

**2004 No. 3270**

**INCOME TAX**

**The Finance Act 2002, Schedule 26, Parts 2 and 9 (Amendment  
No. 2) Order 2004**

*Made* - - - - - *9th December 2004*  
*Laid before the House of Commons* *10th December 2004*  
*Coming into force* - - - *31st December 2004*

The Treasury, in exercise of the powers conferred upon them by paragraph 13 of Schedule 26 to the Finance Act 2002(a) make the following Order:

**Citation, commencement and effect**

1.—(1) This Order may be cited as the Finance Act 2002, Schedule 26, Parts 2 and 9 (Amendment No. 2) Order and shall come into force on 31st December 2004.

(2) This Order has effect in relation to periods of account beginning on or after 1st January 2005.

**Amendments of Part 2 of Schedule 26**

2. Part 2 of Schedule 26 to the Finance Act 2002 is amended as follows.

3. In paragraph 2, after sub-paragraph (2) insert—

“(3) Sub-paragraph (4) applies where a company, in accordance with generally accepted accounting practice, treats rights and liabilities under a contract to which it is party and which is not a loan relationship, as divided between—

- (a) rights and liabilities under one or more derivative financial instruments (“embedded derivatives”), and
- (b) the remaining rights and liabilities (the “host contract”).

(4) The company shall be treated for the purposes of Schedule 26 as—

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

(5) Each relevant contract to which the company is treated as party under sub-paragraph (4) shall be treated as an option, a future or a contract for differences according to whether the rights and liabilities of the embedded derivative would be of that character if contained in a separate contract.”.

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(a) 2002 c. 23. Paragraph 13 was amended by paragraph 2 of Schedule 9 to the Finance Act 2004 (c. 12).

4. In paragraph 5A(a)—

- (a) at the end of sub-paragraph (2)(a) add “or paragraph 2(4), and”;
- (b) at the end of sub-paragraph (2)(b) for “company, and” substitute “company.”; and
- (c) omit sub-paragraph (2)(c).

**Amendments of Part 9 of Schedule 26**

5. Part 9 of Schedule 26 to the Finance Act 2002 is amended as follows.

6. In paragraph 45D(b) for sub-paragraph (8) substitute—

“(8) A loan relationship which is one to which sub-paragraph (1) applies, shall not be treated as a qualifying corporate bond by virtue of section 117(A1) of the Taxation of Chargeable Gains Act 1992, if this paragraph applies to the embedded derivative contract.”.

7. At the end of paragraph 45F add—

“(8) A loan relationship which is one to which sub-paragraph (1) applies, shall not be treated as a qualifying corporate bond by virtue of section 117(A1) of the Taxation of Chargeable Gains Act 1992, if this paragraph applies to the embedded derivative contract.”.

8. In paragraph 45G after sub-paragraph (1)(d) insert—

“(e) the additional conditions in sub-paragraph (1A) are satisfied.

(1A) The additional conditions are—

- (a) the derivative contract is not one to which the company is party at any time in the accounting period for the purposes of a trade carried on by the company (but see sub-paragraph (1B)), and
- (b) the company is not a body falling within paragraph 45C(3) (authorised unit trusts etc).

(1B) The condition in sub-paragraph (1A)(a) does not apply if the company—

- (a) is party to the derivative contract for the purposes of life assurance business, or
- (b) is a mutual trading company.”.

9. Omit paragraph 45H.

10. After paragraph 45I insert—

**“Issuers of securities with embedded derivatives: deemed options**

**45J.**—(1) This paragraph applies to a derivative contract of a company for an accounting period if the following conditions are satisfied—

- (a) section 94A of the Finance Act 1996(c) (loan relationships with embedded derivatives) has effect in relation to a debtor relationship of the company,
- (b) the derivative contract is the relevant contract, or one of the relevant contracts, to which the company is treated under subsection (2)(b) of that section as party in the case of that debtor relationship,
- (c) that relevant contract is treated by virtue of subsection (3) of that section as an option,

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(a) Paragraph 5A was inserted by article 7 of S.I. 2004/2201.

(b) Paragraphs 45A to 45I were inserted by article 15 of S.I. 2004/2201.

(c) 1996 c. 8, section 94A was inserted by paragraph 13 of Part 1 of Schedule 10 to the Finance Act 2004.

(d) the additional conditions in sub-paragraph (2) are satisfied,

(2) The additional conditions are—

(a) at the time when the company became party to the debtor relationship—

(i) it was not carrying on a banking business or a business as a securities house,  
or

(ii) if it was carrying on such a business, it did not become party to the debtor relationship in the ordinary course of that business,

(b) the derivative contract is not one to which any of paragraphs 6 to 8 applies,

(c) the underlying subject matter of the derivative contract is shares,

(d) the company is not a body falling within paragraph 45C(3) (authorised unit trusts etc).

(3) Where this paragraph applies to a derivative contract for an accounting period—

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

(b) sub-paragraph (5), (7) or (9) (as the case may be) of this paragraph shall, subject to sub-paragraph (4), apply instead.

(4) Sub-paragraphs (5), (7) and (9) do not apply where the company is a party to the debtor relationship mentioned in sub-paragraph (1) immediately before the first accounting period to which this paragraph applies.

(5) This paragraph applies if—

(a) the option mentioned in sub-paragraph (1)(c) is exercised at any time in an accounting period, and

(b) shares are issued or transferred in fulfilment of the obligations under the option (the “relevant disposal”)

and where it applies, section 144(2) of Taxation of Chargeable Gains Act 1992 (exercise of options) applies to the relevant disposal as if the amount treated in accordance with section 94A(2) of the Finance Act 1996 as the carrying amount of the option at the time the company became party to the loan relationship (the “initial carrying amount”) was the consideration for the grant of the option.

(6) Sub-paragraph (7) applies if—

(a) the option mentioned in sub-paragraph (1)(c) is exercised at any time in an accounting period,

(b) there is no relevant disposal, and

(c) an amount is paid in fulfilment of the obligations under the option.

(7) Where this sub-paragraph applies—

(a) if E exceeds F, a chargeable gain equal in amount to the amount of the excess shall be treated as accruing to the company in the accounting period,

(b) if F exceeds E, an allowable loss equal in amount to the amount of the excess shall be treated as accruing to the company in the accounting period,

(8) In sub-paragraph (7)—

E is the initial carrying amount of the option;

F is the amount paid in fulfilment of the obligations under the option reduced by the aggregate of—

(a) the initial carrying amount of the option and

(b) the carrying amount of the host contract (within the meaning of section 94A of the Finance Act 1996) at the time the company became party to the loan relationship.

(9) This paragraph applies if the debtor relationship comes to an end at a time when the option mentioned in sub-paragraph (1)(c) has not been exercised, and where it applies the company is treated for the purposes of corporation tax on chargeable gains as having disposed of the option for a consideration equal to the initial carrying amount.

(10) In this paragraph—

“option” has the same meaning as in paragraph 12, apart from sub-paragraph (10);

“securities house” means a person—

- (a) who is authorised for the purposes of the Financial Services and Markets Act 2000, and
- (b) whose business consists wholly or mainly of dealing as a principal in financial instruments within the meaning of section 349(5) and (6) of the Taxes Act 1988.

### **Issuers of securities with embedded derivatives: deemed contracts for differences**

**45K.**—(1) This paragraph applies to a derivative contract of a company for an accounting period if the following conditions are satisfied—

- (a) section 94A of the Finance Act 1996 (loan relationships with embedded derivatives) has effect in relation to a debtor relationship of the company,
- (b) the derivative contract is the relevant contract, or one of the relevant contracts, to which the company is treated under subsection (2)(b) of that section as party in the case of that debtor relationship,
- (c) the relevant contract is treated by virtue of subsection (3) of that section as a contract for differences (other than one which falls within paragraph 45J), and
- (d) the derivative contract is an exactly tracking contract within the meaning of paragraph 45F, and
- (e) the additional conditions in sub-paragraph (2) are satisfied.

(2) The additional conditions are—

- (a) at the time when the company became party to the debtor relationship—
  - (i) it was not carrying on a banking business or a business as a securities house, or
  - (ii) if it was carrying on such a business, it did not become party to the debtor relationship in the ordinary course of that business,
- (b) the derivative contract is not one to which any of paragraphs 6 to 8 applies,
- (c) the underlying subject matter of the derivative contract is land (wherever situated) or shares,
- (d) the company is not a body falling within paragraph 45C(3) (authorised unit trusts etc).

(3) Where this paragraph applies to a derivative contract for an accounting period, paragraph 14(3) (non-trading credits and debits) shall not apply to credits and debits given in relation to the contract for the accounting period by paragraph 15.

(4) In this paragraph “securities house” has the same meaning as in paragraph 45J (see sub-paragraph (10) of that paragraph).

### **Derivatives not embedded in a loan relationship**

**45L.**—(1) Where—

- (a) a company is treated under paragraph 2(4) as party to a derivative contract, and
- (b) regulation 9 of the Disregard Regulations (interest rate contracts) does not apply to the contract,

paragraph 14(3) (non-trading credits and debits) shall not apply to credits and debits given in relation to the fair value profits and losses arising on the contract.

(2) Where paragraph (1) applies, then notwithstanding paragraph 1(2) of this Schedule, profits and losses are to be brought into account in relation to the host contract for the purposes of the Corporation Tax Acts as if the derivative contract embedded in the host contract were treated for accounting purposes as closely related to the host contract.

(3) In this paragraph “the Disregard Regulations” means the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004(a).”.

11. After paragraph 48 insert—

**“Embedded derivatives in connected party loans**

**48A.** Where in any accounting period—

- (a) a company is party as a creditor to a loan relationship falling within section 94A(1) of the Finance Act 1996, and
- (b) the loan relationship is one to which section 87 of that Act applies (accounting methods where parties have a connection),

no loss arising in that period to the company from the derivative contract, or any of the derivative contracts, to which in the case of that loan relationship the company is treated as party by virtue of section 94A(2)(b) of the Finance Act 1996 gives rise to a debit for the purposes of this Schedule.”.

12.—(1) Paragraph 50A(b) is amended as follows.

(2) For sub-paragraph (1) substitute—

“(1) This paragraph applies where—

- (a) there is a change of accounting policy in drawing up a company’s accounts from one period of account (the “earlier period”) to the next (the “later period”), and
- (b) the approach in each of those periods accorded with the law and practice applicable in relation to that period.

(1A) This paragraph applies, in particular, where—

- (a) the company prepares accounts for the earlier period in accordance with UK generally accepted accounting practice and for the later period in accordance with international accounting standards, or
- (b) the company prepares accounts for the earlier period in accordance with international accounting standards and for the later period in accordance with UK generally accepted accounting practice.”.

(3) In sub-paragraph (3), after “means” insert “subject to paragraph (3B),”.

(4) After that sub-paragraph insert—

“(3A) For the purposes of this paragraph the “carrying value” of a contract includes amounts recognised for accounting purposes in relation to the contract in respect of—

- (a) accrued amounts;
- (b) amounts paid or received in advance;
- (c) impairment losses (including provisions for bad or doubtful debts).

(3B) In determining the profits, gains and losses to be recognised in determining the carrying value of the contract for the purposes of this paragraph, the following provisions—

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(a) 2004/3256.

(b) Paragraph 50A was inserted by paragraph 67 of Schedule 10 to the Finance Act 2004.

- (a) section 94A(2) of the Finance Act 1996<sup>(a)</sup> (loan relationships with embedded derivatives), and
- (b) paragraphs 21 and 28 of this Schedule

apply as they apply for the purposes of determining the credits and debits to be brought into account under this Schedule.

(3C) Where—

- (a) a company has ceased to be a party to a derivative contract,
- (b) paragraph 53(3) of this Schedule (credits and debits to be brought into account in respect of profits and losses arising in the cessation period) applied to the cessation, and
- (c) there is a difference between—
  - (i) the amount outstanding in respect of the derivative contract at the end of the earlier period, and
  - (ii) the amount outstanding in respect of the derivative contract at the beginning of the later period,

a debit or credit (as the case may be) corresponding to that difference shall be treated as a debit or credit falling within sub-paragraph (2).

(3D) In sub-paragraph (3C), “the amount outstanding”, in respect of a derivative contract, means so much of the amount recognised as deferred income or deferred loss in the company’s balance sheet, in accordance with generally accepted accounting practice, 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)) as has not been represented by debits or credits brought into account under this Schedule.”.

(5) Omit paragraph (4).

(6) After sub-paragraph (4) insert—

“(5) This paragraph does not apply if or to the extent that such a debit or credit as is mentioned in sub-paragraph (2) falls to be brought into account apart from this paragraph.”.

*Derek Twigg*  
*Jim Murphy*

9th December 2004

Two of the Lords Commissioners of Her Majesty’s Treasury

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<sup>(a)</sup> Section 92A was inserted by section 52 to, and paragraph 13 of Schedule 10 to, the Finance Act 2004.

## **EXPLANATORY NOTE**

*(This note is not part of the Order)*

Article 1 provides for the citation, commencement and effect of the Order.

Article 2 introduces the amendments to Part 2 which are made by articles 3 and 4.

Article 5 introduces the amendments made to Part 9 which are made by articles 6 to 12.

The effect of the amendments to Part 9 is to exclude certain profits and losses on some derivative contracts from the charge to corporation tax as income and, in certain cases, instead to provide for them to be charged to corporation tax as chargeable gains. The derivative contracts to which the amendments apply are 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.

The amendments to Parts 2 and 9 also apply to exclude from the charge to corporation tax as income certain profits and losses on some derivative contracts deemed to be embedded in contracts which are not themselves financial assets or liabilities.

The amendments made by article 12 align paragraph 50A of Schedule 26 with paragraph 19A Sch 9 Finance Act 1996, its counterpart in Chapter 2 Part 4 Finance Act 1996. They also ensure that the comparison in paragraph 50A of the carrying value of derivative contracts is of that value as adjusted for tax purposes.

This Order does not impose any new costs on business.

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No. 2) Order 2004

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