of the company is treated under clause 21 as divided between one or more embedded derivatives and the remaining rights and liabilities;
- the embedded derivative (or one of them) is thereby a contract for differences; and
- Part [6] (loan relationships) applies to credits and debits in respect of those remaining rights and liabilities (the “host contract”) as non-trading credits and debits.

194. If the embedded derivative is closely related to the host contract, generally accepted accounting practice will not in fact require the company to divide the security as mentioned in clause 21. In that case, section 94 of FA 1996 will apply (that provision is rewritten in Part [6] (loan relationships) as clauses [j061094] and [j061094aa], clauses 100 and 101 in the May 2007 draft clauses). But, for example, a company whose functional currency is not sterling may be required to divide its

index-linked securities between an embedded derivative and a host contract, in which case this clause may apply.

195. If credits and debits are not brought into account by virtue of this clause, they cannot be brought into account otherwise for corporation tax purposes because of clause 8.

196. The reference to “section [j0610103]” in *subsection (7)* is to clause 151 in the May 2007 draft clauses.

Clause 44: Company ceasing to be party to derivative contract

197. This clause deals with the case where profits and losses arising to a company from a derivative contract in the accounting period in which it ceases to be party to that contract are not fully represented by credits and debits brought into account for that period. It provides that, to the extent that any credits or debits brought into account in respect of those profits and losses in subsequent accounting periods, they are brought into account for the purposes of this Part in that later period or periods. That is, the clause provides for the taxation of post-cessation receipts from a derivative contract. It is based on paragraph 53(3), (4), (5) and (6) of Schedule 26.

198. *Subsection (2)* provides that the post-cessation credits and debits are brought into account in the same way and to the same extent as credits and debits from a derivative contract to which the company is party in the later period.

199. *Subsections (3) to (6)* set out how certain conditions in this Part may be treated as satisfied in respect of the former derivative contract. Those are conditions that may need to be satisfied for a particular provision to apply in respect of post-cessation credits or debits. The circumstances to be used in applying those conditions are those of the contract and the company immediately before the company ceased to be party to the contract, or the circumstances in the period in which that cessation occurred, as the case may be. For examples of the conditions to which *subsection (3)* or *(5)* may apply, see clauses 31, 56, 70(4), and 80(5).

200. *Subsection (7)* makes clear that the deeming effect of *subsections (3) to (6)* carries through for any question of what are a company’s derivative contracts or whether a company is party to a derivative contract.

Clause 45: Company ceasing to be UK resident treated as assigning derivative contracts

201. This clause and the next apply if a derivative contract moves out of the scope of corporation tax because the company holding it is no longer within the charge to tax because of a change of United Kingdom residence status. This clause imposes a deemed disposal of the contract immediately before the company ceases to be UK resident. It is based on paragraph 22A(1), (2) and (3) of Schedule 26.

202. *Subsection (1)* treats the company which ceases to be UK resident as having assigned the rights and liabilities under the contract for an amount equal to the fair value of those rights and liabilities at the time of that cessation. “Fair value” is defined in clause 134.

203. Subsection (1) also provides that the company is treated for the purposes of this Part as reacquiring the derivative contract for that amount. This deemed value is taken into account if the derivative contract re-enters the scope of corporation tax because of a further change in the residence status of the company or otherwise.

204. *Subsection (2)* has an exception to the general rule. The rule in subsection (1) does not apply to the extent that the rights and liabilities under the derivative contract are held or owed for the purposes of a permanent establishment of the company in the United Kingdom after the company has ceased to be so resident. (“Permanent establishment” is defined in section 832(1) of ICTA by reference to the meaning provided by section 148 of FA 2003.) This will apply if a company moves abroad but leaves behind such a business operation as amounts to a permanent establishment and that operation includes at least some of the rights and liabilities under the derivative contract. In effect, the contract has not left the scope of corporation tax.

Clause 46: Non-UK resident companies treated as assigning derivative contracts no longer held for permanent establishment in UK

205. This clause makes similar provision to the preceding clause if some or all of the rights or liabilities in a derivative contract held or owed for the purposes of a permanent establishment of a non-UK resident company cease to be so held or owed. This may be because the contract is now held for the purposes of another part of the company’s business or because the permanent establishment ceases to be such. In those cases the derivative contract has left the scope of corporation tax. The clause is based on paragraph 22A(1) and (4) of Schedule 26.

206. The significant difference between the conditions for the application of this clause and those for the preceding clause is that this clause does not apply if the rights and liabilities under the contract cease to be held or owed for the purposes of the permanent establishment because of a “related transaction” (defined in clause 33). That is, it does not apply when the contract ceases to be held because it is disposed. That disposal will itself be an occasion leading to amounts being brought into account under this Part.

Clause 47: Contracts within section 22

207. This clause applies fair value accounting in determining the credits and debits to be brought into account in respect of a contract that is treated as a derivative contract because of clause 22. It is based on paragraph 36(1) and (2A) of Schedule 26.

208. Clause 22 applies if the underlying subject matter of a contract includes a holding in a collective investment scheme that fails to meet a “qualifying investments” test. By virtue of this clause’s relationship to clause 22, *Change 1* in

Annex 1 (reference to a “relevant holding” is to a holding which is the underlying subject matter of the contract rather than a holding of the company which is party to the contract) applies here as well. See the commentary on that clause.

Clause 48: Contract becoming contract to which section 22 applies

209. This clause determines the opening valuation of a derivative contract for an accounting period for the purposes of clause 47. The accounting period in question is one in which a relevant contract is treated as a derivative contract because of clause 22 and that period immediately follows another in which it was not so treated. The clause applies only if the relevant contract was a “chargeable asset” (defined in clause 127) at the end of the earlier period. It is based on paragraph 37(1), (2), (3), and (4) of Schedule 26.

210. The reference in paragraph (d) of subsection (1) to “the fair value accounting basis” relevant to clause 47 corrects a missed consequential amendment of paragraph 37(4) of Schedule 26. Paragraph 62 of Schedule 10 to FA 2004 substituted paragraph 36(2A) of Schedule 26, changing the reference there from a mark to market basis of accounting to a fair value basis of accounting, but missed the consequential amendment needed in paragraph 37(4) of Schedule 26.

211. *Subsection (2)* provides that the opening valuation is taken to be the market value of the contract, defined by *subsection (3)* as the market value of the contract for the purposes of corporation tax on chargeable gains (see in particular section 272 of TCGA).

Clause 49: Non-qualifying shares where the associated transactions condition is met

212. This clause applies fair value accounting in determining the credits and debits to be brought into account by virtue of clause 23 in respect of an “associated transaction” that is treated as a derivative contract because of that clause. It is based on section 91B(5) of FA 1996.

213. For the circumstances in which clause 23 applies and for the meaning of “associated transaction”, see the commentary on that clause.

214. *Subsection (3)* makes clear that this clause must be construed as if it were part of the chapter in Part [7] (relationships treated as loan relationships etc) which rewrites sections 91A to 91G of FA 1996.

215. The references to “section [j06191E]” and to “section [jsharesover]” are to clauses 197 and 187 in the May 2007 draft clauses.

Clause 50: Partnerships involving companies

216. This clause and the next two set out how a company partner brings into account credits and debits in respect of its share of a firm’s derivative contracts. This clause provides that each company partner brings credits and debits into account in

calculating its profits chargeable to tax. Credits and debits in respect of the derivative contract are accordingly left out in calculating the firm's profits. It is based on paragraph 49(1) and (2) of Schedule 26.

217. Paragraph (c) in *subsection (1)* requires that the firm is party to a contract that is a derivative contract "or would be a derivative contract if the firm were a company". A firm is not a company. So a contract held by a firm would not meet any test under which a contract is or is treated as a derivative contract because it is held by a company.

218. *Subsection (2)* switches off the normal rule in section 114(1) of ICTA under which the profits of the firm's trade etc are calculated, in accordance with the partners' interests in the firm, as if the firm were a company.

219. "Profit-sharing arrangements", in relation to a partnership, is defined in clause 134. The reference there to "section [j190303]" is to clause 250 of the Partnerships Part in committee paper CC/SC(06)07 published in June 2006. A firm's "profit-sharing arrangements" are described there, in the clauses rewriting section 114 of ICTA, as "the rights of the partners to share in the profits of the trade and the liabilities of the partners to share in the losses of the trade".

220. *Subsection (3)* substitutes the rule that each company partner brings in credits and debits in respect of a derivative contract held by the firm in its calculation of taxable profits.

Clause 51: Determinations of credits and debits by company partners

221. This clause determines the credits and debits to be brought into account under clause 50 by each company partner in a firm. It is based on paragraph 49(3), (4), (5) and (6) of Schedule 26.

222. *Subsections (2) to (4)* treat the actions etc of the firm in relation to its derivative contracts as undertaken by the company partner.

223. *Subsections (5) to (7)* attribute to the company partner a share of the credits and debits arising in respect of the firm's derivative contracts according to that company partner's share of the firm's profits and losses under the firm's profit-sharing arrangements.

Clause 52: Company partners using fair value accounting

224. This clause applies if a company partner uses fair value accounting in relation to its interest in the firm. It applies fair value accounting in determining under clause 51 the company partner's share of the credits and debits arising in respect of the firm's derivative contracts. It is based on paragraph 50 of Schedule 26.

Clause 53: Introduction to sections 54 and 55

225. This clause introduces clauses 54 and 55 and sets out when they apply. These clauses prescribe the credit or debit to be brought into account on a change of accounting basis. This clause is based on paragraph 50A(1) and (1A) of Schedule 26 and paragraph 7(6) of Schedule 6 to F(No 2)A 2005.

226. Accounting standards themselves allow for an element of choice in whether they apply to a company and how they apply. And the circumstances of a company may change so that a different set of standards may be more appropriate to the presentation of the company's accounts. That may involve a switch to or from United Kingdom generally accepted accounting practice from or to international accounting standards. That situation is singled out by *subsection (3)* as a particular example of when these clauses apply.

227. If there is a change in accounting standards, the value of the company's assets and liabilities at the start of the period of account to which the change first applies are restated in accordance with the standards adopted. That value may differ from the value appropriate under the standards formerly used. Clauses 54 and 55 apply if the change is from an accounting policy that "accords with the law and practice applicable" in relation to one period of account to another such standard in relation to the next period.

228. *Subsection (4)* treats a particular situation as a change of accounting policy although there is no change in the actual accounting policy used by the company from one period to the next. Paragraph 7 of Schedule 6 to F(No 2)A 2005 permits a company to elect that a loan relationship is treated as divided as mentioned in clause 21(1) if division would have been permitted under a current United Kingdom generally accepted accounting practice or international accounting standards. The election overrides the company's application of the standards in an earlier version of United Kingdom accounting practice that prevent a loan relationship being so treated as divided between rights and liabilities of one or more embedded derivatives and the remaining rights and liabilities. The result of an election is a change in accounting policy such as is referred to in *subsection (3)*, but only in relation to all the company's affected loan relationships. This rule applies from the date the election has effect. Broadly, the election has effect from the beginning of the period of account in which the election is made or, if earlier, the period in which the first affected loan relationship is acquired.

229. An election under paragraph 7 of Schedule 6 to F(No 2)A 2005 has effect for the purposes of Chapter 2 of Part 4 of FA 1996 (loan relationships) and Schedule 26 to FA 2002. Paragraph 7 of Schedule 6 to F(No 2)A 2005 is rewritten in clause [j0610567], clause 117 in the May 2007 draft clauses. That clause applies an election made under it for the purposes of this Part as well as for the Part in which it appears. Clause [j061094Aaa] in Part [6] (loan relationships), clause 116 in the May 2007 draft clauses, rewrites section 94A of FA 1996, as it applies for the purposes of the loan relationships provisions, as does clause 21 for derivative contracts.

Clause 54: Adjustments on change of accounting policy involving change of value

230. This clause determines the credit or debit to be brought into account if the conditions in clause 53 are met. It is based on paragraph 50A(2), (3) and (5) of Schedule 26.

231. If there is an increase or decrease in the carrying value of the derivative contract, comparing the value at the end of the earlier period with the value at the beginning of the later period, a credit or debit as appropriate is brought into account for the later period. “Carrying value” is defined in clause 126.

232. *Subsection (3)* makes an exception to the general rule. This clause does not apply to the extent that the credit or debit in question is brought into account for the purposes of this Part under another provision. For example, a prior period adjustment brought into account under clause 36(5) would be excepted from the general rule in this clause.

Clause 55: Change of accounting policy: company ceasing to be party to derivative contract

233. This clause requires a credit or debit to be brought into account, similarly to clause 54, in a case where clause 44(2) applies. It is based on paragraph 50A(3C), (3D) and (5) of Schedule 26.

234. It applies if:

- there is a difference between the amount outstanding at the end of the earlier period and the amount outstanding at the beginning of the next period; and
- that difference is in respect of deferred income or deferred loss not yet brought into account after a company has ceased to be party to a derivative contract in circumstances in which clause 44(2) applies.

235. Because the derivative contract from which the income or loss derived is either no longer in existence or no longer held by the company, clause 53 cannot apply to the difference brought about by the change in accounting practice. As in that clause, a credit or debit must be brought into account for the later period in respect of the increase or decrease in the amount outstanding.

236. *Subsection (4)* gives priority to any other provision that brings all or part of that difference into account under this Part.

237. *Subsections (5) and (6)* define what is meant by “the amount outstanding in respect of the derivative contract”. See the commentary on clause 44 for further information on the circumstances in which such amounts arise.

238. This clause corrects an error in the source legislation. Paragraph 50A(3D) of Schedule 26, in defining the “amount outstanding”, refers to an amount recognised “in

respect of the profits, gains or losses that arose from that *relationship* or a related transaction in the cessation period (within the meaning of *section 103(6)*). The highlighted words are of course appropriate to the loan relationships provisions and not to those for derivative contracts. They reflect the wording of the provision equivalent to this clause, paragraph 19A(4C) and (4D) of Schedule 9 to FA 1996, on which paragraph 50A(3C) and (3D) of Schedule 26 were modelled. That provision of FA 1996 is rewritten as clause [j0696919Ab] in Part [6] (loan relationships), clause 24 in the May 2007 draft clauses.

Chapter 5: Anti-avoidance

Overview

239. This Chapter deals with a number of circumstances where transactions in respect of derivative contracts may be undertaken with a view to avoidance of tax. Clauses 56 to 58 deal with contracts which have purposes deemed “unallowable”. Clauses 59 to 61 deal with a miscellany of circumstances where the parties to the contract are connected. Clauses 62 and 63 deal with certain transactions with non-UK residents. The clauses take various steps to remove the tax advantage that would otherwise be obtained.

Clause 56: Derivative contracts for unallowable purposes

240. This clause prevents certain credits and debits being brought into account for the purposes of corporation tax, whether under this Part or otherwise, if the derivative contract in question has an “unallowable purpose” (as defined in clause 57). It is based on paragraph 23(1), (2), (3), (8), (9) and (10) of Schedule 26.

241. *Subsections (2) and (3)* prevent a company bringing into account all debits and those credits that are “exchange credits” (defined in *subsection (6)*) in respect of the derivative contract that are referable to the unallowable purpose. Any necessary apportionment may be made to arrive at the credits that are exchange credits.

242. *Subsection (4)* contains a signpost to an exception from this general rule in clause 58, which provides that some of the debits mentioned in subsection (3) may be brought into account in certain circumstances.

243. *Subsection (5)* makes clear that an amount that is not brought into account because of this clause (subject to the modification of this clause in clause 58) is regarded as brought into account for the purposes of the priority rule in clause 8, and is therefore not in any other way to be brought into account for the purposes of corporation tax.

Clause 57: Meaning of “unallowable purpose”

244. This clause defines “unallowable purpose” for the purposes of clauses 56 and 58. It is based on paragraph 23(1), (2), (3), (4) and (5) of Schedule 26.

245. A purpose is unallowable if it is one of the purposes for which the company is party to the contract (or enters into related transactions in relation to it) and it is not a business or other commercial purpose of the company.

246. *Subsection (3)* excludes any activities in respect of which the company is not within the charge to corporation tax from the business and commercial purposes of the company that are relevant to this definition. For example, if a non-UK resident company is party to the contract for the purposes of a permanent establishment it has in the United Kingdom, the purposes of the activities of the company that are not part of the activities of the permanent establishment are disregarded.

247. *Subsections (4) to (7)* exclude a tax avoidance purpose from the business and commercial purposes of the company for the purposes of this definition. A “tax avoidance purpose” is defined in subsections (6) and (7). If such a purpose is a purpose for which the company is party to the contract (or enters into related transactions in relation to it), it is an excluded purpose. But there is an exception if it is not the main purpose (or one of the main purposes) for which it is party to the contract. The effect of this rule is that a tax avoidance purpose will be an unallowable purpose unless it is a minor part of the company’s motivation for being party to, or entering into related transactions in relation to, the derivative contract.

Clause 58: Allowance of accumulated net losses

248. This clause permits a debit to be made for some of the debits prevented from being brought into account by clause 56. A debit is permitted to the extent those debits are matched by credits in respect of the derivative contract which are brought into account under this Part. But for this purpose credits does not include exchange credits (as defined in clause 56(7)). The clause is based on paragraph 23(1), (4), (5), (6) and (7) of Schedule 26.

249. The amount that is brought into account as a debit under this clause, by virtue of *subsection (4)*, is the amount of the “excess accumulated net losses” found in accordance with the method statement in *subsection (5)*. The method statement calculates two amounts. The amount that may be brought into account as a debit under this clause is the lower of the two amounts.

250. First, it finds the aggregate for the current and any previous accounting period of “net losses” in respect of the contract. A “net loss” is defined by *subsection (2)*. It is the excess of the debits prevented from being brought into account in an accounting period because of clause 56(3) over the exchange credits also so prevented because of clause 56(2). Any amount treated as a debit because of this clause in an earlier accounting period is deducted from the aggregate of the net losses.

251. Second, it finds the aggregate for the current and any previous accounting period of credits other than exchange credits in respect of the contract. Two amounts are deducted from that aggregate: first, the total of any debits brought into account in respect of the contract (that is, those debits not prevented from being brought into

account by clause 56(3)); second, any amount treated as a debit because of this clause in an earlier accounting period.

252. In effect, debits prevented from being brought into account because of clause 56(3) are relieved only to the extent that there are credits other than exchange credits in respect of the contract that exceed debits that are not referable to the unallowable purpose.

Clause 59: Bringing into account adjustments under Schedule 28AA to ICTA

253. This clause brings into account under this Part credits and debits in respect of amounts treated under Schedule 28AA to ICTA (provision not at arm's length) as profits, losses or expenses. It does so to the extent that actual amounts of such profits, losses or expenses would be brought into account. It is based on paragraph 31A of Schedule 26.

254. Schedule 28AA to ICTA identifies adjustments ("imputed amounts") to be made to return the profit or loss from a transaction between parties not at arm's length to what the profit or loss would be had they been at arm's length. This clause ensures that such amounts are taken into account under this Part although they arise under Schedule 28AA rather than under this Part. The separate treatment of credits and debits in respect of imputed profits and losses and debits in respect of expenses follows that in clause 32.

255. *Subsections (3) and (5)* indicate that the credits and debits brought into account by this clause are subject to the same rules as apply under this Part to credits and debits in respect of actual amounts. So, for example, debits in respect of expenses will be those falling within the categories listed in clause 32(4).

Clause 60: Exchange gains and losses where derivative contracts not on arm's length terms

256. This clause makes adjustments further to those in clause 59 if Schedule 28AA to ICTA prescribes adjustments or other treatment of exchange gains and losses. It gives effect to those adjustments or other treatment in this Part. It is based on paragraph 27 of Schedule 26.

257. Under paragraph 1 of Schedule 28AA to ICTA, a company may be treated as not party to a derivative contract. The actual exchange gains and losses on that contract are then disregarded. *Subsection (3)* provides that such exchange gains and losses are also left out of account in determining the credits and debits to be brought into account under this Part.

258. Schedule 28AA to ICTA may also impute amounts of exchange gains and losses (the "adjusted amount") calculated on the basis that the parties to the derivative contract were acting at arm's length although in fact they did not do so. *Subsection (5)* requires the "adjusted amount" to be brought into account under this Part. (*Subsection (7)* indicates that that amount may be nil.)

Clause 61: Transfers of value to connected companies

259. This clause treats as a credit the amount paid by a company for an option if the payment is to a company connected with it, the option is allowed to expire and the expiry is to the benefit of the connected company. It is based on paragraph 26 of Schedule 26.

260. Value is transferred on the expiry of the option because the connected company retains the amount paid for the option and does not suffer the commercial loss that would have occurred had the option been exercised. The required assumption in *subsection (4)*, that the option would have been exercised had the parties not been connected, points to the fact that it would have been advantageous to the option holder to exercise it (and therefore disadvantageous to the company granting the option).

261. The clause applies only if the connected company is not within the charge to corporation tax in respect of the derivative contract under or because of this Part. For example, it will apply if the connected company is not a UK resident company (nor is the derivative contract held for the purposes of a permanent establishment it has in the United Kingdom).

262. *Subsection (5)* indicates that the normal definition of “option”, in clause 15, is shorn of its usual limiting conditions (that a cash-settled option is not an option) for the purposes of this clause.

263. *Subsections (6) and (7)* define “connected company” by reference to the definition in the loan relationships clauses dealing with such companies (which rewrite section 87(3) of FA 1996). The references to “section [j061087d]”, “section [j061087c]” and “section [j061088b]” are respectively to clause 142, 143 and 145 of the May 2007 draft clauses.

Clause 62: Derivative contracts with non-residents

264. This clause prevents a debit in respect of an excess of payments of notional interest by a UK resident company over payments of notional interest to it by a company which is non-UK resident. It applies if the payments are made under a contract to which both are party and at a time they are both party to the contract. It is based on paragraph 31(1), (2), (3), (4) and (9) of Schedule 26.

265. This clause will typically apply to a contract for differences which is an interest rate swap. It has some similarities with clause 61 in that the flow of benefit in the direction of a company outside the charge to corporation tax is restricted.

266. *Subsection (1)* sets out a number of circumstances in which both companies may be party to the contract at a time.

267. *Subsections (2) and (3)* set out the general rule and how the disregarded debit is calculated. *Subsection (4)* defines “notional interest payment”. The rate applied in

calculating such a payment is not necessarily an interest rate as such but paragraph (c) of the definition requires that it matches the interest rate specified in the contract.

268. *Subsection (5)* contains a signpost to clause 63, which provides exceptions from the general rule.

Clause 63: Exceptions to section 62

269. This clause sets out three circumstances in which clause 62 does not apply. It is based on paragraph 31(5), (6), (7), (8) and (9) of Schedule 26.

270. The first exception is if a financial institution holds the derivative contract for the purposes of a United Kingdom trade it carries on.

271. The second exception is if the non-UK resident holds the derivative contract for the purposes of a United Kingdom trade it carries on through a permanent establishment (or branch or agency, if the non-UK resident is not a company). “Permanent establishment” is defined in section 148 of FA 2003.

272. The third exception is if there is a double taxation agreement between the United Kingdom and the territory in which the non-UK resident is resident and that agreement covers payments of interest (whether by relief or otherwise). Unlike the first two exceptions, where the financial institution or non-UK resident must hold the derivative contract as principal, this exception can apply if the non-UK resident holds the derivative contract as agent or nominee of another person. But in that case, the relevant territory is that in which the principal is resident.

Chapter 6: Chargeable gains arising in relation to derivative contracts

Overview

273. This Chapter prescribes the circumstances in which credits and debits in respect of certain contracts are not subject to clause 4 (credits and debits brought into account as trade profits) or clause 5 (credits and debits brought into account as non-trading income under loan relationships). It provides that they are brought into account instead as chargeable gains or allowable losses. It also provides bespoke rules for various types of derivative contract for the purposes of corporation tax on chargeable gains.

274. Stated very broadly, the derivative contracts to which this Chapter applies have underlying subject matter where profits or gains are more appropriately brought into account as chargeable gains rather than as income. But the clauses expressly define the contracts to which the Chapter applies and the rules for corporation tax on chargeable gains that are applied (or disappplied) in relation to any one category of contract.

275. Clauses 64 and 65 respectively switch off clause 4 or clause 5 to contracts falling within a number of specified categories.

276. Clause 66 (to which there are exceptions in clause 67) brings credits and debits on four types of derivative contract into account as chargeable gains or allowable losses. The four types are:

- derivative contracts relating to land and certain tangible movable property (clause 68, with a supplementary rule in clause 69);
- embedded derivatives in a creditor relationship that are options (clause 70, to which there are exceptions in clause 71);
- embedded derivatives in a creditor relationships that are exactly tracking contracts for differences (clause 73; and
- property based total return swaps (clause 75).

277. The remaining provisions of the Chapter (other than various interpretative clauses) provide bespoke chargeable gains rules for a number of circumstances:

- cases that would fall respectively within clause 70 or clause 73 but for the asset representing the creditor relation in question being an “existing asset” (that is, an asset to which certain provisions in FA 2004 apply). The rules that apply are set out respectively in clauses 76 and 78 (there is a supplementary rule in clause 79 if a reorganisation of share capital is in point);
- embedded derivatives in a debtor relationship that are options (the affected derivative contract is defined in clause 80 and the rules that apply are set out in clauses 81 to 83); and
- embedded derivatives in a debtor relationship that are contracts for differences (the affected derivative contract is defined in clause 85 and the rules that apply are set out in clause 87).

278. Chapter 7 contains further rules for a miscellany of situations in which chargeable gains rules are applied or modified.

Clause 64: Exclusion from section 4 of trading credits and debits under some contracts

279. This clause disapplies clause 4 to “relevant credits and debits” from a derivative contract to which one of the provisions listed in *subsection (2)* applies. It is based on paragraphs 45J(3) and 45K(3) of Schedule 26.

280. *Subsection (4)* contains a signpost to the definition of “relevant credits” and “relevant debits” in clause 132. For all contracts except those within clause 75, such debits and credits are the same as credits and debits found under clause 32.

Clause 65: Exclusion from section 5 of non-trading credits and debits under some contracts

281. This clause disappplies clause 5 to “relevant credits and debits” from a derivative contract to which one of the provisions listed in *subsection (2)* applies. It is based on paragraphs 45A(1) and (2), 45FA(1), 45J(3), 45K(3) and 45KA of Schedule 26.

282. The list in subsection (2) differs from that in clause 66(2). This is because the additional items in this list are all cases where the derivative contract (or the item in which the derivative contract is an embedded derivative) is not held for the purposes of a trade carried on by the company holding it. Clause 4 does not apply to credits and debits in respect of such a derivative contract.

283. *Subsection (4)* provides in effect that the reference in subsection (2) to clause 87 applies both to cases meeting the conditions in clause 85 and to cases which meet all those conditions except condition G (that is, it is immaterial when liability under the debtor relationship in question was first owed).

284. *Subsections (6) and (7)* contain signposts to the rules that apply to a contract to which a provision listed in subsection (2) applies. The provisions mentioned in subsection (7) do not provide an alternative taxing rule for the credits and debits removed from the scope of clause 5 (unlike the provision mentioned in subsection (6)). Because of clause 8, these credits and debits cannot be brought into account under any other corporation tax provision, so they are “tax nothings”.

Clause 66: Derivative contracts to which section 68, 70, 73 or 75 applies to be taxed on a chargeable gains basis

285. This clause treats a chargeable gain or allowable loss as arising depending on whether the relevant credits arising on a contract to which one of the provisions listed in *subsection (2)* applies exceed such relevant debits or those debits exceed those credits. It is based on paragraph 45A(1), (4) and (5) of Schedule 26.

Clause 67: Exception from section 66(3)

286. This clause provides an exception to the general rule in clause 66 for a contract to which clause 70 (embedded derivatives in a creditor relationship that are options) applies, subject to a condition being met. It is based on paragraph 45A(4) and (6) of Schedule 26.

287. The condition is that paragraph 2 of Schedule 7AC to TCGA would apply to a gain arising on the disposal of the option represented by the rights and liabilities under the embedded derivative. Schedule 7AC to TCGA provides exemptions from the charge to corporation tax on chargeable gains for disposals of a company’s substantial shareholdings in another company. Paragraph 2 of that Schedule extends the exemption to most disposals of assets relating to shares where a disposal of the shares themselves would qualify for exemption.

288. The condition applies on the assumptions given in *subsection (2)*, which deem the embedded derivative to be such a separate contract as is an option that is disposed of at the end of the accounting period in question and the disposal results in a gain.

Clause 68: Derivative contracts relating to land or certain tangible movable property

289. This clause sets out the type of derivative contract it applies to (so that clause 66 may then apply to credits and debits in respect of the contract). It is based on paragraph 45C(1), (2) and (4) of Schedule 26.

290. As with a number of similar clauses in this Chapter which define the derivative contracts to which they apply, condition A in *subsection (2)* is that the company does not hold the derivative contract for the purposes of a trade. Condition B, in *subsection (3)*, an equally common element in such clauses, is that the company in question is not an “excluded body”. That term is defined in clause 88 for the purposes of this Chapter and refers to various types of collective investment scheme.

291. Condition C, in *subsection (4)*, is the distinguishing characteristic of this type of derivative contract. The underlying subject matter of the contract is either or both of land and certain tangible movable property. *Subsection (5)* contains a signpost to an additional rule in clause 69 that modifies what the underlying subject matter of the contract is taken to consist of.

292. *Subsection (7)* is the first of a number of signposts in this Chapter to the modifications made by Chapter 11 for the application of this Chapter to mutual trading companies and insurance companies.

Clause 69: Subordinate income to be left out of account in determining whether section 68 applies

293. This clause provides for underlying subject matter that is income from property of the type or types mentioned in condition C in clause 68 to be disregarded in determining whether that condition is met. It is disregarded if it is subordinate or of small value in relation to that property. It is based on paragraph 45C(5) and (6) of Schedule 26.

294. This clause is substantially similar to clause 25, which performs the same function in relation to the definition of “excluded property” in clause 24.

Clause 70: Creditor relationships: embedded derivatives which are options

295. This clause sets out the type of derivative contract it applies to (so that clause 66 may then apply to credits and debits in respect of the contract). It also disapplies a chargeable gains provision in TCGA. It is based on paragraph 45D(1), (2), (3), (3A), (4), (8) and (9) of Schedule 26.

296. It applies to a derivative contract that comprises the rights and liabilities treated as a relevant contract, because of a creditor relationship of the company, by

clause 21 if that relevant contract is also treated as an option by that clause. See conditions A and B in *subsections (2) and (3)*. “Creditor relationship” is defined in clause 128 by reference to Part [6] (loan relationships).

297. Condition E in *subsection (6)* sets out the other distinguishing characteristic of this type of derivative contract. It is that the underlying subject matter of the contract is “qualifying ordinary shares” (broadly, fully participating shares in a listed company, holding company or trading company) or “mandatorily convertible preference shares” (shares that have to be converted into qualifying ordinary shares within 24 hours of acquisition). Those terms are defined in clause 72.

298. There are two additional conditions. Condition F, in *subsection (7)*, is that paragraph 9(2) of Schedule 10 to FA 2004 does not have effect in relation to the asset representing the creditor relationship. That provision deems an asset representing a creditor relationship no longer to be such if the asset was in existence at a date so calculated as not to be later than 31 December 2005. See clause 76 for the rules that apply if a “section 21 embedded derivative” would be within this clause if condition F did not apply.

299. Condition G, in *subsection (8)*, is that the exclusions in clause 71 do not apply.

300. *Subsection (10)* provides that the creditor relationship, by virtue of which there is a deemed derivative contract to which this clause applies, is itself not treated as a “qualifying corporate bond” although section 117(A1) of TCGA would otherwise treat it as such. That provision defines a qualifying corporate bond as “any asset representing a loan relationship of a company”. This subsection effectively switches off for the creditor relationship those provisions in TCGA or elsewhere that apply to qualifying corporate bonds.

301. *Subsection (11)* makes provision for a special case of a creditor relationship that is not subject to division as in clause 21 and its loan relationships equivalent. “Section [j061094Aaa]” is clause 116 in the May 2007 draft clauses. It applies to the case where the company accounts for the creditor relationship at fair value through profit and loss. In that case accounting standards do not require the loan relationship to be divided. If the company is party to the creditor relationship for the purposes of its life assurance business, both this Part and Part [6] (loan relationships) have effect as if such a division were deemed to be made under clause 21 and its loan relationships equivalent. This clause can then apply to the derivative contract treated as such under clause 21.

Clause 71: Exclusions from section 70

302. This clause makes two exclusions from the scope of clause 70. It is based on paragraph 45E(1), (3) and (4) of Schedule 26.

303. The exclusions apply in circumstances where the holder is not sharing in the equity risk that is a part of the creditor relationship in which the derivative contract is

an embedded derivative. The circumstances are where the holder of the deemed derivative contract may get a predetermined cash amount (condition A) or where cash payable instead of the shares differs significantly from the value of the shares (condition B).

Clause 72: Meaning of certain expressions in section 70

304. This clause provides definitions of “qualifying ordinary shares” and “mandatorily convertible preference shares” for the purposes of clause 70 and contains signposts to other relevant definitions. It is based on paragraph 45D(4), (5) and (7) of Schedule 26.

305. “Recognised stock exchange”, in condition B of the definition of “qualifying ordinary shares”, has the meaning given by section 841 of ICTA.

Clause 73: Creditor relationships: embedded derivatives which are exactly tracking contracts for differences

306. This clause sets out the type of derivative contract it applies to (so that clause 66 may then apply to credits and debits in respect of the contract). It also disapplies a chargeable gains provision in TCGA. It is based on paragraph 45F(1), (2), (7) and (8) of Schedule 26.

307. It applies to a derivative contract that comprises the rights and liabilities treated as a relevant contract, because of a creditor relationship of the company, by clause 21 if the relevant contract is also treated as a contract for differences by that clause. See conditions A and B in *subsections (2) and (3)*. “Creditor relationship” is defined in clause 128 by reference to Part [6] (loan relationships).

308. Condition C, in subsection (4), and condition D, in *subsection (5)*, set out the distinguishing characteristics of this type of derivative contract. They are that the underlying subject matter of the contract is qualifying ordinary shares listed on a recognised stock exchange and that the derivative contract is an “exactly tracking contract”.

309. “Qualifying ordinary shares” is defined in clause 74 in terms equating to those of condition A in the definition of the same term in clause 72.

310. “Exactly tracking contract” is defined in clause 74(4) by reference to a formula. Such a contract is one under which the amount to be paid to discharge the rights and liabilities under the contract varies according to a percentage figure applied to the cost of the asset representing the creditor relationship when that asset comes into existence. The percentage figure is equal to the movement in the value of the assets (that is, the listed shares) which are the underlying subject matter of the contract (or an index of that value). The period over which the movement in the value of the assets is tracked is the period beginning when the asset representing the creditor relationship came into existence to the date the corresponding debtor relationship comes to an end. (Paragraph (b) of clause 74(6) provides a minor amount of leeway in

measuring that period for the case where a valuation date in respect of the assets in question is not exactly coterminous with either the beginning or end of the period.) In such a case, the discharge amount tracks the value of those assets exactly.

311. Condition G, in *subsection (8)*, is that paragraph 11(2) of Schedule 10 to FA 2004 does not have effect in relation to the asset representing the creditor relationship. That provision deems an asset representing a creditor relationship linked to the value of assets no longer to be such if the asset was in existence at a date so calculated as not to be later than 31 December 2005. See clause 78 for the rules that apply if a derivative contract would be within this clause if condition G did not apply.

312. Paragraph (a) of *subsection (9)* contains a signpost to clause 102, which modifies the rules for acquisition costs in section 38 of TCGA if the asset representing the creditor relationship mentioned in this clause is disposed of.

313. *Subsection (10)* provides that that creditor relationship is itself not treated as a “qualifying corporate bond” although section 117(A1) of TCGA would otherwise treat it as such. See the commentary on the similar provision in clause 70(10).

Clause 74: Meaning of certain expressions in section 73

314. This clause provides some definitions and contains signposts to other definitions for the interpretation of clause 73. It is based on paragraph 45F(4), (5), (6) and (7).

315. See the commentary on that clause in relation to the meaning of “exactly tracking contract”.

Clause 75: Property based total return swaps

316. This clause sets out the type of derivative contract it applies to (so that clause 66 may then apply to credits and debits in respect of the contract). It is based on paragraph 45G(1), (1A), and (1B).

317. Conditions A to D, in *subsections (2) to (5)*, set out the distinguishing characteristics of this type of derivative contract. It is, first, a contract for differences whose underlying subject matter includes interest rates (in addition to other underlying subject matter). Second, one or more indices are specified in the contract which include an index of changes in the value of land (a “capital value index”).

318. By virtue of the special meaning of “relevant debits and credits” in clause 66, as supplied by clause 132(3) for the purposes of cases to which this clause applies, only part of the credits and debits found under clause 32 are brought into charge under clause 66 as a chargeable gain.

Clause 76: Existing assets representing creditor relationships: options

319. This clause makes a number of modifications to the application of TCGA in respect of the “original creditor relationship” (defined in clause 131), being the

creditor relationship mentioned in clause 70. It applies if that clause would have applied to a derivative contract but for condition F in that clause. (See the commentary on clause 70 for the significance of condition F.) It is based on paragraph 45FA(1), (3), (4), (6) and (8) of Schedule 26.

320. The first modification, in *subsection (2)*, is the same as that made by clause 70(10). The creditor relationship is not treated as a “qualifying corporate bond” although section 117(A1) of TCGA would otherwise treat it as such.

321. The second modification is to the amount or value of the consideration applicable to the asset representing the creditor relationship on a disposal of that asset. So much of any interest in respect of the creditor relationship as is brought into account under Part [6] (loan relationships) but, because of the terms of the disposal, is not paid or payable to the company to which it accrues is deducted from the consideration. In effect, the charge under that Part is given priority over the charge to corporation tax on chargeable gains.

322. The third modification also affects the amount of that consideration. It adjusts that amount for any “relevant exchange gains” and “relevant exchange losses”, as those terms are defined in clause 77. The consideration is first increased by any such losses and then reduced by any such gains. If that reduction would exceed the amount of the consideration, that amount becomes nil, and the excess is added to incidental costs of acquisition under section 38 of TCGA.

323. The definition of “relevant exchange gains” and “relevant exchange losses” refers to such gains and losses in respect of the asset representing the creditor relationship as are brought into account under Part [6] (loan relationships) for an accounting period throughout which the company holds the asset. Gains and losses are apportioned as necessary if the company only holds the asset for part of an accounting period. The effect of the adjustments to the consideration is to reverse the application of Part [6] (loan relationships) to exchange gains and losses in respect of the asset in question so that those exchange adjustments are taken into account only in the chargeable gains charge.

324. *Subsection (8)* contains a signpost to a rule in clause 79 facilitating the operation of this clause if there is a relevant reorganisation of share capital.

Clause 77: Meaning of “relevant exchange gains” and “relevant exchange losses” in section 76

325. This clause provides definitions for the purposes of clause 76. It is based on paragraph 45FA(7) of Schedule 26.

326. See the commentary on that clause.

Clause 78: Existing assets representing creditor relationships: contracts for differences

327. This clause makes two modifications to the application of TCGA in respect of the “original creditor relationship” (defined in clause 131), being the creditor relationship mentioned in clause 73. It applies if that clause would apply to a derivative contract but for condition G in that clause. (See the commentary on clause 73 for the significance of condition G.) It is based on paragraph 45FA(1), (3), and (4) of Schedule 26.

328. The first modification, in *subsection (2)*, is the same as that made by clause 73(10). The creditor relationship is not treated as a “qualifying corporate bond” although section 117(A1) of TCGA would otherwise treat it as such.

329. The second modification is the same as that made by clause 76(3). So much of any interest in respect of the creditor relationship as is brought into account under Part [6] (loan relationships) but, because of the terms of the disposal, is not paid or payable to the company to which it accrues is deducted from the consideration applicable to the asset representing the creditor relationship on a disposal of that asset.

330. *Subsection (5)* contains a signpost to a rule in clause 79 facilitating the operation of this clause if there is a relevant reorganisation of share capital.

Clause 79: Creditor relationships with existing assets: reorganisations

331. This clause facilitates the application of the modification in clauses 76(3) and 78(3) (consideration on disposal of asset representing creditor relationship reduced by reference to certain interest). It applies if the asset disposed of is the new holding of shares replacing the original shares in a reorganisation of share capital under sections 126 to 132 of TCGA. It is based on paragraph 45FA(5) of Schedule 26.

332. Sections 126 to 132 of TCGA disregard a disposal of shares in a reorganisation of share capital to which those provisions apply and treat the new holding of shares as the same asset as the shares replaced. This clause reflects that treatment in the application of the rule in clauses 76(3) and 78(3).

Clause 80: Introduction to sections 81 to 83

333. This clause sets out the type of derivative contract it applies to (so that clause 81, 82 or 83 may then apply in respect of the contract). It is based on paragraph 45J(1), (2), and (10) of Schedule 26.

334. It applies to a derivative contract that comprises the rights and liabilities treated as a relevant contract, because of a debtor relationship of the company, by clause 21 if that relevant contract is also treated as an option by that clause. See conditions A and B in *subsections (2) and (3)*. As indicated by *subsection (8)*, “debtor relationship” is defined in clause 128 by reference to Part [6] (loan relationships). For the purposes of this clause, the definition of “option” in clause 15 is shorn of its usual limiting conditions (that a cash-settled option is not an option).

335. Condition C, in *subsection (4)*, is that the underlying subject matter of the contract is shares.

336. A derivative contract is excluded from the scope of this clause if, at the time the company became party to the debtor relationship, it was carrying on a banking business or a business as a “securities house” (a term defined in clause 89) unless it became party to the relationship in the ordinary course of that business.

337. A derivative contract is also excluded if the company that is party to the debtor relationship is an “excluded body” (as defined in clause 88).

338. The rule in paragraph 45J(4) of Schedule 26, which disapplies the rules rewritten in clauses 81 and 83, and modifies the application of the rule rewritten in clause 82, will be rewritten in the transitionals Schedule to the Bill in which this Part appears.

Clause 81: Shares issued or transferred as a result of exercise of deemed option

339. This clause determines for the purposes of section 144(2) of TCGA the value of the consideration given for the option represented by the derivative contract within clause 80 if shares are issued or transferred as a result of the exercise of the option. It is based on paragraph 45J(4A) and (5) of Schedule 26.

340. Section 144(2) of TCGA treats the grant of an option and the transaction under which the grantor fulfils his obligation under the option as a single transaction. The consideration for the option is regarded as part of the consideration for the sale. This clause determines the amount of the consideration for the grant of the option for the purposes of that section. It does so by reference to the carrying value of the option at the time the company became party to the relevant debtor relationship. “Carrying value” is defined in clause 126.

341. The source legislation for this rule, paragraph 45J(5)(a) of Schedule 26, refers to “the amount treated in accordance with section 94A(2) of the Finance Act 1996 as the carrying value of the option”. That section makes no direct reference to the carrying value of any item. But paragraph 50A(3B) of Schedule 26, refers to that section in the course of setting out what the carrying value of a contract is. That reference is rewritten in clause 126. It would in fact be superfluous to add any such reference to the present clause, so the words “in accordance with section 94A(2) of the Finance Act 1996” have not been rewritten here.

342. *Subsection (3)* disapplies the market value rule in section 17(1) of TCGA to the disposal represented by the issue or transfer of shares on the exercise of the option.

Clause 82: Payment instead of disposal on exercise of deemed option

343. This clause provides for a chargeable gain or allowable loss in the same circumstances as those applying in clause 81, except that there is no issue or transfer

of shares. Instead, an amount is paid in fulfilment of the company's obligations under the debtor relationship. It is based on paragraph 45J(6) and (7) of Schedule 26.

344. In a number of circumstances it will suit one or other or both parties to a debtor relationship containing an option for the issue or transfer of shares not to go ahead with such an issue or transfer when the option is exercised. Instead the matter is settled by a monetary payment. Such a cash settlement would fall foul of the limiting conditions in the definition of an "option" in clause 15, so those conditions are disapplied for the purposes of the present clause by clause 80.

345. There is a chargeable gain if the carrying value of the derivative contract at the time the company became party to the debtor relationship exceeds the amount paid in fulfilment of the company's obligations under the debtor relationship. For this purpose that amount is first reduced, but not below nil, by the fair value of the "section [j061094Aaa] host contract" at the time the option is exercised. But if that amount (as so reduced) exceeds that carrying value, an allowable loss arises. The gain or loss, as the case may be, is the amount of the excess.

346. Subsection (2) presents these rules as formulas and the alphabetic labels used in the formulas are defined in clause 84.

Clause 83: Person ceasing to be party to debtor relationship when deemed option not exercised

347. This clause deems there to be an acquisition and disposal of an asset for the purposes of corporation tax on chargeable gains if a company ceases to be party to a debtor relationship within clause 80 at a time when the option has not been exercised. It is based on paragraph 45J(9) and (9A) of Schedule 26.

348. A company may cease to be party to a debtor relationship by redeeming or repaying the liability in question or by some other means (such as assigning the rights and liabilities under the relationship).

349. *Subsection (2)* treats the company as having acquired an asset for consideration equal to the amount paid to cease to be party to the relationship. It also treats the company as having disposed of that asset for consideration equal to the carrying value of the relationship when acquired. But the carrying value is first reduced, as in respect of clause 82, by the fair value of the section [j061094Aaa] host contract at the time the option was acquired. The deemed disposal may give rise to a chargeable gain or allowable loss.

Clause 84: Interpretation of sections 82 and 83

350. This clause defines terms, in particular the alphabetic labels used in the formulas in clauses 82 and 83, for the purposes of those clauses. It is based on paragraph 45J(8) and (9B) of Schedule 26.

351. "Fair value" is defined in clause 134.

Clause 85: Introduction to section 87

352. This clause sets out the type of derivative contract it applies to (so that clause 87 may then apply in respect of the contract). It is based on paragraph 45K(1) and (2) of Schedule 26.

353. It applies to a derivative contract that comprises the rights and liabilities treated as a relevant contract, because of a debtor relationship of the company, by clause 21 if the relevant contract is also treated as a contract for differences by that clause. See conditions A and B in *subsections (2) and (3)*. As indicated in *subsection (10)*, “debtor relationship” is defined in clause 128 by reference to Part [6] (loan relationships).

354. But this clause does not apply to a derivative contract that falls within clause 80. If the definition of “option” in clause 15 is shorn its usual limiting conditions, by virtue of which a cash-settled option is not an option, a contract which is an option under the expanded definition is a contract for differences.

355. Condition D, in *subsection (5)*, as in clause 80, is that the underlying subject matter of the contract is shares.

356. The distinguishing characteristic of this clause, condition C in *subsection (4)*, is that the derivative contract is an “exactly tracking contract”, as defined in clause 86. That term has a similar meaning to that in clause 73, as defined in clause 74, But what is being tracked here is the amount regarded in accordance with generally accepted accounting practice as the proceeds of issue of the liability which represents the debtor relationship in this case. And, as this clause deals with a debtor relationship (while clause 73 deals with a creditor relationship), the period over which the tracking takes place is measured from the date the liability representing the debtor relationship begins to the date the corresponding creditor relationship ends.

357. As in clause 80, a derivative contract is excluded from the scope of this clause if, at the time the company became party to the debtor relationship, it was carrying on a banking business or a business as a “securities house” (a term defined in clause 89) unless it became party to the relationship in the ordinary course of that business.

358. And similarly, a derivative contract is also excluded if the company that is party to the debtor relationship is an “excluded body” (as defined in clause 88).

Clause 86: Meaning of “exactly tracking contract” in section 85

359. This clause defines “exactly tracking contract” for the purposes of clause 85. It is based on paragraph 45K(2A), (2B) and (2C) of Schedule 26.

360. See the commentary on clause 85.

Clause 87: Issuers of securities with embedded derivatives: deemed contracts for differences

361. This clause provides for a chargeable gain or allowable loss to arise if an amount is paid to discharge a company's obligations under a debtor relationship within clause 85. The gain or loss arises when that relationship comes to an end. It is based on paragraph 45K(3), (3A) and (3B) of Schedule 26.

362. The gain or loss is calculated on the assumptions that

- there is a disposal of an asset which is the contract for differences in clause 85;
- the cost of that asset is the amount paid to discharge the company's obligations; and
- the consideration for the disposal is the amount of the proceeds of the issue of the security representing the debtor relationship (or, if the company became party to that relationship at a time after it was created, the carrying value of the section [j061094Aaa] host contract at that time).

363. "Section [j061094Aaa] host contract" is defined in clause 133.

Clause 88: Meaning of "excluded body"

364. This clause defines "excluded body" for the purposes of this Chapter. It is based on paragraphs 45C(3), 45D(2), 45G(1A), 45J(2) and 45K(2) of Schedule 26.

365. The bodies which are excluded bodies are all types of collective investment scheme.

366. "Authorised unit trust" is defined in section 832(1) of ICTA by reference to section 468(6) of that Act, which in turn refers to a scheme in respect of which an order under section 243 of FISMA is in force in the relevant accounting period.

367. "Investment trust" has the meaning given by section 842 of ICTA and "venture capital trust" the meaning given by section 834(1) of ICTA (by reference to Part 6 of ITA).

368. "Open-ended investment company" is defined in clause 134 by reference to section 468A(2) of ICTA which in turn refers to a company incorporated in the United Kingdom to which section 236 of FISMA applies.

369. The term "excluded body" is used in clauses 68, 70, 73, 75, 80, 85 and 95 (in the last case by cross reference to this definition).

Clause 89: Meaning of “securities house”

370. This clause defines “securities house” for the purposes of this Chapter. It is based on paragraphs 45J(10) and 45K(4) of Schedule 26.

371. The term is used in clauses 80, 85 and 95 (in the last case by cross reference to this definition).

Chapter 7: Further provision about corporation tax on chargeable gains

Clause 90: Company ceasing to be party to contract to which section 22 applies

372. This clause provides for a chargeable gain or allowable loss to arise when a company ceases to be party to a relevant contract that is treated as a derivative contract because of clause 22. It is based on paragraph 37(1), (2), (3) and (5) of Schedule 26.

373. Clause 22 applies if the underlying subject matter of a relevant contract is an interest of some kind in a collective investment scheme and that scheme fails to meet a “qualifying investments test” in the relevant accounting period. The relevant contract is treated as a derivative contract for that accounting period and later periods.

374. Clause 48 deals with the value to be attributed to the deemed derivative contract, by reference to its market value when it is so deemed. Clause 47 sets out the credits and debits to be brought into account for the purposes of this Part. This clause deals with the latent profit and loss in the contract immediately before it is deemed to be a derivative contract. It applies if the contract was then a “chargeable asset”. That term is defined in clause 127 as an asset on whose disposal any gain would be a chargeable gain for the purposes of corporation tax on chargeable gains. The charge on that gain or loss is in effect deferred until the company ceases to be party to the contract.

375. A chargeable gain or allowable loss arises at that time on the assumptions that:

- the company had disposed of the relevant contract immediately before the first accounting period in which it is deemed to be a derivative contract; and
- the consideration for the disposal equalled any value given to the relevant contract in the company’s account for the immediately preceding period (this value may be the same as or different from that found under clause 48).

Clause 91: Company ceasing to be party to contract which became derivative contract

376. This company provides for a chargeable gain or allowable loss to arise when a company ceases to be party to a relevant contract that, not having been a derivative contract, became a derivative contract. It is based on paragraph 43(1), (2), (4) and (5) of Schedule 26.

377. There are a number of ways in which a relevant contract that was not a derivative contract may become one. For example, if the terms of the contract change (without creating a new contract) in such a way that the accounting conditions in clause 14 are now met, the contract may become a derivative contract. Or it may be that the contract no longer meets the “excluded property” rule in clause 24 by virtue of which it was not a derivative contract. See for example the circumstances described in clause 104.

378. Where this clause applies, it operates very similarly to clause 90. Again, the gain or loss latent in the relevant contract (which is also a chargeable asset) is deferred until the company ceases to be party to the relevant contract.

379. A chargeable gain or allowable loss arises for the accounting period in which the company ceases to be party to the relevant contract on the assumptions that:

- the company had disposed of the relevant contract immediately before the time it became a derivative contract; and
- the consideration for the disposal equalled the “notional carrying value” of the relevant at that time.

380. “Notional carrying value” has the same meaning as in clause 42(4), that is, the carrying value the contract would have had in the books of the company had a period of account ended immediately before the deemed disposal. See the commentary on that clause as regards the use of “period of account” rather than “accounting period” in that definition.

Clause 92: Contracts ceasing to be derivative contracts

381. This clause provides that, if a contract to which the company continues to be party ceases to be a derivative contract, the company is treated as acquiring the contract for an amount equal to its notional carrying value at the time it ceases to be a derivative contract. It is based on paragraph 43B of Schedule 26.

382. This clause is the companion to clause 42 which deals with the deemed disposal of the relevant contract for the purposes of this Part at the time it ceases to be a derivative contract. See the commentary on that clause.

Clause 93: Carry back of net losses on derivative contracts to which section 66 applies

383. This clause provides that, if a company makes a claim, allowable losses deemed to arise for an accounting period under may be carried back and set against chargeable gains deemed to arise in accounting periods in the previous 24 months. The gains and losses deemed to arise are those given by clause 66 (chargeable gains basis substituted for income basis in charging credits and debits from certain types of derivative contract) It is based on paragraph 43B(1), (2) and (3) of Schedule 26.

384. The clause operates by means of a number of labels, some of which are defined in clause 94.

385. The allowable losses eligible for relief under this clause are losses arising under clause 66 for an accounting period so far as they exceed gains for that period chargeable under that clause. These are referred to as “net section 66 losses”.

386. A claim to carry back the losses must be made within two years of the end of the accounting period in which the losses arise (the “loss period”).

387. So far as there are eligible gains against which the losses can be set in more than one earlier accounting period, the relief is given against gains for a later period before those of an earlier period. The amount of the relief cannot exceed the amount of the eligible gains. If an accounting period of the company straddles the beginning of the 24 month period in respect of which losses may be relieved, the eligible gains for that period are found by apportionment. Apportionment of total gains otherwise eligible for relief in that period is made on a days basis to find the amount actually eligible for relief (see paragraph (b) of *subsection (4)* in this clause and *subsection (6)* in clause 94.

388. The gains eligible for relief in an earlier period are the total clause 66 gains for that period less the total of allowable losses under that clause for that period. There is a further reduction for any other allowable losses for that period so far as those other allowable losses could not be deducted, within the meaning of section 8(1) of TCGA, from other chargeable gains. That is, any allowable losses for the purposes of corporation tax on chargeable gains, other than losses under clause 66, if they cannot be set against any chargeable gains, other than gains under clause 66, are notionally deducted from the clause 66 gains to find the amount of gains against which the losses carried back under this clause can be set. The amount found under this rule is called “net section 66 gains”.

389. *Subsection (3)* provides that, to the extent the losses for a period are carried back and relieved under this clause, they are used up and cannot otherwise be relieved under the provisions for corporation tax on chargeable gains by set off or carry forward.

Clause 94: Meaning of certain expressions in section 93

390. This clause provides the meaning of some terms used in clause 93. It is based on paragraph 45B(4), (5), (6) and (7) of Schedule 26.

391. See the commentary on clause 93.

Clause 95: Introduction to section 96

392. This clause sets out the type of derivative contract it applies to for the purposes of the relief provided by clause 96.

393. It applies if:

- a company is party to a debtor relationship that is divided under clause 21 between the host contract and an equity instrument;
- the equity instrument is deemed to be a derivative contract that is an option; and
- the company makes a payment to the creditor in the relationship to discharge obligations under the relationship.

394. For the purposes of this clause, the definition of “option” in clause 15 is shorn of its usual limiting conditions (that a cash-settled option is not an option).

395. “Equity instrument” is defined in clause 134 as having the meaning it does for accounting purposes. It is defined in International Accounting Standard 32 as follows: “an equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities”.

396. As in a number of other clauses, a derivative contract is excluded from the scope of this clause if, at the time the company became party to the debtor relationship, it was carrying on a banking business or a business as a “securities house” (a term defined in clause 89) unless it became party to the relationship in the ordinary course of that business.

397. And, similarly, a derivative contract is also excluded if the company that is party to the debtor relationship is an “excluded body” (as defined in clause 88).

398. *Subsection (9)* adds condition H, that the liability representing the debtor relationship was not owed before a defined date. This rule reflects the commencement provision of the source legislation for this provision.

Clause 96: Issuers of securities with embedded derivatives: equity instruments

399. This clause deems there to be an allowable loss for the purposes of corporation tax on chargeable gains if a company makes a payment to which clause 95 applies. It is based on paragraph 45JA(3) and (4) of Schedule 26.

400. To find the amount of that loss, the amount paid by the company to discharge obligations under the debtor relationship is first reduced by so much of the payment as represents the fair value of the host contract at that time. This is “RA” in the formula for the calculation of the allowable loss. It cannot be less than nil.

401. Next, the carrying value of the equity instrument that is treated as a derivative contract under clause 21 as at the time the company became party to the debtor relation is deducted from RA. The excess of RA over the carrying value is the amount of the allowable loss.

402. “Fair value” is defined in clause 134. “Carrying value” is defined in clause 126.

403. The definition of “E” in *subsection (2)* does not rewrite the words “in accordance with section 94A(2) of the Finance Act 1996” for the same reasons as those given in the commentary on clause 81.

Clause 97: Treatment of shares acquired on terminal exercise of non-embedded option

404. This clause and the next modify the amounts otherwise allowable as acquisition costs under section 38 of TCGA on the disposal of shares acquired under an option or future. This clause deals with shares acquired as the result of the exercise of rights under an option. It is based on paragraph 45HA(1), (2) and (3) of Schedule 26.

405. This clause applies only if the derivative contract is a “plain vanilla contract” (defined in clause 13). That is, it does not apply to the exercise of rights within rights and liabilities treated as a derivative contract under clause 19, 20 or 21. Although the side note to the clause refers to the “terminal” exercise of the option – and that is how the provision normally operates – it is theoretically possible for the clause to apply to each instalment of a staged exercise of the option. Paragraph (e) of *subsection (1)* is therefore in terms of the exercise “of any of” the rights under the option.

406. In this clause, the definition of “option” in clause 15 includes the usual limiting conditions (which exclude cash-settled options).

407. *Subsection (2)* provides for allowable acquisition costs under section 38(1)(a) of TCGA to be increased (or reduced) when there is a disposal of the shares acquired as a result of the exercise of rights under the option. The increase or reduction in effect reverses the earlier treatment of credits and debits in respect of the option, so far as referable to the shares which were the subject of the option, as non-trading credits and debits for the purposes of Part [6] (loan relationships).

408. *Subsection (2)* also provides that, if there is only a part disposal of those shares, section 42(2) of TCGA applies. That provision deals with the calculation of costs allowable under section 38 of TCGA if there is a part disposal of an asset. It uses an A divided by A+B formula which takes into account the consideration for the part disposal (“A”) and the value of the remainder of the asset (“B”).

409. Clause 99 has the detail on the amount of the credits and debits to be used in calculating the amount of the adjustment to expenditure allowable under section 38 of TCGA.

410. In a case where the adjustment reduces allowable expenditure and exceeds the amount that can be so reduced, the excess reduction is instead treated under *subsection (3)* as additional consideration for the disposal of the shares. This rule is

similar to that in clause 76, except that here the excess is added to the consideration whereas in that clause (which makes adjustments to the consideration) the excess is added to the allowable costs of acquisition.

Clause 98: Treatment of shares acquired on running of future to delivery

411. This clause makes provision equivalent to that in clause 97 if shares are disposed of following their acquisition as the result of the delivery of those shares under the terms of a future. It is based on paragraph 45HA(1A), (2) and (3) of Schedule 26.

412. See the commentary on clause 97.

Clause 99: Meaning of G and L in sections 97 and 98

413. This clause determines the amounts that are used under clause 97 or 98 to modify the amounts allowable as acquisition costs under section 38 of TCGA on the disposal of shares acquired as mentioned in either clause. It is based on paragraph 45HA(4) and (5) of Schedule 26.

414. The credits and debits relevant to the calculation under clause 97(2) or 98(2) are those brought into account under clause 5. That is, they are amounts which are treated as non-trading credits and debits for the purposes of Part [6] (loan relationships). It is unnecessary to take account for this purpose of credits and debits within clause 4, as profits and losses on derivative contracts to which that clause applies are brought into account as trading profits rather than as chargeable gains. Similarly, credits and debits to which clause 6 refers are already taken into account for the purposes of corporation tax on chargeable gains.

415. The credits and debits in question are those referable to the shares acquired or delivered. That is, they are credits and debits arising in respect of the derivative contract before the exercise of the option or the running to delivery of the future, as appropriate, as a result of which the shares were acquired. And they are referable to the shares which are the subject of the contract. *Subsection (2)* also provides that any necessary apportionment of credits and debits may be made on a just and reasonable basis.

416. *Subsection (4)* indicates that the credits and debits in question are those arising in respect of any accounting period of the company during which it is party to the derivative contract up to and including that in which the shares are disposed of. It will of course be a question of fact whether in any of those accounting periods there are relevant credits or debits.

Clause 100: Treatment of net gains and losses on terminal exercise of option

417. This clause also modifies the amounts allowable under section 38 of TCGA in the cases to which it applies. It applies to a disposal of shares acquired as a result of the exercise of rights under an option, if those rights were held under a derivative contract which is an embedded derivative in a creditor relationship within clause 70. It

also applies to a disposal of the asset representing the creditor relationship in such a case. It is based on paragraph 45H(1), (2), (3), (4), (5), (5A) and (6) of Schedule 26.

418. “Creditor relationship” is defined in clause 128.

419. As in clause 97, although the side note to this clause refers to the “terminal” exercise of the option – and that is how the provision normally operates – it is theoretically possible for the clause to apply to each instalment of a staged exercise of the option. Paragraph (c) of *subsection (1)* is therefore in terms of the exercise or disposal of rights “to any extent”.

420. Credits and debits arising in a case to which clause 70 applies are brought into account as chargeable gains or allowable losses under clause 66. The effect of this clause is to reverse that treatment when the asset representing the creditor relationship or the shares acquired under the option are disposed of. It avoids double charging of the value in that asset or shares represented by the credits or debits already brought into charge as a chargeable gain or allowable loss.

421. As regards the disposal of the creditor relationship after the exercise of the option to acquire shares, the amount of the adjustment to be made to costs allowable under section 38 of TCGA is set out in *subsection (3)*. As regards the disposal of the shares themselves, the amount of the adjustment is set out in *subsection (5)*. Clause 101 defines the amounts to be used in calculating the adjustment made by these provisions.

422. The adjustment under subsection (5) applies only if the circumstances in which the shares were acquired involved a disposal treated as not occurring because of section 127 of TCGA. That provision disregards as a disposal the replacement of a holding of shares by another such holding in the course of a reorganisation of share capital. That is, the disposal of the rights under the option, as a result of exercising those rights, was not treated as a disposal.

423. Similarly to clause 97, subsection (5) also provides that, if there is only a part disposal of those shares, section 42(2) of TCGA applies.

424. And similarly again to that clause, if the adjustment to be made under subsection (3) or (5) is a reduction that exceeds the amounts otherwise allowable under section 38 of TCGA, the excess is added to the consideration for the disposal.

425. *Subsection (7)* disapplies sections 37 and 39 of TCGA in relation to a disposal covered by this clause. Those sections remove from the chargeable gains calculation any consideration and expenditure that is taken into account in an income calculation.

Clause 101: Meaning of G, L and CV in section 100

426. This clause provides the meaning of labels used in the calculations made under clause 100(3) and (5). It is based on paragraph 45H(6) and (7) of Schedule 26.

427. The chargeable gains (“G”) and allowable losses (“L”) relevant to those calculations are those referable to the shares acquired as a result of the exercise of the option. That is, they are credits and debits arising in respect of the derivative contract before the exercise of the option, as a result of which the shares were acquired. And they are referable to the shares which are the subject of the contract. *Subsection (2)* also provides that any necessary apportionment of credits and debits is that made on a just and reasonable basis.

428. *Subsection (5)* indicates that the credits and debits in question are those arising in respect of any accounting period of the company during which it is party to the derivative contract up to and including that in which the shares are disposed of.

429. The label “CV” represents the excess of the carrying value of the host contract when the option is exercised over its value when the company became party to the creditor relationship.

430. “Carrying value” is defined in clause 126.

Clause 102: Treatment of net gains and losses on disposal of certain embedded derivatives

431. This clause also modifies the amounts allowable under section 38 of TCGA in the case to which it applies. It applies to a disposal of the asset representing the creditor relationship mentioned in clause 73 in a case where that clause applies. (Clause 73 applies to embedded derivatives which are exactly tracking contracts for differences.) This clause is based on paragraph 45HZA(1), (2), (3), (4) and (5) of Schedule 26.

432. For the circumstances in which clause 73 applies, and for the meaning of an “exactly tracking contract for differences”, see the commentary on that clause.

433. As with clause 100, this clause in effect reverses the treatment of credits and debits in respect of the embedded derivative under clause 66 so that double counting is avoided when the asset representing the creditor relationship is disposed of.

434. And similarly again to that clause and others, if the adjustment to be made under *subsection (2)* is a reduction that exceeds the amounts otherwise allowable under section 38 of TCGA, the excess is added to the consideration for the disposal.

435. *Subsection (4)* disapplies sections 37 and 39 of TCGA in relation to a disposal covered by this clause similarly to clause 100.

Clause 103: Meaning of G, L and CV in section 102

436. This clause provides the meaning of labels used in the calculations made under clause 102(2). It is based on paragraph 45HZA(5) and (6) of Schedule 26.

437. The definitions of “G”, “L” and “CV” are similar to those in clause 101 but modified for the purposes of clause 102. See the commentary on clause 101.

Chapter 8 Contracts which became derivative contracts at certain dates

Overview

438. This Chapter brings together a number of rules that apply in circumstances where a contract becomes a derivative contract at a particular date. The clauses are otherwise similar in their effect to a number of other rules in this Part.

Clause 104: Contracts which became derivative contracts on 16 March 2005

439. This clause brings into account as a chargeable gain or allowable loss, when a company ceases to be party to the contract, the gain or loss latent in a contract that became a derivative contract from 3.00pm on 16 March 2005. (That was the time of the announcement in the 2005 Budget proposals of changes to the definition of what is a derivative contract.) It is based on paragraph 4A(1), (2) and (3) of Schedule 26.

440. A contract that was not a derivative contract before that time but became one after that time is commonly one that formerly met the conditions for its underlying subject matter to be “excluded property” (see the commentary on clause 24). The Finance Act 2002, Schedule 26, Parts 2 and 9 (Amendment) Order 2005 (SI 2005/646) amended the conditions for that purpose from that time to cut down some of the categories of excluded property (see the conditions in clause 26).

441. The clause only applies if the contract was a “chargeable asset” immediately before it became a derivative contract (see the definition of that term in clause 127).

442. *Subsection (5)* requires a chargeable gain or allowable loss to be brought into account for the accounting period in which the company ceases to be party to the contract. The gain or loss is that arising on the assumption the company had disposed of the contract immediately before it became a derivative contract. It is also assumed that it did so for consideration equal to the book value of the contract (if any) at the end of the last accounting period of the company before that to which the changes made by SI 2005/646 apply.

443. Paragraph (b) of *subsection (6)* makes clear that that period is the relevant accounting period in which to find the book value needed to calculate any chargeable gain or allowable loss. In the source legislation, the words used are “the company’s accounting period immediately before its first new period”. The term “new period” is not otherwise used in SI 2005/646. A “new period” cannot predate the first period to which the amendments made by those regulations apply (as set out in article 1 of SI 2005/646). The term was borrowed from Schedule 28 to FA 2002 (see the definition in paragraph 7 of that Schedule).

Clause 105: Contracts which became derivative contracts on 28 July 2005

444. This clause treats a relevant contract to which it applies as a derivative contract entered into by a company on 28 July 2005. It also brings into account as a

chargeable gain or allowable loss, when the company ceases to be party to a contract, the gain or loss latent in the contract at that date. It is based on paragraph 4B(1), (2), (3) and (4) of Schedule 26.

445. The source legislation for this clause was inserted by the Finance Act 2002, Schedule 26, Parts 2 and 9 (Amendment No 2) Order 2005 (SI 2005/2082), which extended the scope of the amendments made by SI 2005/646 to the “excluded property” rules (see clause 24).

446. A contract to which this clause applies is one that was not a derivative contract immediately before 28 July 2005 (although it was a “chargeable asset” at that point). But it would have been a derivative contract had an accounting period of the company begun on that date. That is, in such a case the contract would have been a derivative contract because it would have satisfied the necessary conditions to be one. And it would not have satisfied the “excluded property” conditions so as not to be a derivative contract. Because of the rule in this case, it is immaterial when the actual accounting period of the company began in which 28 July 2005 falls.

447. The definition of “chargeable asset” in clause 127 applies.

448. *Subsection (5)* treats the contract as a derivative contract entered into by the company on 28 July 2005 for consideration equal to the fair value of the contract at that time.

449. *Subsection (6)* brings into account the chargeable gain or allowable loss latent in the contract at the time it is treated as becoming a derivative contract. It does so in the same way as clause 104 with one exception. This is that the consideration for the disposal is equal to the fair value of the contract on 28 July 2005 (that is, the same figure as is taken to be the consideration for the deemed derivative contract in the subsequent application of this Part).

Clause 106: Plain vanilla contracts which became derivative contracts before 30 December 2006

450. This clause modifies the amounts otherwise allowable under section 38 of TCGA as acquisition costs on the disposal of a plain vanilla contract. It applies where the disposal occurs because the company ceases to be party to the contract. It is based on paragraph 4D of Schedule 26.

451. There are two conditions to be satisfied. The first condition is that the plain vanilla contract was previously not a derivative contract but became one at a date before 30 December 2006. Although the clause does not specify in what circumstances the contract became a derivative contract, it is likely to be the case that it had ceased to satisfy the conditions in clause 24 under which the underlying subject matter of the contract was “excluded property”.

452. The second condition is that neither clause 104 nor clause 105 applies on the company ceasing to be party to the contract.

453. The relevance of 30 December 2006 is that it is the date by reference to which the Finance Act 2002, Schedule 26, (Parts 2 and 9) (Amendment) Order 2006 (SI 2006/3269) has effect, so as to add this rule to the provisions in this Part.

454. *Subsection (2)* disapplies clause 8 in respect of a disposal to which this clause applies (that is, the provisions of this Chapter do not exhaust the application of the Corporation Tax Acts to this disposal).

455. The adjustments made by this clause to the acquisition costs allowable under section 38 of TCGA are similar to those made by a number of provisions in Chapter 7 (clauses 97, 98, 100 and 102). As with those clauses, this clause in effect reverses the treatment of credits and debits in respect of the derivative contract so that double counting is avoided when the contract is disposed of.

456. And similarly again to those clauses, if the adjustment to be made under *subsection (3)* is a reduction that exceeds the amounts otherwise allowable under section 38 of TCGA, the excess is added to the consideration for the disposal.

457. *Subsection (8)* indicates that the credits and debits in question, in determining the excess of “G” over “L” or vice versa, are those arising in respect of any accounting period of the company during which it is party to the derivative contract up to and including that in which the contract is disposed of.

Chapter 9: Continuity of treatment: groups and se mergers

Clause 107: Group member replacing another as party to derivative contract

458. This clause and the next three deal with the case where one member of a group of companies replaces another as party to a derivative contract as the result of a related transaction or similar transactions. This clause determines the credits and debits to be brought into account by the transferor company and the transferee company. It treats both as using the same consideration in relation to that transaction or transactions. It is based on paragraph 28(1), (3), (3ZA), (3A), (5) and (7) of Schedule 26.

459. The meaning of one company replacing another as party to a derivative contract is given by clause 109.

460. The clause applies only if there is a related transaction, or a series of transactions having the same effect as a related transaction, between two companies who are members of the same group at the time of the related transaction (or at any time during the series of transactions). Both companies must be within the charge to corporation tax in respect of the related transaction. These rules are in clause 108.

461. For the accounting period in which the transferor enters into the transaction (or the first of the series of transactions) under which it disposes of the derivative contract to the transferee, the transferor is treated under *subsection (3)* as having done so for a consideration equal to the notional carrying value of the contract. As regards the transferee, it is treated under *subsection (4)*, in relation to any accounting period in which it is party to the contract, as having acquired it for the same amount.

462. “Notional carrying value” is defined in *subsection (6)* on the model of the similar definition in clause 42(4). “Carrying value” is defined in clause 126.

463. Should any “discount” arise in respect of the related transaction or the equivalent series of transactions, it is added to the amount treated as consideration by the transferor under *subsection (3)*.

464. “Discount” is defined in *subsection (6)* by reference to clause [j0610100ab] in Part [6] (loan relationships), clause 155 in the May 2007 draft clauses. The clause referred to in *subsection (6)* rewrites section 100(3A) of FA 1996. A discount arises if payment of part of the consideration for a disposal is deferred and the consideration is accordingly increased to recognise the delay.

465. *Subsection (7)* disapplies Schedule 28AA to ICTA in a case where credits and debits are determined under *subsection (2)*. Schedule 28AA to ICTA might otherwise substitute market value for the amounts agreed between the parties, which amounts would give rise to credits and debits for the purposes of this Part. Such a substitution is unnecessary given that this clause requires both parties to use the notional carrying value of the contract rather than the amount shown in the accounts (the amounts “recognised for accounting purposes”).

466. *Subsection (8)* contains a signpost to an exception from this clause if the transferor uses fair value accounting in relation to the transaction which would otherwise trigger the application of this clause.

Clause 108: Transactions to which section 107 applies

467. This clause defines the related transaction or series of transactions which acts or act as a trigger for the application of clause 107. It is based on paragraph 28(2) and (6) of Schedule 26.

468. *Subsection (4)* provides that the meaning of a company being a member of a group is given by section 170 of TCGA (see in particular *subsections (2)* and *(3)* of that section).

Clause 109: Meaning of company replacing another as party to derivative contract

469. This clause gives a particular example of what one company replacing another as party to a derivative contract means. It is based on paragraph 28(4) of Schedule 26.

470. The commonest way in which one company may replace another as party to a derivative contract is by the assignment of the rights and liabilities under the contract. But there may be other types of transaction that have the same effect.

471. This clause ensures that, if the company referred to as the transferee in clause 107 becomes party to a contract that is equivalent to that to which the company referred to as the transferor in that clause has ceased to be party, the transferee is treated as having replaced the transferor in respect of the derivative contract. A novation is an example of this.

Clause 110: Exception to section 107 where transferor uses fair value accounting

472. This clause substitutes its own rules for those in clause 107, in a case to which that clause applies, if the transferor uses fair value accounting in respect of the derivative contract in question. It is based on paragraph 30 of Schedule 26.

473. Where the transferor uses fair value accounting as regards the derivative contract, it must bring in the fair value of that contract in respect of the transaction (or series of transactions) under which it transfers the contract to the transferee. And the transferee is treated as having acquired the derivative contract at that value as at the time of the transfer for the purposes of determining the credits and debits brought into account under this Part for any accounting period in which it is party to the contract.

474. As in clause 107, any “discount” is added to the amount treated as consideration by the transferor. The reference to “section [j0610100ab]” is to clause 155 in the May 2007 draft clauses.

Clause 111: Transferee leaving group after replacing transferor as party to contract: introduction

475. This clause and the next two deal with the case where a transferee within clause 107 ceases to be a member of the group of companies mentioned in clause 108(2) or (3). They provide for a deemed assignment of the derivative contract at the fair value of the rights and liabilities under the contract. This clause sets out when clauses 112 and 113 apply. It is based on paragraph 30A(1) and (8) of Schedule 26.

476. In a case to which clause 107 applies, this clause is triggered by the transferee leaving the relevant group of companies before the end of a six year period beginning with the related transaction or the last of the equivalent series of transaction, as appropriate.

Clause 112: Replacement of transferor otherwise than because of exempt distribution

477. This clause deems the transferee to have assigned the rights and liabilities under the derivative contract immediately before it left the group. It is deemed to have done so for a consideration equal to their fair value at that time and to have

immediately reacquired them for that value. It is based on paragraph 30A(1), (2), (3), (4) and (5) of Schedule 26.

478. Two conditions must be met for this clause to apply. The first is that the company ceases to be a member of the group of companies in question for reasons which are not just that it does so because of an “exempt distribution” under section 213(2) of ICTA. That section provides for a distribution under which there is a demerger of the trading activities of a single company or group of companies to a number of companies or groups to be disregarded for certain purposes.

479. The second condition is that a credit would be brought into account under either this Part (condition A in *subsection (3)*) or Part [6] (loan relationships) (condition B in *subsection (4)*). The credit in question, as regards this Part, is the credit that would be brought into account under this Part on the deemed assignment of the rights and liabilities under the derivative contract.

480. As regards Part [6] (loan relationships), the credit in question is the credit that must be brought into account under that Part because of clause [j0696912Aba](2)(a) and (b) in that Part in a case where the transferee has a “hedging relationship” between the derivative contract and a creditor relationship. That clause makes matching provision for loan relationships to that made by this clause for derivative contracts. It rewrites paragraph 12A of Schedule 9 to FA 1996. “Clause [j0696912Aba]” is clause 53 in the May 2007 draft clauses.

481. In either case, the second condition will not be satisfied if the assignment would give rise to a debit. So the clause does not give rise to a reduction of the transferee’s liability to corporation tax.

482. *Subsection (5)* contains signposts to the provisions giving the meaning of “creditor relationship” and “hedging relationship”. “Hedging relationship” is described in clause 130 in a number of ways. Broadly, these relate to cases where the derivative contract is entered into to shelter the company from risks (such as a fluctuation in values because of the movement in a relevant market such as a stock or commodities exchange) associated with holding or owing the hedged asset or liability.

Clause 113: Replacement of transferor because of exempt distribution

483. This clause deems the transferee to have assigned the rights and liabilities under the derivative contract at the time a “chargeable payment” is made. The assignment is deemed to be for a consideration equal to the fair value of the rights and liabilities at that time. The transferee is also deemed to have immediately reacquired the rights and liabilities for that value. It is based on paragraph 30A(3), (4), (5), (6) and (7) of Schedule 26.

484. As with clause 112, the clause applies if a number of conditions are met. The first is that the company ceases to be a member of the group of companies just because of an “exempt distribution” under section 213(2) of ICTA.

485. The second condition is that there is a “chargeable payment”, within the meaning of section 214(2) of ICTA within 5 years of that distribution being made. A “chargeable payment” is broadly a payment made otherwise than for genuine commercial reasons or in connection with tax avoidance.

486. Conditions A and B, in *subsections (3) and (4)*, are the same as the conditions in clause 112(3) and (4). See the commentary on that clause.

Clause 114: Formation of SE by merger: disregard of incidental transfers of derivative contracts

487. This clause and the next two deal with the case where there is a merger of companies from more than one Member State of the European Union to form an SE. They apply if there is a transfer of rights and liabilities under a derivative contract in the course of that merger. This clause provides that the transfer of those rights and liabilities is ignored for the purposes of this Part. It also provides that the transferor and transferee are treated as the same person other than in connection with exchange gains and losses. It is based on paragraph 30B(1), (2), (3) and (7) of Schedule 26.

488. An “SE” is a “Societas Europaea”, a term used to refer to a public limited liability company established under EC regulation 2157/2001/EC. This clause applies only if the SE is within the charge to corporation tax (either because it is resident in the United Kingdom or because it has a “permanent establishment” in the United Kingdom that is so liable).

489. *Subsection (6)* defines whether a company is resident in a member State of the European Union for the purposes of this clause. The definition requires that the company is within a charge to tax in the member state and is not treated, by virtue of a double taxation agreement as resident in a non-member State. (Double taxation agreements commonly have a tiebreaker rule if a company is treated as resident in more than one country or territory by virtue of the applicable law of each country or territory.)

490. *Subsection (2)* includes exceptions from the general rule that the transfer is ignored and the parties to the transfer treated as the same person. The first exception applies to the question of determining the credits or debits to be brought into account (and by whom) in respect of exchange gains and losses. The second exception is for determining which company is to bring into account any credits or debits that do not relate to the transfer of the derivative.

491. *Subsection (5)* contains signposts to the further exceptions to this clause in the following two clauses.

Clause 115: Exception to section 114: transferor using fair value accounting

492. This clause makes an exception from the general rule in clause 114 if the transferor of the derivative contract in question uses fair value accounting in respect

of that contract. It is based on paragraph 30B(4) of Schedule 26 (which applies paragraph 30 of that Schedule for this purpose).

493. As in clause 110, which is based on paragraph 30 of Schedule 26, this clause directs that the transferor is to bring the fair value of the contract at the date of transfer into account as consideration for the transfer. And the transferee (that is, the SE) is treated as acquiring the derivative contract for consideration of that value in determining credits and debits in respect of the contract for any accounting period in which it is party to the contract.

494. Again, as in clause 110, any “discount” is added to the amount of the consideration to be brought into account by the transferor. See the commentary on that clause.

Clause 116: Exception to section 114: tax avoidance etc

495. This section makes an exception from the rules in clause 114 if the merger is not effected for genuine commercial reasons or the merger is intended to facilitate avoidance of corporation tax, income tax or capital gains tax. It is based on paragraph 30B(5) and (6) of Schedule 26.

496. *Subsection (4)* provides that this clause does not apply if the merging companies have applied for clearance in advance from HMRC and been granted it.

Chapter 10: Special kinds of company

Clause 117: Investment trusts: profits or losses of a capital nature

497. This clause and the next except certain capital profits and losses of an investment trust or venture capital trust from the scope of this Part, that is, credits and debits in respect of such profits or losses do not fall within clause 32. This clause deals with investment trusts. It is based on paragraph 38 of Schedule 26 and articles 2 and 3 of the Investment Trusts and Venture Capital Trusts (Definition of Capital Profits, Gains or Losses) Order 2006 (SI 2006/1182).

498. *Subsection (1)* provides the exception. The rest of the clause deals with the definition of the capital profits and losses to which it applies. The clause refers to “profits and losses” rather than “profits, gains and losses” as in the source legislation. But no difference is seen in the meaning of “profits” and “gains” in the context of transaction of a capital nature.

499. *Subsections (2)* and *(3)* define capital profits and losses for investment trusts that are users respectively of United Kingdom generally accepted accounting practice or international accounting standards. *Subsection (4)* defines the Statement of Recommended Practice relevant to the application of that practice and those standards.

500. *Subsection (5)* contains powers for the amendment by Treasury order of the meaning of “profits or losses of a capital nature” in this clause. This rewrites the

powers in paragraph 38(2) of Schedule 26 used to make the order in SI 2006/1182 applying to investment trusts and venture capital trusts who use international accounting standards. The effect of that order in relation to investment trusts is rewritten in subsections (3) and (4).

Clause 118: Venture capital trusts: profits or losses of a capital nature

501. This clause excepts certain capital profits and losses of a venture capital trust from the scope of this Part. It is based on paragraph 38A of Schedule 26 and articles 2 and 3 of the Investment Trusts and Venture Capital Trusts (Definition of Capital Profits, Gains or Losses) Order 2006 (SI 2006/1182).

502. Apart from paragraph (b) of *subsection (2)*, this clause has the same effect as clause 117. That paragraph adds to the category of profits or losses coming within the scope of this clause profits and losses equivalent to those that are excepted in the case of an investment trust, See the commentary on that clause.

Chapter 11: Mutual trading companies and insurance companies

Overview

503. This chapter brings together a number of rules that vary the application of this Part to mutual trading companies or insurance companies. These rules are of course of interest only to such companies. By extracting them from the rules which they modify, the remaining detail presented in those rules is reduced.

Clause 119: Modifications for mutual trading companies

504. This clause modifies a number of the rules in this Part in relation to mutual trading companies. It is based on paragraphs 4(2B), (2C) and (2CA), 45C(1) and (2), 45D(2) and (3), 45F(2) and (3) and 45G(1A) and (1B) of Schedule 26.

505. The modification in *subsection (2)* has the effect of ensuring that contracts held by a mutual trading company are not derivative contracts because their underlying subject matter consists of “excluded property” within clause 24.

506. The remaining modifications in this clause have the effect of ensuring that the capital gains treatment in clause 66 applies to derivative contracts of a mutual trading company.

Clause 120: Modifications for insurance companies

507. This clause introduces the modifications for insurance companies made by clauses 121 to 123. It is new.

Clause 121: Modification of section 26

508. This clause has the effect of ensuring that contracts held by an insurance company for the purposes of its life assurance business are not derivative contracts because their underlying subject matter consists of “excluded property” within clause 24. It is based on paragraph 4(2C) of Schedule 26.

Clause 122: Modifications of Chapter 6

509. This clause makes modifications of Chapter 6 (chargeable gains arising in relation to derivative contracts). The modifications have the effect of ensuring that the capital gains treatment in clause 66 applies to derivative contracts of an insurance company held for the purposes of its life assurance business. It is based on paragraphs 45C(1) and (2), 45D(2) and (3), 45F(2) and (3) and 45G(1A) and (1B) of Schedule 26.

Clause 123: Modifications of Chapter 9

510. This clause makes modifications of Chapter 9 (continuity of treatment: groups and SE mergers) in respect of insurance companies. The modifications add further transactions to those given in clause 108 for the application of clause 107 and restrict the application of that clause. It is based on paragraphs 28(1) and (2) and 29 of Schedule 26.

511. Clause 107 deals with the case where one member of a group of companies replaces another as party to a derivative contract as the result of a related transaction or similar transactions. It determines the credits and debits to be brought into account by the transferor company and the transferee company by treating both as using the same consideration in relation to that transaction or transactions.

512. This clause first adds two further cases to the list in clause 108 of transactions that trigger the operation of clause 107. They are cases involving the transfer of classes of insurance business between two companies where the transfer does not fall within clause 107.

513. *Subsection (4)* then disapplies clause 107, in respect of a triggering transaction falling within the original categories in clause 108, in relation to the transfer of derivative contracts moving into or out of a company's long-term insurance fund.

514. *Subsection (5)* disapplies clause 107 in respect of a triggering transaction falling within the categories treated as added to clause 108 by subsection (3), if derivative contracts are in one of the categories set out in section 440(4) of ICTA before the transfer and in a different category after the transfer.

515. *Subsection (7)* defines whether an asset is within the same category before and after the transfer if one of the companies participating in the transfer is an overseas life insurance company.

Clause 124: Application of Part 1 of Schedule 11 to FA 1996

516. This clause applies Part 1 of Schedule 11 to FA 1996 in relation to derivative contracts as it applies to loan relationships, but with modifications. It is based on paragraph 42 of Schedule 26.

517. Schedule 11 to FA 1996 performs a similar role in relation to Chapter 2 of Part 4 of that Act (loan relationships) as this Chapter does in relation to this Part. The

modifications made by this clause are those needed to apply the rules in Part 1 of that Schedule by reference to derivative contracts.

518. But *subsection (2)* provides that any provision of Part 1 of Schedule 11 to FA 1996 that applies only to debtor relationships is not applied in relation to derivative contracts.

519. The May 2007 draft clauses, rewriting Chapter 2 of Part 4 of FA 1996, do not include anything for Schedule 11 to FA 1996.

Chapter 12: General and supplementary provision

Clause 125: Power to amend certain provisions

520. This clause contains powers for the amendment of certain Chapters, clauses or definitions in this Part. The amendments are broadly concerned with redefining what is or is not a derivative contract (whether by reference to the underlying subject matter of a relevant contract or otherwise). They are also concerned with adjusting the regime for special cases. It is based on paragraph 13 of Schedule 26 and paragraph 52 of Schedule 4 to FA 2005.

521. *Subsections (1) and (2)* define what provisions in this Part may be amended by an order under this clause. In the source legislation, the powers cover anything in paragraphs 2 to 12 in Part 2 of Schedule 26 (that is, everything in that Part other than the paragraph containing the powers) and all of Part 9 (paragraphs 43A to 51). Part 2 of Schedule 26 is primarily concerned with defining the contracts to which the Schedule applies. Part 9 contains miscellaneous rules but is predominantly concerned with the various rules substituting capital gains treatment of credits and debits or modifying the rules for corporation tax on chargeable gains in relation to or by reference to derivative contracts.

522. The lists in these subsections reflect the fact that the rules in those Parts of Schedule 26 are now ordered differently in the rewrite of those Parts in this Part. The lists in effect preserve but do not extend the scope of the powers.

523. *Subsections (3) and (4)* illustrate the extent of the powers as regards the contracts to which the Part applies, but do not do so for the power generally to amend provisions that appear in Part 9 of Schedule 26. Subsection (6) contains the usual inclusion of power to make such provision as follows on from the main changes made under the power.

524. *Subsection (5)* contains the commencement provisions for an order made under this clause. The normal rule is that an order applies to accounting periods ending on or after the date on which the order comes into force. That rule includes a degree of retrospection in that the order may apply by reference to events that occurred in that accounting period before the order came into force. Retrospective application is partly increased by paragraph (b) of this subsection, which allows the order to apply to periods of account beginning in the year in which they are made

(which would cover, for example, an accounting period of less than 12 months which has ended before the order is made).

Clause 126: Meaning of “carrying value”

525. This clause defines the meaning of “carrying value” for the purposes of this Part. It is based on paragraph 50A(3A) and (3B) of Schedule 26.

526. *Subsections (2) and (3)* ensure that the effect of clause 21, under which certain embedded derivatives are treated as derivative contracts, and of clauses 107 to 109, under which the consideration for a transfer of a derivative contract between members of a group of companies is specified, carries through for the purposes of calculating the carrying value under this clause.

527. *Subsection (4)* provides a definition of “impairment loss” (a term taken from international accounting standards) which is not supplied by the source legislation other than by virtue of its reference to “amounts recognised for accounting purposes”. The definition is modelled on that provided for loan relationships by section 103(1) of FA 1996. See *Change 5* in Annex 1.

Q6. We welcome comments on the proposal to supply a definition of “impairment loss” for the purposes of this clause.

Clause 127: Meaning of “chargeable asset”

528. This clause defines the meaning of “chargeable asset” for the purposes of this Part. It is based on paragraphs 4A(4), 4B(5), 37(6) and 43A(3) of Schedule 26.

529. The definition extends under *subsection (2)* to amounts that are treated under section 143 of TCGA as assets whose disposal falls within TCGA. Those assets are obligations under a futures contract, that is, the obligation to supply or to take delivery of a commodity or other item under the contract at an agreed price. If there has been such market movement in the price of the commodity that the obligation is heading to produce a profit, a disposal of the obligation (before the contract has run to delivery) would be a disposal of an asset for the purposes of TCGA.

Clause 128: Meaning of “creditor relationship” and “debtor relationship”

530. This clause defines “creditor relationship” and “debtor relationship” for the purposes of this Part. It is based on paragraphs 30A(7) and 54(1) of Schedule 26.

531. In the source legislation, these terms are defined by reference to the definitions in section 103(1) of FA 1996. They mean, in relation to a company, any loan relationship of that company in the case of which it stands in the position of, respectively, creditor or debtor as respects the debt in question. In short, a creditor relation refers to a debt owned and a debtor relationship to a debt owed by the company. The clause defines the terms by reference to clause [j061081], clause 9 in the May 2007 draft clauses, which rewrites the definitions in section 103(1) of FA 1996.

Clause 129: Meaning of expressions relating to exchange gains and losses

532. This clause provides for the interpretation of references in this Part to “exchange gains” or “exchange losses” in relation to a company. It is based on paragraph 54(2), (2A) and (3) of Schedule 26.

533. *Subsection (2)* provides that, in the event that the comparison of values described in *subsection (1)* gives neither a gain nor a loss, an exchange gain of nil arises. This rule will apply in a case where it is necessary for there be an exchange gain or exchange loss for a provision to apply (say, clause 60(6)).

534. *Subsection (5)* teases out what a reference to an exchange gain or loss from a company’s derivative contracts means (for the purposes of, say, clause 35(1)).

535. *Subsection (3)* provides powers for the Treasury to make regulations as to the calculation of exchange gains and losses and any other profits, gains or losses if the company uses fair value accounting. See the Loan Relationships and Derivative Contracts (Exchange Gains and Losses using Fair Value Accounting) Regulations 2005 (SI 2005/3422). As in the case of the powers in clause 125, regulations made under these powers may apply to periods of account beginning in the year in which they are made.

Clause 130: Meaning of “hedging relationship”

536. This clause sets out two cases in which a company is regarded as having a “hedging relationship” for the purposes of this Part. It is based on paragraph 12(14) of Schedule 26.

537. The concept of “hedging” has to do with contracts undertaken to protect the company’s assets (or to guard against increase in its liabilities) in a case where there is some form of market volatility associated with the item. The cases described in this clause derive from those set out in accounting standards. Paragraph 86 of Financial Reporting Standard 26, the equivalent for United Kingdom generally accepted accounting practice of International Accounting Standard 39, describes a hedging relationship as follows:

“Hedging relationships are of three types:

fair value hedge: a hedge of the exposure to changes in fair value of a recognised asset or liability or an unrecognised firm commitment, or an identified portion of such an asset, liability or commitment that is attributable to a particular risk and could affect profit or loss.

cash flow hedge: a hedge of the exposure to variability in cash flows that is (i) attributable to a particular risk associated with a recognised asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss.

hedge of a net investment in a foreign operation as defined in FRS 23.”

538. Paragraph 9 of Financial Reporting Standard 26 also provides definitions of “hedging instrument” and “hedged item”.

539. The term “hedging relationship” is used in clauses 26, 112 and 113.

Clause 131: Meaning of “original creditor relationship”

540. This clause provides the meaning of “original creditor relationship” for the purposes of this Part. It is based on paragraph 12(1) and (11D) of Schedule 26.

541. It refers to a creditor relationship (defined in clause 128) that is treated under clause 21 as divided between a host contract and one or more embedded derivatives.

542. The term “original creditor relationship” is used in clauses 76 and 78.

Clause 132: Meaning of “relevant credits” and “relevant debits”

543. This clause provides the meaning of “relevant credits” and “relevant debits” for the purposes of this Part. It is based on paragraphs 45A(3), 45FA(2), 45G(2), (3) and (4), 45J(3), 45K(3), 45KA(2) and 45L(1B) of Schedule 26.

544. Although the clause applies for the purposes of the Part, it is in practice relevant to Chapter 6 (chargeable gains arising in relation to derivative contracts). And for all but one case the meaning is the same as that of credits and debits within clause 32.

545. The exception is the meaning of the terms in the case of a derivative contract to which clause 75 (property based total return swaps). For the purposes of clause 66, as it applies to derivative contracts within clause 75, the credits and debits found by clause 32 are relevant credits and debits only to the extent they match the amounts found by applying the calculation formula in *subsection (4)*.

546. Clause 75 applies to contracts for differences in which there is a specified “capital value index” (see the commentary on that clause). Subsection (4) finds an amount of credits and debits by calculating the percentage change (“R%”) in the value of that index over the relevant accounting period (or part of that period, if the company is not party to the contract throughout) and applying R% to the “notional principal amount”. That term is not defined but is used in relation to derivative contracts to describe the notional amount of capital by reference to which payments are due between the parties to the contract (see condition D in clause 75). (The term is also used in clause 62; see the commentary on that clause.)

Clause 133: Meaning of “section 21 embedded derivative” and “[section [j061094Aaa]] host contract”

547. This clause provides the meaning of two labels commonly used in this Part. It is based on paragraph 12(1), (11A) and (11B) of Schedule 26.

548. Section 94A of FA 1996 deals with the case where, in accordance with generally accepted accounting practice, a loan relationship is treated under as divided between rights and liabilities in one or more embedded derivatives and the remaining rights and liabilities in a “host contract”. The labels “section 21 embedded derivative” and “[section [j061094Aaa]] host contract” are used in this Part to describe those elements in the divided loan relationship.

549. Clause 21 deals with this division for the purposes of this Part, hence the use of that clause in the label. The reference in the other label to “[section [j061094Aaa]]” is to clause 116 in the May 2007 draft clauses that rewrites section 94A of FA 1996 as it applies to loan relationships.

Clause 134: Other definitions

550. This clause defines a number of terms for the purposes of this Part. It is based on paragraphs 12(1), (2), (9), (11), (11C), (12), (13), (15) and (17) and 54(1) and (4) of Schedule 26.

551. There are four types of definition:

- a self-contained definition (“fair value”, “fair value accounting”, “insurance company”, “non-life mutual business”, “shares”, “UK company” and “warrant”);
- a definition by reference to a provision in the Tax Acts (“bank”, “capital redemption policy”, “depository receipt”, “intangible fixed assets”, “investment trust”, “life assurance business”, “open-ended investment company” and “profit sharing arrangements”);
- a definition by reference to FISMA or related material, including “FISMA(RA)O 2001”, that is, the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001, SI 2001/544 (“contract of insurance”, “contract of long-term insurance”, “financial trader”, “insurance business transfer scheme”, “Insurance Prudential Sourcebook”, and “long-term insurance business”); and
- a definition that gives the term the meaning it has for accounting purposes (“designated”, “equity instrument”, “financial instrument”, “income statement”, “statement of changes in equity”, and “statement of total recognised gains and losses”).

552. Uses of terms in the latter category have in particular been discussed in the context of the clauses in which they are used.

Annex 1 Changes

1. Derivative contracts: amendment of references to a “relevant holding” in a collective investment scheme in relation to certain relevant contracts treated as derivative contracts: clauses 22 and 47
2. Loan relationships and derivative contracts: definition of offshore funds for qualifying investment test: clauses [j06969108](4), [j0696104](1)(a)(iii) and 22
3. Derivative contracts: amendment of a condition to be satisfied to determine whether the underlying subject matter of a relevant contract is “excluded property” for the purposes of Part [8]: clause 26
4. References to “officer of Revenue and Customs” and removal of references to a person to whom a claim or election is made: clauses [j033202], [j033502], [j050318] and 30
5. Derivative contracts: meaning of “impairment loss” for the purposes of the meaning of “carrying value”: clause 126

Change 1: Derivative contracts: amendment of references to a “relevant holding” in a collective investment scheme in relation to certain relevant contracts treated as derivative contracts: clauses 22 and 47

This change clarifies the meaning of references to a “relevant holding” in unit trust schemes, open-ended investment companies and offshore funds in determining whether a relevant contract is a derivative contract.

Paragraph 36 of Schedule 26 to FA 2002 treats as a derivative contract a relevant contract to which a company is party in an accounting period, that is not otherwise a derivative contract for the purposes of that Schedule, if its “underlying subject matter consists wholly or partly of a holding which is, in that period, a relevant holding”. The paragraph does not directly define “relevant holding” for the purposes of this rule. Instead, paragraph 36(3) of that Schedule provides that “for the purposes of this paragraph a person holds a relevant holding in an accounting period if, at any time in that period, he holds...” and there follows a list of what such a holding may comprise. The reference here to a “person” is at odds with the reference in paragraph 36(1)(b) of that Schedule to a holding of which the underlying subject matter of a relevant contract consists.

The source legislation was modelled on a similar provision for loan relationships (see paragraph 4(1) of Schedule 10 to FA 1996). The reference there is to a holding held by a company. In adopting the model in paragraph 4 of Schedule 10 to FA 1996, the reference to a holding of a legal person was retained in error.

Clause 22(3), which rewrites paragraph 36(3) of Schedule 26 to FA 2002, gives a meaning of “relevant holding”, for the purposes of subsection (1) of that clause, that brings matters back into alignment. It defines the case where “the underlying subject matter of a contract consists wholly or partly of a relevant holding in an accounting period”. That wording matches the phrase “its underlying subject matter consists wholly or partly of a relevant holding in that period” in subsection (1).

This Change also applies to clause 47, which determines the accounting basis to be used in determining the credits and debits to be brought into account in relation to a relevant holding mentioned in clause 22.

This change provides a clarification of the law. But it is expected to have no practical effect as it is in line with current practice.

Change 2: Loan relationships and derivative contracts: definition of offshore funds for qualifying investment test: clauses [j06969108](4), [j0696104](1)(a)(iii) and 22

This change provides that the definition of “offshore fund” in paragraph 8(7F) of Schedule 10 to FA 1996 applies for all purposes of the “non-qualifying investments test” (known as the “qualifying investments test” in Part [6] (loan relationships)).

Paragraph 4 of Schedule 10 to FA 1996 provides for a company's "relevant interest in an offshore fund" to be treated as a right under a creditor relationship where the fund fails to satisfy the non-qualifying investments test: broadly where more than 60% of the holdings of the fund represent investments that would be loan relationships if held directly by the company.

The meaning of "relevant interest in an offshore fund" for the purposes of paragraph 4 of Schedule 10 to FA 1996 is given by paragraph 7 of the same Schedule. This is a material interest in an offshore fund for the purposes of Chapter 5 of Part 17 of ICTA or an interest which would be such an interest on the assumption that the unit trust schemes and arrangements referred to in section 756A(1)(b) and (c) of ICTA were not limited to collective investment schemes. Section 756A of ICTA, which gives the meaning of "relevant interest in an offshore fund" for the purposes of Chapter 5 of Part 17 of ICTA requires that offshore funds should be collective investment schemes.

The "non-qualifying investments test" referred to in paragraph 4(1) of Schedule 10 to FA 1996 is found in paragraph 8 of that Schedule. Paragraph 8(7F) requires "offshore fund", for the purpose of the test, to have the same meaning as in Chapter 5 of Part 17 of ICTA. It does not carry the assumption in paragraph 7(1)(b) of Schedule 10 to FA 1996 that unit trust schemes and arrangements referred to in section 756A(1)(b) and (c) of ICTA need not be limited to collective investment schemes.

The definition in paragraph 8(7F) of Schedule 10 to FA 1996 clearly applies to offshore funds held by the investing company, ie the same company and the same offshore fund referred to in paragraph 4(1) of that Schedule (to which the definition in paragraph 7 of that Schedule refers) since the definition also construes "assets of an offshore fund". This can only refer to "assets of the fund" in paragraph 8(5)(b) of that Schedule, which sub-paragraph in turn gives the meaning of "investments of an offshore fund" for the purposes of paragraph 8(1) of that Schedule ("investments of ... the fund"). This is the offshore fund referred to in paragraph 4(1).

In consequence, the wider definition of a relevant interest in paragraph 7 of Schedule 10 to FA 1996 is lost when paragraph 8 of that Schedule is applied because any such non-collective investment scheme is excluded from the test by the definition of "offshore fund" in paragraph 8(7F). The wording of paragraph 4(1) of that Schedule makes it clear that the "offshore fund" referred to in that sub-paragraph should be subject to the test in paragraph 8. But if a company has a material interest in an offshore fund under paragraph 4 as a result of the assumption in paragraph 7(1)(b), that fund is not recognised for the purposes of the non-qualifying investments test.

Therefore the narrower definition of an offshore fund is adopted in clause [j06969108](4) and as the assumption in paragraph 7(1)(b) of Schedule 10 to FA 1996 serves no purpose it is excluded from the reference to interests in offshore funds in clause [j0696104] (1)(a)(iii) for the purposes of the qualifying investments test.

Clause 22 in Part [8] (derivative contracts) refers also to a holding that is “an interest in an offshore fund” and applies the meaning of that phrase in section 759 of ICTA rather than the wider meaning in paragraph 7 of Schedule 10 to FA 1996. This change therefore applies also for the purposes of that clause.

This change is in principle adverse to some taxpayers and favourable to others. But it is expected to have no practical effect as it is in line with current practice.

Change 3: Derivative contracts: amendment of a condition to be satisfied to determine whether the underlying subject matter of a relevant contract is “excluded property” for the purposes of Part [8]: clause 26

This change adds acquiring a plain vanilla contract to the circumstances that are relevant to the contract satisfying condition A in clause 26. The circumstances in question are those in which a company carrying on life assurance business becomes party to such a contract.

Paragraph 3 of Schedule 26 to FA 2002 sets out the conditions to be satisfied for a relevant contract (defined in paragraph 2(2) of that Schedule as an option, a future or a contract for differences) to be a derivative contract for the purposes of that Schedule. But paragraph 4 of Schedule 26 to FA 2002 excludes a relevant contract from contracts that are derivative contracts for the purposes of that Schedule if, although the relevant contract meets the conditions in paragraph 3 of that Schedule, its underlying subject matter consists wholly of property within specified excluded types of property. One such type is certain shares in a company or rights of a unit holder under a unit trust scheme if the relevant contract satisfies a condition in paragraph 4(2A), (2B), (2C), (2CA) or (2D) of Schedule 26 to FA 2002.

The conditions in paragraph 4(2A) of Schedule 26 to FA 2002 require that the relevant contract is a plain vanilla contract “entered into” by a company carrying on life assurance business. (A “plain vanilla contract” is defined in paragraph 2(2B) of Schedule 26 to FA 2002 as a relevant contract other than one to which the company is treated as being party by virtue of a provision mentioned in paragraph 2(2A) of that Schedule, that is, a contract which is variously treated as divided between one or more embedded derivative contracts and the remaining rights and liabilities under the contract.) But the conditions in paragraph 4(2B), (2C) and (2CA) of Schedule 26 to FA 2002 refer to the circumstance in which the relevant contract is “entered into or acquired”. That is, the condition can be met in circumstances where the company in question was not a party to the contract when it was made but became party to the contract at a later point, say by the assignment to it of the assignor’s rights and liabilities under the contract.

There is no reason in relation to the condition in paragraph 4(2A) of Schedule 26 to FA 2002 to distinguish between a case in which a company enters into a contract and one in which it acquires the contract. It is not HMRC’s practice to make any such distinction. Clause 26(2), which rewrites paragraph 4(2A) of Schedule 26 to FA 2002, therefore refers to a plain vanilla contract “entered into or acquired” by a company

carrying on life assurance business. This brings it into line with the conditions in paragraph 4(2B), (2C) and (2CA) of Schedule 26 to FA 2002 that are also rewritten in clause 26. Because of the change, some relevant contracts may cease to be derivative contracts for the purposes of this Part so that profits and losses from the contract are not charged by virtue of this Part.

This change is in taxpayers' favour in principle. But it is expected to have no practical effect as it is in line with current practice.

Change 4: References to “officer of Revenue and Customs” and removal of references to a person to whom a claim or election is made: clauses [j033202], [j033502], [j050318] and 30

This change replaces references to the “Board of Inland Revenue” in the source legislation with references to “an officer of Revenue and Customs”. It also omits references to a person to whom a claim or election is to be made.

It brings the income and corporation tax codes back into line.

(A) References in the source legislation to the “Board of Inland Revenue” are treated by section 50(1) of the Commissioners for Revenue and Customs Act 2005 (CRCA) as references to “the Commissioners for Her Majesty’s Revenue and Customs”. The rest of this note accordingly refers to the Commissioners for Her Majesty’s Revenue and Customs (“the Commissioners”) rather than to the Board of Inland Revenue.

The provisions affected by this change will in future authorise or require things to be done by or in relation to an officer of Revenue and Customs rather than by or in relation to the Commissioners. This reflects the way in which HMRC are organised and operate in practice. Section 13 of CRCA allows nearly all functions conferred on the Commissioners to be exercised by any officer. All of the functions affected by this change, which are in the main concerned with administrative processes, are in fact exercised by officers of the Commissioners, and the Commissioners themselves are not personally involved in their exercise.

(B) Where the source legislation provides for a claim or election to be made to the Commissioners, this Bill does not expressly state to whom such a claim or election is to be made. Where a notice to deliver a corporation tax return has been issued paragraphs 57 and 58 of Schedule 18 to FA 1998 require the claim to be made in the return or by amendment of the return if possible. A return must be made to the officer who issued it. A notice amending a return must be made to an officer. Similarly, where the claim is made outside a return or amendment, paragraph 2(1) of Schedule 1A to TMA requires the claim to be made to an officer.

Each provision affected by the conversion of references to the Commissioners will be identified in the Table of Origins by a cross-reference to this change.

This change has no implications for the amount of tax due, who pays it or when. It affects (in principle and in practice) only administrative matters.

Change 5: Derivative contracts: meaning of “impairment loss” for the purposes of the meaning of “carrying value”: clause 126

This change provides a meaning for the term “impairment loss” which is used in the meaning of “carrying value”.

Paragraph 54(1) of Schedule 26 to FA 2002 provides that “carrying value”, where that term is used in that Schedule, is to be construed in accordance with paragraph 50A(3A) and (3B) of that Schedule. Paragraph 50A of Schedule 26 to FA 2002 brings an adjustment into account under that Schedule on a company changing to international accounting standards. Sub-paragraph (3A) provides that, for the purposes of that paragraph, “the carrying value of a contract includes amounts recognised for accounting purposes” in relation to a derivative contract in respect of a number of items including “impairment losses (including provisions for bad and doubtful debts)”.

The term “impairment loss” is not defined in Schedule 26 to FA 2002. It is arguable that the reference in sub-paragraph (3A) to “amounts recognised for accounting purposes” brings with it the meaning of that term provided by generally accepted accounting practice. For example, paragraph 6 of International Accounting Standard 36 says: “impairment loss is the amount by which the carrying amount of an asset or a cash-generating unit exceeds its recoverable amount.” And there are similar but not identical references to impairment losses in other standards. The term could therefore be included in clause 134 (other definitions) beside a number of other terms taken from generally accepted accounting practice which have the meaning they have for accounting purposes.

However, section 103(1) of FA 1996 provides a definition of “impairment loss” for the purposes of Chapter 2 of Part 4 of that Act (loan relationships). That Chapter includes Schedule 9 to FA 1996 which has a number of paragraphs dealing specifically with impairment losses (for example, paragraphs 5ZA to 6C). Paragraph 19A of that Schedule deals with the adjustment to be made for the purposes of that Chapter on a change of accounting policy. That paragraph is drafted in very similar terms to paragraph 50A of Schedule 26 to FA 2002. It also includes the equivalent of paragraph 50A(3A) of Schedule 26 to FA 2002, with a mention of impairment losses, so that the definition in section 103(1) of FA 1996 applies.

As this is one of the cases in which the provisions for derivative contracts deal with a matter in equivalent manner to the provisions for loan relationships, it adds consistency in the construction of equivalent provisions to adopt the definition of “impairment loss” in section 103(1) of FA 1996 for the purposes of paragraph 50A(3A) of Schedule 26 to FA 2002. That definition (together with the subsidiary definition of “impairment” in section 103(1) of FA 1996) has therefore been rewritten in clause 126(4).

This change provides a clarification of the law. But it is expected to have no practical effect as it is in line with current practice.