

CORPORATION TAX ACT 2009

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 7: Derivative contracts

Overview

1489. This Part deals with profits and losses arising to a company from its derivative contracts. It is based on Schedule 26 to FA 2002.
1490. In most cases, the company's accounts treatment of its derivatives is followed in identifying and quantifying the credits and debits which make up profits and losses in respect of its derivative contracts for tax purposes.
1491. If the contract is held for the purposes of a company's trade, credits and debits arising from it are treated as receipts and expenses in calculating the profits of the trade under Part 3 of this Act. If it is not so held, the credits and debits are brought into account under Part 5 of this Act (loan relationships) in determining whether the company has non-trading profits or a non-trading deficit from its loan relationships. But, in a number of cases (primarily if the underlying subject matter of the derivative contract is land or shares), credits and debits are instead treated as giving rise to chargeable gains or allowable losses for the purposes of TCGA.
1492. There are similarities between many of the core rules for derivative contracts and those for loan relationships. The arrangement and drafting of the provisions for such common rules in Parts 5 and 6 and this Part is matched so far as appropriate. There are also rules for the interaction of the two regimes if a loan relationship includes a derivative contract (see section 700).
1493. Secondary legislation modifies the effect of these sections. See in particular the [Exchange Gains and Losses \(Bringing into Account Gains or Losses\) Regulations 2002 \(SI 2002/1970\)](#), as amended, the [Loan Relationships and Derivative Contracts \(Disregard and Bringing into Account of Profits and Losses\) Regulations 2004 \(SI 2004/3256\)](#), as amended, and the [Loan Relationships and Derivative Contracts \(Change of Accounting Practice\) Regulations 2004 \(SI 2004/3271\)](#), as amended. The modifications in secondary legislation have not been rewritten in these sections.
1494. The Part uses a number of defined terms. The more important are those in sections 576 to 583 (meaning of "derivative contract" and other basic definitions) in Chapter 2, section 596 (meaning of "related transaction") in Chapter 3 and sections 702 to 710 (other general definitions) in Chapter 13.
1495. [Part 10](#) of Schedule 2 contains a number of transitional rules affecting the application of this Part. The commentary draws attention where relevant to particular paragraphs. But see particularly the paragraphs headed "contracts which became derivative contracts on 16 March 2005", "contracts which became derivative contracts on 28 July 2005" and "plain vanilla contracts which became derivative contracts before 30 December 2006" which have more general effect.

Chapter 1: Introduction

Section 570: Overview of Part

1496. This section contains a brief description of the Part and includes a signpost to the key definition for the Part, that of “derivative contract”. It is new.

Section 571: General rule: profits chargeable as income

1497. This section provides that profits arising to a company from its derivative contracts are chargeable to corporation tax as income. It is based on paragraph 1(1) of Schedule 26 to FA 2002.

1498. Profits arising to a company from its derivative contracts are generally chargeable to corporation tax as income, even if they would otherwise be regarded as capital profits under accounting rules. But some such profits are charged instead to corporation tax as chargeable gains. *Subsection (2)* signposts this exception to the general rule.

1499. Profits are so chargeable “in accordance with this Part”. That is, this Part contains all the necessary rules for identifying and quantifying the amount to be charged to tax. These rules take priority over any rule that might otherwise apply. See in particular section 699 (priority of this Part for corporation tax purposes).

Section 572: Profits and losses to be calculated using credits and debits given by this Part

1500. This section sets out how profits and losses from derivative contracts are calculated. It is based on paragraph 14(1) of Schedule 26 to FA 2002.

1501. The terms “credit” and “debit” are used in accounting practice. The Part operates by reference to accounts drawn up in accordance with generally accepted accounting practice (see section 595 (general principles about the bringing into account of credits and debits)).

1502. Chapter 3 contains the main rules for finding the relevant credits and debits. *Subsection (2)* indicates that in some cases profits and losses are calculated using other factors (the sections in question all give rise to amounts to be charged to corporation tax as chargeable gains).

Section 573: Trading credits and debits to be brought into account under Part 3

1503. This section provides for the treatment of credits and debits if the company is a party to the derivative contract for the purposes of a trade it carries on. It is based on paragraph 14(2) and (4) of Schedule 26 to FA 2002.

1504. Credits and debits are treated respectively as receipts and expenses of the company’s trade. Profits and losses in respect of the derivative contract are therefore charged under Part 3 (trading income).

1505. The provisions referred to in *subsection (4)* are those that would otherwise prevent a debit being taken into account as an expense of the trade.

1506. The provisions referred to in *subsection (5)* disapply this section, either because the contract in question is taken outside the scope of this Part or because credits and debits are taken into account instead in computing chargeable gains.

Section 574: Non-trading credits and debits to be brought into account under Part 5

1507. This section provides for credits and debits to be brought into account under Part 5 (loan relationships) if section 573 does not apply to them. It is based on paragraph 14(3) of Schedule 26 to FA 2002.

1508. Credits and debits are treated as non-trading credits and non-trading debits for the purposes of Part 5 and lumped in with any non-trading credits and non-trading debits arising on the company's loan relationships to determine whether there is an amount to charge (or to relieve as a deficit) under that Part. Profits and losses in respect of such credits and debits arising from the derivative contract are therefore charged under Part 5.
1509. *Subsection (3)* has the same function for non-trading credits and debits as does section 573(5) for trading credits and debits. The paragraphs in Part 10 of Schedule 2 headed "existing assets representing creditor relationships: options", "existing assets representing creditor relationships: contracts for differences" and "disapplication of section 658" also disapply this section.

Chapter 2: Contracts to which this Part applies

Section 575: Overview of Chapter

1510. This section describes the purpose and content of the Chapter. It is new.

Section 576: "Derivative contract"

1511. This section sets out the conditions under which a contract of a company is a derivative contract. It is based on paragraph 2(1) of Schedule 26 to FA 2002.
1512. The first condition, that it is a "relevant contract" (defined in section 577), limits the application of the term "derivative contract" to contracts that derive their value from underlying subject matter (defined in section 583) which is subject to changes in market prices or other factors.
1513. The second condition, that it meets the "accounting conditions" in section 579, means that the contract either:
- is treated by the relevant accounting standards as a derivative or as a financial asset or liability; or
 - has underlying subject matter within certain categories.
1514. The third condition, that section 589 (contracts excluded because of underlying subject matter: general) or "any other provision of the Corporation Tax Acts" does not prevent it being a derivative contract, cuts down the scope of this Part, particularly in relation to contracts whose underlying subject matter is land or shares. Section 226(3) of FA 1994 (Lloyd's underwriters: relevant contract forming part of a premium trust fund not to be a derivative contract) is an example of such another provision.

Section 577: "Relevant contract"

1515. This section defines the term "relevant contract". It is based on paragraph 2(2) of Schedule 26 to FA 2002.
1516. In this Part, the term is used to refer generically to a contract within one of the three categories of contract listed here. In many contexts it is immaterial whether the relevant contract is an option, a future or a contract for differences.
1517. See also sections 584 to 586, under which some of the rights and liabilities under a contract are themselves *treated* as a relevant contract. The deemed relevant contract is a derivative contract if it meets the other conditions in section 576(1).

Section 578: Relevant contracts of a company and being party to such contracts

1518. This section explains what references in this Part to a company's relevant contracts, or to a company being a party to such a contract, mean. It is based on paragraphs 2(2A) and 53(1) and (2) of Schedule 26 to FA 2002.

1519. A relevant contract is “of” a company if that company has entered into or acquired the contract. A reference to a company being a party to a contract means the company has entered into or acquired the contract.
1520. *Subsection (2)* explains what “acquires” means in relation to a contract for the purposes of this Part. The words “whether by assignment or otherwise” in the source legislation have not been reproduced as they add nothing.

Section 579: The accounting conditions

1521. This section sets out the conditions mentioned in section 576(1)(b). It is based on paragraph 3 of Schedule 26 to FA 2002.
1522. Most derivative contracts meet the first of the conditions in *subsection (1)*, that the relevant contract is treated for accounting purposes as a derivative. *Subsections (3)* and *(5)* explain when a relevant contract is treated for accounting purposes as a derivative. Financial Reporting Standard 25 (“FRS 25”) deals with the presentation of financial instruments in accounts.
1523. The second condition has two legs. The first covers a contract that does not meet a particular requirement of Financial Reporting Standard 26 (measurement in accounts of financial instruments) (“FRS 26”) that must be satisfied if the contract in question is to be treated as a derivative under FRS 25. Paragraph 9(b) of FRS 26 prescribes that the “financial instrument or other contract within the scope of this Standard... requires no initial net investment or an initial net investment that is smaller than would be required for other types of contract that would be expected to have a similar response to changes in market factors”.
1524. The second leg of the second condition is that the contract is nevertheless treated for accounting purposes as a financial asset or financial liability. *Subsections (4)* and *(5)* have the same function in relation to the second condition as have subsections (3) and (5) in relation to the first condition.
1525. The third condition brings in contracts that fail the first or second condition but have underlying subject matter within one of the categories prescribed in *subsection (2)*. If the underlying subject matter is commodities, it does not matter what category of relevant contract the contract is. But only a contract for differences can meet the condition by reference to the other prescribed categories of underlying subject matter. So an option or future whose underlying subject matter is one or more of the categories in subsection (2) (b) is only a derivative contract if it meets one of the other accounting conditions.

Section 580: “Option”

1526. This section defines the term “option”. It is based on paragraph 12(1), (8) and (10) of Schedule 26 to FA 2002.
1527. Subject to the non-exhaustive definition in *subsection (1)* and the limitation in *subsection (2)* (itself limited by *subsection (3)*), the word takes its ordinary meaning. “Warrant”, in subsection (1), is defined in section 710 (other definitions).
1528. The limitation in subsection (2) excludes cash-settled options from the meaning of “option”. Contracts so excluded fall within the definition of contracts for differences and are therefore subject to the rules applying to relevant contracts generally and those applying specifically to contracts for differences.
1529. *Subsection (4)* lists a number of provisions that dispense with this limitation and so do not exclude cash-settled options from the meaning of “option” in that context.

Section 581: “Future”

1530. This section defines the term “future”. It is based on paragraph 12(1), (6), (7) and (10) of Schedule 26 to FA 2002.
1531. *Subsections (3) and (4)* exclude cash-settled futures from the scope of the definition in the same way that section 580(2) and (3) does for cash-settled options in relation to the definition of “option”. Contracts so excluded also fall within the definition of contracts for differences.

Section 582: “Contract for differences”

1532. This section defines the term “contract for differences”. It is based on paragraph 12(1), (3), (4) and (5) of Schedule 26 to FA 2002.
1533. This is the broadest category of relevant contract and the definition is expressed initially in wide-ranging terms. *Subsection (2)* therefore excludes a number of categories of contract from the scope of the definition, in particular an option and a future, but also a loan relationship and a number of other types of financial instrument. Section 710 has definitions of “contract of insurance” and “capital redemption policy”. For the meaning of “loan relationship”, see section 302.
1534. *Subsection (3)* emphasises the wide-ranging nature of the indices or factors that may be designated in a contract for differences. The words in the source legislation “and, for those purposes, a numerical value may be attributed to any variation in a matter”, have not been rewritten as they add nothing. It is of the essence of any index or factor used in a contract for differences that it has such a numerical value.

Section 583: “Underlying subject matter”

1535. This section defines the term “underlying subject matter” for each category of relevant contract. It is based on paragraph 11 of Schedule 26 to FA 2002.
1536. *Subsection (5)* echoes section 579(2)(b) in explaining that certain factors may be the underlying subject matter of a contract for differences. One of those factors is interest rates. *Subsection (6)* provides that interest rates are not regarded as the underlying subject matter of a contract for differences if such rates are only used incidentally in determining the variable amount of a payment due under the contract at a variable date. That is, in such a case an interest rate or rates are a factor in the operation of the contract but are not themselves what its outcome depends on.
1537. *Subsection (7)* applies to all categories of relevant contract. It stops certain types of property from being regarded as the underlying subject matter of the contract just because *income* from that property is included in that underlying subject matter. Contracts to which this provision applies are therefore, as regards this aspect of their underlying subject matter, not excluded as derivative contracts under section 589.

Sections 584 to 586: Cases where companies treated as parties to relevant contracts

Overview

1538. These three sections treat certain rights and liabilities under a contract (an “embedded derivative”) as themselves constituting a relevant contract independent of the remaining rights and liabilities under the main contract. The deemed relevant contract is a derivative contract if it meets the conditions in section 576(1)(b) and (c).
1539. All three cases cater for the provision in accounting standards for a financial or other instrument to be treated as divided between:
- the rights and liabilities that constitute one or more derivatives or one or more derivative financial instruments or equity instruments; and

- the remaining rights and liabilities under the instrument.
1540. All three cases provide for the deemed relevant contract to be treated as an option, future or contract for differences if that is what a contract having only the rights and liabilities of the deemed relevant contract would be. So references in this Part to an option, future or contract for differences include a reference to the deemed relevant contract unless the context requires otherwise. And provisions dealing with a “relevant contract” or “derivative contract” apply to an embedded derivative that is treated as a relevant contract or qualifies as a derivative contract unless the context requires otherwise.
1541. A number of provisions in this Part make special provision for one or other category of embedded derivative (see in particular Chapters 7 and 8 (chargeable gains arising in relation to derivative contracts)).

Section 584: Hybrid derivatives with embedded derivatives

1542. This section treats a relevant contract divided in accordance with generally accepted accounting practice between one or more embedded derivatives and a host contract as a number of relevant contracts for the purposes of this Part. It is based on paragraph 2B of Schedule 26 to FA 2002.
1543. It applies if a relevant contract that is not itself a derivative for accounting purposes is so divided into one or more embedded derivatives and the remaining rights and liabilities (“the host contract”) which by themselves amount to a relevant contract.
1544. The host contract is also treated as a relevant contract with the same consequences as for the embedded derivative (in this respect, this section differs from its two successors).
1545. A relevant contract which may be treated as containing such deemed relevant contracts is called a “hybrid derivative” (*subsection (4)*). *Subsection (5)* lists the provisions which apply in relation to a hybrid derivative.

Section 585: Loan relationships with embedded derivatives

1546. This section treats the embedded derivative or embedded derivatives in a company’s loan relationship as relevant contracts. It is based on section 94A of FA 1996.
1547. It applies if a loan relationship is treated under generally accepted accounting practice as divided between rights and liabilities under one or more derivative financial instruments or equity instruments (the embedded derivative(s)) and the remaining rights and liabilities which by themselves constitute a loan relationship.
1548. For the meaning of “equity instrument”, see section 710 (that is, it has the meaning it has for accounting purposes). It is defined in paragraph 11 of International Accounting Standard 32 as follows: “an equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities”.
1549. *Subsection (4)* is a signpost to section 415 in Part 5 (loan relationships) which deals with the remaining rights and liabilities which by themselves constitute a loan relationship.
1550. *Subsection (5)* includes a signpost to section 416 which provides for a company to elect that certain of its loan relationships shall be split as mentioned in section 415 and this section, if they would not be so split under the accounting practice the company uses.

Section 586: Other contracts with embedded derivatives

1551. This section provides for the embedded derivative or embedded derivatives in a contract that is neither a hybrid derivative nor a loan relationship to be treated as relevant contracts. It is based on paragraph 2A of Schedule 26 to FA 2002.

1552. It applies if such a contract is divided under generally accepted accounting practice between one or more embedded derivatives and the remaining rights and liabilities under the contract.
1553. *Subsection (2)(a)* is written in terms of the rights and liabilities of the embedded derivative rather than, as in the source legislation, simply referring to the embedded derivative. This aligns the rule here with the expression of the similar rule in the preceding two sections.
1554. The source legislation for subsection (2)(b) refers at the equivalent point to a contract “whose rights and liabilities consist only of one of the *non-financial* embedded derivatives”. “Non-financial” is part of the label “non-financial embedded derivative” in paragraph 2A of Schedule 26 to FA 2002, which applies to the relevant contract to which the company is deemed to be a party under this provision. It is not appropriate to the embedded derivative itself by virtue of which the company is treated as a party to a relevant contract. That is, the embedded derivative has first to be identified before there is a deemed relevant contract to which such a label can be applied. “Non-financial” has therefore not been rewritten in subsection (2)(b).

Section 587: Contract relating to holding in OEIC, unit trust or offshore fund

1555. This section treats as a derivative contract a relevant contract that is not otherwise such a contract if its underlying subject matter consists wholly or partly of a holding in a collective investment scheme and that scheme fails to meet a “qualifying investments test”. It is based on paragraph 36(1), (2), (3) and (4) of Schedule 26 to FA 2002.
1556. A number of the contracts to which this section would appear to apply are in fact already derivative contracts because their underlying subject matter does not qualify as “excluded property” under section 589. This section therefore sweeps up any relevant contract that fails to meet the conditions for a derivative contract despite its underlying subject matter consisting wholly or partly of a “relevant holding”.
1557. The words “but for this section”, at the end of paragraph (a) in *subsection (1)*, avoid conflict between the effect of the section (the contract is a derivative contract) and the condition for the section to apply (the contract is not a derivative contract).
1558. If *subsection (2)* applies to treat the relevant contract as a derivative contract in a particular accounting period, that treatment persists for so long as the contract is a relevant contract of the company (even if the circumstances that first led to it being treated as a derivative contract no longer apply).
1559. *Subsection (3)* describes what a “relevant holding” is for the purposes of the section. It is drafted in terms of the underlying subject matter of the contract rather than, as in the source legislation, referring to a relevant holding of a “person”. This corrects a misfiring of the provision that arose from adapting a similar provision for loan relationships (see paragraph 4(1) of Schedule 10 to FA 1996, rewritten in section 490 of this Act). See *Change 63* in Annex 1. (This Change also applies to section 601; see the signpost to that section in *subsection (6)*.)
1560. The meaning of “material interest in an offshore fund” in subsection (3)(a)(iii) is provided by reference to Chapter 3 of Part 6 of this Act, where the definition is based on paragraph 7 of Schedule 10 to FA 1996, to which the source legislation for this section refers. But that definition pleads into the meaning given to “offshore fund” in section 489(1), which is slightly wider in scope than that given in section 756A of ICTA. See *Change 60* in Annex 1.
1561. *Subsection (5)* refers to the power to amend the definition of “relevant holding”, by regulations under section 17 of F(No 2)A 2005, in relation to the source legislation for both this section and its loan relationships equivalent (section 490 in Part 5). The power has not yet been exercised.

1562. The provisions mentioned in *subsections (6) and (7)* are those that deal specifically with contracts to which this section applies. But a contract treated as a derivative contract by this section is subject to other provisions that operate on derivative contracts so far as the context permits.

Section 588: Associated transaction treated as derivative contract

1563. This section treats an “associated transaction” in respect of shares held by an “investing company” as either a derivative contract or a transaction in respect of a derivative contract, if it would not already be such a contract or transaction. It is based on section 91B(5) of FA 1996.
1564. If the section does so, credits and debits arising from the associated transaction are then brought into account under this Part under section 603.
1565. Chapter 7 of Part 6 (shares with guaranteed returns etc) deals with certain shares which in substance are equivalent to loan relationships. It provides that the same consequences follow for tax purposes as if the company’s holding of shares were a loan relationship.
1566. **Section 523** (which is also based on section 91B of FA 1996) applies to “non-qualifying shares”. A share is “non-qualifying” if one of various conditions is met. One of those conditions (see section 532) is that there is a scheme or arrangement under which the share and “one or more associated transactions” are designed to equate to an investment yielding a commercial rate of interest. An “associated transaction” is one of entering into, or acquiring rights and liabilities under, a derivative contract or contracts having some similarity to a derivative contract or a contract of insurance or indemnity.
1567. *Subsection (4)* applies if there is such an associated transaction (the “associated transactions condition”).

Section 589: Contracts excluded because of underlying subject matter: general

1568. This section, supplemented by the next four, provides that a relevant contract is not a derivative contract if its underlying subject matter falls wholly into certain categories (or is treated as doing so) and one or more conditions applies. It is based on paragraph 4(1), (2), (2ZA) and (4) of Schedule 26 to FA 2002.
1569. Profits and losses arising in relation to such contracts are therefore not brought into account under this Part but are taxed as appropriate under other provisions, primarily as chargeable gains.
1570. *Subsection (1)* introduces the term “excluded property” to describe underlying subject matter that causes the relevant contract not to be a derivative contract. *Subsection (2)*, supplemented by *subsections (3) to (6)* defines the term, with further detail appearing in sections 590 to 592.
1571. Intangible fixed assets are excluded property, but only in the case of an option or future. Profits and losses in respect of such a contract are dealt with primarily under Part 8.
1572. The major categories of excluded property, in relation to any type of relevant contract, are (a) shares in a company and (b) rights of a unit holder under a unit trust scheme. But in such cases the relevant contract must both satisfy one of the conditions in section 591 and not have the characteristics of a commercial investment.
1573. *Subsection (3)* takes certain types of share out of the excluded category. These are:
- shares dealt with by Chapter 7 of Part 6 (shares with guaranteed returns etc); and
 - shares in an open-ended investment company if that company fails to meet the qualifying investments test for the purposes of the loan relationships provisions.
1574. For more on the qualifying investments test, see the commentary on section 587.

Section 590: Disregard of subordinate or small value underlying subject matter

1575. This section provides that the parts of a relevant contract's underlying subject matter that are subordinate or of small value are ignored in determining for the purposes of section 589 whether its underlying subject matter consists wholly of excluded property. It is based on paragraph 9 of Schedule 26 to FA 2002.
1576. A relevant contract may contain a number of minor elements in addition to its main purpose. For example, there may also be an option to settle the contract in one or more currencies by reference to a particular exchange rate or there may be some minor leeway as to the settlement date.
1577. *Subsection (3)* provides that any question of whether part of the underlying subject matter is "subordinate" or of "small value" is determined by reference to the time the company enters into or acquires the contract. But the section does not otherwise provide any definition of "subordinate" or "small value". Paragraph CFM13120 of HMRC's Corporate Finance Manual (and the examples in CFM13120a) provides guidance.
1578. See also section 593 which deals with the case of an option or future where the part of the underlying subject matter that is not excluded property is neither subordinate nor of small value.

Section 591: Conditions A to E mentioned in section 589(5)

1579. This section provides the conditions mentioned in section 589(5)(a) which govern whether shares in a company or rights of a unit holder under a unit trust scheme are excluded property under that section. It is based on paragraphs 4(2A) to (2D) and 12(1) and (11A) of Schedule 26 to FA 2002.
1580. Condition A applies to certain relevant contracts entered into or acquired by life insurers that are an "approved derivative" within the meaning of Rule 3.2.5 of the Insurance Prudential Sourcebook issued by the Financial Services Authority on 25 October 2006 or, in the case of an overseas life insurance company which is a European Economic Area firm or a "treaty firm", are derivative instruments falling within article 23.3 of the EC Consolidated Life Directive (EC/2002/83).
1581. Rule 3.2.5 of the Insurance Prudential Sourcebook sets out a number of conditions to do with the purposes for which the derivative is held, how the risk under the derivative is managed and the circumstances in which it is entered into or acquired. See the definition of "Insurance Prudential Sourcebook" in section 431(2) of ICTA.
1582. Condition A does not apply to a relevant contract that meets the condition in section 579(1)(b) (one that is treated by accounting standards as a financial asset or liability, but is not treated as a derivative by accounting standards because of the size of the initial outlay).
1583. The source legislation for condition A applies only to cases where the contract is "entered into" by the company. But the source legislation for conditions B to D in this section applies if the company enters into *or acquires* the contract. This condition has been brought into line with those conditions. See *Change 64* in Annex 1.
1584. See also section 592 which extends the application of condition A to certain rights and liabilities that are treated as a relevant contract by section 584.
1585. Condition B applies if the company is not a party to the relevant contract for the purposes of its trade and there is a "hedging relationship" (defined in section 707) between the relevant contract and either (a) shares or rights of a unit holder in a unit trust scheme or (b) the company's share capital or related liability.
1586. Condition B does not apply if the relevant contract is one treated as such by section 585 (that is, it is an embedded derivative in a loan relationship).

1587. Condition C applies if the company is not a party to the relevant contract for the purposes of its trade and the contract is a quoted option to subscribe for shares.
1588. Condition D deals with a relevant contract that relates to the acquisition by company A of a major investment in the share capital of company B other than for the purposes of core activities of company A's trade. The reference to "activities forming an integral part of a trade" ensures that the condition is not disappplied in the case of, say, a financial trader. For a financial trader, the particular contract may be relevant to its structural assets, which might be regarded as held in the course of its trade, but may not actually be relevant to its core trading activities. The contract must be an option or future for the acquisition or delivery of shares. As with condition B, condition D does not apply if the relevant contract is one treated as such by section 585.
1589. Condition E applies if there is a hedging relationship between the relevant contract and an asset or liability representing a loan relationship to which section 585 applies. The second leg of condition E is that each of the relevant contracts to which the company is treated as a party under that section is a derivative contract to which one of the provisions specified in paragraph (b) of *subsection (6)* applies. Under the provisions listed in *subsection (7)*, credits and debits are brought into account in calculating chargeable gains rather than as income. Part 10 of Schedule 2 extends that list in respect of certain rules in that Part.
1590. The section does not rewrite those parts of paragraph 4(2B)(a), (2C)(a) and (2CA) (a) of Schedule 26 to FA 2002 that refer to the trading activities of an insurance company or mutual trading company. They are redundant following changes in the source legislation for sections 633 and 634.

Section 592: Embedded derivatives treated as meeting condition in section 591 etc

1591. This section extends the ability to satisfy one of the conditions in section 591 to certain embedded derivatives within the meaning of section 584. It is based on paragraphs 2B(3), 45M and 54(1) of Schedule 26 to FA 2002.
1592. If this section applies, the underlying subject matter of the embedded derivative may satisfy the definition of "excluded property" in section 589(2). The embedded derivative may thereby not be a derivative contract for the purposes of this Part.
1593. The section applies only if the "hybrid derivative" (within the meaning of section 584) is a relevant contract within section 579(1)(b). That is one that is not treated as a derivative by accounting standards because of the size of the initial outlay (for example, a prepaid equity forward) but is treated as a financial asset or liability. Also, the "host contract" (*subsection (5)*) must be treated for accounting purposes as (or as part of) a financial asset.
1594. The embedded derivative must itself satisfy section 579(1)(a) (a relevant contract that is treated for accounting purposes as a derivative). And its underlying subject matter must be wholly shares in a company or rights of a unit holder in a unit trust scheme. *Subsection (4)* indicates that section 590 applies if appropriate to determine whether the "wholly" test in paragraph (c) of *subsection (1)* is met.
1595. If the section applies, the embedded derivative is treated as satisfying one of the conditions in section 591, and therefore meets one element of the meaning of "excluded property" in section 589(2). In the source legislation the embedded derivative is treated as meeting condition A in section 591 because this rule is expected to be relevant primarily (although not exclusively) to insurance companies (and condition A specifically applies to such companies). But it is sufficient to deem the embedded derivative to meet any one of the conditions in section 591 for the purposes of section 589(2).
1596. The section does two more things. First, it treats the embedded derivative (which in all likelihood is not now a derivative contract, because of section 589) as a "chargeable

asset” for the purposes of this Part and TCGA. See the definition of that term in section 703.

1597. Second, the host contract is treated as a “creditor relationship” of the company for the purposes of the Corporation Tax Acts. That primarily affects the operation of Parts 5 and 6 (loan relationships). But it also affects those sections in this Part that operate by reference to a creditor relationship (for example, section 631(4)). See the definition of “creditor relationship” in section 704.

Section 593: Contracts where part of underlying subject matter is excluded property

1598. This section provides for an option or future to be treated in certain cases as divided between a relevant contract whose underlying subject matter consists wholly of excluded property within the meaning of section 589 and one whose underlying subject matter consists wholly of other underlying subject matter. It is based on paragraph 46 of Schedule 26 to FA 2002.

1599. See the commentary on section 589 for the significance of the underlying subject matter of a contract being or not being “excluded property”.

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

Section 594: Overview of Chapter

1600. This section describes the purpose and content of the Chapter. It is new.
1601. The Chapter provides in particular for the application of generally accepted accounting practice in determining the profits and losses to be brought into account under this Part. In some cases, it provides for departure from generally accepted accounting practice for that purpose. Chapter 4 contains provisions about credits and debits for a number of special situations.

Section 595: General principles about the bringing into account of credits and debits

1602. This section specifies for the identification of the credits and debits to be brought into account under this Part. It is based on paragraphs 15(1), (4) and (9) and 17A(1) of Schedule 26 to FA 2002.
1603. *Subsections (1) and (2)* make general statements on the part played by accounts prepared in accordance with generally accepted accounting practice in identifying credits and debits for the purposes of this Part. “Generally accepted accounting practice” is defined by section 832(1) of ICTA by reference to section 50(1) of FA 2004. If a company prepares accounts in accordance with international accounting standards, those standards constitute generally accepted accounting practice. Otherwise UK generally accepted accounting practice applies.
1604. The general statement in subsection (2) refers to credits and debits which are amounts “recognised in determining the company’s profit or loss” for the period. For the meaning of “recognised” in this context, see section 597.
1605. But that statement is qualified by the more specific rule in *subsection (3)* that those credits and debits must “fairly represent” profits, losses and expenses that arise in respect of the derivative contract or arise from certain transactions in respect of the contract (labelled “related transactions”).
1606. There is a further significant rule in *subsection (7)* that makes both the general statement in subsection (2) and the rule in subsection (3) subject to the qualifying effect of “the following provisions of this Part”.

Section 596: Meaning of “related transaction”

1607. This section provides the meaning of “related transaction” for the purposes of this Part. It is based on paragraph 15(7) and (8) of Schedule 26 to FA 2002.
1608. The term is used extensively in this Part in provisions which may apply to or involve consideration of the acquisition or disposal of a derivative contract.

Section 597: Amounts recognised in determining a company’s profit or loss

1609. This section explains what “an amount recognised in determining a company’s profit and loss” means. It is based on paragraph 17B of Schedule 26 to FA 2002.
1610. The various statements listed in paragraphs (a) and (b) of *subsection (1)* are those mentioned in UK generally accepted accounting practice or international accounting standards. But subsection (1)(c) caters for amounts recognised in any accounting statement not among those listed.
1611. The statements listed in paragraphs (a) and (b) of subsection (1) include a “statement of comprehensive income”, “statement of recognised income and expense” and “statement of income and retained earnings”. These statements are not mentioned in the source legislation but are the equivalents in more recently applying accounting standards of the statements listed there.
1612. So far as the terms in those paragraphs derive from accounting standards, they are defined in section 710 as having the meaning they have for accounting purposes.
1613. *Subsection (2)* brings in prior period adjustments for this purpose but *subsection (3)* excludes amounts recognised “by way of correction of a fundamental error”. Such amounts are brought into account in the prior period affected by the error (so that the amounts so brought into account “fairly represent” profits and losses etc in respect of the contract in that period).
1614. See also sections 613 to 615 for the treatment of adjustments shown in accounts on a change of accounting policy.

Section 598: Regulations about recognised amounts

1615. This section provides powers for regulations that amend the amounts regarded as “recognised” in one or other of the various statements mentioned in section 597(1). It is based on paragraph 17C of Schedule 26 to FA 2002 and paragraph 52 of Schedule 4 to FA 2005.
1616. For regulations made under this power, see the [Loan Relationships and Derivative Contracts \(Disregard and Bringing into Account of Profits and Losses\) Regulations 2004 \(SI 2004/3256\)](#), as amended, and the [Loan Relationships and Derivative Contracts \(Change of Accounting Practice\) Regulations 2004 \(SI 2004/3271\)](#), as amended.

Section 599: Meaning of “amounts recognised for accounting purposes”

1617. This section defines “amounts recognised for accounting purposes” by reference to the case of a company that has not prepared accounts in accordance with generally accepted accounting practice. It is based on paragraph 17A(2), (3) and (4) of Schedule 26 to FA 2002.
1618. This section is particularly relevant to the application of section 595 and the interpretative provision in section 597.
1619. See the commentary on section 595(2) for the relevance of “generally accepted accounting practice”. Unless a company uses international accounting standards for a period, the default meaning of “generally accepted accounting practice” is UK generally accepted accounting practice (see section 50(1) of FA 2004). When this section applies,

it therefore uses UK generally accepted accounting practice (as defined in section 50(4) of FA 2004).

Section 600: Contract which is or forms part of financial asset or liability

1620. This section provides that fair value accounting is used in the case of certain contracts for the purposes of the general rule in section 595(2). It is based on paragraph 17A(1A) of Schedule 26 to FA 2002.
1621. The contracts to which this section applies are those that are not treated as a derivative for accounting purposes because they fail the requirement of the relevant accounting standard as regards the initial net investment required by the contract but are nevertheless treated as a financial asset or liability. See the commentary for section 579.

Section 601: Contract relating to holding in OEIC, unit trust or offshore fund

1622. This section applies fair value accounting in determining the credits and debits to be brought into account in respect of a contract that is treated as a derivative contract because of section 587. It is based on paragraph 36(1) and (2A) of Schedule 26 to FA 2002.
1623. **Section 587** applies if the underlying subject matter of a contract includes a holding in a collective investment scheme that fails to meet a “qualifying investments” test. Because this section operates by reference to section 587, *Change 63* in Annex 1 (reference to a “relevant holding” is to a holding which is the underlying subject matter of the contract rather than a holding of the company which is a party to the contract) applies here as well.

Section 602: Contract becoming one relating to holding in OEIC, unit trust or offshore fund

1624. This section determines the opening valuation of a derivative contract for the purposes of section 601. It is based on paragraph 37(1), (2), (3), and (4) of Schedule 26 to FA 2002.
1625. The accounting period to which this section applies is that in which a relevant contract is treated as a derivative contract because of section 587 if that period immediately follows another in which it was not so treated. The section applies only if the relevant contract was a “chargeable asset” (defined in section 703) at the end of the earlier period.
1626. For the meaning of “market value” for the purposes of corporation tax on chargeable gains, see in particular section 272 of TCGA.

Section 603: Associated transaction treated as derivative contract

1627. This section applies fair value accounting in determining the credits and debits to be brought into account by virtue of section 588 in respect of an “associated transaction” that is treated as a derivative contract because of that section. It is based on section 91B(5) of FA 1996.
1628. For the circumstances in which section 588 applies and for the meaning of “associated transaction”, see the commentary on that section.
1629. *Subsection (1)* provides that this section must be construed as if it were part of Chapter 7 in Part 6 (shares with guaranteed returns etc). That Chapter rewrites sections 91A to 91G of FA 1996.

Section 604: Credits and debits treated as relating to capital expenditure

1630. This section brings a credit or debit that is treated in the accounts as part of a fixed capital asset or project into account under this Part in the same way as a credit or debit

that is brought into account in determining the company's profit or loss. It is based on paragraph 25 of Schedule 26 to FA 2002.

1631. Generally accepted accounting practice may permit a credit or debit of an income nature to be included in the value of a fixed capital asset or project. If this happens, the credit or debit bypasses the statements mentioned in section 597. This section overrides that treatment, except in the cases mentioned in *subsections (3) and (5)*.
1632. Subsection (5) prevents any debit being taken into account under this Part that writes down the value of the asset or project in question, or creates a reserve for amortisation or depreciation of that asset or project, so far as the write down etc is attributable to a debit brought into account under this section. As this section overrides the accounts treatment of the capitalised debit, this rule in this subsection prevents a double deduction should the asset or project be written down, or a reserve created for its amortisation or depreciation, whether in the same or a later period, if the amount taken to profit and loss is attributable to the amount brought into account under this section.
1633. The source legislation for subsection (5) refers to "so much of any amortisation or depreciation as represents *a writing off of the interest component of the asset*". The rule is identical to that in the equivalent rule for loan relationships (section 320(6)). But the "interest component" of the asset refers to something that is dealt with by the loan relationships provisions and has no relevance to the derivative contracts provisions. The emphasised words have therefore not been reproduced in this section. See *Change 65* in Annex 1.

Section 605: Credits and debits recognised in equity

1634. This section brings a credit or debit that is recognised in equity or shareholders' funds, rather than in one of the statements mentioned in section 597(1), into account for the purposes of this Part in the same way as a credit or debit that is brought into account in determining the company's profit or loss. It is based on paragraph 25A of Schedule 26 to FA 2002.
1635. As in the case of section 604, this section overrides the accounts treatment.

Section 606: Exchange gains and losses

1636. This section provides that exchange gains and losses arising from a derivative contract are included in the profits and losses mentioned in section 595(3). It is based on paragraph 16 of Schedule 26 to FA 2002.
1637. *Subsection (1)* does not rewrite the words "and related transactions" in paragraph 16(1) of Schedule 26 to FA 2002. They are not considered to add to the effect of this provision.
1638. *Subsection (3)* excludes exchange gains and losses arising in two circumstances from the basic rule in subsection (1) if those gains and losses are recognised in the company's "statement of total recognised gains and losses", "statement of recognised income and expense", "statement of changes in equity" or "statement of income and retained earnings". Those terms are defined in section 710 as having the meaning they have for accounting purposes. Some are taken from UK generally accepted accounting practice and the others from international accounting standards, but are otherwise equivalent terms. This subsection is subject to the effect of any regulations made under the power in *subsection (5)*.
1639. The section contains two regulatory powers. The first is in *subsection (4)*. It concerns exchange gains and losses from a derivative contract whose underlying subject matter is wholly or partly currency. Regulations may exclude such gains from the scope of subsection (1). For regulations made under this power, see the [Loan Relationships and Derivative Contracts \(Disregard and Bringing into Account of Profits and Losses\) Regulations 2004 \(SI 2004/3256\)](#), as amended.

1640. The second is in subsection (5). Regulations may countermand the effect of the rule in subsection (3) or of regulations made under subsection (4). Where the regulations apply, the affected amounts are brought into account under this Part as credits or debits arising from a company's derivative contracts or for the purposes of corporation tax on chargeable gains. (The [Exchange Gains and Losses \(Bringing into Account Gains or Losses\) Regulations 2002 \(SI 2002/1970\)](#), as amended, are made partly under the power rewritten in subsection (5). But, as amended by regulation 5 of [SI 2005/2013](#), [SI 2002/1970](#) now has no direct impact on the source legislation for this section.)
1641. The source legislation for this section was repealed by paragraph 9 of Schedule 6 to F(No 2)A 2005, subject to the making of an order for the repeal to have effect. That prospective repeal is preserved by the paragraph "repeal of provisions concerning exchange gains and losses from derivative contracts" in Part 10 of Schedule 2.

Section 607: Pre-contract or abortive expenses

1642. This section adds pre-contract and abortive expenses to the expenses that are taken into account under section 595(3) in determining a company's profits and losses under this Part. It is based on paragraph 15(5) of Schedule 26 to FA 2002.

Section 608: Company ceasing to be party to derivative contract

1643. This section brings into account amounts recognised in accounts in respect of a derivative contract after the accounting period in which the company ceases to be a party to that contract. It is based on paragraph 53(3), (4), (5) and (6) of Schedule 26 to FA 2002.
1644. The accounting policies of a company may treat part of the profit or loss in respect of a contract as deferred income or loss to be brought into account in accounting periods later than that in which the company ceased to be a party to the contract. This section identifies amounts to be treated as credits and debits in subsequent periods until all the deferred income or loss has been brought into account under this Part.
1645. *Subsections (3) to (6)* set out how certain conditions in this Part may be treated as satisfied in respect of the former derivative contract. Those are conditions that may need to be satisfied for a particular provision to apply in respect of post-cessation credits or debits. For examples of the conditions to which subsection (3) or (5) may apply, see sections 573 and 690.
1646. *Subsection (7)* makes clear that the deeming effect of subsections (3) to (6) carries through for any question of what a company's derivative contracts are or whether a company is a party to a derivative contract (see section 578).

Section 609: Company ceasing to be UK resident

1647. This section and the next apply if a derivative contract moves out of the scope of corporation tax because the company holding it is no longer within the charge to tax in respect of it. This section treats a company as making a deemed disposal and reacquisition of the contract at its fair value immediately before the company ceases to be UK resident. It is based on paragraph 22A(1), (2) and (3) of Schedule 26 to FA 2002.
1648. "Fair value" is defined in section 710.
1649. *Subsection (1)* provides that the company is treated for the purposes of this Part as reacquiring the derivative contract for the same amount. This deemed value will be taken into account should the derivative contract re-enter the scope of corporation tax because of a further change in the residence status of the company or otherwise.
1650. *Subsection (2)* has an exception to the general rule. This applies if a company moves abroad but leaves behind such a business operation as amounts to a permanent establishment and that operation includes at least some of the rights and liabilities under

the derivative contract. In effect, the contract has not left the scope of corporation tax. (“Permanent establishment” is defined in section 832(1) of ICTA by reference to the meaning provided by section 148 of FA 2003.)

1651. *Subsection (3)* provides an order of priority if this section would apply in relation to the same circumstances as trigger section 631 or 632. There is an equivalent order of priority in section 333 in Part 5. There is no reason for the two sets of provisions to differ in this respect. This subsection brings the provisions for loan relationships and derivative contracts into line. See *Change 66* in Annex 1.

Section 610: Non-UK resident company ceasing to hold derivative contract for UK permanent establishment

1652. This section treats a non-UK resident company as making a deemed disposal and reacquisition of a derivative contract at its fair value if and to the extent that some or all of the rights or liabilities under a contract held or owed for the purposes of a permanent establishment of that company cease to be so held or owed. The section is based on paragraph 22A(1) and (4) of Schedule 26 to FA 2002.
1653. The circumstances in which this section applies include where the contract is now held for the purposes of another part of the company’s business (which is not a permanent establishment) or where the permanent establishment ceases to be such. In those cases the derivative contract has left the scope of corporation tax.
1654. A significant difference between the conditions for the application of this section and those for the preceding section is that this section does not apply if the rights and liabilities under the contract cease to be held or owed for the purposes of the permanent establishment because of a “related transaction” (defined in section 596). That is, it does not apply when the contract ceases to be held because it is disposed of. That disposal is itself an occasion leading to amounts being brought into account under this Part.
1655. *Subsection (3)* introduces the same priority rule as is introduced in the preceding section. See again *Change 66* in Annex 1.

Section 611: Release under statutory insolvency arrangement of liability under derivative contract

1656. This section exempts from the scope of this Part any credit arising on the release of a company’s liability to pay an amount under a derivative contract, if the release is part of a statutory insolvency arrangement. It is based on paragraph 22(5) of Schedule 26 to FA 2002.
1657. A “statutory insolvency arrangement” is defined in section 834(1) of ICTA by reference to the Insolvency Act 1986 and other provisions having a similar effect.

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

Section 612: Overview of Chapter

1658. This section describes the purpose and content of the Chapter. It is new.

Section 613: Introduction to sections 614 and 615

1659. This section sets out when sections 614 and 615 apply. It is based on paragraph 50A(1) and (1A) of Schedule 26 to FA 2002 and paragraph 7(6) of Schedule 6 to F(No 2)A 2005.
1660. A company may decide to apply a different set of standards to the presentation of the company’s results. Regulatory rules may also require that a company switches to a different set of standards. If there is such a change of accounting policy, the value of

the company's assets and liabilities at the start of the first period of account to which the change applies are restated in accordance with the standards adopted.

1661. This section applies only if the change is from an accounting policy that "accords with the law and practice applicable" in relation to the earlier period to another such policy in relation to the next. The law and practice in question is that provided in particular by the Companies Acts and the Accounting Standards Board (or their equivalents in its country of residence if the company is non-UK resident but within the charge to corporation tax in respect of a derivative contract).
1662. **Sections 614 and 615** prescribe the credit or debit to be brought into account on a change of accounting policy, according to whether the value of the company's assets and liabilities increases or decreases on the change.
1663. *Subsection (4)* treats a particular situation as a change of accounting policy although there is no change in the actual accounting policy used by the company from one period to the next. International accounting standards and new UK generally accepted accounting practice require a company, in certain circumstances, to divide a loan relationship between rights and liabilities under a loan relationship and rights and liabilities under one or more derivative financial instruments or equity instruments (see section 585(1)).
1664. **Section 416** allows a company subject to old UK generally accepted accounting practice (which does not permit it to divide a loan relationship in that way) to elect that a loan relationship is treated as divided as mentioned in section 415(1) (the equivalent for loan relationships of section 585(1)), if division would be permitted under new UK generally accepted accounting practice or international accounting standards. Section 416 applies an election made under it for the purposes of this Part as well as for Part 5.
1665. The result of such an election is a change in accounting policy for the purposes of sections 614 and 615, but only in relation to all the derivative financial instruments or equity instruments in the company's affected loan relationships. This rule applies from the date the election has effect. Broadly, the election has effect from the beginning of the period of account in which the first loan relationship is acquired to which an election can apply.

Section 614: Change of accounting policy involving change of value

1666. This section treats the increase or decrease in the carrying value of a derivative contract on a change of accounting policy as a credit or debit to be brought into account in the later period. It is based on paragraph 50A(2), (3) and (5) of Schedule 26 to FA 2002.
1667. "Carrying value" is defined in section 702.
1668. *Subsection (3)* makes an exception to the general rule in so far as a credit or debit arising from the change of accounting policy is brought into account for the purposes of this Part under another provision. For example, a prior period adjustment brought into account under section 597(2) would be excepted from the general rule in this section.

Section 615: Change of accounting policy after ceasing to be party to derivative contract

1669. This section requires a credit or debit to be brought into account, similarly to section 614, in a case where section 608(2) applies. It is based on paragraph 50A(3C), (3D) and (5) of Schedule 26 to FA 2002.
1670. **Section 608** applies if profits and losses arising to a company from a derivative contract for the accounting period in which the company ceases to be a party to the contract are not wholly reflected in credits and debits brought into account under this Part for that period. In effect, it is a "post-cessation receipts" provision.

1671. Because the derivative contract from which the income or loss derived is either no longer in existence or no longer held by the company, section 613 cannot apply in this case. Section 615 deals with the amount by which the value of the residual deferred income or loss in respect of the former contract alters as a result of the change of accounting policy affecting a subsequent period.
1672. *Subsection (4)* corresponds to the rule in section 614(3).
1673. *Subsection (6)* corrects a minor error in the source legislation. Paragraph 50A(3D) of Schedule 26 to FA 2002, in defining the “amount outstanding”, refers to an amount recognised “in respect of the profits, gains or losses that arose from that *relationship* or a related transaction in the cessation period (within the meaning of *section 103(6)*”. The words with emphasis are of course appropriate to the loan relationships provisions and not to those for derivative contracts. They reflect the wording of paragraph 19A(4C) and (4D) of Schedule 9 to FA 1996 (rewritten as section 318 in Part 5), on which paragraph 50A(3C) and (3D) of Schedule 26 to FA 2002 was modelled. More appropriate wording has been substituted.

Section 616: Disapplication of fair value accounting

1674. This section reverses the effect of sections 584 and 586 if certain conditions are met by reference to an embedded derivative identified by either of those sections. It is based on paragraphs 45L(1), (1A), (1B), (1C), (2) and (3) of Schedule 26 to FA 2002.
1675. Because the contract out of which the embedded derivative arose is treated as one that is not split in accordance with section 584 or 586, the section disapplies sections 573 and 574 to that derivative.
1676. It also sets aside fair value accounting as an accounting basis in calculating profits and losses on the contract in question. For contracts to which this section applies, splitting of the contract under section 584 or 586, or the use of fair value accounting, may produce unacceptably volatile results for tax purposes.
1677. The section does not apply to an embedded derivative within section 584 that comes within section 592 (so that it may meet the “excluded property” conditions in section 589). Nor does it apply if regulation 9 of the Disregard Regulations applies ([SI 2004/3256](#), as amended). That regulation prescribes credits and debits, in the case of derivative contracts that are interest rate contracts, for the purposes of paragraph 17B of Schedule 26 to FA 2002 (rewritten in section 597).
1678. Nor does the section apply if an election is made under section 617 for this section not to apply. A company may choose to make such an election if it prefers to retain fair value accounting for contracts within section 584 or 586.
1679. *Subsection (3)* treats the relevant contract that was divided under section 584 as not so divided. It is therefore treated as a single derivative contract for the purposes of this Part. But again the contract is treated as one to which fair value accounting does not apply.
1680. *Subsections (4)* and *(5)* treat the contract that was divided under section 586 as not so divided. The contract is therefore outside the scope of this Part. It is dealt with for tax purposes according to what sort of contract it is. *Subsection (5)* also provides that section 46 in Part 3 of this Act (calculation of trade profits in accordance with generally accepted accounting practice) applies as if fair value accounting was not generally accepted accounting practice for that company.
1681. *Subsections (3)* and *(4)* apply to the “original contract” (defined in *subsection (7)*) rather than (as in the source legislation) the “contract” to avoid confusion with the relevant contract referred to in *subsection (1)(a)*.

Section 617: Election for section 616 not to apply

1682. This section allows a company to elect that section 616 does not apply to its contracts. It is based on paragraph 45L(2A), (2B) and (2C) of Schedule 26 to FA 2002.
1683. For some companies the benefit afforded by section 616 may be disproportionate to the administrative and accounting burden of distinguishing and tracking affected contracts. Or the degree of volatility in the tax consequences of splitting the contract or using fair value accounting may be acceptable to the company holding the contract.
1684. An election under this section applies to all of a company's contracts. Section 618 contains further provisions modifying or extending the effect of an election made by a member of a group of companies.
1685. *Subsection (2)* excludes two types of contract from an election. They are, first, a "contract of long-term insurance" (defined in section 431(2) of ICTA) and, second, a contract where the embedded derivative identified by section 584 or 586 has commodities as its underlying subject matter.
1686. Subsection (2)(b) says "embedded derivative" rather than "embedded derivative contract". The [Finance Act 2002, Schedule 26, \(Parts 2 and 9\) \(Amendment\) Order 2006, SI 2006/3269](#) omitted the definition of "embedded derivative contract" from the source legislation. But the use of the term in paragraph 45L(2A) of Schedule 26 to FA 2002 was missed. "Embedded derivative" matches the amendments introduced in this respect by that Order. See in particular sections 584 and 586.
1687. Unlike the source legislation, the section does not specify how the election must be made. See *Change 1* in Annex 1.

Section 618: Elections under section 617: groups of companies

1688. This section applies or disapplies the effect of an election under section 617 in a number of cases where a party to a contract is a member of a group of companies. It is based on paragraph 45LA of Schedule 26 to FA 2002.
1689. In the first case, *subsection (1)* treats the group member who is a counterparty to a contract to which a fellow group member is a party as having made an election in relation to that contract if that fellow group member has made an election. This rule ensures parity of treatment of the contract within the group.
1690. In the second case, *subsection (2)* provides that a group member to whom a fellow group member has transferred a contract is treated as having made an election in relation to that contract if the fellow group member makes an election. This rule applies even if that fellow group member makes the election at a time after the transfer has been made or at a time when the companies are no longer members of the same group. This rule ensures that a company cannot exclude some of its contracts from the effect of an election by first transferring them to another group member.
1691. The reference in subsection (2) to a contract "to which section 584... or section 586... applies" corrects a missed consequential amendment to paragraph 45LA(3)(b) of Schedule 26 to FA 2002. The reference there to "paragraph 2(3)" is otiose following the replacement of that provision by paragraph 2(2A) of Schedule 26 to FA 2002 (by article 3 of the [Finance Act 2002, Schedule 26, \(Parts 2 and 9\) \(Amendment\) Order 2006, SI 2006/3269](#)) and the insertion of paragraphs 2A and 2B of Schedule 26 to FA 2002 (by article 4 of that Order). Sections 584 and 586 apply to the types of contract to which paragraph 2(3) of Schedule 26 to FA 2002 applied.
1692. The third case is if:
- B becomes a party in place of A to a relevant contract treated as such by section 584 or 586, at a time when they are members of the same group;

- that contract was within section 616 in A's hands (that is, A had not made an election); and
- B's other contracts are outside section 616 by virtue of an election B has made (whether an election made before B has succeeded A as a party to the contract or one made later).

1693. *Subsection (4)* ring-fences the contract in question, so that any existing or later election by B is ineffective in relation to that contract. This rule ensures that a contract cannot be selected for preferential treatment under another group member's election if the member who is the original party to the contract does not otherwise wish to make an election. This rule is however disapplied if A makes an election in respect of its contracts subsequent to B becoming a party to the contract in place of A.

Section 619: Partnerships involving companies

1694. This section and the next two set out how a company partner brings into account credits and debits in respect of its share of a firm's derivative contracts. This section provides that each company partner, not the firm, brings credits and debits into account in calculating its profits chargeable to tax. It is based on paragraph 49(1) and (2) of Schedule 26 to FA 2002.

1695. Paragraph (c) in *subsection (1)* requires that the firm is a party to a contract that "is a derivative contract or would be a derivative contract if the firm were a company". A firm is not a company. So a contract held by a firm would not meet any test under which a contract is or is treated as a derivative contract because it is held by a company.

1696. *Subsection (2)* switches off the normal rule in section 1259 (which rewrites section 114(1) of ICTA) under which the profits of the firm's trade etc are calculated, in accordance with the partners' interests in the firm, as if the firm were a company.

Section 620: Determination of credits and debits by company partners

1697. This section determines the credits and debits to be brought into account under section 619(3) by each company partner in a firm. It is based on paragraph 49(3), (4), (5) and (6) of Schedule 26 to FA 2002.

1698. *Subsections (2) to (4)* attribute the actions of the firm to the partner for the purposes of applying the rules that determine the credits and debits to be brought into account in accordance with this Part.

1699. "Profit-sharing arrangements", in relation to a partnership, is defined in section 710. A firm's "profit-sharing arrangements" are described in section 1262, in the sections rewriting section 114 of ICTA, as "the rights of the partners to share in the profits of the trade and the liabilities of the partners to share in the losses of the trade".

Section 621: Company partners using fair value accounting

1700. This section applies fair value accounting, in determining under section 620 the company partner's share of the credits and debits arising in respect of the firm's derivative contracts, if that company partner uses fair value accounting in relation to its interest in the firm. It is based on paragraph 50 of Schedule 26 to FA 2002.

Section 622: Contracts ceasing to be derivative contracts

1701. This section provides that, if a relevant contract to which the company continues to be a party ceases to be a derivative contract, there is a deemed disposal of the contract at the time of that cessation. It is based on paragraphs 43A(5) and 43B of Schedule 26 to FA 2002.

1702. *Subsection (2)* deems the company to have disposed of the contract in a “related transaction” (defined in section 596) for consideration equal to the “notional carrying value” of the contract at the time it ceases to be a derivative contract. Depending on the amount of the consideration attributed to that disposal under this subsection, a credit or debit arises to be brought into account under this Part. That credit or debit is additional to any other credit or debit that arises in relation to the contract, while it was a derivative contract, for the accounting period in which the deemed disposal occurs. “Carrying value” is defined in section 702.
1703. The source legislation for *subsection (4)* refers to the amount that would have been the carrying value of the contract in the accounts of the company “if an accounting period had ended immediately before that time”. The source legislation for the equivalent definition in section 625(6), paragraph 28(3) of Schedule 26 to FA 2002, refers to the value found “if a period of account had ended immediately before” the requisite time. But, if a period of account comes to an end, that is the end of an accounting period under section 10. The two definitions have been brought into line using “period of account”.
1704. After the contract ceases to be a derivative contract, it is likely to be a chargeable asset for the purposes of corporation tax on chargeable gains. *Subsection (5)* therefore signposts section 662 which prescribes the acquisition cost of the contract for that purpose.

Section 623: Index-linked gilt-edged securities with embedded contracts for differences

1705. This section provides that credits and debits arising in respect of an embedded derivative in an index-linked gilt-edged security are not brought into account under this Part if conditions are met. It is based on paragraphs 12(1), (11A) and (11B) and 45I of Schedule 26 to FA 2002.
1706. If the embedded derivative is closely related to the host contract, generally accepted accounting practice does not in fact require the company to divide the security as mentioned in section 585. In that case, sections 399 and 400 in Part 5 (loan relationships) apply. But, for example, a company whose functional currency is not sterling may be required to divide its index-linked securities between an embedded derivative and a host contract, in which case this section may apply.

Chapter 5: Continuity of treatment on transfers within groups

Section 624: Introduction to Chapter

1707. This section describes the purpose of the Chapter. *Subsection (3)* is based on paragraph 28(6) of Schedule 26 to FA 2002 but otherwise the section is new.

Section 625: Group member replacing another as party to derivative contract

1708. This section and the next three deal with the case where one member of a group of companies replaces another as a party to a derivative contract as the result of a related transaction or similar transactions. This section determines the credits and debits to be brought into account by the transferor company and the transferee company. It is based on paragraph 28(1), (3), (3ZA), (3A) and (7) of Schedule 26 to FA 2002.
1709. “Notional carrying value” is defined in *subsection (6)* on the model of the similar definition in section 622(4). “Carrying value” is defined in section 702.
1710. Should any “discount” arise in respect of the related transaction or the equivalent series of transactions, it is added to the amount treated as consideration by the transferor under *subsection (3)* (but not to the amount treated as consideration given by the transferee under *subsection (4)*).

1711. “Discount” is defined in subsection (6) by reference to section 480 in Part 5 (loan relationships). A discount arises if payment of part of the consideration for a disposal is deferred and the consideration is accordingly increased to recognise the delay.
1712. *Subsection (7)* disapplies Schedule 28AA to ICTA in a case where credits and debits are determined under *subsection (2)*. Schedule 28AA to ICTA might otherwise substitute market value for the amounts agreed between the parties, which amounts would give rise to credits and debits for the purposes of this Part. Such a substitution is unnecessary given that this section requires both parties to use the notional carrying value of the contract rather than amounts shown in the accounts (the amounts “recognised for accounting purposes”).

Section 626: Transactions to which section 625 applies

1713. This section defines the related transaction or series of transactions which acts or act as a trigger for the application of section 625. It is based on paragraph 28(2) of Schedule 26 to FA 2002.

Section 627: Meaning of company replacing another as party to derivative contract

1714. This section gives a particular example of what the reference in section 625(1) to one company replacing another as a party to a derivative contract means. It is based on paragraph 28(4) of Schedule 26 to FA 2002.
1715. The commonest way in which one company may replace another as a party to a derivative contract is by the assignment of the rights and liabilities under the contract. But there may be other types of transaction that have the same effect.
1716. This section ensures that, if the company referred to as the transferee in section 625 becomes a party to a contract whose rights and liabilities are equivalent to those of the contract to which the company referred to as the transferor in that section has ceased to be a party, the transferee is treated as having replaced the transferor in respect of the derivative contract. A novation is an example of this.
1717. This section still applies in the event of the transferor again becoming a party to the original contract (that is, a contract to which it had previously ceased to be a party).

Section 628: Transferor using fair value accounting

1718. This section substitutes rules based on fair value accounting for those in section 625, in a case to which that section applies, if the transferor uses fair value accounting in respect of the derivative contract in question. It is based on paragraph 30 of Schedule 26 to FA 2002.
1719. As regards the transferee, this section treats it as having acquired the derivative contract at the fair value of the contract as at the time of the transfer for the purposes of determining the credits and debits brought into account under this Part, regardless of whether it itself uses fair value accounting as respects the contract. This treatment continues to apply for any accounting period in which the transferee is a party to the contract.
1720. As in section 625, any “discount” is added to the amount treated as consideration by the transferor (only).

Section 629: Tax avoidance

1721. This section disapplies section 625 in two cases where avoidance of tax is involved. It is based on paragraph 28(3ZB), (3ZC) and (3ZD) of Schedule 26 to FA 2002.
1722. The first case (*subsection (1)*) is if the transferor is a party to arrangements for tax avoidance purposes under which the derivative contract will be transferred on by

the transferee. The second case (*subsection (4)*) is if another provision countering tax avoidance (section 698) applies to a disposal which would otherwise be within section 625.

Section 630: Introduction to sections 631 and 632

1723. This section and the next two provide for a deemed assignment of the derivative contract in question if a transferee within section 625 ceases to be a member of the group of companies mentioned in section 626(2) or (3). This section sets out when sections 631 and 632 apply and defines terms used in this and those sections. It is based on paragraph 30A(1), (5A) and (8) of Schedule 26 to FA 2002.
1724. If section 625 applies because of a series of transactions within section 626(3), the relevant time limit in respect of the transferee leaving the relevant group of companies before the end of a six year period begins with the *last* of the transactions in the series of transactions. This contrasts with the rule in section 625(3) which determines the consideration to be brought into account by the transferor by reference to the *first* transaction in the series.
1725. The rules in these sections take priority if the rules in section 609 or 610 would apply in the same circumstances (see the commentary on those sections).

Section 631: Transferee leaving group otherwise than because of exempt distribution

1726. This section deems the transferee within section 625 to have assigned (and immediately reacquired) the rights and liabilities under the derivative contract, immediately before it left the group, for a consideration equal to their fair value at that time. It is based on paragraph 30A(2), (3), (4), (5) and (8) of Schedule 26 to FA 2002.
1727. One of the conditions for this section to apply is that the company ceases to be a member of the group of companies in question for reasons which are not just that it does so because of an “exempt distribution” under section 213(2) of ICTA. That section provides for a distribution arising from the demerger of the trading activities of a single company or group of companies to a number of companies or groups to be disregarded for certain purposes.
1728. The second condition is that a credit would be brought into account under either this Part (condition A in *subsection (3)*) or Part 5 (loan relationships) (condition B in *subsection (4)*). The credit in question, as regards this Part, is the credit that would be brought into account under this Part on the deemed assignment under this section of the rights and liabilities under the derivative contract.
1729. As regards Part 5, the credit in question is the credit brought into account under that Part because of section 345(2)(a) and (b) in a case where the transferee has a “hedging relationship” between the derivative contract and a creditor relationship. That section makes matching provision for loan relationships to that made by this section for derivative contracts.
1730. In either case, the second condition is not satisfied if the assignment would give rise to a debit. So the section cannot give rise to a reduction of the transferee’s liability to corporation tax.
1731. “Hedging relationship” is described in section 707 in a number of ways. Broadly, these relate to cases where the derivative contract is entered into to shelter the company from risks associated with holding or owing the hedged asset or liability (such as a fluctuation in values because of movement in a relevant market, such as a stock or commodities exchange).

Section 632: Transferee leaving group because of exempt distribution

1732. This section deems the transferee within section 625 to have assigned (and immediately reacquired) the rights and liabilities under the derivative contract at the time a “chargeable payment” is made, for a consideration equal to the fair value of the rights and liabilities at the time of that payment, if it left the group solely because of an exempt distribution. It is based on paragraph 30A(3), (4), (5), (6), (7) and (8) of Schedule 26 to FA 2002.
1733. A “chargeable payment” is broadly a payment made in connection with tax avoidance or otherwise than for genuine commercial reasons.
1734. Conditions A and B, in *subsections (3) and (4)*, are the same as the conditions in section 631(3) and (4). See the commentary on that section.

Chapter 6: Special kinds of company

Overview

1735. This Chapter contains rules that modify the application of this Part to mutual trading companies or insurance companies. The Chapter does not rewrite paragraph 41 of Schedule 26 to FA 2002 as it is merely introductory.

Section 633: Mutual trading companies

1736. This section treats the activities of a mutual trading company as not being those of a trade. It is based on paragraph 43 of Schedule 26 to FA 2002.
1737. Because of this section, any credits and debits arising to a mutual trading company do not fall within section 573 (trading credits and debits to be brought into account under Part 3). And any provision that operates in part by reference to whether the company is a party to a contract for the purposes of a trade (or a type of business which constitutes a trade) does not apply to a mutual trading company in that respect.

Section 634: Insurance companies

1738. This section treats certain activities of an insurance company as not being those of a trade. It is based on paragraphs 41A and 43 of Schedule 26 to FA 2002.
1739. This section has the same effect, in relation to the activities specified in paragraphs (a) and (b), as the preceding section has for mutual trading companies.
1740. For the meaning of “life assurance business” and “basic life assurance and general annuity business”, see section 431(2) of ICTA.

Section 635: Creditor relationships: embedded derivatives which are options

1741. This section requires a life assurance company to treat a creditor relationship as mentioned in section 585(1) despite the fact that it accounts for that relationship at fair value through profit and loss. It is based on paragraph 45D(3A) of Schedule 26 to FA 2002.
1742. Under generally accepted accounting practice, a company that accounts for a creditor relationship at fair value through profit and loss would not divide the relationship between embedded derivatives and the remaining rights that are a loan relationship. This section overrules that accounting rule for the purposes of both this Part and Part 5 (loan relationships).

Section 636: Modifications of Chapter 5

1743. This section makes modifications of Chapter 5 (continuity of treatment on transfers within groups) in respect of insurance companies. It is based on paragraphs 28(1) and (2) and 29 of Schedule 26 to FA 2002.
1744. [Section 625](#) deals with the case where one member of a group of companies replaces another as a party to a derivative contract as the result of a related transaction or similar transactions. It determines the credits and debits to be brought into account by the transferor company and the transferee company by treating both as using the same consideration in relation to that transaction or transactions.
1745. This section first adds two further cases to the list in section 626 of transactions that trigger the operation of section 625. They are cases involving the transfer of classes of insurance business between two companies where the transfer does not already fall within section 625.
1746. *Subsection (4)* then disapplies section 625, in respect of a triggering transaction falling within the original categories listed in section 626, in relation to the transfer of derivative contracts moving into or out of a company's long-term insurance fund.
1747. *Subsection (5)* disapplies section 625 in respect of a triggering transaction falling within the categories treated as added to section 626 by subsection (3), if derivative contracts are in one of the categories set out in section 440(4) of ICTA before the transfer and in a different category after the transfer.
1748. For the meaning of "contract of long-term insurance", "insurance business transfer scheme", "qualifying overseas transfer" and "overseas life insurance company", see section 431(2) of ICTA (as modified, in relation to the meaning of "qualifying overseas transfer", by regulation 6(5) of the [Overseas Life Insurance Companies Regulations 2006 \(SI 2006/3271\)](#)). Because the meaning of "overseas life insurance company" is provided by that section "for the interpretation of the life assurance provisions of the Corporation Tax Acts" (and this section is such a provision), it is unnecessary to rewrite paragraph 29(4) of Schedule 26 to FA 2002.

Section 637: Investment trusts: profits or losses of a capital nature

1749. This section and the next except certain capital profits and losses of an investment trust or venture capital trust from the scope of this Part so that credits and debits in respect of such profits or losses do not fall within section 595. This section deals with investment trusts. It is based on paragraph 38 of Schedule 26 to FA 2002 and articles 2 and 3 of [The Investment Trusts and Venture Capital Trusts \(Definition of Capital Profits, Gains or Losses\) Order 2006 \(SI 2006/1182\)](#).
1750. *Subsection (1)* refers to "profits or losses" rather than "profits, gains and losses" as in the source legislation. But there is no difference in the meaning of the two phrases in the context of an investment trust's transactions of a capital nature.
1751. *Subsection (2)* uses the meaning of profits or losses of a capital nature given by [SI 2006/1182](#) for both trusts using UK generally accepted accounting practice and those using international accounting standards. It does not rewrite the meaning given in paragraph 38(3) of Schedule 26 to FA 2002 as the relevant Statement of Recommended Practice uses terms from international accounting standards (and accordingly does not rewrite the part of paragraph 38(2)(a) of that Schedule which refers to that meaning).
1752. *Subsection (4)* contains powers for the amendment by Treasury order of the meaning of "profits or losses of a capital nature" in this section. This rewrites the powers in paragraph 38(2) of Schedule 26 to FA 2002 used to make the order in [SI 2006/1182](#) applying to investment trusts and venture capital trusts that use international accounting standards.

1753. There were similar rules in relation to “capital profits, gains and losses” of authorised unit trusts and open-ended investment companies in paragraphs 32 and 33 of Schedule 26 to FA 2002 with regulatory powers in paragraph 34 of that Schedule. The first two of those paragraphs were omitted by F(No 2)A 2005. Paragraph 34 of that Schedule is now omitted and not rewritten as it is redundant.
1754. [Schedule 1](#) to this Act inserts section 842(2D) and (2E) of ICTA (investment trusts: net excess of relevant credits over relevant credits under this Part treated as income derived from shares or securities for the purposes of approval of a company under that section, so far as the credits and debits are brought into account under section 574). This insertion is based on paragraph 39 of Schedule 26 to FA 2002.

Section 638: Venture capital trusts: profits or losses of a capital nature

1755. This section excepts certain capital profits and losses of a venture capital trust from the scope of this Part. It is based on paragraph 38A of Schedule 26 to FA 2002 and articles 2 and 3 of the [Investment Trusts and Venture Capital Trusts \(Definition of Capital Profits, Gains or Losses\) Order 2006 \(SI 2006/1182\)](#).
1756. This section has the same effect for venture capital trusts as section 637 has for investment trusts. See the commentary on that section.
1757. This section does not rewrite paragraph 38A(2)(a)(part) and (3) of Schedule 26 to FA 2002 for the same reasons as those mentioned in the commentary on section 637 in relation to not rewriting paragraph 38(3) of Schedule 26 to FA 2002.

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:

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

- 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 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% x 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.

Chapter 8: Further provision about chargeable gains and derivative contracts

Section 660: Contract relating to holding in OEIC, unit trust or offshore fund

1825. This section provides for a chargeable gain or allowable loss to arise when a company ceases to be a party to a relevant contract that is treated as a derivative contract because of section 587. It is based on paragraph 37(1), (2), (3) and (5) of Schedule 26 to FA 2002.
1826. **Section 587** applies if the underlying subject matter of a relevant contract is an interest in a collective investment scheme and that scheme fails to meet a “qualifying investments test” in the relevant accounting period. The relevant contract is treated as a derivative contract for that accounting period and later periods.
1827. **Section 602** provides for value to be attributed to the deemed derivative contract by reference to its market value when it is so deemed. Section 601 sets out the credits and debits to be brought into account for the purposes of this Part.
1828. This section deals with the profit and loss latent in the contract immediately before it is deemed to be a derivative contract. It applies if the contract was then a “chargeable asset”. That term is defined in section 703 as an asset on whose disposal any gain would be a chargeable gain for the purposes of corporation tax on chargeable gains. The charge on that accrued gain or loss is in effect deferred until the company ceases to be a party to the contract.
1829. The consideration for the disposal equals any value given to the relevant contract in the company’s accounts for the period immediately preceding that in which it is deemed to be a derivative contract. This value may be the same as or different from that found under section 602.

Section 661: Contract which becomes derivative contract

1830. This section provides for a chargeable gain or allowable loss to arise when a company ceases to be a party to a relevant contract that, not having been a derivative contract, became a derivative contract. It is based on paragraph 43A(1), (2), (4) and (5) of Schedule 26 to FA 2002.
1831. There are a number of ways in which a relevant contract that was not a derivative contract may become one. For example, if the terms of the contract change (without creating a new contract) in such a way that the accounting conditions in section 579 are now met, the contract may become a derivative contract. Or it may be that the contract no longer meets the “excluded property” rule in section 589 by virtue of which it was not a derivative contract. See for example the circumstances described in the

paragraph “contracts which became derivative contracts on 16 March 2005” in Part 10 of Schedule 2.

1832. If this section applies, it operates similarly to section 660. Again, bringing into account the gain or loss latent in the relevant contract (which is also a chargeable asset) is deferred until the company ceases to be a party to the relevant contract.
1833. “Notional carrying value” has the same meaning as in section 622(4), that is, the carrying value the contract would have had in the books of the company had a period of account ended immediately before the deemed disposal. See the commentary on that section as regards the use of “period of account” rather than “accounting period” in that definition.
1834. See also the paragraph headed “disapplication of section 661” in Part 10 of Schedule 2 which applies if the relevant contract became a derivative contract before 30 December 2006.

Section 662: Contracts ceasing to be derivative contracts

1835. This section provides that, if a relevant contract to which the company continues to be a party ceases to be a derivative contract, the company is treated as acquiring the contract for an amount equal to its notional carrying value at the time it ceases to be a derivative contract. It is based on paragraph 43B of Schedule 26 to FA 2002.
1836. This section is the companion to section 622 which deals with the deemed disposal of the relevant contract for the purposes of this Part at the time it ceases to be a derivative contract. See the commentary on that section.

Section 663: Contracts to which section 641 applies

1837. This section provides that, if a company makes a claim, allowable losses deemed to arise for an accounting period may be carried back and set against chargeable gains deemed to arise in accounting periods in the previous 24 months. It is based on paragraph 45B(1), (2) and (3) of Schedule 26 to FA 2002.
1838. The gains and losses deemed to arise are those given by section 641 (chargeable gains basis substituted for income basis in charging credits and debits from certain types of derivative contract).
1839. The gains eligible for relief in an earlier period are the total section 641 gains for that period less the total of allowable losses under that section for that period. Those gains are further reduced by any other allowable losses for that period so far as those other allowable losses could not be deducted, within the meaning of section 8(1) of TCGA, from other chargeable gains. That is, any allowable losses for the purposes of corporation tax on chargeable gains, other than losses under section 641, are notionally deducted from the section 641 gains if they cannot be set against any chargeable gains, other than gains under section 641, to find the amount of gains against which the losses carried back under this section can be set. The amount found under this rule is called “net section 641 gains”.
1840. *Subsection (3)* provides that, to the extent the losses for a period are carried back and relieved under this section, they are used up and cannot otherwise be relieved under the provisions for corporation tax on chargeable gains by set off or carry forward.

Section 664: Meaning of certain expressions in section 663

1841. This section provides the meaning of some terms used in section 663. It is based on paragraph 45B(4), (5), (6), (7) and (8) of Schedule 26 to FA 2002.

Section 665: Introduction to section 666

1842. This section sets out the type of contract it applies to for the purposes of the relief provided by section 666. It is based on paragraphs 12(1) and (11A) and 45JA(1), (2) and (5) of Schedule 26 to FA 2002.
1843. 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).
1844. “Equity instrument” is defined in section 710 as having the meaning it does for accounting purposes. (See the commentary on section 585 for further detail.)
1845. 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 652 to 655 in Chapter 7. They apply if the underlying subject matter of the embedded derivative is shares.

Section 666: Allowable loss treated as accruing

1846. This section deems there to be an allowable loss for the purposes of corporation tax on chargeable gains if a company pays an amount to discharge obligations under the debtor relationship to which section 665(2) refers. It is based on paragraphs 12(1) and (11B) and 45JA(3) and (4) of Schedule 26 to FA 2002.
1847. The allowable loss equals any excess of that payment (as first reduced by the fair value of the host contract at that time) over the carrying value of the equity instrument that is treated as a derivative contract under section 585 as at the time the company became a party to the debtor relationship.
1848. “Fair value” is defined in section 710.
1849. The definition of “B” in *subsection (2)* does not rewrite the words “in accordance with section 94A(2) of the Finance Act 1996” for the same reasons as given in the commentary on section 653.
1850. See also the paragraph headed “disapplication of section 666” 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 667: Shares acquired on exercise of non-embedded option

1851. This section and the next modify the amounts otherwise allowable as acquisition costs under section 38 of TCGA on the disposal of shares acquired under an option or future. This section deals with shares acquired as the result of the exercise of rights under an option. It is based on paragraph 45HA(1), (2) and (3) of Schedule 26 to FA 2002.
1852. This section applies only if the derivative contract is a “plain vanilla contract” (defined in section 708). That is, it does not apply to the exercise of rights within rights and liabilities treated as a derivative contract under section 584, 585 or 586. Although the provision normally operates on the terminal exercise of the option, it is theoretically possible for it to apply to each instalment of a staged exercise of the option. Paragraph (e) of *subsection (1)* is therefore in terms of the exercise of “any of” the rights under the option.
1853. *Subsection (2)* provides for allowable acquisition costs under section 38(1)(a) of TCGA to be increased (or reduced) when there is a disposal of the shares acquired as a result of the exercise of rights under the option. The increase or reduction in effect reverses the earlier treatment of credits and debits in respect of the option, so far as referable to the shares which were the subject of the option, as non-trading credits and debits for the purposes of Part 5 (loan relationships).

1854. Subsection (2) also provides that, if there is only a part disposal of those shares, section 42(2) of TCGA applies. That provision deals with the calculation of costs allowable under section 38 of TCGA if there is a part disposal of an asset. It uses an A divided by $A+B$ formula which takes into account the consideration for the part disposal (“A”) and the value of the remainder of the asset (“B”).
1855. [Section 669](#) sets out the amount of the credits and debits to be used in calculating the amount of the adjustment to expenditure allowable under section 38 of TCGA.
1856. In a case where the adjustment reduces allowable expenditure and exceeds the amount that can be so reduced, the excess reduction is instead treated under *subsection (3)* as additional consideration for the disposal of the shares.

Section 668: Shares acquired on running of future to delivery

1857. This section makes provision equivalent to that in section 667 if shares are disposed of following their acquisition as the result of the delivery of those shares under the terms of a future. It is based on paragraph 45HA(1A), (2) and (3) of Schedule 26 to FA 2002.
1858. See the commentary on section 667.

Section 669: Meaning of G and L in sections 667 and 668

1859. This section determines the amounts used under section 667 or 668 to modify the amounts allowable as acquisition costs under section 38 of TCGA on the disposal of shares acquired as mentioned in either section. It is based on paragraph 45HA(4) and (5) of Schedule 26 to FA 2002.
1860. The credits and debits relevant to the calculation under section 667(2) or 668(2) are those brought into account under section 574. That is, they are amounts which are treated as non-trading credits and debits for the purposes of Part 5 (loan relationships). It is unnecessary to take account for this purpose of credits and debits within section 573, as profits and losses on derivative contracts to which that section applies are brought into account as trading profits rather than as chargeable gains.
1861. The credits and debits in question are those referable to the shares acquired or delivered. That is, they are credits and debits arising in respect of the derivative contract before the exercise of the option or the running to delivery of the future, as appropriate, as a result of which the shares were acquired. And they are referable to the shares which are the subject of the contract. *Subsection (2)* also provides that any necessary apportionment of credits and debits may be made on a just and reasonable basis.
1862. *Subsection (4)* indicates that the credits and debits in question are those arising in respect of any accounting period of the company during which it is a party to the derivative contract up to and including that in which the shares are disposed of. It is a question of fact whether in any of those accounting periods there are relevant credits or debits.

Section 670: Treatment of net gains and losses on exercise of option

1863. This section modifies the amounts allowable under section 38 of TCGA in respect of a disposal of (a) shares acquired as a result of the exercise of rights under an option, if those rights were held under a derivative contract which is an embedded derivative in a creditor relationship within section 645 or (b) the asset representing the creditor relationship in such a case. It is based on paragraph 45H(1), (2), (3), (4), (5), (5A) and (6) and 12(11C) of Schedule 26 to FA 2002.
1864. “Creditor relationship” is defined in section 704.
1865. As in section 667, it is theoretically possible for the section to apply to each instalment of a staged exercise of the option as well as the terminal exercise of the option. Paragraph

(c) of *subsection (1)* is therefore in terms of the exercise or disposal of “any of” those rights.

1866. Credits and debits arising in a case to which section 645 applies are brought into account as chargeable gains or allowable losses under section 641. The effect of this section is to reverse that treatment when the asset representing the creditor relationship or the shares acquired under the option are disposed of. It avoids double charging of so much of the value in that asset or shares as represents the credits or debits already brought into charge as a chargeable gain or allowable loss.
1867. The adjustment under *subsection (5)* applies only if the circumstances in which the shares were acquired involved a disposal treated as not occurring because of section 127 of TCGA. That provision disregards as a disposal the replacement of a holding of shares by another such holding in the course of a reorganisation of share capital. That is, the disposal of the rights under the option, as a result of exercising those rights, was not treated as a disposal.
1868. Similarly to section 667, if the adjustment to be made under *subsection (3)* or (5) is a reduction that exceeds the amounts otherwise allowable under section 38 of TCGA, the excess is added to the consideration for the disposal.
1869. *Subsection (7)* disapplies sections 37 and 39 of TCGA in relation to a disposal covered by this section. Those sections remove from the chargeable gains calculation any consideration and expenditure that is taken into account in an income calculation.

Section 671: Meaning of G, L and CV in section 670

1870. This section provides the meaning of labels used in the calculations made under section 670(3) and (5). It is based on paragraphs 12(1) and (11B) and 45H(6) and (7) of Schedule 26 to FA 2002.
1871. The chargeable gains (“G”) and allowable losses (“L”) relevant to those calculations are those referable to the shares acquired as a result of the exercise of the option. That is, they are credits and debits arising in respect of the derivative contract before the exercise of the option as a result of which the shares were acquired. And they are referable to the shares which are the subject of the contract.
1872. *Subsection (5)* indicates that the credits and debits in question are those arising in respect of any accounting period of the company during which it is a party to the derivative contract up to and including that in which the shares are disposed of.

Section 672: Treatment of net gains and losses on disposal of certain embedded derivatives

1873. This section modifies the amounts allowable under section 38 of TCGA on a disposal of the asset representing the creditor relationship mentioned in section 648 in a case where that section applies. It is based on paragraph 45HZA(1), (2), (3), (4) and (5) of Schedule 26 to FA 2002.
1874. For the circumstances in which section 648 applies, and for the meaning of an “exactly tracking contract for differences”, see the commentary on that section.
1875. As with section 670, this section in effect reverses the treatment of credits and debits in respect of the embedded derivative under section 641 so that double counting is avoided when the asset representing the creditor relationship is disposed of.
1876. And similarly again to that section and others, if the adjustment to be made under *subsection (2)* is a reduction that exceeds the amounts otherwise allowable under section 38 of TCGA, the excess is added to the consideration for the disposal.

Section 673: Meaning of G, L and CV in section 672

1877. This section provides the meaning of labels used in the calculations made under section 672(2). It is based on paragraphs 12(1) and (11B) and 45HZA(5) and (6) of Schedule 26 to FA 2002.
1878. The definitions of “G”, “L” and “CV” are similar to those in section 671 but modified for the purposes of section 672. See the commentary on section 671.

Chapter 9: European cross-border transfers of business

Overview

1879. This Chapter gives the rules that apply for derivative contracts in the case of cross-border transfers within the European Community of the whole or part of a business carried on in the United Kingdom.

Section 674: Introduction to Chapter

1880. This section sets out the two conditions required for the Chapter to apply together with the claim requirement. It is based on paragraphs 30D(1), (2), (3) and (4), 30G(1) and 30I(1) of Schedule 26 to FA 2002.
1881. The source legislation for *subsection (2)(c)* requires that the transferee is resident in the United Kingdom or within the corporation tax charge in section 11 of ICTA. The subsection says “within the charge to corporation tax” as the result is the same.
1882. See also the paragraph headed “references to Companies Act 2006” in Part 10 of Schedule 2 which provides for the interpretation of references to section 658 of that Act before that section comes into force.

Section 675: Transfer of derivative contract at notional carrying value

1883. This section provides the rule that if either of the conditions in section 674 applies, debits and credits in respect of derivative contracts which are transferred as part of the business transfer are brought into account by both transferor and transferee as if the contracts had been transferred at the carrying value in the accounts of the transferor. It is based on paragraph 30D(1), (2) and (6) of Schedule 26 to FA 2002.
1884. The definition of “notional carrying value” is the same as that used in section 625(6).

Section 676: Transferor using fair value accounting

1885. This section provides the rule to apply in place of section 675 if the transferor company uses fair value accounting. It is based on paragraph 30D(7) of Schedule 26 to FA 2002.

Section 677: Tax avoidance etc

1886. This section disapplies the Chapter if the transfer of business is not effected for genuine commercial reasons, unless the Commissioners for HMRC are satisfied, following an application, that this Chapter should apply. It is based on paragraph 30F(1) and (2) of Schedule 26 to FA 2002.

Section 678: Procedure on application for clearance

1887. This section sets out the procedure to be followed for an application that section 677 should not apply. It is based on paragraph 30F(3) of Schedule 26 to FA 2002.
1888. This section follows the procedure set out in the equivalent provision in Part 5 (loan relationships) (see section 427).

Section 679: Decision on application for clearance

1889. This section sets out how the outcome of an application that section 677 should not apply is notified. It is based on paragraph 30F(3) of Schedule 26 to FA 2002.
1890. This section follows the procedure set out in the equivalent provision in Part 5 (loan relationships) (see section 428).

Section 680: Disapplication of Chapter where transparent entities involved

1891. This section disapplies the Chapter under certain circumstances if transparent entities are involved in the transfer of business. It is based on paragraphs 30G(1) and (2) and 30I(1) of Schedule 26 to FA 2002.

Section 681: Interpretation

1892. This section defines “company” and explains what company residence in a member State means for the purposes of the Chapter. It is based on paragraph 30I of Schedule 26 to FA 2002.

Chapter 10: European cross-border mergers

Overview

1893. This Chapter gives the rules that apply for derivative contracts in the case of European cross-border mergers if the merging companies are resident in different member States of the European Community.

Section 682: Introduction to Chapter

1894. This section sets out the conditions (which include the different categories of merger) under which the Chapter applies. It is based on paragraphs 30B(1) and (2) and 30H(1) of Schedule 26 to FA 2002.
1895. The source legislation for *subsection (5)* requires that the transferee is resident in the United Kingdom or within the corporation tax charge in section 11 of ICTA. The subsection says “within the charge to corporation tax” as the result is the same.
1896. See also the paragraph headed “references to Companies Act 2006” in Part 10 of Schedule 2 which provides for the interpretation of references to section 658 of that Act before that section comes into force.

Section 683: Meaning of “the transferee” and “transferor”

1897. This section gives the meaning of the two terms for the different categories of merger set out in section 682(2). It is based on paragraph 30B(9) of Schedule 26 to FA 2002.

Section 684: Transfer of derivative contract at notional carrying value

1898. This section provides that debits and credits in respect of derivative contracts transferred under a merger are brought into account as if the transfer had been for a consideration of an amount equal to the carrying value of the contract in the transferor company’s or companies’ accounts. It is based on paragraph 30B(3) of Schedule 26 to FA 2002.

Section 685: Transferor using fair value accounting

1899. This section provides the rule to apply in place of section 684 if the transferor company uses fair value accounting. It is based on paragraph 30B(4) of Schedule 26 to FA 2002.

Section 686: Tax avoidance etc

1900. This section disapplies the Chapter if the merger is not effected for genuine commercial purposes unless the Commissioners for HMRC are satisfied, following an application, that this Chapter should apply. It is based on paragraph 30B(6), (7) and (8) of Schedule 26 to FA 2002.
1901. *Subsections (2) and (3)* provide a clearance procedure equivalent to that in the previous Chapter.

Section 687: Disapplication of Chapter where transparent entities involved

1902. This section disapplies the Chapter under certain circumstances if transparent entities are involved in the merger. It is based on paragraphs 30H(1) and (2) and 30I(1) of Schedule 26 to FA 2002.

Section 688: Interpretation

1903. This section defines some terms used in the Chapter. It is based on paragraphs 30B(9) and 30I of Schedule 26 to FA 2002.

Chapter 11: Tax avoidance

Section 689: Overview of Chapter

1904. This section describes the content of the Chapter. It is new.

Section 690: Derivative contracts for unallowable purposes

1905. This section prevents certain credits and debits being brought into account for corporation tax purposes, whether under this Part or otherwise, if the derivative contract in question has an “unallowable purpose”. It is based on paragraph 23(1), (2), (3), (8), (9) and (10) of Schedule 26 to FA 2002.
1906. *Subsection (3)* prevents a company bringing into account all debits in respect of the derivative contract that are referable to the unallowable purpose. But *subsection (2)* only does so for credits that are “exchange credits” (defined in *subsection (6)*).
1907. *Subsection (4)* signposts the relief in section 692, which provides that some of the debits mentioned in subsection (3) may be brought into account in the shape of “excess accumulated net losses”.
1908. *Subsection (5)* makes clear that an amount that is not brought into account because of this section (or section 692) is nevertheless regarded as brought into account for the purposes of the priority rule in section 699. That rule provides that this Part exhausts the corporation tax treatment of an amount to which it applies, unless otherwise stated. The amounts in question are therefore not to be brought into account for corporation tax purposes in any other way.

Section 691: Meaning of “unallowable purpose”

1909. This section defines “unallowable purpose” and “has an unallowable purpose” for the purposes of sections 690 and 692. It is based on paragraph 24 of Schedule 26 to FA 2002.
1910. A purpose is unallowable if it is one of the purposes for which the company is a party to the contract (or enters into related transactions in relation to it) but it is not a business or other commercial purpose of the company.
1911. *Subsection (2)* excludes any activities in respect of which the company is not within the charge to corporation tax from the business and commercial purposes of the company that are relevant to this definition. For example, if a non-UK resident company is a

party to the contract for the purposes of a permanent establishment it has in the United Kingdom, the purposes of the activities of the company that are not part of the activities of the permanent establishment are disregarded.

1912. *Subsections (3) to (6)* exclude a tax avoidance purpose from the business and commercial purposes of the company for the purposes of this definition. The effect of this is that a tax avoidance purpose is an unallowable purpose unless it is a minor part of the company's motivation for being a party to, or entering into related transactions in relation to, the derivative contract.

Section 692: Allowance of accumulated net losses

1913. This section gives relief for some of the debits prevented from being brought into account by section 690. It is based on paragraph 23(1), (4), (5), (6) and (7) of Schedule 26 to FA 2002.
1914. The amount that is relieved under this section by being brought into account as a debit, by virtue of *subsection (4)*, is the amount of the "excess accumulated net losses" found in accordance with the method statement in *subsection (5)*.
1915. In effect, debits excluded for an accounting period because of section 690(3) are nevertheless relieved in that or a later period to the extent that there are non-excluded credits against which they can be set.
1916. The calculation of the amount to be relieved is on a cumulative basis and that amount is reduced by any debit already given under this section.

Section 693: Bringing into account adjustments under Schedule 28AA to ICTA

1917. This section brings into account under this Part credits and debits in respect of amounts treated under Schedule 28AA to ICTA (provision not at arm's length) as profits, losses or expenses. It is based on paragraph 31A of Schedule 26 to FA 2002.
1918. It brings credits and debits into account to the extent that actual amounts of such profits, losses or expenses would be brought into account.
1919. Schedule 28AA to ICTA identifies adjustments ("imputed amounts") to be made to return the profit or loss from a transaction between parties not at arm's length to what that profit or loss would be had the parties been at arm's length. This section ensures that such amounts are taken into account under this Part although they arise under Schedule 28AA rather than under this Part.
1920. *Subsections (3) and (5)* indicate that the credits and debits brought into account by this section are subject to the same rules as apply under this Part to credits and debits in respect of actual amounts. So, for example, debits brought into account in respect of expenses are those falling within the categories listed in section 595(4).

Section 694: Exchange gains and losses

1921. This section gives effect in this Part to adjustments or other treatment of exchange gains and losses prescribed by Schedule 28AA to ICTA, further to those in section 693. It is based on paragraph 8(1) and (4) of Schedule 28AA to ICTA and paragraph 27 of Schedule 26 to FA 2002.
1922. Under paragraph 1 of Schedule 28AA to ICTA, a company may be treated as not a party to a derivative contract. The actual exchange gains and losses on that contract are then disregarded. *Subsection (3)* provides that such exchange gains and losses are also left out of account in determining the credits and debits to be brought into account under this Part.
1923. Schedule 28AA to ICTA may also impute amounts of exchange gains and losses (the "adjusted amount") calculated on the basis that the parties to the derivative contract are

acting at arm's length although in fact they do not do so. *Subsection (5)* requires the "adjusted amount" to be brought into account under this Part.

Section 695: Transfers of value to connected companies

1924. This section treats as a credit the amount paid by a company for the grant of an option by a company connected with it if the option is allowed to expire to the benefit of the connected company. It is based on paragraph 26 of Schedule 26 to FA 2002.
1925. Value is transferred on the expiry of the option because the connected company retains the amount paid for the option and does not suffer the commercial loss that would have occurred had the option been exercised. The required assumption in *subsection (6)*, that the option would have been exercised had the parties not been connected, points to the fact that it would have been advantageous to the option holder to exercise it (and therefore disadvantageous to the company granting the option).
1926. The section applies only if the connected company is not within the charge to corporation tax in respect of the derivative contract under or because of this Part. For example, it applies if the connected company is not a UK resident company (and the derivative contract is not held for the purposes of a permanent establishment it has in the United Kingdom).
1927. *Subsection (7)* indicates that, 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).

Section 696: Derivative contracts with non-UK residents

1928. This section excludes a debit if a company within the charge to corporation tax makes payments of notional interest in excess of payments of notional interest to it by a company which is non-UK resident. It is based on paragraph 31(1), (2), (3), (4) and (9) of Schedule 26 to FA 2002.
1929. This section typically applies to a contract for differences which is an interest rate swap. It has some similarities with section 695 in that the flow of benefit in the direction of a company outside the charge to corporation tax is countered in taxing the other company.
1930. *Subsection (4)* defines "notional interest payment". The rate applied in calculating such a payment is not necessarily an interest rate as such but paragraph (c) of the definition requires that it matches the interest rate specified in the contract.

Section 697: Exceptions to section 696

1931. This section sets out three circumstances in which section 696 does not apply. It is based on paragraph 31(5), (6), (7), (8) and (9) of Schedule 26 to FA 2002 and section 153(2) of FA 2003.
1932. The third exception is if there is a double taxation agreement between the United Kingdom and the territory in which the non-UK resident is resident which covers payments of interest (whether by relief or otherwise). Unlike the first two exceptions, where the financial institution or non-UK resident must hold the derivative contract as principal, this exception can apply if the non-UK resident holds the derivative contract as agent or nominee of another person. But in that case, the relevant territory is that in which the principal is resident.
1933. "Permanent establishment" is defined in section 148 of FA 2003.

Section 698: Disposals for consideration not fully recognised by accounting practice

1934. This section brings into account that part of the consideration for a disposal of rights or liabilities under a derivative contract that is not fully recognised under applicable generally accepted accounting practice, if the company in question made the disposal with avoidance motives. It is based on paragraph 27A of Schedule 26 to FA 2002.
1935. *Subsection (5)* gives priority to paragraph 1(2) of Schedule 28AA to ICTA, if that provision would apply a tax charge on the disposal in question. That paragraph may operate in effect through section 693.

Chapter 12: Priority rules

Section 699: Priority of this Part for corporation tax purposes

1936. This section provides that this Part has priority, as regards amounts brought into account in accordance with it in respect of any matter, over any corporation tax provision that would otherwise apply. It is based on paragraph 1(2) of Schedule 26 to FA 2002.
1937. This rule covers not only the case where an amount is dealt with under sections 573 or 574 but also a case to which Chapter 7 applies.
1938. *Subsection (3)* lists particular cases where the rule is disregarded.
1939. *Section 700* deals with the case where Part 5 (loan relationships) has priority over this Part. If that Part applies to any amounts, those amounts are not in fact brought into account in accordance with this Part and so this section cannot apply.

Section 700: Relationship of this Part to Part 5: loan relationships

1940. This section gives priority to Part 5 if the amount that would otherwise be brought into account under this Part, or (if different) the profit or loss accruing to the company on the derivative contract, is brought into account under that Part. This section is based on section 101 of FA 1996.
1941. This rule covers, for example, the case where a loan relationship arises from the conduct of a derivative contract (say, if one party defaults on a payment in the course of an interest rate swap and so owes money to the other). A payment due in respect of the loan relationship is dealt with under Part 5 and not under this Part.
1942. *Subsection (3)* sets out the significant exception to the general rule, that is, in a case where section 585 (loan relationships with embedded derivatives) applies. This Part applies instead of Part 5 to profits and losses in respect of an embedded derivative that is a derivative contract.

Chapter 13: General and supplementary provisions

Section 701: Power to amend some provisions

1943. This section contains powers for the amendment of this Part (and related paragraphs in Part 10 of Schedule 2). It is based on paragraph 13 of Schedule 26 to FA 2002 and paragraph 52 of Schedule 4 to FA 2005.
1944. The permitted amendments are broadly concerned with redefining what is or is not a derivative contract (whether by reference to the underlying subject matter of a relevant contract or otherwise). They are also concerned with adjusting the regime for special cases.
1945. *Subsections (1)* and *(2)* define what provisions in this Part and Schedule 2 may be amended by an order under this section. The lists in these subsections reflect the fact

that the rules in the amendable provisions of the source legislation (Parts 2 and 9 of Schedule 26 to FA 2002) are now ordered differently in this Part.

1946. *Subsection (5)* contains the commencement provisions for an order made under this section. The normal rule is that an order applies to accounting periods ending on or after the date on which the order comes into force. That rule includes a degree of retrospection in that the order may apply by reference to events that occurred in that accounting period before the order came into force. Retrospective application is partly increased by paragraph (b) of this subsection, which allows the order to apply to periods of account beginning in the year in which they are made (which would cover, for example, an accounting period of less than 12 months which has ended before the order is made).

Section 702: “Carrying value”

1947. This section defines the meaning of “carrying value” for the purposes of this Part. It is based on paragraphs 28(6) and 50A(3A) and (3B) of Schedule 26 to FA 2002.
1948. *Subsections (2)* and *(3)* ensure that the effect of various provisions dealing with special cases carries through for the purposes of calculating the carrying value under this section.
1949. *Subsection (4)* provides a definition of “impairment loss” (a term taken from international accounting standards) which is only implied by the source legislation by virtue of its reference to “amounts recognised for accounting purposes”. The definition is modelled on that provided for loan relationships by section 476. See *Change 67* in Annex 1.

Section 703: “Chargeable asset”

1950. This section defines the meaning of “chargeable asset” for the purposes of this Part. It is based on paragraphs 4A(4), 4B(5), 37(6) and 43A(3) of Schedule 26 to FA 2002.
1951. The definition extends under *subsection (2)* to amounts that are treated under section 143 of TCGA as assets whose disposal falls within TCGA. Those assets are obligations under a futures contract, that is, the obligation to supply or to take delivery of a commodity or other item under the contract at an agreed price. If there has been such market movement in the price of the commodity that the obligation is heading to produce a profit, a disposal of the obligation (before the contract has run to delivery) would be a disposal of an asset for the purposes of TCGA.

Section 704: “Creditor relationship” and “debtor relationship”

1952. This section defines “creditor relationship” and “debtor relationship” for the purposes of this Part. It is based on paragraphs 30A(7) and 54(1) of Schedule 26 to FA 2002.
1953. These terms occur in this Part in connection with a loan relationship or a relevant contract within section 585(2). The section therefore defines the terms by reference to section 302 in Part 5. In short, a creditor relationship refers to a debt *owned* and a debtor relationship to a debt *owed* by the company.

Section 705: Expressions relating to exchange gains and losses

1954. This section provides for the interpretation of references in this Part to “exchange gains” or “exchange losses” in relation to a company. It is based on paragraph 54(2), (2A) and (3) of Schedule 26 to FA 2002.
1955. *Subsection (2)* provides that, in the event that the comparison of values described in *subsection (1)* gives neither a gain nor a loss, an exchange gain of nil arises. This rule applies in a case where it is necessary for there be an amount of an exchange gain or exchange loss for a provision to apply (say, section 694(6)).

1956. *Subsection (3)* provides powers for the Treasury to make regulations as to the calculation of exchange gains and losses and any other profits, gains or losses if the company uses fair value accounting. See [The Loan Relationships and Derivative Contracts \(Exchange Gains and Losses using Fair Value Accounting\) Regulations 2005 \(SI 2005/3422\)](#). As in the case of the powers in section 701, regulations made under these powers may apply to any period of account beginning in the year in which they are made.
1957. *Subsection (5)* sets out what a reference to an exchange gain or loss from a company's derivative contracts means (for the purposes of, say, section 606(1)).

Section 706: “Excluded body”

1958. This section defines “excluded body” for the purposes of this Part. It is based on paragraphs 45C(3), 45D(2), 45G(1A), 45J(2) and 45K(2) of Schedule 26 to FA 2002.
1959. The bodies which are excluded bodies are all types of collective investment scheme.
1960. “Authorised unit trust” is defined in section 832(1) of ICTA by reference to section 468(6) of that Act, which in turn refers to a scheme in respect of which an order under section 243 of FISMA is in force in the relevant accounting period.
1961. “Investment trust” has the meaning given by section 842 of ICTA and “venture capital trust” the meaning given by section 834(1) of ICTA (by reference to Part 6 of ITA).
1962. “Open-ended investment company” is defined in section 710 by reference to section 468A(2) of ICTA which in turn refers to a company incorporated in the United Kingdom to which section 236 of FISMA applies.

Section 707: “Hedging relationship”

1963. This section sets out two cases in which a company is regarded as having a “hedging relationship” for the purposes of this Part. It is based on paragraph 12(14) of Schedule 26 to FA 2002.
1964. The concept of “hedging” has to do with contracts undertaken to protect the company's assets (or to guard against increase in its liabilities) in a case where there is some form of market volatility associated with the item. The cases described in this section derive from those set out in accounting standards. Paragraph 86 of Financial Reporting Standard 26, the equivalent for UK generally accepted accounting practice of International Accounting Standard 39, describes a hedging relationship as follows:

Hedging relationships are of three types:

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

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

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

1965. Paragraph 9 of Financial Reporting Standard 26 also provides definitions of “hedging instrument” and “hedged item”.

Section 708: “Plain vanilla contract”

1966. This section defines “plain vanilla contract”. It is based on paragraph 2(2B) of Schedule 26 to FA 2002.
1967. The term means any relevant contract except those to which a company is treated as a party under section 584, 585 or 586.

Section 709: “Securities house”

1968. This section defines “securities house” for the purposes of this Chapter. It is based on paragraphs 45J(10), 45JA(5) and 45K(4) of Schedule 26 to FA 2002.

Section 710: Other definitions

1969. This section defines a number of terms for the purposes of this Part. It is based on paragraphs 12(1), (2), (9), (11), (12), (13) and (17) and 54(1) and (4) of Schedule 26 to FA 2002.
1970. Where appropriate, terms used in this Part in connection with the business of a life assurance company take the meaning given in Chapter 1 of Part 12 of ICTA (see in particular section 431(2) of ICTA).
1971. The section does not rewrite those definitions in paragraph 54(1) of Schedule 26 to FA 2002 of terms that are no longer in use in that Schedule (for example, “UK company”) or have been replaced by other terms (for example, “nested derivative”). Nor does it rewrite the definition of “investment trust” as that is already provided by section 842 of ICTA.