EXPLANATORY MEMORANDUM

THE FINANCE ACT 2002, SCHEDULE 26, PARTS 2 AND 9 (AMENDMENT) ORDER 2004 No.2201

1. This explanatory memorandum has been prepared by the Commissioners of Inland Revenue and is laid before the House of Commons by Command of Her Majesty.

2. Description

2.1 This Order provides amendments to Schedule 26 to the Finance Act 2002 (derivative contracts). The main purpose of the amendments is to exclude certain profits and losses on some derivative contracts from the charge to corporation tax as income and instead to provide for them to be charged to corporation tax as chargeable gains. The derivative contracts to which the amendments apply are those whose underlying subject matter is land and those which are deemed to exist as a result of section 94A Finance Act 1996 which provides for the accounting treatment applicable to complex financial instruments to be followed for tax purposes by the bifurcation of the instrument into a debt component and a derivative component.

3. Matters of Special interest to the Select Committee on Statutory Instruments

3.1 None.

4. Legislative Background

4. These regulations are being made under powers conferred by paragraph 13 Schedule 26 Finance Act 2002. The power was amended so as to apply to Part 9 as well as Part 2 by paragraph 2 Schedule 9 Finance Act 2004. They are the first exercise of the power given by paragraph 13.

5. Extent

5.1 The instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 The Financial Secretary to the Treasury has made the following statement:

In my view the provisions of the Finance Act 2002, Schedule 26, Parts 2 and 9 (Amendment) Order 2004 are compatible with the convention rights.

7. Policy Background

7.1 There is no developed market in property derivatives in the UK. This is partly due to uncertainties over the tax treatment of such derivatives, which do not fall within the comprehensive and clear regime for other derivatives which are taxed as income by Schedule 26 Finance Act 2002. But neither was it thought appropriate for the full panoply of Schedule 26 to apply to these derivatives, as where they perform a hedging function, it will usually be to hedge an asset (land) that falls within the rules for chargeable gains.

7.2 Accordingly, the Order provides for property derivatives to be included in Schedule 26, but for a special tax treatment to be given to the gains and losses arising in each period that are given by that Schedule. The gains and losses are brought into account for corporation tax as chargeable gains and allowable losses, with the ability to carry back losses for up to 2 years. It is expected that when the Order comes into force a market in property derivatives will develop.

7.3 The other main effect of the Order is to provide a similar tax treatment for "embedded derivatives". Since 1996 the tax treatment of "hybrid" financial instruments such as convertible securities has been governed by Chapter 2 Part 4 FA 1996 (loan relationships). This legislation, in sections 92 to 94 FA 1996, provided for non-standard tax treatment (capital gains rather than income) in some cases of the "equity" element of convertibles and other hybrid securities, and for a form of exemption for the index-liked element of an index linked gilt.

7.4 The carving out of the non-standard element was difficult and did not draw the line in the right place having regard to the substance and the economics of the instruments. This was primarily because UK Generally Accepted Accounting Practice did not cater expressly for such instruments.

7.5 Under International Accounting Standards 32 and 39 (which are likely to be adopted as a UK Standard from 2005) there is now a way to separate the derivative element of a hybrid instrument from its host debt contract. Accordingly Schedule 10 FA 2004 repeals sections 92 to 94 FA 1996, and replaces them with section 94A which provides that a hybrid instrument is bifurcated for tax purposes into a host contract to which Chapter 2 Part 4 FA 1996 applies, and an "embedded derivative" to which Schedule 26 applies.

7.6 The Order then sets out how a deemed derivative created by section 94A is taxed. In general they will be taxed like other derivatives as income: but where sections 92 to 94 would have given non-standard tax treatment to an element of the contract, the Order will provide for non-standard treatment of the embedded derivative. That will be in general be like the treatment given to property derivatives. But for the embedded derivative element of an index-linked gilt, there will be a total exemption.

7.7 There has been consultation on this Order. A draft of the parts of the Order relating to property derivatives was published at the time of the Pre-Budget Report in 2003 with an accompanying document. There has been consultation with relevant bodies on both the property derivatives parts and the rest of the Order and later drafts have been published on the Inland Revenue's website for comments.

8. Impact

8.1 A Regulatory Impact Assessment has not been published for this instrument.

8.2 The regulations are expected to have negligible Exchequer impact as they generally maintain the status quo where relevant contracts already exist, and pave the way for a tax treatment of contracts that do not currently exist in the absence of this Order.

9. Contact

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