

# **Tax Law Rewrite – Bill 5**

## **Responses to Paper CC/SC(07) 21 Derivative contracts**

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28 December 2007

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## **INTRODUCTION**

1. In June 2007 we published Committee Paper CC/SC (07) 21 on the HMRC internet website [www.hmrc.gov.uk/rewrite](http://www.hmrc.gov.uk/rewrite). The closing date for responses was 19 October 2007. The draft clauses rewrite the legislation for derivative contracts.

2. The purpose of this response document is to provide details of the substantive technical points made and to explain our analysis and proposals in respect of them. Minor points, such as suggestions to improve punctuation or to correct obvious errors in the clauses, origins cited or the explanatory notes, are not covered but all comments received have been carefully considered. Some respondents made useful suggestions about the explanatory notes. We have not commented on these in every case but we will revisit the explanatory notes with them in mind.

3. Several respondents made policy suggestions for reform. Such issues are outside the remit of the Tax Law Rewrite project but we have passed them to the relevant specialists for consideration. Some commented on strategic issues concerning the rewrite of the derivative contracts provisions. The comments largely echoed those made in response to the draft clauses published in May for the loan relationships provisions (Chapter 2 of Part 4 of FA 1996). These have been discussed with respondents and considered by the project's Steering Committee, who reaffirmed their support for inclusion of the clauses for both loan relationships and derivative contracts in Bill 5.

4. A number of minor changes were proposed and one question asked in the Committee Paper. Where no mention is made of the changes in this response document, they either received approval or were not mentioned in responses.

5. We received written responses from the following:

- The Chartered Institute of Taxation
- The Confederation of British Industry
- Ernst & Young LLP
- The Institute of Chartered Accountants in England and Wales
- International Swaps and Derivatives Association, Inc.
- KPMG LLP
- London Investment Banking Association
- PricewaterhouseCoopers LLP

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- One individual

6. The following abbreviations for tax legislation are used in this response document:

- FA Finance Act
- ICTA Income and Corporation Taxes Act 1988
- ITA Income Tax Act 2007
- ITEPA Income Tax (Earnings and Pensions) Act 2003
- Schedule 26 Schedule 26 to the Finance Act 2002
- TCGA Taxation of Chargeable Gains Act 1992

7. We are grateful for all the comments made, many of which were detailed, and we appreciate the time and effort that went into them. We have sent each respondent a copy of this response document.

**General comments**

8. A number of respondents made suggestions for simplification of the legislation. For example:

*The complexity of [the primary and secondary legislation] could be reduced if debits and credits reflected in places other than the income statement or profit and loss account were taxed only by exception, for instance through operation of an anti-abuse provision, rather than as the general rule.*

9. The writer may have in mind paragraph 17B(1)(b) and (c) of Schedule 26 which mentions parts of the accounts other than the profit and loss account or income statement, but may also have in mind paragraphs 25 and 25A of Schedule 26 which bring in amounts credited or debited to capital account(s). While the role of the profit and loss account or income statement can be brought out more clearly, as the first and normal place to look for credits and debits to be brought into account, this suggestion is outside the scope of the project. But it has been referred to our policy colleagues.

***10. While we cannot introduce such significant change as the respondent proposes, we will bring out the role of the profit and loss account in determining the credits and debits to be brought into account under this Part.***

*Question 1: We welcome comments on the use of “profits and losses” in this Part.*

11. We asked respondents to comment on the appropriateness of referring to “profits and losses” in respect of derivative contracts, as in the source legislation (see

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paragraphs 1(1), 14(1) and 15(1) of Schedule 26). The draft clauses rewriting the loan relationships provisions in Chapter 2 of Part 4 of FA 1996, published in May 2007, used “gains and losses” for equivalent purposes, the source legislation in that case generally referring to “profits, gains and losses”.

12. We received numerous comments but there was no consensus. Votes were received for “profits and losses”, “gains and losses” and “profits, gains and losses”. This is a typical comment:

*We prefer “profits and losses” to “gains and losses”, as used in the rewritten clauses on loan relationships: see our comments on those clauses. However, as we said there, the overriding requirement is for consistency in terminology where there is no real difference in meaning.*

13. This comment is also typical in its insistence that the essential question is that there should be consistency between the provisions for loan relationships and derivative contracts in this matter. We continue to give the matter consideration but are tending to the conclusion that both regimes should use “profits and losses”.

**14. *Subject to further consideration, we propose to retain “profits and losses” in these clauses. And we aim to achieve consistency in this matter between the rewritten provisions for loan relationships and derivative contracts.***

15. Schedule 26 is particularly dependent on labels to identify certain types of contract or parts of contracts or other events or transactions with suitable drafting economy. Following the amendments to the Schedule made by The Finance Act 2002, Schedule 26, (Parts 2 and 9) (Amendment) Order 2006 (SI 2006/3269), there are in particular labels to deal with the elements in contracts which are bifurcated in accordance with generally accepted accounting practice (see also the bifurcation of a loan relationship referred to in section 94A of FA 1996, which is rewritten for the purposes of this Part in clause 21).

16. For the most part the draft clauses simply use the labels that appear in the source legislation, such as “non-financial embedded derivative”, “nested derivative” or “quasi-derivative host contract”. In a few cases, the clauses replace the label in the source legislation with a new one. But a number of respondents questioned the meaningfulness of these labels (including those taken directly from the source legislation). For example:

*The terminology in other definitions is also misleading. For instance one might imagine that there was some “non-financial” character to a “non-financial embedded derivative” (clause 19(4)). However the description “non-financial” is related to what the embedded derivative (in an accounting sense) is embedded in. That is a “non-financial contract” (again clause 19(4)). That is in turn confusing because a “non-financial contract” is something which is neither a loan relationship nor a hybrid derivative... The confusion is compounded by the definition of a “hybrid derivative”. The one thing that is*

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*certain about a hybrid derivative is that it is not a derivative at all, for accounting purposes... The “nested derivative” is an embedded derivative for accounting purposes but what it is nested in, the “hybrid derivative”, is something that is not a derivative, but is a “derivative contract”.*

17. A number of the provisions introduced or substituted in Schedule 26 were the outcome of a considerable consultation process. It is therefore arguable that the labels used in the legislation are the best available. Alternative labels may be subject to the same sort of objection that the current labels attract. We will nevertheless continue to look for possible more descriptive and less opaque labels where these would communicate more readily with the user of the provisions. For now we propose to retain the labels used by Schedule 26 and the other source legislation.

**18. *We continue to consider whether more appropriate labels may be devised but propose otherwise to use labels taken from the source legislation.***

19. One respondent challenged the decision to rewrite the chargeable gains provisions (mainly contained in paragraphs 45A to 45M of Schedule 26) in Chapters 6 and 7.

*The draft legislation includes a substantial body of material dealing with chargeable gains and allowable losses. This represents a major departure from the previous practice of the rewrite, and from consolidated legislation generally, which has always maintained a strict separation between material dealing with the calculation of chargeable gains and that dealing with income. We are surprised that there is no invitation to comment on this, nor even any mention of it as a possibly contentious issue.*

*We consider that the proposed approach is wrong in principle. The chargeable gains legislation should be kept as a separate code. We recognise the attraction of grouping all the tax legislation relating to a particular type of transaction in one place, but this objective can largely be met by signposting the relevant chargeable gains rules. The transaction-based approach to tax legislation has never been found to be practicable in any other context (although the idea has been discussed), and even in the case of a well-defined topic such as derivatives there is no clear line to be drawn between “chargeable gains on derivatives” and the rest of the chargeable gains code. Indeed Chapter 7 of the present draft demonstrates some of the grey areas...*

*It may be argued that the derivatives provisions apply only to companies, and the charge on capital gains will therefore necessarily be to corporation tax, so this legislation belongs in a corporation tax bill. However if that were so all the other company-specific chargeable gains rules, such as Schedule 7AC TCGA 1992 and all the [chargeable gains] provisions dealing with groups, should also be included in a corporation tax bill. So far as we know this has not been proposed. In any case the argument is fallacious, since one still has to go via section 2 of the TCGA to find the amount of chargeable gains before returning to the corporation tax bill for the actual charging provision.*

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*We therefore consider that the operative provisions dealing with chargeable gains should be removed from the present draft and replaced with suitable signposts. This need not actually change the overall content very much, since the bulk of the chapters in question is taken up with definitions which will still be needed to deal with the exclusion of the profits in question from taxation as income. Conversely the relevant provisions can be added quite briefly to the TCGA, if all the detailed definitional material is incorporated by cross-reference.*

20. The writer correctly states our previous general approach. But we consider this response underplays the differences in the corporation tax context. In an income tax Bill, provisions affecting the Capital Gains Tax charge would have stuck out very clearly (and would have been outside the scope of such a Bill). The charge on chargeable gains of a company will be included in the corporation tax charge (rewritten in this first Corporation Tax Bill (“Bill 5”)) even if most of the detail of what is charged or allowed is to be found in TCGA. The respondent acknowledges that the complete export of the material in Chapters 6 and 7 of this Part to TCGA would amount to a not inconsiderable drafting task, ie the need to include all the contextual and definitional material. The respondent envisages exporting only the operational rules and dealing with the insertion by using cross-references to Bill 5. While that is certainly possible, we do not think it would be user-friendly and that the balance of advantage rests with the approach chosen in the draft Part. In view of the points made by the respondent, we will ask a question when the draft Bill is published in February asking for comments on the approach taken.

***21. We do not propose to remove or amend the clauses as suggested but will invite comments in response to the draft Corporation Tax Bill on the approach taken to these chargeable gains provisions.***

**Clause 1: Overview of Part**

*We note that the derivative contracts legislation contains a very detailed overview section. If the rewrite proceeds, we consider that the overview in clause 1 needs to be as detailed as that contained in the draft loan relationship rewrite clauses.*

*The first thing which any user of this legislation needs to know is whether profits in respect of any particular instrument or transaction are taxed as income or as chargeable gains. The rewritten version does not provide the answer to this question in any very accessible form...*

*What is needed is to bring clauses 2(1) and 8(1) back together as a single “general rule”, that all profits arising to a company from its derivative contracts are taxed as income under this Part and not in any other way, and to expand clause 6 so that, rather than in effect directing the user to read the whole of Chapter 6, it itemises the exceptions, distinguishing:*

*(a) cases where the profits are taxed as income but not under the rules in clauses 4 and 5 (clauses 9 and 29(4), and possibly also Schedule 29 FA 2002);*

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*(b) cases which are charged exclusively under the chargeable gains code (broadly as in the existing clause 6(2), though clauses 76 and 78 fall under a different heading);*

*(c) cases where clauses 4 and 5 do apply, but a chargeable gain may arise as well (clause 106); and*

*(d) cases which are not charged at all (clauses 43, 56, 67, 76, 78, 117 and 118).*

22. These are some of the comments received on the content and order of Chapter 1. They also point up the question of harmonising the structure and language of the provisions for derivative contracts and loan relationships where appropriate and practical to do so. We recognise the need to make the general principles, and the interaction between those principles, clearer. This includes both the order in which they appear and showing how they relate to the other material mentioned in this Chapter. We will recast the material in Chapter 1 to do so.

***23. We agree broadly with these comments and will amend this clause and the rest of Chapter 1 to give the user a full introduction to the Part, including signposts to the most important principles contained in these provisions.***

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

*The clause says nothing about losses.*

24. This is true, but the general rule is only about profits. Other clauses indicate how losses are to be calculated and brought into account. See clauses 3 to 6.

***25. We do not propose to amend the clause.***

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

*We strongly prefer the current wording of paragraph 14(2) of FA 2002 Schedule 26 to the rewritten provisions in clause 4. Under a typical derivative contract, a company will be both entitled to receive payments and obliged to make payments. Accordingly, in our view, it is better to refer to “profits and losses” (or even better “profits, gains and losses”...) rather than “debts and credits”, since a company’s accounts will reflect a net profit or loss on each of its derivative contracts for each accounting period.*

26. Paragraph 14(2) of Schedule 26 refers in fact to the “credits and debits given in respect of [the] contract” and brings those credits and debits into account as receipts or expenses of the trade “according to whether they are credits or debits”. This rule follows paragraph 14(1) of that Schedule which provides that “the profits and losses arising from the derivative contracts of a company shall be computed in accordance with this paragraph using the credits and debits given... by the following provisions of this Schedule”. It is therefore in keeping with the source legislation to refer to credits and debits.

27. *We do not propose to amend the clause.*

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

*It might be helpful to have a signpost [to the definition of chargeable assets in clause 127], given that clause 127 is quite a long way after the CGT provisions.*

28. This clause doesn't actually use the term "chargeable asset", even in the descriptions of the clauses mentioned in subsection (2). So it might puzzle more than it assists to add a signpost here. The term first appears in clause 27 (nested derivatives treated as meeting condition A in section 26 etc).

29. *We propose to add "chargeable asset", as used in this Part, to the list of defined terms listed in the index of defined expressions in Schedule 4 to the Bill.*

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

*As for [the reference in subsection (3) to] paragraph 1(3) of Schedule 29 [of FA 2002], it may be sensible to give Schedule 29 priority over Schedule 26 in a case where both potentially apply, but the source legislation does not seem to us to do so. There appears to be no clearly defined order of priority as between the two schedules, since each applies "except where otherwise indicated", and in the case of an instrument which is both a derivative contract and an intangible fixed asset each schedule "indicates otherwise" with respect to the other.*

30. The respondent correctly notes that both regimes are stated to have priority "except where otherwise indicated". For the derivative contracts provisions, the most obvious example is the priority given to the loan relationships provisions by section 101 of FA 1996, rewritten in clause 9.

31. But in fact paragraph 75 of Schedule 29 to FA 2002 indicates that that Schedule does not apply to "financial assets", a term defined to include derivative contracts (by reference to Part 2 of Schedule 26). So it is incorrect to include paragraph 1(3) of Schedule 29 to FA 2002 as a provision to the contrary of this priority rule.

32. *We will delete the reference in clause 8(3) to paragraph 1(3) of Schedule 29 to FA 2002.*

**Clause 9: Relationship of this Part to Part 6: loan relationships**

*The drafting of this clause needs to make it clear that clause 27 is to take precedence over this provision.*

33. The source legislation for clause 27 is paragraph 45M of Schedule 26. This comment appears to have in mind that paragraph 45M(2) deems a quasi-derivative host contract within clause 20 (hybrid derivatives) to be a creditor relationship. That sets up the situation mentioned in clause 9(1)(a), ie there is "a derivative contract by

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virtue of which the company is party to any loan relationship”. But section 101 of FA 1996, the source legislation for clause 9, actually applies in that case to take a profit on that deemed loan relationship out of the scope of Schedule 26. Section 101 of FA 1996 is aimed at the situation where particular cash flows arising under a contractual arrangement fall to be brought into account under the loan relationships rules, notwithstanding the fact that the contractual arrangements as a whole constitute a derivative contract. For example, interest charged where payments under a swap contract are made late (in accordance with the ISDA Master Agreement) is interest on a money debt, brought into account under section 100 of FA 1996, even though the cash flow forms part of the derivative contract.

34. Paragraph 45M of Schedule 26 deals with a different situation. It replaces the actual situation (ie the company is party to a “hybrid derivative contract”) with a statutory fiction (ie the company is party to two contracts, a creditor loan relationship and a “nested derivative”). Once this statutory fiction applies, all profits and losses on the zero coupon bond element become taxable under the loan relationships provisions so there is no need to go to section 101 of FA 1996.

35. *We do not propose to amend the clause.*

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

*[Subsection (5)] seems a bit odd, given that clause 12 does not use the term “derivative contracts”.*

36. Clause 12 is all about a person’s contracts. This subsection makes it clear that the rules here apply also where a provision refers to a person’s derivative contracts or the person being party to a derivative contract.

37. *We do not propose to amend the clause.*

**Clause 14: The accounting conditions**

*The words “as amended from time to time” should be inserted at the end of clause 14(1)(a) and (1)(b), to allow for the fact that the accounting standards referred to in each of the sub-clauses might be amended at a later date.*

38. The wording of paragraph (a) in subsection (1) is already a reference to accounting purposes as applicable for the accounting period in question, so the suggested additional words would be redundant. As regards paragraph (b), the reference is to a specific requirement in Financial Reporting Standard 26. Any amendment of that Standard may or may not amend the requirement in a way that is still compatible with the policy intention of this rule (let alone that the requirement might be renumbered). So we think that any amendment of the Standard in this respect should be addressed by a change to the statute (using the powers rewritten in clause 125).

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*We note that it is HMRC's intention that a contract which is treated as being an equity instrument in the hands of an issuer for accounting purposes should fall outside the derivative contracts legislation. Our members have expressed concern that, under the current definition of a derivative contract contained in the derivative contracts legislation, it is not free from doubt that an equity instrument would fall outside the scope of the derivative contract legislation. They noted that the same difficulties apply as regards the proposed wording in clause 14.*

39. This comment appears to relate to a suggestion made in the responses to the publication in May 2007 of the draft clauses for the loan relationships provisions that the derivative contracts provisions should include the equivalent of section 81(4) of FA 1996. That provision states that: "For the purposes of this Chapter a debt shall not be taken to arise from a transaction for the lending of money to the extent that it is a debt arising from rights conferred by shares in a company". It is possible that, say, a preference share could fall within the definition of a loan relationship but for section 81(4). But it seems far less likely that such a share could have characteristics that satisfy the definition of a derivative contract. Were it to do so, it is not beyond doubt that it would not be appropriate for it to be treated as a derivative contract falling within these provisions. This is ultimately a policy suggestion and has been referred to our colleagues for consideration.

40. *We do not propose to amend the clause.*

**Clause 17: Meaning of "contract for differences"**

*"The definition of a "contract for differences" in clause 17 retains the obscure reference to "a contract the purpose or pretended purpose of which". Perhaps the idea here is that one can look at both the "subjective" purpose of a contract the purpose claimed by a party as a reason for entering into the contract – and an "objective" purpose – one which an outside observer might reasonably conclude was a purpose for entering into a contract, based on its anticipated effects. If that is the case, could some more explicit, albeit less compact language be used to clarify Parliament's intention."*

41. The phrase derives from the description of a contract for differences in paragraph 19 of Schedule 2 to the Financial Services and Markets Act 2000. The matters described in that Schedule are the categories of investments relevant to regulated activities under section 22 of that Act. The phrase also occurs in section 420 of ITEPA (meaning of securities etc) in the description in subsection (4) of a contract similar to a contract for differences.

42. As the respondent notes, the stated purpose and the actual purpose of a contract may be different (without any suggestion of deception, intended or otherwise). "Pretended" refers to the stated purpose. As the phrase derives from the Financial Services and Markets Act 2000 and is already in use in ITEPA, it would be unhelpful to replace it with wording which might suggest a different meaning here.

43. *We do not propose to amend the clause.*

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

*Paragraph (a) in sub-clause (1) would be better prefixed by “apart from this section,”.*

44. While there are no such words in the source legislation for this clause, paragraph 36 of Schedule 26, we agree that they are helpful and match the approach taken in the source legislation elsewhere (e.g. paragraphs 4B(2)(b) and 45I(2) of Schedule 26).

45. *We agree and will amend the clause.*

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

*I don’t understand quite what “subordinate” is getting at; and I am not sure that it is helpful not to quantify “small”. Couldn’t some prima facie guidance be given in the notes? I seem to recall that in a CGT context “small” often means 5%. (The same points arise in clause 69.)*

The departmental Corporate Finance Manual deals with these issues in paragraph CFM 13120. It offers examples in CFM 13120a that illustrate both “subordinate” and “small”. It also says: “The word “small” is not defined, but if the value of the minor subject matter is 5% or less of the value of the entire subject matter of the contract, HMRC will regard it as being small.”

46. *We will add a reference to CFM 13120 in the explanatory notes for this clause.*

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

*...the reference to “approved derivatives” appears to restrict the exclusion to non-linked assets only. This arises because the concept of approved derivatives, borrowed from FSA rules, is applicable only to non-linked assets. The equivalent concept for derivatives held by linked funds is “permitted derivatives contracts”... As the rules are currently drafted, a strict reading of the tax legislation could mean that many non-linked derivatives would be excluded from the derivative contract rules. However, linked derivatives over similar underlying subject matter and held for similar reasons would be taxed as derivative contracts. This is inconsistent and contrary to the intentions of the exclusion, which we understand are to align the tax treatment of derivatives over shares held to provide exposure to shares and share indices in the long-term insurance fund with direct holdings in shares in the long-term insurance fund. We would therefore suggest that the exclusion is extended to refer to both “approved derivatives” and “permitted derivatives contracts”.*

47. We do not consider that Condition A in clause 26(2) has the effect suggested. Rule 3.2.5 of the Insurance Prudential Sourcebook does indeed say that it is for the purpose of GENPRU 2 Annex 7R (and we can accept the view that it applies only to non-linked assets). But clause 26(2) says (as does the source legislation in

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paragraph 4(2A) of Schedule 26) that a contract is excluded if it is an approved derivative for the purpose of Rule 3.2.5. In our view that means no more than that it is a contract which meets all of the conditions in paragraphs (1) to (3) of the Rule. Such an interpretation avoids the disadvantage that would be present if linked assets could not be excluded contracts, particularly given that a similarly narrow interpretation of the Financial Services Authority's rules might conclude that some or some part of the assets in an internal linked fund are linked assets and some not.

48. Changes to the FSA Handbook following PS 07/17, made by FSA 2007/53, include an amendment to Rule 3.2.5 appear to make the position clear. It now reads:

3.2.5 R For the purpose of GENPRU 2 Annex 7 (Admissible assets in insurance), and also in relation to permitted links, a derivative or quasi-derivative is approved if...

49. *We do not propose to amend the clause.*

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

*Referring to the nested derivative in sub-clause (1)(b) as a derivative contract begs the question of whether it is excluded from being treated as such by sub-clause (2) and clause 24. Referring to it at this point simply as a contract would avoid the problem, and would be consistent with the language of clause 14.*

50. The clause reflects the source legislation (paragraph 45M(1)(b) of Schedule 26). But we agree that it is premature, in relation to meeting the condition in clause 14(1)(a), to describe the contract as a "derivative contract". It would be better to refer to it as a "relevant contract".

51. *We agree and will amend the clause.*

**Clause 29: Derivatives not embedded in a loan relationship**

*Where clause 29(4) applies there are no amounts "brought into account in accordance with this Part", since this Part is expressly stated not to apply, so clause 8(1) is simply irrelevant (and in any case would itself be excluded by clause 29(4)). Paragraph 34 of the commentary makes a similar point. And where clause 29(5) applies, clause 8(1) presumably applies to the hybrid derivative in the normal way.*

52. The responded offered this comment in connection with the reference to this clause in clause 8(3) as an example of a "provision to the contrary" of the general rule that amounts brought into account are the only amounts brought into account for corporation tax purposes in respect of a matter.

53. This clause provides for a particular treatment of a particular contract. If and only if it applies do the various consequences (in subsections (2) to (5)) cut in instead of what would otherwise apply under this Part. In short, this Part has first to apply before it doesn't apply. It is in that sense that clause 8 refers to this clause as a provision to

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the contrary of the general rule. The reference in subsection (4) – “despite section 8(1)” – rewrites the words “This sub-paragraph has effect notwithstanding paragraph 1(2)” in paragraph 45L(2) of Schedule 26.

54. Despite the force of the respondent’s argument, we think it is helpful to retain the parenthesis in subsection (4) and to refer to this clause in clause 8(3). But we continue to consider ways in which the scope of the Part may be more clearly stated.

**55. *We do not propose to amend clause 29(4) or to delete the reference to it in clause 8(3).***

**Clause 30: Election for section 29 not to apply**

**Clause 31: Elections under section 30: groups of companies**

*It isn’t clear to me whether “any of” [in clause 30(1)] means “all” or “any one or more of” and I think this subsection needs to be clarified. If in clause 30(1) “any of” means “all of” then does the deemed election apply to all of the other company’s contracts? The same point arises in subsection (2).*

56. Two respondents made this point. An election under clause 30, which rewrites paragraph 45L(2A) to (2C) of Schedule 26, is made in relation to all contracts to which it may apply (ie excluding the contracts mentioned in paragraphs (a) and (b) of subsection (1) which rewrite the same paragraphs of paragraph 45L(2A)). See paragraph CFM 13558 in the departmental Corporate Finance Manual which describes elections out of paragraph 45L of Schedule 26. The intra-group transfer provisions in paragraph 45LA, rewritten in clause 31, work on that basis that an election applies to all a company’s contracts to which it may apply. As regards the first company mentioned in clause 31(1)(b), the election of the company mentioned in clause 31(1)(a) applies only in relation to the contract to which both companies are party. Note “in relation to that contract” in the tail words to clause 31(1).

**57. *We propose to amend the clause to clarify that an election under clause 30 applies to all a company’s contracts other than those it cannot apply to.***

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

58. This Chapter received considerable attention from most respondents. Substantial and useful analyses of the source legislation were produced to show in what ways the clauses were regarded as needing improvement. Respondents also recognised the commonality of the rules in question with those for loan relationships (sections 84 to 85B of FA 1996) and referred to their comments on the draft clause rewriting those rules which were published in May 2007. The following comments are from one respondent but are broadly typical of the comments received:

*The manner in which the key operative provisions in paragraphs 15 to 17B [of Schedule 26] have been redrafted in clauses 32 to 37 of draft Bill 5 has obscured the meaning of the legislation and made it difficult to interpret and apply. ...in the original provisions it was easy to distinguish the words and phrases that should be interpreted in accordance with taxation principles that*

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*can be derived from the body of statute law as a whole and from case law, and those words which took their meaning from the world of accounting. In the rewritten provisions, that clarity is obscured or lost altogether.*

59. The respondent then proposed this order for the presentation of the rules and for indicating the interaction of the rules. The proposal was offered for both loan relationships and derivative contracts clauses.

*(a) Define the matters that are to be taken into account – profits gains and losses and expenses relating to loan relationships/derivative contracts and related transactions.*

*(b) State explicitly that the amounts to be taken into account in respect of these matters and the timing thereof is to be determined by reference to GAAP accounts, and indicate where in the accounts to look for the corresponding credits and debits.*

*(c) Provide for exceptions and special cases (accounts not complying with GAAP, amounts to be brought into account even though not reflected in profit or loss).*

60. We have some sympathy with the suggested order of the rules. But we think the prominence given here to the rule in paragraph 17A of Schedule 26 (computation in accordance with generally accepted accounting practice) undervalues the tax statute rule in paragraph 15(1) of Schedule 26. Paragraph 15(1) of Schedule 26 states that the credits and debits to be brought into account in respect of derivative contracts are those “sums which, when taken together, fairly represent ... profits and losses of the company which... arise to the company from its derivative contracts and related transactions”. Paragraph 17A of Schedule 26 is subject to the provisions of that Schedule, and explicitly subject to paragraph 15(1) of the Schedule. The fact that paragraph 15 of Schedule 26 is itself subject generally to “the following provisions of this Schedule” (see sub-paragraph (9)) does not override this specific indication of how the two paragraphs interact. The tax rule, that the sums in question, “when taken together, fairly represent” the profits and losses in respect of the derivative contract, is an overarching tax principle that does not of itself refer to accountancy or accounting standards.

61. Nevertheless, we recognise both the need to clarify how the rules in this Chapter interact and the fact that similar issues arise in relation to the draft clauses for loan relationships.

***62. We are giving careful consideration, in conjunction with our work on the equivalent loan relationships provisions, to a restatement or reordering of the rules in Chapter 3 which brings out more clearly what the rules provide and how they interact to determine profits and losses to be brought into account under the derivative contracts Part.***

**Clause 32: Credits and debits to be brought into account**

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

*I found this area confusing. In clause 32(5) shouldn't "before" be "with a view to" or something like that? And the implication of "may" and "yet" in clause 34(1) is that the contract does actually have to be entered into for expenses to be deductible. What exactly is proposed here?*

63. Clause 34 deals with abortive expenditure (where the contract or related transaction is never entered into) and expenditure incurred in a period before that in which the company enters into the contract or related transaction. It provides for the company to bring in debits in relation to such expenditure to the same extent that expenditure in connection with actually entering a contract in that period would have been.

64. *We will amend the clause to clarify its scope.*

**Clause 32: Credits and debits to be brought into account**

**Clause 35: Exchange gains and losses from derivative contracts**

*We suggest that, rather than continuing with two sections, Clause 32 be amended so as to make it clear that exchange gains and losses are within the ambit of that clause unless there is an express provision to the contrary. Clause 35 could then be redrafted to be such an express provision to the contrary.*

*We also think that HMRC should use this as an opportunity to make clearer the rules in relation to foreign exchange gains and losses in the context of fair valued derivatives. In particular it would be helpful to clarify the meaning of exchange gain or loss when the fair value movement on a currency derivative is recognised in the STRGL/SOCIE. At present the regulations define exchange gain or loss on fair valued derivatives only where the movements go to P&L.*

65. We are grateful for these comments and suggestions, some of which are of particular interest to our policy colleagues. An announcement was made in the Pre-Budget report in October as follows: "Regulations [on exchange gains and losses in this and the loan relationships regimes] will be laid before the end of this year to make a short term change and then a technical note and draft regulations will be laid in the first quarter of 2008 to come into effect for accounting periods beginning on or after January 2009." The exchange gains and losses provisions in Schedule 26 to FA 2002 (and in the loan relationships provisions in FA 1996) may then be repealed on an appointed day in accordance with section 37 of and paragraph 9 of Schedule 6 to F(No 2)A 2005. At this stage it is unclear what effect the prospective regulations will have on the primary legislation to be rewritten in the first corporation tax rewrite Bill.

66. *We will defer a response to these comments until the prospective amendments to the primary legislation are known.*

**Clause 33: Meaning of “related transaction”**

*We suggest the terminology in subsection (2) (and wherever else it appears in the loan relationship and derivative contracts legislation) be made consistent ie it should refer to rights and obligations rather than rights or liabilities.*

67. We agree that the source legislation is not wholly consistent in its use of “rights and liabilities” and “rights and obligations”. It appears that the latter phrase has more currency among users of these provisions. We would like to give further consideration to whether there is any difference in the expressions that should be retained. But, subject to that, we will generally substitute “obligations” for “liabilities”, other than in any particular case where “liabilities” is more correct (that is, it is describing something other than obligations under a contract).

**68. *We agree and propose to amend references to “rights and liabilities” to “rights and obligations” in all cases where it is wholly appropriate to do so.***

**Clause 35: Exchange gains and losses from derivative contracts**

*The view stated in paragraph 161 of the commentary that exchange gains and losses cannot arise from related transactions seems at least questionable. “Related transactions” are defined as including performance of the contract according to its terms, and if an exchange difference is recognised on performance one could argue whether it arises from that “related transaction”, or from the contract itself, or from both. If the view is taken that it arises from the contract, the same would presumably apply to any other sort of gain or loss arising on performance, which means that treating performance of the contract as a related transaction is pointless.*

69. We have reconsidered the view expressed in the explanatory notes in the light of this comment. We agree that the statement in the explanatory notes may mislead.

*The statement in paragraph 162 of the commentary, that the purpose of sub-clause (3) is merely to exclude from sub-clause (1) items which do not need to be included there because they fall within clause 32 anyway, is obviously incorrect. These items are supposed to be excluded from clause 32. This does however raise the question whether sub-clauses (3) and (4) are strongly enough expressed to achieve that purpose. Merely saying that sub-clause (1) does not apply to the disregarded items would not exclude them from clause 32 if they fall within its terms without needing to rely on clause 35(1).*

70. We agree that the comment in the notes is misleading. But we think that subsections (3) and (4) adequately rewrite the source legislation (paragraph 16(3) and (3A) of Schedule 26). However, the clause (and notes) may change as a result of the matters mentioned in paragraph 65.

**71. *We agree the notes mislead in these two matters and will amend them.***

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*Sub-clauses (3) and (4) read strangely together, since they appear to overlap to a substantial extent and to prescribe different rules for the same circumstances. If (as seems likely) sub-clause (4) is intended to apply only in cases where sub-clause (3) does not, because condition (b) in that sub-clause is not satisfied, it should say so. As it stands it appears to allow the regulations to override sub-clause (3), in a case where it does apply, by disregarding only some part of the exchange gain or loss on a currency contract which is less than the whole. (And if that actually is the intention sub-clause (3) should be expressed as being subject to any regulations made under sub-clause (4).)*

72. Subsection (3) applies to the whole of a gain or loss and subsection (4) only to part of a gain or loss. The two provisions operate independently, so there are in effect two bites at the cherry to arrive at the disapplication of subsection (1). It isn't the case that one rule is subject to the other; subsection (2) indicates that subsection (1) is subject to both (ie it says "subsections (3) *and* (4)", rather than "subsections (3) *or* (4)").

**73. *We do not propose to amend the clause.***

**Clause 38: Power to make regulations about accounts**

*The way in which this clause is expressed, allowing regulations to modify the effect of clause 36(4), seems inappropriate when clause 36(4) is merely a definition of the accounts which are to be used for the purposes of clause 36(2). The regulations are actually concerned with the exclusion and alternative treatment of specific amounts, not with any modification of the types of accounts which may be used. That being so, they would be more accurately expressed as modifying the effect of clause 36(2) rather than clause 36(4). The same misconception seems to have infected the new heading to this clause. The regulations in question are not regulations about accounts. They are regulations about the computation of profit or loss for tax purposes.*

74. The clause reflects the source legislation, paragraph 17C(1) of Schedule 26, which applies the regulations to amounts within paragraph 17B(1) of that Schedule, rewritten in clause 36(4), rather than to amounts within paragraph 17A (rewritten in clause 36(2) and (3)). We consider that clause 38 is correctly drafted but will reconsider whether the side note can be made more informative.

**75. *We do not propose to amend the clause but will reconsider the side note.***

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

*It is not clear to us what is meant by a "fixed capital asset or project". We note that the draft rewritten clause merely reproduced the wording of the existing legislation, where the same uncertainty arises.*

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76. “Fixed” as opposed to “circulating” capital appears to be a term of widespread use. So a “fixed capital asset or project” is an asset or project that would be reflected in fixed capital in the company’s accounts.

**77. *We do not propose to amend the clause.***

*The draft rewritten clause replicates an error in the existing legislation, which was caused by the draftsman seeking to mirror the wording of FA 1996 Schedule 9 paragraph 14 when he originally drafted FA 2002 Schedule 26 paragraph 25. The error is the wording in clause 39(6), which is apt to describe the position of a loan relationship and not a derivative contract.*

78. We agree the source legislation is drafted in terms that reflect the loan relationships regime rather than derivative contracts. This point was made by more than one respondent. We are considering with our policy colleagues how the rule would be better expressed. We will then consider whether any change in the law this might entail is such a minor change as can be made by the project. Consultation on any such change would be included with the draft Corporation Tax Bill to be published in February.

**79. *We are considering whether the clause should be amended and, if so, whether this is a minor change that the project can make.***

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

*The Explanatory Document states that Clause 40 is intended to replace paragraph 25A Schedule 16 FA 2002. We consider that the provisions of Clause 40 should be integrated with the provisions of Clause 32 [credits and debits to be brought into account].*

80. This is one of a number of suggestions received for the reordering of material in Chapter 3. We will take all such comments into consideration in addressing the general issues affecting this Chapter (see paragraph 62).

**81. *We will consider this suggestion carefully in redrafting Chapter 3.***

**Clause 42: Contracts ceasing to be derivative contracts**

*We consider that it is important that there is a cross reference in this clause to contracts which become derivative contracts by virtue of clause 91.*

82. There is no direct connection between clauses 42 and 91 (company ceasing to be party to contract which became derivative contract), so a cross-reference may only serve to confuse. There is a connection with clause 92 (contracts ceasing to be derivative contracts), which sets out the TCGA consequences of the same event. A cross-reference to clause 92 is already in place in clause 42 (and vice versa).

**83. *We do not propose to amend the clause.***

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

*Does it need to be made clearer that clause 8 (priority of rules under this Part for corporation tax) does apply, so that credits and debits not brought into account by clause 43 are still within clause 8(1)? The latter applies to ‘amounts that are brought into account in accordance with this Part’ whereas clause 43(6) provides that the credits and debits ‘may not be so brought into account’.*

84. We consider that, although this clause provides (as does the source legislation, paragraph 45I of Schedule 26) that the credits and debits in question are not brought into account for the purposes of this Part, these amounts are covered by the rule in clause 8(1) (priority of rules under this Part for corporation tax) and so do not fall within any other corporation tax charging provision. The source legislation lacks such an explicit statement as that found in paragraph 23(8) of Schedule 26 but departmental practice achieves the same result.

**85. *We will give consideration to making clear that clause 8(1) applies to the credits and debits mentioned in subsection (6).***

**Clause 44: Company ceasing to be party to derivative contract**

*In clause 44(4) we note... that ‘particular class, category or description’ of business in paragraph 53(4)(b) Schedule 26 FA 2002 has been abbreviated to ‘particular description’. This appears to rest on the tenable assumption that a class or category of business is a ‘description’ of business, but it does leave open the query as to why the words ‘class’ and ‘category’ were employed in the source legislation.*

86. Although the source legislation appears to treat “description” as different from “class” or “category”, it must be doubtful there is a difference. And “description” is sufficient to cover “class” and “category” as well (as indicated by the respondent).

**87. *We do not propose to amend the clause.***

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

*This clause, in common with the current wording of FA 2002 Schedule 26 paragraph 22A, does not prevent a potential double charge where a deemed market value disposal arises at the same time under clauses 111 and 112. (To see how this has been addressed in the context of the loan relationships legislation, see FA 1996 Schedule 9 paragraph 10A.)*

88. This is a policy suggestion and has been referred to our policy colleagues for consideration. On the face of it, it is reasonable to ensure that there is no double charge under both the “company migration” and “degrouching” provisions, as is the case in the loan relationships provisions. But it is not clear whether any attempt to provide an order of priority between those provisions would be a minor change which the project could make.

**89. We are considering whether the clause should be amended and, if so, whether this is a minor change that the project can make.**

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

*Is the inclusion [in subsection (1)] of the word ‘any’ before ‘circumstances’ necessary, as it does not appear in paragraph 22A(1)(b) Schedule 26 FA 2002?*

90. We agree that the word does not appear in the source legislation. Moreover, the equivalent loan relationships provision, paragraph 10A of Schedule 9 to FA 1996, rewritten in clause 38(1) in the clauses published in May 2007, does not include “any” at this point.

**91. We agree and will remove “any” from clause 46(1).**

**Clause 50: Partnerships involving companies**

*The words “in accordance with the firm’s profit sharing arrangements” at the end of sub-clause (2) seem inappropriate. The adjustment in question is to be made in calculating the profits or losses of the trade. The allocation of the resulting figure between the partners in accordance with the firm’s profit sharing arrangements is a separate operation. What is actually needed is something more like “under section [248(2) or (3)]”: c.f. clause 249(2) in paper CC/SC(06)07 [ie the draft clauses rewriting partnership rules in Chapter 7 of Part 4 of ICTA].*

92. The source legislation, paragraph 49(2) of Schedule 26, says “in accordance with section 114(1)” of ICTA. We are considering further what best rewrites that phrase in the light of how section 114 of ICTA is rewritten in Bill 5.

**93. We will reconsider the phrase in question when the clauses rewriting section 114 of ICTA are at a more advanced stage.**

**Clause 62: Derivative contracts with non-UK residents**

*There is a slight difference in approach between clause 62(4) and the source legislation in paragraph 31(4) of Schedule 26. The source legislation allows for the possibility that the specified interest rate may vary. Hence it has to provide that the rate used in calculating the notional interest is at all times the same as a rate of interest specified in the contract. Clause 62(4)(c), by contrast, is expressed in terms of the specified rate of interest, so assuming by implication that there is only one. This does still cover the case where the interest rate is variable because each rate would necessarily apply for a defined period, and the clause 62(4) calculation of notional interest would then apply to each such period separately. We prefer the approach of the rewrite, but it does mean that the words “at all times” are now otiose since the drafting assumes that there is only one rate throughout the specified period.*

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94. We agree there is an argument that the rewritten provision may differ unintentionally from the source legislation (paragraph 31(4) of Schedule 26). Other respondents also queried whether the drafting here worked and suggested that the wording of the source legislation be retained.

*95. We agree there is doubt as to whether the clause exactly rewrites the source legislation and will amend the clause so that it follows the source legislation more closely.*

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

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

*It seems rather unsatisfactory that these clauses only disapply clauses 4 and 5. This implies that the “general rule” in clause 2(1), in particular, does still apply in some way, even though the usual machinery of clauses 4 and 5 is excluded. (We note that, despite its heading, clause 6 is merely a signpost: it does not actually provide that the “general rule” does not apply in the cases mentioned.)*

96. If clauses 4 and 5 are disapplied, so that the credits and debits fall out respectively of the trading income Part or the loan relationships Part, the application of those clauses by other clauses is also disapplied. As regards this Part, that merely leaves the chargeable gains and allowable losses treatment provided by Chapters 6 and 7 to apply. We think the signpost in clause 2 (general rule that profits arising from derivative contracts are chargeable as income) to clause 6 (exception to the general rule: derivative contracts giving rise to chargeable gains) is sufficient to indicate the general rule is cut down where Chapter 6 applies.

*97. We do not propose to amend the clause.*

**Clause 74: Meaning of certain expressions in section 73**

*Sub-clause (5) defines R% as “the percentage change ...”, where the source legislation has “a percentage change ...”. The source legislation is correct, since paragraphs (a) and (b) of the definition specify two possible measures of value, which would not necessarily change by the same percentage: the contract would necessarily use one or the other... The same point arises [in clause 86 (meaning of “exactly tracking contract” in section 85)] as in clause 74.*

98. The draft clause integrates “a” from sub-paragraph (4) of paragraph 45F of Schedule 26 and “the” from sub-paragraph (5) of that paragraph. But it still provides for two possible measures (paragraphs (a) and (b) in the definition of “R”). It will be sufficient to meet either. We consider the draft is correct and rewrites the source legislation without introducing a change.

*99. We do not propose to amend either clause.*

**Clause 80: Introduction to sections 81 to 83 [issuers of securities with embedded derivatives: deemed options]**

*Why “because of” and not simply “by” [in subsection (3)]? The former suggests that clause 21(3) has an indirect effect, but its effect is direct in that it deems certain contracts to be options, etc. The same point arises in, e.g., clause 85(3)(a) and 95(5).*

100. The source legislation for this and the other references say “by virtue of” section 94A(3) of FA 1996. The deeming of a contract as an option etc by clause 21 is indirect in that that clause must first deem something to be a relevant contract. Only if that applies is the resulting relevant contract deemed to be an option etc. It is arguable that clause 21(2) and 21(3) are really only two results of the same deeming (rather than one deeming consequential on the other). And nothing may be lost by going for the simpler “by”.

101. *We agree and will say “by” section 21(3) in this and similar places in the clauses.*

*We suggest that it should be made clearer in Clause 80 that the treatment in this part only applies where the Clause 21 “embedded derivative” is a derivative contract and not an equity instrument. As currently drafted the legislation retains the existing lack of clarity in this regard (ie it is all implied by the opening words “is a party to a derivative contract....”).*

102. Clause 21, which rewrites section 94A of FA 1996, deals with the case where rights and obligations under a loan relationship are divided in accordance with generally accepted accounting practice between rights and obligations under a loan relationship and rights and obligations under “one or more derivative financial instruments or equity instruments”. Prima facie, equity instruments are therefore within the scope of a provision which applies to a “section 21 embedded derivative”. International Accounting Standard 32 defines an “equity instrument” as “any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities”. We therefore think that careful consideration needs to be given to the facts of the particular case to determine whether clauses 80 to 84 apply to the equity instrument in question. A section 21 embedded derivative may of course not itself be a derivative contract if it is knocked out of the regime because of another rule, particularly one of those in Chapter 2.

103. *We do not propose to amend the clause.*

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

*A signpost to the definition of “[section {j061094Aaa}] host contract” would be useful. The definition has generally been signposted in other places where this highly non-intuitive expression is used.*

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104. We agree. A signpost to the definition of this term in clause 133 has been provided for all other uses of the term.

105. *We agree and will add a signpost to clause 133.*

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

*We consider that the heading of clause 91 would read better were it to refer to relevant contracts which come within the derivative contract legislation. The current heading “company ceasing to be party to contract which became derivative contract” is less than clear.*

106. The change suggested would not bring out the fact that this clause operates when the company ceases to be party to the contract. This clause and its neighbours all deal with cessation situations. The current heading includes the two key concepts which trigger the clause.

107. *We do not propose to amend the side note.*

*[Clause 90(2)] refers to “any chargeable gain or allowable loss which would have been treated as accruing to it on the assumptions specified ...” whereas clause 91(2) just says “any chargeable gain or allowable loss treated as accruing to it on the assumptions specified ...”, to mean exactly the same thing. The longer form of words used in this clause is probably the more accurate of the two, and is used in various other places, but in any case consistent wording should be used throughout.*

108. Although the difference reflects differences in the source legislation (compare paragraph 37(5) and paragraph 43A(2) of Schedule 26), there is no policy reason for the provisions to differ. We agree the longer form of words is acceptable for both and that consistency is desirable.

109. *We agree and will amend clause 90(2).*

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

*We have been unable to trace the origin of the words in sub-clause (6)(b) which replace the reference in the source legislation to the company’s “first new period”. The commentary observes that this expression was borrowed from Schedule 28 of FA 2002 but, even supposing that the Schedule 28 definition is applicable for this purpose, that definition is “its first accounting period to begin on or after 1 October 2002”. The commentary says that a “new period” cannot predate the first period to which the amendments made by SI 2005/646 apply. However we do not see how the commencement date of those regulations can have any bearing on what is simply a definition of a particular form of words. It seems to us that the reality is that SI 2005/646 inadvertently failed to provide a relevant definition. No doubt the rewrite can correct this deficiency, but it should be made clear that that is what it is doing.*

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110. We accept that the words in subsection (6)(b) remedy an omission in the source legislation (paragraph 4A(3) as amended by the Finance Act 2002, Schedule 26, (Parts 2 and 9) (Amendment) Order 2005 (SI 2005/646)). They do so by reference to the use of the term “first new period” in Schedule 28 to FA 2002 (see the interpretation provisions in paragraph 7 of that Schedule). To reflect fully the commencement provisions for that amendment (see paragraph 1(2) of SI 2005/646), it may be necessary to qualify the reference to 1 January 2005. We will consult on this change in the law on the publication of the draft Corporation Tax Bill next February.

111. *We agree that subsection (6)(b) represents a change in the law and will consult on the proposed change.*

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

*The words “recognised for accounting purposes” in sub-clause (7) are not in the source legislation and are, at best, confusing. The whole point of this clause is that the amounts brought into account in accordance with sub-clauses (2) to (5) do not necessarily correspond to those recognised for accounting purposes.*

112. The source legislation for subsection (7), paragraph 28(3A) of Schedule 26, refers to the case where “the debits or credits to be brought into account for the purposes of this Schedule in respect of any amounts fall to be determined in accordance with sub-paragraph (3)”. Paragraph 28(3) (rewritten in clause 107(2) to (4)) applies “for the purpose of determining the credits and debits to be brought into account for the purposes of this Schedule in respect of the derivative contract” and requires both parties to the inter-group transaction to treat the transaction as entered into for “a consideration equal to the notional carrying value of the contract”. “Notional carrying value” is then defined in terms of accounts figures. We consider that “amounts” in paragraph 28(3A) means the amounts that appear in the accounts. Those are amounts that may be affected by the rule in paragraph 28(3) that determines the credits and debits to be brought into account for tax purposes in this case. The words “recognised for accounting purposes” are added to make clear what these amounts are.

113. *We do not propose to amend the clause.*

**Clause 108: Transactions to which section 107 applies**

*Sub-clause (3) is not easy to follow, mainly because of the way in which it juxtaposes condition (a), which is based on the factual situation, and condition (b) which can only be hypothetical (since the related transaction in question did not actually occur). It might be better if condition (b) were replaced by wording such as “... on the assumption that each of those companies would have been within the charge to corporation tax in respect of the related transaction”.*

114. We have some sympathy with this comment. The clause follows the source legislation, paragraph 28(2)(b)(ii) of Schedule 26, in referring to “the related

transaction” as if it were actual rather than deemed. We will give further thought as to whether this can be clarified and whether it would be a change that the project can make.

115. *We agree and will try to clarify the point.*

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

*If ‘Societas Europaea’ in paragraph 30B(a) of Schedule 26 FA 2002 is not to be rewritten, the term ‘SE’ requires definition.*

116. Paragraph 30B of Schedule 26 has been replaced and supplemented by paragraphs 30B to 30I of the Schedule; see the Corporation Tax (Implementation of the Mergers Directive) Regulations 2007, SI 2007/3186. Clauses rewriting paragraphs 30B to 30I will be published for consultation in the draft Corporation Tax Bill next spring. The revised paragraph 30B also caters for a merger of two or more cooperative societies as a European Cooperative Society (“SCE”) (see paragraph 10 of Schedule 2 to SI 2007/3186). Both SE and SCE will be defined in a general definitions clause and the terms will appear in the Schedule containing an index of defined expressions.

117. *We propose to provide a definition of “SE” and “SCE”.*

*It is not clear what the consequence is of “ignoring” a transfer, in the context of legislation which operates on accountancy figures rather than computing profits and losses for individual transactions. In order to produce the intended result, if the transfer is not actually carried out at carrying value, one has effectively to rewrite the accounts of both companies, and this cannot really be described as ignoring anything. Presumably recognition of this problem was at least part of the reason for the Finance (No.2) Act 2005 amendments which put paragraph 28 of Schedule 26 (and its counterpart for loan relationships) into a more explicit form. Strangely, however, the corresponding provisions on SE mergers, introduced at the same time, remained in the old form. It is not clear what difference, if any, this is intended to make to the result; if no practical difference is intended both provisions should be expressed in the same way.*

118. The source legislation for subsection (2) has been substituted, as mentioned above. The substituted rule provides that the transferor and transferee companies are treated as having entered into the transfer of rights and obligations under a derivative contract for a consideration equal to the notional carrying value of the contract.

119. *This clause will be amended in the light of the substituted source legislation.*

**Chapter 10: Special kinds of company**

*Is it intended to rewrite paragraph 39 Schedule 26 FA 2002 elsewhere, relating to the approval for s 842 ICTA purposes of investment trusts?*

120. *We propose to rewrite paragraph 39 of Schedule 26 via a consequential amendment to section 842 of ICTA.*

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

*It would probably be more accurate, in sub-clause (1), to say simply that the profits or losses of a capital nature are not to be brought into account in accordance with this Part, omitting “as credits or debits”. Profits or losses of a capital nature will in general represent the net of at least one credit and one debit, rather than representing credits or debits in their own right. The same applies in clause 118 [venture capital trusts: profits or losses of a capital nature].*

121. The words “as credits or debits” repeat the source legislation exactly (see paragraphs 38(1) and 38A(1) of Schedule 26). Although the remainder of each of the source legislation paragraphs is devoted to defining what “capital profits, gains or losses” means for this purpose, the words “as credits or debits” serve as a link to paragraph 15(1) of Schedule 26. We consider the words serve the same purpose in the rewritten provisions.

*Subsection (4)(b) struck me as a bit circular- perhaps “such” could be inserted after “subsequent”?*

122. Subsection (4)(a) deals with the currently applicable Statement of Recommended Practice (SORP), which may be modified etc, and subsection (4)(b) dealing with any replacement SORP, which may be modified etc. We do not think there is any circularity.

*What happens if there is a transitional accounting period in which both the 2003 SORP (as amended) and a subsequent SORP are permitted to be used? The intention must be that one follows whichever standard the company actually uses, but the legislation does not obviously lead to that result.*

123. Whether there can be two SORPs permitted to be used at any one time appears to be hypothetical at this stage. The clause assumes (as does the source legislation, paragraph 38(4) of Schedule 26) that SORPs will be consecutive rather than concurrent. The connector “or” between subsection (4)(a) and (4)(b) appears to allow the clause to apply, if need be, by reference to whichever SORP the company is applying (correctly).

124. *We do not propose to amend the clause.*

**Chapter 12: General and supplementary provision**

*Paragraph 51 of Schedule 26 FA 2002 (provision of deduction of tax) was amended by paragraph 422(6) of Schedule 1 Income Tax Act 2007, as a signpost to s 980 Income Tax Act 2007 (derivative contracts: exception from duties to deduct). Why has this signpost not been rewritten in the Paper CC/SC(07)21 draft clauses?*

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125. We did not consider that the signpost was of use to the user of these provisions. But at least one respondent disapproved its omission.

126. *We will consider adding the signpost to this Chapter.*

**Clause 126: Meaning of “carrying value”**

*Are profits to be taken into account in determining carrying value? Subsection (1) only refers to “impairment losses”.*

The items mentioned in subsection (1) do not explicitly include “profits”, although there may well be positive entries within “accrued amounts” and “amounts paid or received in advance”. But subsection (1), based on paragraph 50A(3A) of Schedule 26, is not an exhaustive definition. The items mentioned in paragraphs (a) to (c) illustrate what figures need to be extracted from the accounts to find the carrying value. Subsection (2), which refers to profits and losses, is based on paragraph 50A(3B) of Schedule 26. This is a complementary rule to that in subsection (1) and deals with cases where the accounts figures are themselves modified or overridden by specific tax rules do in this context.

*The reference to the word “debit” is potentially confusing... as this would normally be expected to be an amount taken to profit or loss as the contra entry to an adjustment to the carrying value of an asset. It would be better to replace the word “debit” [in subsection (4)] by “reduction in the carrying value”.*

127. We think it is sufficiently clear that the debit in question, in respect of an “impairment loss”, is a debit to profit and loss account with a matching credit to the asset account. Subsection (1) makes clear that the amounts of such a loss are those “recognised for accounting purposes in relation to the contract”.

128. *We do not propose to amend the clause.*

**Clause 130: Meaning of “hedging relationship”**

*Is it right [in subsection (5)] to limit [the liabilities of a company] to share capital and not to include, for example, share premium account. What about companies that have no par value shares, as may be the case in the US? Perhaps they don’t hedge that sort of exposure.*

129. This is a policy suggestion and has been referred to our policy colleagues. The subsection rewrites the current source legislation.

130. *We do not propose to amend the clause.*

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

*It appears from paragraph 545 of the commentary that the intended meaning of sub-clause (3) is that, where clause 75 [property based total return swaps] applies, the relevant credits and debits are calculated (presumably for each*

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*debit and credit separately) as the lesser of the amount given by clause 32[credits and debits to be brought into account] and the amount given by clause 132(4). If so, the legislation is not at all clearly expressed. One might think that practically all debits and credits are both “given by” clause 32 and “within” clause 132(4), because both those provisions will give values for the items in question even if the values are not the same. Alternatively, if one takes references to debits and credits as being to their numerical values, one would think that if clause 32 and clause 132(4) give different values for a particular item then it does not count as a relevant debit or credit at all, since there is no specific value which is both given by clause 32 and within clause 132(4). The one meaning which cannot readily be extracted from the clause 132(3) approach is the intended one. What is needed is a drafting approach which explicitly addresses the amount of the debits or credits in question rather than (apparently) just classifying debits or credits as being or not being “relevant”.*

131. While we have sympathy in part with these remarks, it is difficult to depart radically from the model of the source legislation (paragraph 45G(2) of Schedule 26) without making a change which is outside the scope of the project. The explanatory notes are perhaps misleading in suggesting that the amount found under clause 132(4) acts as a cap on the amounts found under clause 32. The R% x N rule may give a credit where the accounts show a debit, or it may give a larger credit (or debit) than the accounts credit (or debit) – see the example in paragraph CFM13540a in the departmental Corporate Finance Manual.

132. *We do not propose to amend the clause but will improve the assistance offered by the explanatory notes.*

**Clause 134: Other definitions**

*We note the inclusion now in clause 134 (other definitions) of various terms defined as having ‘the meaning it has for accounting purposes’. This adds clarification to the source legislation and appears sufficient in the case of the definitions of “income statement”, “statement of changes in equity” and “statement of total recognised gains and losses”; but is this sufficient in the case of the definitions of “equity instrument” and “financial instrument”?*

133. ITA amended paragraph 45J(10) of Schedule 26 to apply the definition of “financial instrument” in section 984 of that Act. Clause 89 rewrites paragraph 45J(10) of Schedule 26 and is the only place where the term “financial instrument” appears in these clauses. The definition in clause 134 is therefore redundant.

134. Paragraph 11 of IAS 32 (Financial instrument disclosures) has a definition of “equity instrument”. The explanatory notes will be amended to contain further detail about this definition.

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**135. We propose to delete the definition of “financial instrument” in clause 134 and to add appropriate information in the explanatory notes.**