

CORPORATION TAX ACT 2009

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 10: Derivative contracts

Extended meaning of reference in [section 591\(6\)\(b\)](#)

3529. This paragraph extends the list of provisions relevant to condition E in section 591 (conditions A to E mentioned in section 589(5)). It is based on paragraph 4(2D) of Schedule 26 to FA 2002.

Disapplication of [section 645](#)

3530. This paragraph disapplies section 645 (creditor relationships: embedded derivatives which are options) to a derivative contract if paragraph 9(2) of Schedule 10 to FA 2004 has effect in relation to the asset representing the creditor relationship which hosts the derivative contract. It is based on paragraphs 12(11C) and 45D(2) and (4) of Schedule 26 to FA 2002.

3531. That provision of FA 2004 deems an asset representing a creditor relationship no longer to be such if the asset was in existence at a date not later than 31 December 2005. See the following paragraphs for the rules that apply if a derivative contract would be within section 645 if this paragraph did not apply.

Existing assets representing creditor relationships: options

3532. This paragraph, supplemented by the next two, disapplies section 574 (non-trading credits and debits to be brought into account under Part 5) in respect of a derivative contract and modifies the application of TCGA in respect of the “original creditor relationship” mentioned in section 645 (creditor relationships: embedded derivatives which are options), if that section would have applied to the derivative contract but for the disapplication in the preceding paragraph. This paragraph is based on paragraphs 12(11C) and (11D), 45A(2) and 45FA(1), (3), (4), (6) and (8) of Schedule 26 to FA 2002.

3533. *Sub-paragraph (2)* disapplies section 574 in respect of the “relevant credits and debits” arising on the option. Any gain or loss on the exercise or abandonment of the option is dealt with under the provisions of TCGA, as those provisions apply to the creditor relationship. “Relevant credits and debits” are defined in section 659.

3534. The first modification of TCGA in respect of the original creditor relationship, in *sub-paragraph (3)*, is the same as that made by section 645(8). The creditor relationship is not treated as a “qualifying corporate bond” although section 117(A1) of TCGA would otherwise treat it as such.

3535. The second modification, in *sub-paragraph (4)*, is to the amount or value of the consideration applicable to the asset representing the creditor relationship on a disposal of that asset. So much of any interest in respect of the creditor relationship as is

brought into account under Part 5 (loan relationships) but, because of the terms of the disposal, is not paid or payable to the company to which it accrues, is deducted from the consideration. In effect, the charge under that Part is given priority over the charge to corporation tax on chargeable gains.

3536. The third modification, in *sub-paragraph (6)*, also affects the amount of that consideration. It adjusts that amount for any “relevant exchange gains” and “relevant exchange losses”, as those terms are defined in the paragraph below. The consideration is first increased by any such losses and then reduced by any such gains. If that reduction would exceed the amount of the consideration, that amount becomes nil and, under *sub-paragraph (7)*, the excess is added to incidental costs of acquisition under section 38 of TCGA.
3537. The definition of “relevant exchange gains” and “relevant exchange losses” refers to such gains and losses in respect of the asset representing the creditor relationship as are brought into account under Part 5 (loan relationships) for an accounting period throughout which the company holds the asset. Gains and losses are apportioned as necessary if the company only holds the asset for part of an accounting period. The effect of the adjustments to the consideration is to reverse the application of that Part to exchange gains and losses in respect of the asset in question so that those exchange adjustments are taken into account only in the chargeable gains arising in respect of the asset representing the creditor relationship.
3538. The second of these paragraphs provides definitions for the purposes of the first paragraph. It is based on paragraphs 12(11C) and 45FA(7) of Schedule 26 to FA 2002.
3539. The third of these paragraphs provides for the meaning in the first paragraph of the asset representing the creditor relationship if there has been a reorganisation of share capital. It is based on paragraphs 12(11C) and 45FA(5) of Schedule 26 to FA 2002.

Disapplication of [section 648](#)

3540. This paragraph disapplies section 648 (creditor relationships: embedded derivatives which are exactly tracking contracts for differences) to a derivative contract if paragraph 11(2) of Schedule 10 to FA 2004 has effect in relation to the asset representing the creditor relationship. It is based on paragraphs 12(11C) and 45F(2) and (7) of Schedule 26 to FA 2002.
3541. That provision of FA 2004 deems an asset representing a creditor relationship linked to the value of assets no longer to be such if the asset was in existence at a date not later than 31 December 2005. See the following paragraphs for the rules that apply if a derivative contract would be within section 648 if this paragraph did not apply.

Existing assets representing creditor relationships: contracts for differences

3542. This paragraph and the next one make, with one exception, corresponding provision in respect of a derivative contract and its host contract, if section 648 (creditor relationships: embedded derivatives which are exactly tracking contracts for differences) would apply to the derivative contract but for the disapplication in the preceding paragraph, to that made by the paragraphs above for “existing assets representing creditor relationships: options”. The exception is that these paragraphs do not provide specially for exchange gains and losses (“relevant exchange gains” and “relevant exchange losses” in the earlier paragraphs). These paragraphs are based on paragraphs 12(11C) and (11D) and 45FA(1), (2), (3), (4) and (5) of Schedule 26 to FA 2002.

Disapplication of [section 658](#)

3543. This paragraph disapplies section 658 (chargeable gain or allowable loss treated as accruing when certain debtor relationships come to an end) to a derivative contract (and

makes a consequential provision) if the liability representing the debtor relationship that hosts the derivative contract was owed before a date that is usually in 2005. It is based on paragraphs 45K(2) and 45KA(1) of Schedule 26 to FA 2002.

3544. The consequential provision is that, if section 658 would apply to a derivative contract but for this paragraph, this paragraph disapplies section 574 (non-trading credits and debits to be brought into account under Part 5) in respect of the relevant credits and debits arising on the derivative contract. Any gain or loss arising on the contract for differences is dealt with under the provisions of TCGA, as those provisions apply to the liability representing the debtor relationship. “Relevant credits” and “relevant debits” are defined in section 659.

Disapplication of [section 661](#)

3545. This paragraph disapplies section 661 (contract which became derivative contract) if the time when the relevant contract became a derivative contract was before 30 December 2006 (the date by reference to which the amendments made by the [Finance Act 2002, Schedule 26, \(Parts 2 and 9\) \(Amendment\) Order 2006 \(SI 2006/3269\)](#) have effect.). It is based on paragraph 43A(4) of Schedule 26 to FA 2002.

Disapplication of [section 666](#)

3546. This paragraph disapplies section 666 (allowable loss treated as accruing where amount paid in discharge of obligations under debtor relationship) if the liability representing the debtor relationship was owed before a date which is usually in 2005. It is based on paragraph 45JA(1) and (2) of Schedule 26 to FA 2002.

Contracts which became derivative contracts on 16 March 2005

3547. This paragraph brings into account as a chargeable gain or allowable loss, when a company ceases to be a party to the contract, the gain or loss latent in a contract that became a derivative contract from 3.00pm on 16 March 2005 (the time at which the 2005 Budget announced proposed changes to the definition of what is a derivative contract). It is based on paragraph 4A(1), (2) and (3) of Schedule 26 to FA 2002.
3548. A contract that was not a derivative contract before that time but became one after that time is commonly one that formerly met the conditions for its underlying subject matter to be “excluded property” (see the commentary on section 589 (contracts excluded because of underlying subject matter: general)). The [Finance Act 2002, Schedule 26, Parts 2 and 9 \(Amendment\) Order 2005 \(SI 2005/646\)](#) amended the conditions for that purpose from that time to cut down the range of excluded property (see the conditions in section 591 (conditions A to E mentioned in section 589(5))). Rather than covering most cases where the underlying subject matter of the contract is shares, either by themselves or in conjunction with holdings in shares, the excluded property rule now focuses on contracts used to hedge assets which are shares on which chargeable gains arise.
3549. The paragraph only applies if the contract was a “chargeable asset” immediately before it became a derivative contract (see the definition of that term in section 703).
3550. *Sub-paragraph (5)* requires a chargeable gain or allowable loss to be brought into account on the assumption the company disposed of the contract immediately before it became a derivative contract and did so for consideration equal to the book value of the contract (if any) at the end of the last accounting period of the company before that to which the changes made by [SI 2005/646](#) apply.
3551. Paragraph (b) of *sub-paragraph (6)* defines that period. In the source legislation, the words used are “the company’s accounting period immediately before its first new period”. The term “new period” is not otherwise used in [SI 2005/646](#). But a “new period” cannot predate the first period to which the amendments made by those regulations apply (as set out in article 1 of [SI 2005/646](#)). The paragraph has therefore

been aligned with the commencement terms of [SI 2005/646](#). See *Change 106* in Annex 1.

Contracts which became derivative contracts on 28 July 2005

3552. This paragraph treats a relevant contract to which it applies as a derivative contract entered into by a company on 28 July 2005 and determines the value of the consideration given for the contract. It also brings into account as a chargeable gain or allowable loss when the company ceases to be a party to the contract the gain or loss latent in the contract at 28 July 2005. It is based on paragraph 4B(1), (2), (3) and (4) of Schedule 26 to FA 2002.
3553. The [Finance Act 2002, Schedule 26, Parts 2 and 9 \(Amendment No 2\) Order 2005 \(SI 2005/2082\)](#) extends the scope of the amendments made by [SI 2005/646](#) to the “excluded property” rules (see section 589 (contracts excluded because of underlying subject matter: general)). See the comments on the amendment of the “excluded property” rules in connection with the preceding paragraph.
3554. A contract to which this paragraph applies is one that was not a derivative contract immediately before 28 July 2005 (although it was a “chargeable asset” at that point). But it would have been a derivative contract had an accounting period of the company begun on that date, that is, when the amendments made by [SI 2005/2082](#) came into force. Because of the rule in this case, it is immaterial when the actual accounting period of the company began in which 28 July 2005 falls.
3555. The definition of “chargeable asset” in section 703 applies.
3556. *Sub-paragraph (6)* brings into account the chargeable gain or allowable loss latent in the contract at the time it is treated as becoming a derivative contract. It does so in the same way as the preceding paragraph with one exception. This is that the consideration for the disposal is equal to the fair value of the contract on 28 July 2005 (that is, the same figure as is taken to be the consideration for the deemed derivative contract in the subsequent application of Part 7 to the contract).

Plain vanilla contracts which became derivative contracts before 30 December 2006

3557. This paragraph modifies the amounts otherwise allowable as acquisition costs under section 38 of TCGA on the disposal of a plain vanilla contract if the disposal occurs because the company ceases to be a party to the contract. It is based on paragraph 4D of Schedule 26 to FA 2002.
3558. There are two conditions to be met. The first is that the plain vanilla contract was previously not a derivative contract but became one at a date before 30 December 2006. Although the paragraph does not specify in what circumstances the contract became a derivative contract, it is likely to be the case that it had ceased to satisfy the conditions in section 589 (contracts excluded because of underlying subject matter: general) under which the underlying subject matter of the contract was “excluded property”.
3559. The second condition is that neither of the two preceding paragraphs applies on the company ceasing to be a party to the contract.
3560. 30 December 2006 is the date by reference to which the amendments made by the [Finance Act 2002, Schedule 26, \(Parts 2 and 9\) \(Amendment\) Order 2006 \(SI 2006/3269\)](#) have effect.
3561. *Sub-paragraph (2)* disapplies section 699 (priority of Part 7 for corporation tax purposes) in respect of a disposal to which this paragraph applies (that is, the provisions of this paragraph do not exhaust the application of the Corporation Tax Acts to this disposal).

*These notes refer to the Corporation Tax Act 2009
(c.4) which received Royal Assent on 26 March 2009*

3562. The adjustments made by this paragraph to the acquisition costs allowable under section 38 of TCGA are similar to those made by a number of provisions in Chapter 8 of Part 7. As with those sections, this paragraph in effect reverses the treatment of credits and debits in respect of the derivative contract so that double counting is avoided when the contract is disposed of.
3563. And similarly again to those sections, if the adjustment to be made under *sub-paragraph (3)* is a reduction that exceeds the amounts otherwise allowable under section 38 of TCGA, the excess is added to the consideration for the disposal.
3564. “Plain vanilla contract” is defined in section 708.

Issuers of securities with embedded derivatives: deemed options

3565. This paragraph disapplies sections 653 and 655 and varies the application of section 654 in a case where the company was a party to the debtor relationship in question immediately before its first accounting period to begin on or after 1 January 2005. It is based on paragraph 45J(4) of Schedule 26 to FA 2002.
3566. The paragraph preserves the commencement rules that apply on the insertion of paragraph 45J of Schedule 26 to FA 2002.

Contract becoming derivative contract on 12 March 2008

3567. This paragraph determines the consideration treated as given for a relevant contract that became a derivative contract on 12 March 2008 by virtue of certain provisions of FA 2008. It is based on paragraph 20 of Schedule 22 to FA 2008.
3568. Paragraph 20 of Schedule 22 to FA 2008 amends the source legislation for sections 579(1) and 589(5) with effect from 12 March 2008, the effect of which is that a number of relevant contracts became derivative contracts. This paragraph determines the consideration treated as given for such a derivative contract so that the provisions setting out the credits and debits to be brought into account under Part 7 may be applied.

Avoidance relying on continuity of treatment provisions: transactions before 16 May 2008

3569. This paragraph preserves the commencement rules applying on the introduction of the source legislation for section 629. It is based on paragraph 5(3) of Schedule 22 to FA 2008.

Disposals for consideration not fully recognised by accounting practice: disposals before 16 May 2008

3570. This paragraph preserves the commencement rules applying on the introduction of the source legislation for section 698. It is based on paragraph 4(3) of Schedule 22 to FA 2008.

References to Companies Act 2006

3571. This paragraph provides for the interpretation of references to section 286 of the Companies Act 2006 until such time as that section is brought into force. It is based on regulation 6 of [The Corporation Tax \(Implementation of the Mergers Directive\) Regulations 2008 \(SI 2008/1579\)](#).
3572. The paragraph applies the equivalent provision in the predecessor Companies Act until an order brings section 658 of the Companies Act 2006 into force.

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(c.4) which received Royal Assent on 26 March 2009*

Repeal of provisions concerning exchange gains and losses from derivative contracts

3573. This paragraph preserves the prospective repeal by F(No 2)A 2005 of some provisions dealing with exchange gains and losses. It is based on paragraph 9(1) of Schedule 6 to F(No 2)A 2005.