

# CORPORATION TAX ACT 2009

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## EXPLANATORY NOTES

### COMMENTARY ON SECTIONS

#### **Part 7: Derivative contracts**

##### **Overview**

#### *Chapter 7: Chargeable gains arising in relation to derivative contracts*

##### **Overview**

1758. This Chapter sets out when profits and losses in relation to derivative contracts are dealt with as chargeable gains or allowable losses for the purposes of the charge to corporation tax on chargeable gains rather than being taken into account as income under Part 3 (trading income) or Part 5 (loan relationships).

#### *Section 639: Overview of Chapter*

1759. This section gives an overview of the contents of the Chapter. It is new.

1760. [Sections 640](#) and [651](#) switch off respectively [section 574](#) and both that section and [section 573](#), under which credits and debits are brought into account as income, so that the credits and debits in question may be used instead to give rise to chargeable gains or allowable losses.

1761. [Section 641](#) (to which there are exceptions in [section 642](#)) brings credits and debits on four types of derivative contract into account as chargeable gains or allowable losses. The four types are:

- derivative contracts relating to land and certain tangible movable property ([section 643](#), with a supplementary rule in [section 644](#));
- embedded derivatives in a creditor relationship that are options ([section 645](#), to which there are exceptions in [section 646](#));
- embedded derivatives in a creditor relationship that are exactly tracking contracts for differences ([section 648](#)); and
- property based total return swaps ([section 650](#)).

1762. The remaining provisions of the Chapter (other than various interpretative sections) provide bespoke chargeable gains rules for a number of cases:

- embedded derivatives in a debtor relationship that are options (the affected derivative contract is defined in [section 652](#) and the rules that apply are set out in [sections 653](#) to [655](#)); and
- embedded derivatives in a debtor relationship that are contracts for differences (the affected derivative contract is defined in [section 656](#) and the rules that apply are set out in [section 658](#)).

1763. Chapter 8 contains further rules for a miscellany of situations in which chargeable gains rules are applied or modified.

***Section 640: Credits and debits not to be brought into account under Part 5***

1764. This section disapplies section 574 to “relevant credits and debits” in respect of a derivative contract to which one of the provisions listed in *subsection (2)* applies. It is based on paragraph 45A(1) and (2) of Schedule 26 to FA 2002.

***Section 641: Derivative contracts to be taxed on a chargeable gains basis***

1765. This section treats a chargeable gain or allowable loss as arising in respect of a contract to which one of the provisions listed in *subsection (2)* applies. It is based on paragraph 45A(1), (4) and (5) of Schedule 26 to FA 2002.
1766. Whether there is such a gain or loss depends on whether the relevant credits arising in respect of the contract exceed such relevant debits or those debits exceed those credits.

***Section 642: Exception from section 641***

1767. This section provides an exception to the general rule in section 641 for a contract to which section 645 (embedded derivatives in a creditor relationship that are options) applies if a condition is met. It is based on paragraph 45A(4) and (6) of Schedule 26 to FA 2002.
1768. The condition is that paragraph 2 of Schedule 7AC to TCGA would apply to a gain arising on the disposal of the option represented by the rights and liabilities under the embedded derivative. Schedule 7AC to TCGA provides exemptions from the charge to corporation tax on chargeable gains for disposals of a company’s substantial shareholdings in another company. Paragraph 2 of that Schedule extends the exemption to most disposals of assets relating to shares if a disposal of the shares themselves would qualify for exemption.
1769. The condition applies on the assumptions given in *subsection (2)*, which deem the embedded derivative to be a separate contract that is an option which is disposed of at the end of the accounting period in question and the disposal results in a gain.

***Section 643: Contracts relating to land or certain tangible movable property***

1770. This section sets out the type of derivative contract it applies to (so that section 641 may then apply to credits and debits in respect of the contract). It is based on paragraph 45C(1) and (4) of Schedule 26 to FA 2002.
1771. As with a number of similar sections in this Chapter which define the derivative contracts to which they apply, condition B in *subsection (3)* is that the company does not hold the derivative contract for the purposes of a trade it carries on. This subsection does not rewrite the disapplication of the condition to life assurance and mutual trading companies that is provided by paragraph 45C(2) of Schedule 26 to FA 2002. That disapplication is obsolete by virtue of the rules in sections 633 and 634.
1772. Condition C, in *subsection (4)*, an equally common element in such sections, is that the company in question is not an “excluded body”. That term is defined in section 706 for the purposes of this Part and refers to various types of collective investment scheme.
1773. Condition A, in *subsection (2)*, is the distinguishing characteristic of this type of derivative contract. The underlying subject matter of the contract is either or both of land and certain tangible movable property. *Subsection (5)* contains a signpost to an additional rule in section 644 that modifies what the underlying subject matter of the contract is taken to consist of.

***Section 644: Income to be left out of account in determining whether section 643 applies***

1774. This section provides for underlying subject matter that is income from property of the type or types mentioned in condition A in section 643 to be disregarded in determining whether that condition is met. It is based on paragraph 45C(5) and (6) of Schedule 26 to FA 2002.
1775. This section is substantially similar to section 590, which performs the same function in relation to the definition of “excluded property” in section 589.

***Section 645: Creditor relationships: embedded derivatives which are options***

1776. This section sets out the type of derivative contract it applies to (so that section 641 may then apply to credits and debits in respect of the contract). It also disapplies a chargeable gains provision in TCGA. It is based on paragraphs 12(1) and (11A) and 45D(1), (2), (3), (8) and (9) of Schedule 26 to FA 2002.
1777. Condition C in *subsection (4)* sets out the main distinguishing characteristic of the type of derivative contract to which this section applies. It is that the underlying subject matter of the contract is “qualifying ordinary shares” (broadly, fully participating shares in a listed company, holding company or trading company) or “mandatorily convertible preference shares” (shares that have to be converted into qualifying ordinary shares within 24 hours of acquisition).
1778. *Subsection (7)* provides that the creditor relationship, by virtue of which there is a deemed derivative contract to which this section applies, is itself not treated as a “qualifying corporate bond” although section 117(A1) of TCGA would otherwise treat it as such. That section defines a qualifying corporate bond as “any asset representing a loan relationship of a company”. This subsection effectively switches off for the creditor relationship those provisions in TCGA or elsewhere that apply to qualifying corporate bonds.
1779. Condition D, in *subsection (5)*, does not rewrite the disapplication of the condition to life assurance and mutual trading companies that is provided by paragraph 45D(3) of Schedule 26 to FA 2002. That disapplication is obsolete by virtue of the rules in sections 633 and 634.
1780. See also Part 10 of Schedule 2 which disapplies this section and applies other rules if the asset representing the creditor relationship is an asset in relation to which paragraph 9(2) of Schedule 10 to FA 2004 has effect.

***Section 646: Exclusions from section 645***

1781. This section makes two exclusions from the scope of section 645. It is based on paragraph 45E(1), (3) and (4) and 12(11C) of Schedule 26 to FA 2002.
1782. The exclusions apply in circumstances where the holder is not sharing in the equity risk that is a part of the creditor relationship in which the derivative contract is an embedded derivative. The circumstances are where the holder of the deemed derivative contract may get a predetermined cash amount (condition A) or where cash payable instead of the shares differs significantly from the value of the shares (condition B).

***Section 647: Meaning of certain expressions in section 645***

1783. This section provides definitions of “mandatorily convertible preference shares” and “qualifying ordinary shares” for the purposes of section 645 and contains signposts to other relevant definitions. It is based on paragraph 45D(4), (5), (6) and (7) of Schedule 26 to FA 2002.

1784. “Shares” is defined in section 710. “Recognised stock exchange”, in condition B of the definition of “qualifying ordinary shares”, has the meaning given by section 841 of ICTA.

***Section 648: Creditor relationships: embedded derivatives which are exactly tracking contracts for differences***

1785. This section sets out the type of derivative contract it applies to (so that section 641 may then apply to credits and debits in respect of the contract). It also disapplies a chargeable gains provision in TCGA. It is based on paragraphs 12(1) and (11A) and 45F(1), (2), and (8) of Schedule 26 to FA 2002.
1786. Condition C, in *subsection (4)*, and condition D, in *subsection (5)*, set out the distinguishing characteristics of this type of derivative contract. They are that the underlying subject matter of the contract is qualifying ordinary shares listed on a recognised stock exchange and that the derivative contract is an “exactly tracking contract”.
1787. “Exactly tracking contract” is defined in section 649(2) by reference to a formula. Such a contract is one under which the amount to be paid to discharge the rights and liabilities under the contract varies according to a percentage figure applied to the cost of the asset representing the creditor relationship when that asset comes into existence. The percentage figure is equal to the movement in the value of the assets (that is, the listed shares) which are the underlying subject matter of the contract (or an index of that value). The period over which the movement in the value of the assets is tracked is the period from when the asset representing the creditor relationship came into existence to the date the corresponding debtor relationship comes to an end. (Paragraph (b) of section 649(3) provides a minor amount of leeway in measuring that period for the case where a valuation date in respect of the assets in question is not exactly coterminous with either the beginning or end of the period.) In such a case, the discharge amount tracks the value of those assets exactly.
1788. Condition E, in *subsection (6)*, does not rewrite the disapplication of the condition to life assurance and mutual trading companies that is provided by paragraph 45F(3) of Schedule 26 to FA 2002. That disapplication is obsolete by virtue of the rules in sections 633 and 634.
1789. *Subsection (8)* provides that that creditor relationship is itself not treated as a “qualifying corporate bond” although section 117(A1) of TCGA would otherwise treat it as such. See the commentary on the similar provision in section 645(7).
1790. *Subsection (9)* contains a signpost to section 672, which modifies the rules for acquisition costs in section 38 of TCGA if the asset representing the creditor relationship mentioned in this section is disposed of.
1791. See also Part 10 of Schedule 2 which disapplies this section and applies other rules if the asset representing the creditor relationship is an asset in relation to which paragraph 11(2) of Schedule 10 to FA 2004 has effect.

***Section 649: Meaning of certain expressions in section 648***

1792. This section provides definitions for the interpretation of section 648. It is based on paragraph 45F(4), (5), (6) and (7) and 12(11C) of Schedule 26 to FA 2002.
1793. See the commentary on section 648 in relation to the meaning of “exactly tracking contract”.
1794. “Shares” is defined in section 710.

***Section 650: Property based total return swaps***

1795. This section sets out the type of derivative contract it applies to (so that section 641 may then apply to credits and debits in respect of the contract). It is based on paragraph 45G(1) and (1A) of Schedule 26 to FA 2002.
1796. Conditions A to D, in *subsections (2) to (5)*, set out the distinguishing characteristics of this type of derivative contract. It is, first, a contract for differences whose underlying subject matter includes interest rates (in addition to other underlying subject matter). Second, one or more indices are specified in the contract including an index of changes in the value of land (a “capital value index”).
1797. Condition E, in *subsection (6)*, does not rewrite the disapplication of the condition to life assurance and mutual trading companies that is provided by paragraph 45G(1B) of Schedule 26 to FA 2002. That disapplication is obsolete by virtue of the rules in sections 633 and 634.
1798. By virtue of the special meaning of “relevant debits and credits” in this section, provided by section 659(3), only part of the credits and debits found under section 595 is brought into account under section 641 as a chargeable gain or allowable loss.

***Section 651: Credits and debits not to be brought into account under Part 3 or Part 5***

1799. This section disapplies section 573 to “relevant credits and debits” from a derivative contract to which one of the provisions listed in *subsection (2)* applies. It is based on paragraphs 45J(3) and 45K(3) of Schedule 26 to FA 2002.

***Section 652: Introduction to sections 653 to 655***

1800. This section sets out the type of derivative contract it applies to (so that section 653, 654 or 655 may then apply in respect of the contract). It is based on paragraphs 12(1) and (11A) and 45J(1), (2), and (10) of Schedule 26 to FA 2002.
1801. It applies to a derivative contract that comprises the rights and liabilities treated by section 585 as a relevant contract, because of a debtor relationship of the company, if that relevant contract is also treated as an option by that section. For the purposes of this section, the definition of “option” in section 580 is shorn of its usual limiting conditions (that a cash-settled option is not an option).
1802. The paragraph “issuers of securities with embedded derivatives: deemed options” in Part 10 of Schedule 2 disapplies the rules in sections 653 and 655, and modifies the application of the rule in section 654 if the company was a party to the debtor relationship before its first accounting period to begin on or after 1 January 2005.
1803. For other rules that apply if a company is a party to an embedded derivative because of a debtor relationship of the company and the embedded derivative is treated as an option, see sections 665 and 666 in Chapter 8. They apply if the embedded derivative is an equity instrument and the company pays an amount to the creditor in the loan relationship in discharge of obligations under the relationship.

***Section 653: Shares issued or transferred as a result of exercise of deemed option***

1804. This section determines for the purposes of section 144(2) of TCGA the value of the consideration given for the option represented by the derivative contract within section 652 if shares are issued or transferred as a result of the exercise of the option. It is based on paragraph 45J(3), (4A) and (5) of Schedule 26 to FA 2002.
1805. Section 144(2) of TCGA treats the grant of an option and the transaction under which the grantor fulfils the obligation under the option as a single transaction. The consideration for the option is regarded as part of the consideration for the sale. This

section determines the amount of the consideration for the grant of the option for the purposes of that section. It does so by reference to the carrying value of the option at the time the company became a party to the relevant debtor relationship. "Carrying value" is defined in section 702.

1806. The source legislation for this rule, paragraph 45J(5)(a) of Schedule 26 to FA 2002, refers to "the amount treated in accordance with section 94A(2) of the Finance Act 1996 as the carrying value of the option". That section makes no direct reference to the carrying value of any item. But paragraph 50A(3B) of Schedule 26 to FA 2002 refers to that section in the course of setting out what the carrying value of a contract is. That reference is rewritten in section 702, but in terms of section 585. It would be superfluous to add any such reference to the present section, so the words "in accordance with section 94A(2) of the Finance Act 1996" have not been rewritten here.

#### ***Section 654: Payment instead of disposal on exercise of deemed option***

1807. This section provides for a chargeable gain or allowable loss in the same circumstances as those applying in section 653, except that an amount is paid in fulfilment of the company's obligations under the debtor relationship (and there is no issue or transfer of shares). It is based on paragraphs 12(1) and (11B) and 45J(3), (6), (7), (8) and (9B) of Schedule 26 to FA 2002.
1808. In a number of circumstances it may suit one or other or both parties to a debtor relationship containing an option for the issue or transfer of shares not to go ahead when the option is exercised. Instead the matter is settled by a monetary payment. Such a cash settlement would fall foul of the limiting conditions in the definition of an "option" in section 580, so those conditions are disapplied for the purposes of the present section by section 652.
1809. There is a chargeable gain if the carrying value of the derivative contract at the time the company became a party to the debtor relationship exceeds the amount paid in fulfilment of the company's obligations under the debtor relationship. For this purpose that amount is first reduced, but not below nil, by the fair value of the host contract at the time the option is exercised. But if that amount (as so reduced) exceeds that carrying value, an allowable loss arises. The gain or loss, as the case may be, is the amount of the excess.

#### ***Section 655: Ceasing to be party to debtor relationship when deemed option not exercised***

1810. This section deems there to be an acquisition and disposal of an asset for the purposes of corporation tax on chargeable gains if a company ceases to be a party to a debtor relationship within section 652 at a time when the option has not been exercised. It is based on paragraphs 12(1) and (11B) and 45J(3), (8), (9), (9A) and (9B) of Schedule 26 to FA 2002.
1811. A company may cease to be a party to a debtor relationship by redeeming or repaying the liability in question or by some other means (such as assigning the rights and liabilities under the relationship).
1812. *Subsection (2)* treats the company as having acquired an asset for consideration equal to the amount paid to cease to be a party to the relationship. It also treats the company as having disposed of that asset for consideration equal to the carrying value of the relationship when acquired. But the carrying value is first reduced, as in respect of section 654, by the fair value of the host contract at the time the option was acquired. The deemed disposal may give rise to a chargeable gain or allowable loss.

***Section 656: Introduction to section 658***

1813. This section sets out the type of derivative contract it applies to (so that section 658 may then apply in respect of the contract). It is based on paragraphs 12(1) and (11A) and 45K(1) and (2) of Schedule 26 to FA 2002.
1814. *Subsection (3)(b)* provides that this section does not apply to a derivative contract that falls within section 652. The definition of “option” in section 580 is shorn for the purposes of that section of its usual limiting conditions (by virtue of which a cash-settled option is not an option). A contract which is an option under the modified definition is a contract for differences and would otherwise fall also within this section.
1815. The distinguishing characteristic of this section, condition C in *subsection (4)*, is that the derivative contract is an “exactly tracking contract”, as defined in section 657. That term has a similar meaning to that in section 648, as defined in section 649. But what is being tracked here is the amount regarded in accordance with generally accepted accounting practice as the proceeds of issue of the liability which represents the debtor relationship in this case. And, as this section deals with a debtor relationship (while section 648 deals with a creditor relationship), the period over which the tracking takes place is measured from the date the liability representing the debtor relationship begins to the date the corresponding creditor relationship ends.

***Section 657: Meaning of “exactly tracking contract” in section 656***

1816. This section defines “exactly tracking contract” for the purposes of section 656. It is based on paragraph 45K(2A), (2B) and (2C) of Schedule 26 to FA 2002.

***Section 658: Chargeable gain or allowable loss treated as accruing***

1817. This section provides for a chargeable gain or allowable loss to arise when a debtor relationship within section 656 comes to an end if an amount is paid to discharge a company’s obligations under that relationship. It is based on paragraphs 12(1) and (11B) and 45K(3), (3A) and (3B) of Schedule 26 to FA 2002.
1818. The gain or loss is calculated on the assumptions that:
- there is a disposal of an asset which is the contract for differences in section 656;
  - the cost of that asset is the amount paid to discharge the company’s obligations; and
  - the consideration for the disposal is the amount of the proceeds of the issue of the security representing the debtor relationship (or, if the company became a party to that relationship at a time after it was created, the carrying value of the host contract at that time).
1819. See the paragraph headed “disapplication of section 658” in Part 10 of Schedule 2 which applies if the liability representing the debtor relationship was owed by the company immediately before its first accounting period to begin on or after 1 January 2005.

***Section 659: Meaning of “relevant credits” and “relevant debits”***

1820. This section provides the meaning of “relevant credits” and “relevant debits” for the purposes of this Chapter. It is based on paragraphs 45A(3), 45G(2), (3) and (4), 45J(3) and 45K(3) of Schedule 26 to FA 2002.
1821. For all but one case the meaning is the same as that of credits and debits within section 595(3) and (4).
1822. The exception is the meaning of the terms in the case of a derivative contract to which section 650 (property based total return swaps) applies. For the purposes of section 641, as it applies to derivative contracts within section 650, the credits and debits found by

*These notes refer to the Corporation Tax Act 2009  
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section 595(3) and (4) are relevant credits and debits only to the extent they are also amounts found by applying the calculation formula in *subsection (4)*.

1823. **Section 650** applies to contracts for differences in which there is a specified “capital value index” (see the commentary on that section). Subsection (4) finds an amount of credits and debits by calculating the percentage change (“R%”) in the value of that index over the relevant accounting period (or part of that period, if the company is not a party to the contract throughout) and applying R% to the “notional principal amount”. That term is not defined but is used in relation to derivative contracts to describe the notional amount of capital by reference to which payments are due between the parties to the contract (see the reference to interest rates in condition D in section 650).
1824. The  $R\% \times N$  rule may give a credit but the accounts show a debit, or may give a larger credit (or debit) than the accounts credit (or debit). See the example in paragraph CFM13540a of HMRC’s Corporate Finance Manual.