
STATUTORY INSTRUMENTS

2006 No. 3269

CORPORATION TAX

The Finance Act 2002, Schedule 26,
(Parts 2 and 9) (Amendment) Order 2006

Made - - - - 7th December 2006
Laid before the House of
Commons - - - - 8th December 2006
Coming into force - - 30th December 2006

The Treasury make the following Order in exercise of the powers conferred by paragraph 13 of Schedule 26 to the Finance Act 2002⁽¹⁾ and paragraph 52 of Schedule 4 to the Finance Act 2005⁽²⁾.

General

Citation, commencement and effect

1.—(1) This Order may be cited as the Finance Act 2002, Schedule 26, (Parts 2 and 9) (Amendment) Order 2006, and shall come into force on 30th December 2006.

(2) Subject to paragraph (3), this Order has effect in relation to accounting periods ending on or after the date on which this Order comes into force.

(3) Article 7 has effect in relation to disposals occurring on or after the day on which this Order comes into force.

Amendment of Schedule 26: general

2. Schedule 26 to the Finance Act 2002 (derivative contracts) is amended as follows.

Amendment of Part 2 of Schedule 26

Amendment of paragraph 2 of Schedule 26

3. In paragraph 2 (derivative contracts and relevant contracts) for sub-paragraphs (3) to (5) substitute—

(1) 2002 c. 23; paragraph 13 was amended by paragraph 2 of Schedule 9 to the Finance Act 2004 (c. 12).
(2) 2005 c. 7.

- “(2A) For provisions which treat a company as being party to a relevant contract see—
- (a) section 94A of the Finance Act 1996 (loan contracts with embedded derivatives);
 - (b) paragraph 2A below (non-financial contracts with embedded derivatives);
 - (c) paragraph 2B below (hybrid derivatives).

(2B) In this Schedule “plain vanilla contract” means a relevant contract other than one to which a company is treated as being party by virtue of a provision mentioned in subparagraph (2A).”.

Insertion of paragraphs 2A and 2B of Schedule 26

4. After paragraph 2 insert—

“Non-financial contracts with embedded derivatives

2A.—(1) This paragraph applies where—

- (a) a company is party to a contract (a “non-financial contract”) which is not a loan relationship and to which paragraph 2B does not apply, and
- (b) in accordance with generally accepted accounting practice, the company treats rights and liabilities under the contract as divided between—
 - (i) rights and liabilities under one or more derivatives (“embedded derivatives”), and
 - (ii) the remaining rights and liabilities (the “non-financial host contract”).

(2) The company is to be treated for the purposes of this Schedule as—

- (a) party to a relevant contract (a “non-financial embedded derivative”) whose rights and liabilities consist only of the embedded derivative, or
- (b) if there is more than one embedded derivative, party to relevant contracts each of whose rights and liabilities consist only of one of the non-financial embedded derivatives.

(3) Each relevant contract to which the company is treated as party under subparagraph (2) is to be treated as an option, a future, or a contract for differences according to whether the rights and liabilities of the embedded derivative would be of that character if contained in a separate contract.

Hybrid derivatives

2B.—(1) This paragraph applies where—

- (a) a company is party to a relevant contract which satisfies the conditions in paragraph (b) or (c) of paragraph 3(1) (a “hybrid derivative”),
- (b) in accordance with generally accepted accounting practice, the company treats rights and liabilities under the contract as divided between—
 - (i) rights and liabilities under one or more derivatives (“embedded derivatives”), and
 - (ii) the remaining rights and liabilities (the “host contract”), and
- (c) a contract consisting of only those remaining rights and liabilities would be a relevant contract.

(2) The company is to be treated for the purposes of this Schedule as—

- (a) party to a relevant contract whose rights and liabilities consist only of the embedded derivative, or (if there is more than one derivative), party to relevant contracts each of whose rights and liabilities consist only of one of the embedded derivatives, and
 - (b) party to a relevant contract whose rights and liabilities are those of the host contract.
- (3) Each relevant contract to which the company is treated as party under sub-paragraph (2)(a) (a “nested derivative”) or (2)(b) (a “quasi-derivative host contract”) is to be treated as an option, a future, or a contract for differences according to whether the rights and liabilities of the embedded derivative or host contract would be of that character if contained in a separate contract.”.

Amendment of paragraph 3 of Schedule 26

- 5.—(1) Amend paragraph 3(3) (contracts to satisfy accounting requirements etc.) as follows.
- (2) In sub-paragraph (1)(a) omit “financial instrument”.
 - (3) In sub-paragraph (2)(b)(iv) for “and” substitute “or”.
 - (4) In sub-paragraph (3) omit “financial instrument”.
 - (5) In sub-paragraph (5)—
 - (a) omit paragraph (a),
 - (b) in paragraph (aa) omit “by the company”, and
 - (c) in paragraph (b)—
 - (i) omit “by the company”, and
 - (ii) for “derivative financial instruments” substitute “derivatives”.

Amendment of paragraph 4 of Schedule 26

- 6.—(1) Amend paragraph 4(4) (contracts excluded by virtue of their underlying subject matter) as follows.
- (2) In sub-paragraph (2)(b) after “(2C)” insert “, (2CA)”.
 - (3) For sub-paragraph (2A) substitute—
 - “(2A) The conditions specified in this sub-paragraph are that the relevant contract—
 - (a) is a plain vanilla contract entered into by a company carrying on life assurance business;
 - (b) is an approved derivative for the purposes of Rule 4.3.5 of the Integrated Prudential Sourcebook; and
 - (c) does not fall within paragraph 3(1)(b).”.
 - (4) In sub-paragraph (2B)—
 - (a) in paragraph (b)(ii) after “of the company” insert “or any liability related to share capital of the company”, and
 - (b) in paragraph (c) for the words from “a deemed relevant contract” to the end substitute “a loan-contract embedded derivative.”
 - (5) After sub-paragraph (2C) insert—

(3) Paragraph 3 was amended by article 3 of [S.I. 2004/2201](#), article 3 of [S.I. 2005/646](#) and article 4 of [S.I. 2005/2082](#).

(4) Paragraph 4 was amended by article 4 of [S.I. 2004/2201](#), article 4 of [S.I. 2005/646](#), article 5 of [S.I. 2005/2082](#) and article 5 of [S.I. 2005/3440](#).

“(2CA) The conditions specified in this sub-paragraph are—

- (a) the relevant contract is entered into or acquired—
 - (i) by a company otherwise than in the course of activities forming an integral part of a trade carried on by it, or
 - (ii) by a company which is a mutual trading company;
- (b) the relevant contract is—
 - (i) an option to acquire shares in a company, or
 - (ii) a future requiring delivery of shares in a company;
- (c) the relevant contract is not a loan-contract embedded derivative; and
- (d) the shares to be acquired or delivered constitute, or would (if acquired or delivered) constitute a substantial shareholding within the meaning of paragraph 8 of Schedule 7AC to TCGA 1992.”.

Substitution of paragraph 4C of Schedule 26

7. For paragraph 4C(5) substitute—

“Treatment of credits and debits on former chargeable asset

4D.—(1) This paragraph applies if—

- (a) a company is party to a plain vanilla contract which (not having been a derivative contract) became a derivative contract before 30th December 2006,
- (b) the company disposes of the derivative contract by ceasing to be a party to it, and
- (c) paragraphs 4A and 4B do not apply in relation to the contract.

(2) For the purposes of computing any chargeable gain accruing to the company on the disposal—

- (a) paragraph 1(2) does not apply; and
- (b) the sums allowable as a deduction under section 38(1)(a) of TCGA 1992 (acquisition costs) shall—
 - (i) if G exceeds L, be increased by the amount of that excess, and
 - (ii) if L exceeds G, be reduced by the amount of that excess.

(3) If the amount of the excess in sub-paragraph (2)(b)(ii) is greater than the amount of expenditure allowable under section 38(1)(a) of TCGA 1992, the amount of the excess that cannot be deducted from the expenditure shall, for the purpose mentioned in sub-paragraph (2), be added to the amount of the consideration for the disposal.

(4) In this paragraph—

G is the sum of the credits brought into account under paragraph 14(3) in respect of the derivative contract in each relevant accounting period, and

L is the sum of the debits brought into account under paragraph 14(3) in respect of the derivative contract in each relevant accounting period.

(5) For the purposes of sub-paragraph (4) a “relevant accounting period” is—

- (a) the accounting period in which the disposal is made, or
- (b) any previous accounting period.”.

Amendment of paragraph 9 of Schedule 26

8.—(1) Amend paragraph 9(6) (underlying subject matter which is subordinate or of small value disregarded) as follows.

- (2) In sub-paragraph (1) omit “or (4)”.
- (3) Omit sub-paragraph (4).
- (4) In sub-paragraph (5)—
 - (a) in paragraph (a) omit “or”, and
 - (b) omit paragraph (c).

Amendment of paragraph 12 of Schedule 26

9.—(1) Amend paragraph 12(7) (definition of terms relating to derivative contracts) as follows.

(2) For sub-paragraph (1) substitute—

“(1) This paragraph defines the following expressions for the purposes of this Schedule—

- a capital redemption policy (see sub-paragraph (2));
- a contract for differences (see sub-paragraphs (3) to (5));
- a depositary receipt (in relation to shares) (see sub-paragraph (17));
- designated (see sub-paragraph (13));
- a future (see sub-paragraphs (6), (7) and (10));
- a hedging relationship between a relevant contract and an asset or liability, in the case of any company (see sub-paragraph (14));
- intangible fixed assets (see sub-paragraph (11));
- Integrated Prudential Sourcebook (see sub-paragraph (15));
- loan-contract embedded derivative (see sub-paragraph (11A));
- loan-contract host contract (see sub-paragraph (11B));
- long-term insurance fund (see sub-paragraph (16));
- an option (see sub-paragraphs (8) and (10));
- original asset (see sub-paragraph (11C));
- original creditor relationship (see sub-paragraph (11D));
- shares in a company (see sub-paragraph (12));
- a warrant (see sub-paragraph (9)).”.

(3) After sub-paragraph (11) insert—

“(11A) ”Loan-contract embedded derivative” means a contract to which a company is treated as party by virtue of section 94A(2)(b) of the Finance Act 1996.

(11B) ”Loan-contract host contract” means a loan relationship to which a company is treated as party by virtue of section 94A(2)(a) of the Finance Act 1996.

(11C) ”Original asset” means an asset representing an original creditor relationship.

(11D) ”Original creditor relationship” means a loan relationship to which—

(6) Paragraph 9 was amended by article 11 of [S.I. 2004/2201](#) and article 7 of [S.I. 2005/646](#).

(7) Paragraph 12 was amended by article 13 of [S.I. 2004/2201](#), article 9 of [S.I. 2005/646](#), article 8 of [S.I. 2005/2082](#) and article 6 of [S.I. 2005/3440](#).

- (a) a company is creditor, and
- (b) section 94A of the Finance Act 1996 applies.”.
- (4) In sub-paragraph (13) before “has the same meaning” insert “, except in paragraph 45G,”.
- (5) In sub-paragraph (14) for paragraph (b) substitute—
 - “(b) in any other case—
 - (i) the hedging instrument is intended to act as a hedge of the exposure to changes in fair value of the hedged item that is attributable to a particular risk and could affect the profit or loss of the company, and
 - (ii) the hedged item is an asset or liability recognised for accountancy purposes or is an identified portion of such an asset or liability.”.
- (6) In sub-paragraph (16) for “and “contract of long-term insurance” have” substitute “has”.

Amendment of Part 9 of Schedule 26

Substitution of paragraphs 44 and 45 of Schedule 26

10. For paragraphs 44 and 45 substitute—

“Contracts which become derivative contracts

43A.—(1) This paragraph applies if—

- (a) a company is a party to a relevant contract which (having not been a derivative contract) becomes a derivative contract, and
- (b) immediately before the time at which the relevant contract becomes a derivative contract, the relevant contract is a chargeable asset.

(2) The company shall, when it ceases to be a party to the relevant contract, bring into account (for the accounting period in which it ceases to be party to the relevant contract) the amount of any chargeable gain or allowable loss treated as accruing to the company on the assumption—

- (a) that it had made a disposal of the relevant contract immediately before the relevant time, and
- (b) that the disposal had been for a consideration equal to the notional carrying value of the relevant contract at that time.

(3) For the purposes of this paragraph an asset is a chargeable asset if any gain accruing on the disposal of the asset by the company would be a chargeable gain for the purposes of TCGA 1992 (and includes any obligations under futures contracts which, by virtue of section 143 of that Act, are regarded as assets to the disposal of which that Act applies).

(4) For the purposes of this paragraph “the relevant time” means the time, on or after 30th December 2006, at which the relevant contract becomes a derivative contract.

(5) For the purposes of this paragraph the “notional carrying value” of a contract at any time is the amount which 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.

Contracts which cease to be derivative contracts

43B.—(1) This paragraph applies if a company is party to a relevant contract which (having been a derivative contract) ceases to be a derivative contract.

- (2) The company is to be treated—
 - (a) for the purposes of this Schedule, as if at the relevant time it had disposed of the contract in a related transaction for a consideration of an amount equal to the notional carrying value of the contract at that time, and
 - (b) for the purposes of TCGA 1992, as if immediately after that time it had reacquired the contract for the same consideration.
- (3) In this paragraph “the relevant time” means the time at which the contract ceases to be a derivative contract.
- (4) Paragraph 43A(5) (meaning of “notional carrying value”) applies for the purposes of this paragraph.”.

Omission of paragraphs 44 and 45 of Schedule 26

- 11. Omit paragraphs 44 and 45.

Amendment of paragraph 45C of Schedule 26

- 12. In paragraph 45C(8) (derivative contracts relating to land or certain tangible movable property) omit sub-paragraphs (1)(d) and (1A).

Amendment of paragraph 45D of Schedule 26

- 13.—(1) Amend paragraph 45D(9) (creditor relationships: embedded derivatives which are options) as follows.

- (2) In sub-paragraph (1) for paragraphs (a) to (c) substitute—
 - “(a) the derivative contract is a loan-contract embedded derivative to which the company is treated as party by virtue of a creditor relationship of the company (“the original relationship”),
 - (b) the derivative contract is treated as an option by virtue of section 94A(3) of the Finance Act 1996.”.
- (3) In sub-paragraph (2)(a) for “creditor relationship” substitute “original relationship”.
- (4) For sub-paragraph (2)(f) substitute—
 - “(f) the original asset is not an existing asset.”.
- (5) In sub-paragraph (3)(a) for “creditor relationship” substitute “original relationship”.
- (6) In sub-paragraph (3A) for “paragraph” substitute “Schedule and Chapter 2 of Part 4 of the Finance Act 1996”.
- (7) In sub-paragraph (8) for “creditor relationship” substitute “original relationship”.

Amendment of paragraph 45E of Schedule 26

- 14. In paragraph 45E(10) (exclusions from paragraph 45D) omit sub-paragraph (2).

(8) Paragraph 45C was inserted by article 15 of [S.I. 2004/2201](#) and amended by article 8 of [S.I. 2005/3440](#).
(9) Paragraph 45D was inserted by article 15 of [S.I. 2004/2201](#) and amended by article 13 of [S.I. 2005/2082](#).
(10) Paragraph 45E was inserted by article 15 of [S.I. 2004/2201](#) and amended by article 14 of [S.I. 2005/2082](#).

Amendment of paragraph 45F of Schedule 26

15.—(1) Amend paragraph 45F(11) (creditor relationships: embedded derivatives which are exactly tracking contracts for differences) as follows.

(2) In sub-paragraph (1) for paragraphs (a) to (c) substitute—

“(a) the derivative contract is a loan-contract embedded derivative to which the company is treated as party by virtue of a creditor relationship of the company (“the original relationship”),

(c) the derivative contract is treated as a contract for differences by virtue of section 94A(3) of the Finance Act 1996.”.

(3) In sub-paragraph (2)(a) for “creditor relationship” substitute “original relationship”.

(4) In sub-paragraph (2)(c) omit sub-paragraph (i).

(5) For sub-paragraph (2)(f) substitute—

“(f) the original asset is not an existing asset.”.

(6) In sub-paragraph (3)(a) for “creditor relationship” substitute “original relationship”.

(7) In sub-paragraph (4), in the definition of “C”, for “the asset which represents the creditor relationship” substitute “the original asset”.

(8) In sub-paragraph (6)—

(a) in paragraph (a)(i) for “the asset representing the creditor relationship” substitute “the original asset”

(b) in paragraph (a)(ii) for “corresponding debtor relationship” substitute “debtor relationship corresponding to the creditor relationship mentioned in sub-paragraph (1)”, and.

(c) in paragraph (b) for “the asset representing the creditor relationship” substitute “the original asset”.

(9) In sub-paragraph (8) for “creditor relationship” substitute “original relationship”.

Amendment of paragraph 45FA of Schedule 26

16. For paragraph 45FA(12) (creditor relationships: existing assets) substitute—

“Creditor relationships: existing assets

45FA.—(1) This paragraph applies if paragraph 45D or 45F would apply to a derivative contract for an accounting period but for sub-paragraph (2)(f) of that paragraph.

(2) Paragraph 14(3) (non-trading debits and credits) shall not apply to the credits and debits given in relation to the contract for the accounting period by paragraph 15.

(3) The original creditor relationship by virtue of which paragraph 45D or 45F would apply to the derivative contract shall not be treated as a qualifying corporate bond by virtue of section 117(A1) of TCGA 1992.

(4) For the purposes of TCGA 1992 the amount or value of the consideration for any disposal of the original asset shall be treated as adjusted so as to exclude so much of it as, on a just and reasonable apportionment, relates to any interest which—

(a) falls to be brought into account under Chapter 2 of Part 4 of the Finance Act 1996 (loan relationships) as accruing to any company at any time; and

(11) Paragraph 45F was inserted by article 15 of [S.I. 2004/2201](#) and amended by article 7 of [S.I. 2004/3270](#), by article 15 of [S.I. 2005/646](#) and by article 15 of [S.I. 2005/2082](#).

(12) Paragraph 45FA was inserted by article 16 of [S.I. 2005/2082](#).

(b) in consequence of, or of the terms of, the disposal, is not paid or payable to the company to which it is treated for the purposes of that Chapter as accruing.

(5) Where—

(a) there has been a reorganisation for the purposes of sections 126 to 132 of TCGA 1992, and

(b) for the purposes of those sections, the original asset mentioned in sub-paragraph (4) is treated as the original shares,

the reference in sub-paragraph (4) to the disposal of the original asset includes a reference to the disposal of the asset which, as a result of the reorganisation, has become the new holding for the purposes of those sections.

(6) For the purposes of TCGA 1992 the amount or value of the consideration for any disposal by a company of the original asset—

(a) shall be increased by the addition of any relevant exchange losses, and

(b) shall (after giving effect to any such increase) be reduced (but not below nil) by the deduction of any relevant exchange gains,

but this sub-paragraph does not apply in a case where paragraph 45F would apply but for sub-paragraph (2)(f) of that paragraph.

(7) For the purposes of sub-paragraph (6), “relevant exchange gains” and “relevant exchange losses” are—

(a) the amount of any exchange gains or losses in respect of the original asset that are brought into account under Chapter 2 of Part 4 of the Finance Act 1996 by the company for an accounting period throughout which the company holds the original asset; and

(b) for any accounting period not falling within paragraph (a) in which the company holds the original asset, an amount which, on a just and reasonable apportionment, represents so much of the amount of any exchange gains or losses brought into account under that Chapter in respect of the original asset, by the company making the disposal, for that period as is referable to the part of the period for which the company holds the asset.

(8) Where the amount of the relevant exchange gains falling to be deducted under sub-paragraph (6)(b) exceeds the amount required to reduce the amount or value of the consideration to nil, the excess shall be treated for the purposes of section 38(1)(c) of TCGA 1992 as incidental costs of making the disposal of the original asset.”.

Amendment of paragraph 45H of Schedule 26

17.—(1) Amend paragraph 45H(13) as follows.

(2) In sub-paragraph (2) for paragraph (a) substitute—

“(a) sub-paragraph (3) has effect in relation to a disposal of the asset representing the original creditor relationship mentioned in paragraph 45D(1)(a) (“the original relationship”), and”.

(3) In sub-paragraph (3) for “asset representing the associated creditor relationship” substitute “original asset”.

(4) After sub-paragraph (5) insert—

“(5A) Sections 37 and 39 of TCGA 1992 do not apply in relation to a disposal mentioned in sub-paragraph (1)(b), (2)(a) or (b) above.”

(5) In sub-paragraph (6), in the definition of “G”, for paragraph (a) substitute—

“(a) the relevant Chapter 2 amount, and”.

(6) In sub-paragraph (7) for paragraph (a) substitute—

“(a) the “relevant Chapter 2 amount” means the amount by which the carrying value of the loan-contract host contract at the date on which the option is exercised exceeds the carrying value of that contract at—

- (i) the date on which the company became party to the original relationship, or
- (ii) (if later) the date on which the derivative contract became one to which paragraph 45D applies;”.

Insertion of paragraph 45HZA of Schedule 26

18. After paragraph 45H insert—

“Treatment of net gains and losses on disposal of certain embedded derivatives

45HZA.—(1) This paragraph applies where—

- (a) a derivative contract is one to which paragraph 45F (creditor relationships: embedded derivatives which are exactly tracking contracts for differences) applies for an accounting period, and
- (b) the asset representing the original relationship mentioned in paragraph 45F(1)(a) is disposed of in the accounting period.

(2) For the purpose of computing any chargeable gain accruing to the company on the disposal, the sums allowable as a deduction under section 38(1)(a) of TCGA 1992 (acquisition costs) shall—

- (a) if G exceeds L, be increased by the amount of that excess,
- (b) if L exceeds G, be reduced by the amount of that excess.

(3) If the amount of the excess in sub-paragraph (2)(b) is greater than the amount of expenditure allowable under section 38(1)(a) of TCGA 1992, the amount of the excess that cannot be deducted from the expenditure so allowable shall, for the purpose mentioned in sub-paragraph (2), be added to the amount of the consideration for the disposal.

(4) Sections 37 and 39 of TCGA 1992 do not apply in relation to the disposal.

(5) In this paragraph—

G is the sum of—

- (a) the relevant Chapter 2 amount, and
- (b) the amount of any chargeable gains treated as accruing to the company under paragraph 45A(4)(a) in respect of the derivative contract in each relevant accounting period, and

L is the sum of the amounts of any allowable losses treated as accruing to the company under paragraph 45A(4)(b) in respect of the derivative contract in each relevant accounting period.

(6) For the purposes of paragraph (5)—

- (a) the relevant Chapter 2 amount means the amount by which the carrying value of the loan-contract host contract at the date of the disposal exceeds the carrying

value of that contract at the date on which the company became party to the original relationship;

- (b) a relevant accounting period is—
 - (i) the accounting period in which the disposal is made, or
 - (ii) any previous accounting period.”.

Amendment of paragraph 45HA of Schedule 26

19.—(1) Amend paragraph 45HA (14) as follows.

(2) For sub-paragraph (1) and the heading preceding paragraph 45HA substitute—

“Treatment of credits and debits on terminal exercise of non-embedded option or running to delivery of future

45HA.—(1) This paragraph applies where—

- (a) a company is party to a derivative contract in an accounting period,
- (b) the derivative contract is a plain vanilla contract which is an option,
- (c) rights comprised in the plain vanilla contract are exercised to any extent in that accounting period, and
- (d) those rights are rights to acquire shares.

(1A) This paragraph also applies where—

- (a) a company is party to a derivative contract in an accounting period,
- (b) the derivative contract is a plain vanilla contract which is a future,
- (c) delivery is taken of an asset in accordance with the terms of the future, and
- (d) that asset is shares.”.

(3) In sub-paragraph (2)—

- (a) for “In any such case” substitute “Where this paragraph applies”, and
- (b) for “so acquired” substitute “acquired or delivered”.

(4) In sub-paragraph (4), in the definition of “G”, for “sub-paragraph (1)(b)” substitute “sub-paragraph (1)(c) or the delivery mentioned in sub-paragraph (1A)(c)”.

Amendment of paragraph 45I of Schedule 26

20.—(1) Amend paragraph 45I(15) (index-linked gilt-edged securities with embedded contracts for differences) as follows.

(2) In sub-paragraph (1) for paragraph (a) substitute—

- “(a) the derivative contract is a loan-contract embedded derivative to which the company is treated as party by virtue of a creditor relationship of the company,”.

(3) In sub-paragraph (1)(c) for “equivalent deemed loan relationship” substitute “loan-contract host contract”.

(4) In sub-paragraph (1) omit paragraph (d).

(5) In sub-paragraph (1)(e) for the words from the beginning to “that section” substitute “the derivative contract is treated by virtue of section 94A(3) of the Finance Act 1996”.

(14) Paragraph 45HA was inserted by article 17 of [S.I. 2005/2082](#) and amended by article 10 of [S.I. 2005/3440](#).

(15) Paragraph 45I was inserted by article 15 of [S.I. 2004/2201](#).

- (6) In sub-paragraph (3) omit the definition of “the equivalent deemed loan relationship”.

Amendment of paragraph 45J of Schedule 26

21.—(1) Amend paragraph 45J(16) (issuers of securities with embedded derivatives: deemed options) as follows.

- (2) In sub-paragraph (1) for paragraphs (a) and (b) substitute—

“(a) the derivative contract is a loan-contract embedded derivative to which the company is treated as party by virtue of a debtor relationship of the company (“the original relationship”),”.

(3) In sub-paragraph (1)(c) for the words from the beginning to “that section” substitute “the derivative contract is treated by virtue of section 94A(3) of the Finance Act 1996”.

(4) In sub-paragraph (2)(a), in both places, and in sub-paragraph (4) for “debtor” substitute “original”.

- (5) In sub-paragraph (3)(b) for “(9)” substitute “(9A)”.

- (6) For sub-paragraphs (8) and (9) substitute—

“(8) In sub-paragraph (7)—

E is—

- (a) in a case where the company was a party to the original relationship at the time it was created, the initial carrying value of the option, and
- (b) in a case where the company became a party to the original relationship at a later time, the carrying value of the option at that time;

F is the amount paid by the debtor in fulfilment of the obligations under the original relationship reduced (but not below nil) by the fair value of the loan-contract host contract at the date on which the option is exercised.

(9) Sub-paragraph (9A) applies if the company ceases to be a party to the original relationship at a time when the option mentioned in sub-paragraph (1)(c) has not been exercised.

(9A) The company is treated for the purposes of corporation tax on chargeable gains—

- (a) as having disposed of an asset for a consideration equal to G, and
- (b) as having acquired that asset for a consideration equal to H.

(9B) In sub-paragraph (9A)—

G is—

- (a) in a case where the company was a party to the original relationship at the time it was created, the initial carrying value of the option, and
- (b) in a case where the company became a party to the original relationship at a later time, the carrying value of the option at that time;

H is—

- (a) in a case where the company ceases to be a party to the original relationship as a result of the redemption or repayment of the liability representing the original relationship, the amount paid by the company, and
- (b) in any other case, the consideration given by the company on its ceasing to be party to the original relationship,

(16) Paragraph 45J was inserted by article 10 of S.I. 2004/3270 and amended by article 16 of S.I. 2005/646, article 18 of S.I. 2005/2082 and article 11 of S.I. 2005/3440.

in either case reduced (but not below nil) by the fair value of the loan-contract host contract at the date on which it so ceases.”.

Amendment of paragraph 45JA of Schedule 26

22.—(1) Amend paragraph 45JA(17) (issuers of securities with embedded derivatives: equity instruments) as follows.

(2) In sub-paragraph (1)—

(a) for paragraph (a) substitute—

“(a) the company is party to a loan-contract embedded derivative by virtue of a debtor relationship of the company (“the original relationship”),

(b) in paragraph (b) for “subsection (1) of that section in the case of that debtor relationship” substitute “section 94A(1) of the Finance Act 1996 in the case of the original relationship”, and

(c) in paragraph (b)(ii), at the end, insert “of the company”.

(3) Omit sub-paragraph (1)(e).

(4) In sub-paragraph (1)(f) for “loan” substitute “original”.

(5) In sub-paragraphs (2)(a), in both places, and (2)(b) for “debtor” substitute “original”.

(6) In sub-paragraph (4) for the definition of “RA” substitute—

“RA is the amount paid as mentioned in sub-paragraph (1)(f) reduced (but not below nil) by an amount equal to the fair value of the loan-contract host contract at the time that amount is paid;”.

(7) In sub-paragraph (4), in the definition of “E”, for “debtor” substitute “original”.

Amendment of paragraph 45K of Schedule 26

23.—(1) Amend paragraph 45K(18) (issuers of securities with embedded derivatives: deemed contracts for differences) as follows.

(2) In sub-paragraph (1)—

(a) For paragraphs (a) and (b) substitute—

“(a) the derivative contract is a loan-contract embedded derivative to which the company is treated as party by virtue of a debtor relationship of the company (“the original relationship”),”.

(3) For sub-paragraph (1)(d) substitute—

“(d) the derivative contract is an exactly tracking contract within the meaning of sub-paragraph (2A), and”.

(4) In sub-paragraphs (2)(a), in both places, and (2)(e) for “debtor” substitute “original”.

(5) In sub-paragraph (2)(c) omit “land (wherever situated) or”.

(6) After sub-paragraph (2) insert—

“(2A) For the purposes of this paragraph “an exactly tracking contract” is a contract for differences where D is equal to the amount determined by applying R% to C where—

D is the amount that must be paid to discharge the rights and liabilities that fall to be treated as comprised in the contract;

(17) Paragraph 45JA was inserted by paragraph 19 of [S.I. 2005/2082](#).

(18) Paragraph 45K was inserted by article 10 of [S.I. 2004/3270](#) and amended by article 17 of [S.I. 2005/646](#) and article 20 of [S.I. 2005/2082](#).

R% is a relevant percentage change in the value of the underlying subject matter of the contract (see sub-paragraph (2B));

C is the amount falling for the purposes of Chapter 2 of Part 4 of the Finance Act 1996 to be regarded in accordance with generally accepted accounting practice as the proceeds of issue of the liability which represents the original relationship.

(2B) In sub-paragraph (2A), the reference to a relevant percentage change in the value of the underlying subject matter of the contract is a reference to the percentage change (if any) over the relevant period in—

- (a) the value of the assets which are the underlying subject matter of the contract, or
- (b) any index of the value of those assets.

(2C) In sub-paragraph (2B) “the relevant period” means—

- (a) the period between—
 - (i) the date when the liability representing the original relationship came into existence, and
 - (ii) the date when the corresponding creditor relationship comes to an end; or
- (b) any other period in which almost all of that period is comprised, and which differs from that period exclusively for purposes connected with giving effect to a valuation in relation to rights or liabilities under the liability representing the original relationship.”.

(7) In sub-paragraphs (3A)(a) and (3B)(b) for “debtor” substitute “original”.

(8) In sub-paragraph (3B) for paragraph (c) substitute—

- “(c) the consideration for the disposal of that asset—
 - (i) in a case where the company was party to the original relationship at the time it was created, is equal to the amount of the proceeds of issue of the security representing that relationship, and
 - (ii) in a case where the company became party to the original relationship after that time, is equal to the amount of the carrying value of the loan-contract host contract at that time, and”.

Insertion of paragraph 45KA of Schedule 26

24. After paragraph 45K insert—

“Securities with embedded options: existing liabilities

45KA.—(1) Where in any accounting period paragraph 45K would apply to a derivative contract but for sub-paragraph (2)(e) of that paragraph, paragraph 14(3) (non-trading credits and debits) shall not apply to the relevant credits and debits.

(2) For the purposes of this paragraph the relevant credits and debits are the credits and debits given in relation to the contract for the accounting period by paragraph 15.”.

Amendment of paragraph 45L of Schedule 26

25.—(1) Amend paragraph 45L(19) (derivatives not embedded in a loan relationship) as follows.

(2) In sub-paragraph (1) for the words from the beginning to the end of paragraph (a) substitute—

(19) Paragraph 45L was inserted by article 10 of [S.I. 2004/3270](#) and amended by article 21 of [S.I. 2005/2082](#) and article 12 of [S.I. 2005/3440](#).

- “(1) This paragraph applies where—
- (a) a company is party to a non-financial embedded derivative or a nested derivative (“the contract”),”.
- (3) For sub-paragraph (1A) substitute—
- “(1A) In this paragraph “the original contract” means—
- (a) the non-financial contract mentioned in paragraph 2A to which the company is party, and as a result of which the company falls to be treated under paragraph 2A(2) as party to the non-financial embedded derivative; or
 - (b) the hybrid derivative mentioned in paragraph 2B to which the company is party, and as a result of which the company falls to be treated under paragraph 2B(2) as party to the nested derivative.”.
- (4) In sub-paragraph (1B)(b) for the words from “whether” to the end substitute “whether that contract is a hybrid derivative or a non-financial contract”.
- (5) In sub-paragraph (1C)—
- (a) for “a derivative contract” substitute “a hybrid derivative”, and
 - (b) for paragraph (a) substitute—
 - “(a) were not one where the rights and liabilities are treated for accounting purposes as divided as mentioned in sub-paragraph (2) of paragraph 2B, and”.
- (6) In sub-paragraph (2)—
- (a) for the words from the beginning to “a derivative contract” substitute “If the contract is a non-financial contract”,
 - (b) for paragraph (a) substitute—
 - “(a) were not one where the rights and liabilities are treated for accounting purposes as divided as mentioned in sub-paragraph (2) of paragraph 2A, and”, and
 - (c) insert the following words after paragraph (b) (but not as part of that paragraph)—

“and, accordingly, this Schedule shall not apply to the contract, but section 42 of the Finance Act 1998 shall apply to the contract as if fair value accounting were not generally accepted accounting practice in relation to the company.”.

Amendment of paragraph 45LA of Schedule 26

26. In paragraph 45LA(20) (elections under paragraph 45L(2A): further provisions) in sub-paragraph (4)(a) for “paragraph 2(4)” substitute “paragraph 2A or 2B”.

Amendment of paragraph 45M of Schedule 26

27.—(1) Amend paragraph 45M(21) (treatment of host contract as a loan relationship) as follows.

(2) For sub-paragraphs (1) and (2) substitute—

- “(1) This paragraph applies where for an accounting period—
- (a) a company is party to a hybrid derivative contract falling within paragraph 3(1)(b),
 - (b) the nested derivative is a derivative contract falling within paragraph 3(1)(a),

(20) Paragraph 45LA was inserted by article 13 of [S.I. 2005/3440](#).

(21) Paragraph 45M was inserted by article 18 of [S.I. 2005/646](#) and amended by article 22 of [S.I. 2005/2082](#) and article 14 of [S.I. 2005/3440](#).

- (c) the underlying subject matter of the derivative contract consists, or is treated as consisting, wholly of—
 - (i) shares in a company, or
 - (ii) rights of a unit holder under a unit trust scheme, and
- (d) the quasi-derivative host contract is treated for accounting purposes as, or as forming part of, a financial asset.
- (2) Where this paragraph applies—
 - (a) the quasi-derivative host contract shall be treated for the purposes of the Corporation Tax Acts as if it were a creditor relationship of the company, and
 - (b) the nested derivative shall be treated—
 - (i) as satisfying the conditions in paragraph 4(2A), and
 - (ii) as a chargeable asset (within the meaning of paragraph 4A(4)).”
- (3) Omit sub-paragraphs (5) and (6).

Amendment of paragraph 50A of Schedule 26

28. In paragraph 50A(22) (adjustment on company changing to international accounting standards), in sub-paragraph (3B)(b), for “paragraphs 21 and 28” substitute “paragraph 28”.

Consequential amendments

Amendment of paragraph 54 of Schedule 26

- 29.**—(1) Amend paragraph 54(1)(23) (interpretation of expressions) as follows.
- (2) Insert at the appropriate places the following definitions—
- ““carrying value”, in relation to a contract, shall be construed in accordance with sub-paragraphs (3A) and (3B) of paragraph 50A;”
 - ““hybrid derivative” shall be construed in accordance with paragraph 2B;”
 - ““nested derivative” shall be construed in accordance with paragraph 2B(1)(b)(i);”
 - ““plain vanilla contract” shall be construed in accordance with paragraph 2(2B);”
 - ““quasi-derivative host contract” shall be construed in accordance with paragraph 2B(1)(b)(ii);”
 - ““TCGA 1992” means the Taxation of Chargeable Gains Act 1992.”.
- (3) Omit the definition of “embedded derivative contract”(24).

Amendment of references to the Taxation of Chargeable Gains Act 1992

30.—(1) In the specified provisions of Schedule 26, for “the Taxation of Chargeable Gains Act 1992”(25) substitute “TCGA 1992”.

(2) In paragraph (1) “the specified provisions” means paragraph 4A(4),(26) paragraph 45A(6), paragraph 45B(8), sub-paragraphs (7) and (8) of paragraph 45D, paragraph 45F(8), sub-paragraphs

(22) Paragraph 50A was inserted by paragraph 67 of Schedule 10 to the Finance Act 2004 (c. 12). Sub-paragraphs (3A) and (3B) were inserted by article 12 of S.I. 2004/3270.

(23) Paragraph 54(1) was amended by article 15 of S.I. 2005/3440; there are other amendments but none is relevant.

(24) The definition of “embedded derivative contract” was inserted by article 15 of S.I. 2005/3440.

(25) 1992 c. 12.

(26) Paragraph 4A was inserted by article 15 of S.I. 2004/2201.

(2)(b)(ii), (3), (4) and (5) of paragraph 45H,(27) sub-paragraphs (2) and (3) of paragraph 45HA, paragraph 45J(5)(a)(28) and paragraph 45LA(6).

Dave Watts

Frank Roy

Two of the Lords Commissioners of Her
Majesty's Treasury

7th December 2006

(27) Paragraphs 45A to 45I were inserted by article 15 of [S.I. 2004/2201](#). Paragraph 45D(8) was substituted by article 13(5) of [S.I. 2005/2082](#), paragraph 45F(8) was substituted by article 15(4) of [S.I. 2005/2082](#), and paragraph 45H(2)(b)(ii) was substituted by article 9(3) of [S.I. 2005/3440](#).

(28) Paragraph 45J was inserted by article 10 of [S.I. 2004/3270](#) and relevantly amended by article 18(4) of [S.I. 2005/2082](#).

Status: This is the original version (as it was originally made). This item of legislation is currently only available in its original format.

EXPLANATORY NOTE

(This note is not part of the Order)

Schedule 26 to the Finance Act 2002 (c. 23) (“Schedule 26”) makes provision relating to derivative contracts. Paragraph 13 of Schedule 26 confers power on the Treasury to amend provisions in that Schedule, and this Order exercises that power to make amendments. The Order makes provision for a new method of classifying derivative contracts, and the new classification has prompted a considerable number of consequential amendments in later paragraphs of Schedule 26. The Order also contains new provisions that apply if a contract moves in or out of the legislation applying to derivative contracts.

This Order begins with provisions of a general nature. Article 1 provides for citation, commencement, effect and interpretation; and article 2 provides for Schedule 26 to be amended.

Articles 3 to 9 provide for the amendment of paragraphs 2 to 12 of Schedule 26. Paragraph 2 of Schedule 26, in its amended form, and the new paragraphs 2A and 2B of Schedule 26 make provision for the new method of classifying derivative contracts.

Articles 10 to 28 provide for the amendment of Part 9 of Schedule 26. The new paragraph 43A of Schedule 26 contains provisions that apply to contracts which become derivative contracts, and the new paragraph 43B of Schedule 26 contains provisions that apply to contracts which cease to be derivative contracts.

Article 29 makes consequential amendments to paragraph 54 of Schedule 26 to insert a number of definitions applying generally in Schedule 26; and article 30 provides for the amendment of references to the Taxation of Chargeable Gains Act 1992 (c. 12).

A full regulatory impact assessment has not been produced for this instrument as no impact on the private or voluntary sectors is foreseen.