

## **EXPLANATORY MEMORANDUM TO THE**

### **FINANCE ACT 2002, SCHEDULE 26, PARTS 2 AND 9 (AMENDMENT No. 2) ORDER 2005**

#### **2005 No. 2082**

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

This memorandum contains information for the Select Committee on Statutory Instruments.

#### **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 modify the provisions of Part 9 of the Schedule relating to derivative contracts which are embedded in other contracts, in particular to distinguish between contracts which were held at the date of a company's adopting International Accounting Standards from those later acquired.
- 2.2 The Order also inserts new paragraphs 4B and 4C to cover additional cases where a contract becomes a derivative contract for tax purposes as a result of the changes made to Schedule 26 by the Finance Act 2002, Schedule 26, Parts 2 and 9 (Amendment) Order 2005 (SI 2005/646).

#### **3. Matters of special interest to the Select Committee on Statutory Instruments**

- 3.1 The Department regrets that compliance with the 21-day rule is not possible in this case in respect of article 6. This article forms part of a significant anti-avoidance package announced by the Chancellor of the Exchequer on Budget Day, 16<sup>th</sup> March 2005. Unless the article comes into force immediately, there is significant risk that transactions would be entered into to exploit any gaps the Order is intended to fill.

#### **4. Legislative Background**

- 4.1 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.

#### **5. Extent**

- 5.1 This instrument applies to all of the United Kingdom.

## **6. European Convention on Human Rights**

6.1 The Paymaster General has made the following statement regarding Human Rights:

In my view the provisions of the Finance Act 2002, Schedule 26, Parts 2 and 9 (Amendment No. 2) Order 2005 are compatible with the Convention rights.

## **7. Policy background**

7.1 The main effect of the Order is to provide an appropriate tax treatment for the holders and issuers of securities and other contracts containing “embedded derivatives”. From 1996 the tax treatment of “hybrid” financial instruments such as convertible securities has been governed by sections 92 to 94 in Chapter 2 Part 4 FA 1996 (loan relationships). This legislation was repealed by the Finance Act 2004 and replaced by section 94A which divides a contract with an “embedded derivative” into a “host contract” treated as debt and an embedded derivative treated as an option or other contract whose underlying subject matter is shares

7.2 The Order further modifies the way the deemed derivatives created by section 94A are taxed so far as relates to the issuer of the security. It also provides further modifications for the tax treatment of derivatives embedded in contracts which are not debt contracts, and makes other minor amendments to the legislation in Schedule 26 Finance Act 2002 about derivative contracts.

7.3 There has been consultation on this Order with relevant bodies.

## **8. Impact**

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

8.2 There is no impact on the public sector.

## **9. Contact**

Richard Thomas at Her Majesty’s Revenue & Customs Tel 020 7147 2558 or e-mail [richard.thomas@hmrc.gsi.gov.uk](mailto:richard.thomas@hmrc.gsi.gov.uk) can answer any queries regarding the instrument.