

## **Technical Paper: changes to loan relationships and derivative contracts rules on amounts not fully recognised for accounting purposes**

This Technical Paper invites views on proposals to amend Sections 311 and 312, and Sections 599A and 599B, of the Corporation Tax Act 2009 (CTA).

The Corporation Tax rules on loan relationships and derivative contracts are set out in Parts 5 to 7 CTA. These rules provide that the amounts to be brought into account for tax purposes are those that, in accordance with generally accepted accounting practice (GAAP), are recognised in determining a company's profit or loss for the period. In certain circumstances where assets and liabilities are 'matched', GAAP may permit or require the whole or part of those assets and liabilities (and/or the income arising on them) not to be recognised (or to become 'derecognised'). Consequently, amounts which would otherwise be brought into account for tax purposes are not brought into account.

Legislation introduced in Finance Act (FA) 2006 which became Section 85C of Finance Act 1996 was targeted at preventing Corporation Tax avoidance involving accounting (and hence tax) derecognition of credits arising on a company's loan relationships, where an interest receipt is matched with the payment of a dividend on 'liabilities', and there is as a consequence no net liability to tax, even though no deduction is due for the dividend under the Corporation Tax Acts.

As introduced in FA 2006, Section 85C addressed cases where Company A invests money or makes a loan, issues preference shares to company B matching the loan, and derecognises the loan. Company A pays dividends on the shares issued to Company B. Where these conditions are met, credits and debits arising on company A's creditor loan relationship are brought into account for tax purposes on the assumption that the loan relationship is fully recognised in its accounts.

Section 85C was amended in Finance Acts 2007 and 2009 in response to new tax avoidance schemes notified under the Disclosure of Tax Avoidance Scheme (DOTAS) rules. The new schemes involved derecognition in circumstances where Company A receives a capital contribution from and pays all benefits to Company B, or issues securities to Company B, and schemes in which Company A issues shares to, receives a capital contribution from or issues securities or Company B, that mirror the performance of a derivative contract.

The legislation in question is now to be found at Sections 311 and 312 CTA (for loan relationships), and Sections 599A and 599B CTA (for derivative contracts). Section 311 sets out the three cases (conditions A, B and C), and Section 599A sets out the two cases (conditions A and B) in which credits and debits arising on a creditor loan relationship or derivative are brought into account for tax purposes on the assumption that the loan relationship or derivative contract in question is fully recognised in the accounts.

## **Finance (No.2) Bill 2010: further targeted measures**

Further disclosures under the DOTAS rules have indicated that Corporation Tax avoidance schemes involving derecognition continue to be developed. Recently notified schemes have involved derecognition where a company with a loan asset or valuable derivative:

- enters into an agreement with another entity under which in return for additional shares or an increased interest in that entity it undertakes to make payments equal to the amounts it receives (interest and principal) which transfer the benefit of that loan or derivative to the other entity
- derecognises that loan or derivative in an accounting period because it is contractually committed to issue securities to a connected company in the following accounting period that will form part of its capital in that next period

In consequence, Finance (No.2) Bill 2010 includes legislation to address these new examples of tax avoidance schemes involving derecognition.

Firstly, new conditions have been added to Sections 311 and 599A CTA so that they apply where a company acquires or varies a 'relevant interest' in another company, or a partnership or a trust. 'Relevant interest' here means an interest in the other company's shares or other capital, or an entitlement to the partnership's profits or capital, or an interest in the trust's property.

Secondly, the current rules are extended so that they apply where derecognition is triggered by an event that occurs in a later accounting period to that in which the derecognition takes place. This measure is to be found in Schedule 5 to Finance (No.2) Bill 2010.

[Budget Note 17](#) announced that this measure has effect from Budget Day 22 June 2010.

## **Finance Bill 2011: a general rule on 'derecognition'**

As a result of persistent avoidance involving derecognition schemes, the Government has announced that it will consult on recasting the legislation so that it operates as a general rule that derecognition in the accounts is not followed for the purposes of the loan relationships and derivative contracts rules in Parts 5 to 7 of CTA.

Sections 311 and 599A would be amended by repealing the 'conditions' in which derecognition in the accounts is not observed for tax purposes, and replacing them with a rule that a creditor loan relationship or derivative contract is always fully recognised for tax purposes if amounts are derecognised in accounts as a result of 'arrangements'. There would be some consequential changes to Section 312 CTA.

'Arrangements' would take the meaning commonly used in such legislation to include any arrangements, scheme or understanding of any kind, whether or not legally enforceable, involving a single transaction or two or more transactions.

Recasting the rule in this way will mean that it will apply to a wider range of circumstances than is currently the case, and will obviate the need to insert new Conditions each time further examples of tax avoidance involving derecognition arise. This will protect The Exchequer from repeated manifestations of schemes involving derecognition and provide greater certainty on the application of the legislation.

However, it is not the intention that this should have an inappropriate impact on normal trading transactions, hedging arrangements, or conduit loans or other 'pass-through' arrangements, in which GAAP may require derecognition of certain amounts. HM Revenue & Customs (HMRC) acknowledge that certain transactions will be affected by the proposal to amend the legislation and therefore invites comments on the extent to which they should be excluded from the amended rule. Where necessary, cases in which the application of the assumption that amounts should be fully recognised would lead to an unfair tax result will be addressed by an express legislative exclusion (for example by reference to hedging relationships within the 'Disregard Regulations' SI 2004/3256).

HMRC also acknowledges that any changes to the tax rules on derecognition need to take into account the International Accounting Standards Board's proposals in Exposure Draft ED/2009/3 for new guidance on when a financial asset is to be removed from a company's financial statements.

Comments on the draft legislation should be emailed to the following HMRC contacts **by 17 September 2010**.

[Tony Sadler](#) or [Richard Rogers](#)

## **Draft legislation and Explanatory Note**

Subject to responses to the proposals, an announcement may be made later in 2010 that the draft legislation set out below will be included in Finance Bill 2011, with effect from the date of that announcement.

- [Draft legislation \(Finance Bill 2011\)](#)
- [Draft Explanatory Note](#)
- [Consolidated version of the amended legislation](#)

### **Draft legislation (Finance Bill 2011)**

#### **Amounts not fully recognised for accounting purposes**

##### **Amendments of Sections 311, 312 and 599A of CTA 2009**

1 (1) Section 311 of CTA 2009 (loan relationships: amounts not fully recognised for accounting purposes) is amended as follows.

(2) In sub-section (2)

- (a) at the end of paragraph (a) insert 'and', and
- (b) for paragraphs (b) and (c) substitute  
(b) as a result of arrangements to which the company is at any time a party, an amount is (in accordance with generally accepted accounting practice) not fully recognised for the period in respect of the creditor relationship'.

(3) Omit sub-sections (3) to (5).

- (4) In sub-section (6)
- (a) in the opening words
    - (i) before 'relationship' insert 'creditor' and
    - (ii) omit ', a contribution to it or securities issued by it.' and
  - (b) in paragraphs (a) and (b), omit 'contribution or securities'.

(5) After sub-section (6) insert:

'(7) In this Section 'arrangements' includes any arrangements, scheme, or understanding of any kind, whether or not legally enforceable, involving a single transaction or two or more transactions'.

2 (1) Section 312 of that Act (determination of credits and debits where amounts not fully recognised) is amended as follows.

(2) In sub-section (1), omit paragraph (b) and the 'or' before it.

(3) After that sub-section insert:

'(1A) Sub-section (1B) applies in a case where

- (a) pursuant to the arrangements mentioned in Section 311(2)(b), the company becomes, or is treated as becoming, a party to a debtor relationship, and
- (b) an amount is (in accordance with generally accepted accounting practice) not fully recognised for any period in respect of the debtor relationship.

(1B) In determining the debits and credits which a company is to bring into account for any period for the purposes of this Part in respect of the debtor relationship, the assumption in sub-section (2) is to be made'.

(4) In sub-section (4)(b):

- (a) for 'sub-section (1)(a)' substitute 'sub-section (1)', and
- (b) for 'sub-section (1)(b)' substitute 'sub-section (1B)'.

3 (1) Section 599A of that Act (derivative contracts: amounts not fully recognised for accounting purposes) is amended as follows.

(2) In sub-section (2):

- (a) at the end of paragraph (a) insert 'and', and
- (b) for paragraphs (b) and (c) substitute
  - (b) as a result of arrangements to which the company is at any time a party, an amount is (in accordance with generally accepted accounting practice) not fully recognised for the period in respect of the contract'.

(3) Omit sub-sections (3) to (5)

(4) In sub-section (6):

- (a) in the opening words, omit ', a contribution to it or securities issued by it', and
- (b) in paragraphs (a) and (b), omit ', contribution or securities'.

(5) After sub-section (6) insert:

'(7) In this Section 'arrangements' includes any arrangements, scheme or understanding of any kind, whether or not legally enforceable, involving a single transaction or two or more transactions.'

## **Consequential repeals**

4 In consequence of the amendments made by this Schedule, omit  
(a) in Schedule 30 to FA 2009, paragraph 2(2) to (6), and  
(b) [in Schedule X to F(2)A 2010, paragraphs X to Y].

## **Commencement**

5 (1) The amendments made by this Schedule have effect in relation to periods of account beginning on or after [xx xxxx 2010].

(2) But, for the purposes of sub-paragraph (1), a period of account beginning before, and ending on or after [xx xxxx 2010] is to be treated as if so much of the period as falls before that date, and so much of the period as falls on or after that date, were separate periods of account.

## **Draft Explanatory Note**

### **Clause xx Schedule xx: Derecognition**

#### **Summary**

1. Draft clause xx and Schedule xx amend the Corporation Tax rules on loan relationships and derivative contracts that apply to amounts that are not fully recognised for accounting purposes. Under the current rules, where a company 'derecognises' a loan or derivative and its associated cash flows in accordance with generally accepted accounting practice ('GAAP'), in specified circumstances amounts are brought into account for tax purposes as if the accounts had in fact recognised them. The proposed amendments to these rules change the basis on which the legislation operates so that for periods ending after xx xxxx 2010, 'derecognition' is generally disregarded for tax purposes, with certain exceptions.

#### **Details of the schedule**

2. Paragraph 1 amends Sections 311 of the Corporation Tax Act 2009 (CTA). It removes the Conditions in that Section which set out the circumstances in which amounts derecognised under GAAP are taxed as if they were recognised.
3. Currently these Conditions reflect the avoidance schemes which have so far made use of the concept of derecognition to ensure that amounts that would otherwise be taxable fall out of account. The Conditions are:
  - that a company is party a creditor loan relationship (that is, holds a loan as a financial asset) and
  - is also party to a debtor loan relationship (a financial liability), or has received a capital contribution, or has issued securities, or, from xx/xx, acquires or varies a capital interest in another company or partnership and
  - as a result of the application of GAAP, amounts are not fully recognised in respect of the creditor loan relationship and the debtor loan relationship, capital contribution, securities, or capital interest in question
4. Where these conditions apply, Section 312 of CTA provides that amounts are brought into account for Corporation Tax purposes as if there had been

5. Instead of these conditions, the draft Schedule inserts a new rule into Section 311 of CTA that applies where a company is party to 'arrangements' under which amounts are not fully recognised under GAAP in respect of a creditor loan relationship. 'Arrangements' are defined broadly, and include all arrangements, schemes and understanding of any type.
6. Paragraph 2 amends Section 312 of CTA is amended to reflect the changes to the wording of Section 311 CTA. The effect of Section 312 remains that for tax purposes loan relationship credits arise on the creditor relationships as if they had been recognised in the accounts. Where there is a debtor loan relationship that corresponds to the creditor loan relationship, debits are similarly brought into account, up to the credits on the creditor relationship.
7. Paragraph 3 makes equivalent changes to Section 599A of CTA, which applies where a company is party to a derivative contract, receives a capital contribution, issues securities, or acquires a capital interest in another company or partnership, and amounts are not fully recognised and as a result of the application of GAAP, amounts are not fully recognised in respect of the derivative contract and the capital contribution, securities, or capital interest in question.
8. Paragraph 4 repeals parts of the Schedules to Finance Acts (FA) 2009 and 2010 that introduced certain of the current provisions.
9. Paragraph 5 sets out the commencement provisions. The changes have effect for periods of account beginning on or after xx xxxx 2010. Accounting periods beginning before and ending that date are treated as if they were separate periods and the new rules apply to the later period.

#### **Background Note**

10. The Corporation Tax rules that apply to loan relationships are based on the principle that amounts taxed and relieved as credits and debits under those rules are the profits and losses recognised in accounts drawn up in accordance with generally accepted accounting practice.
11. In certain circumstances, accounting rules require financial instruments, and the cash flows arising on them, to be derecognised. For example, a company may have made a loan or hold securities from which it receives income in the form of interest, and have issued fixed rate preference shares under which matching amounts are paid as dividends. While the company would be economically 'flat' in respect of its interest income and dividend payment, it is claimed that the income escapes tax.
12. The resulting asymmetry between the accounting and the tax treatment has been exploited in tax avoidance schemes. Legislation was first introduced in FA 2006 to counter this avoidance and has been added to in subsequent Finance Acts as new schemes have come to light. Rather than continue to make additions to the legislation in response to new examples of avoidance based on derecognition, these amendments create a general rule that taxable amounts arising on loan relationships and derivative contracts are to be computed as if there had been no derecognition for accounting purposes.

## **Consolidated version of the amended legislation**

### **Section 311 Amounts not fully recognised for accounting purposes: introduction**

- (1) Section 312 applies for the purpose of determining the credits and debits which a company is to bring into account for a period for the purposes of this Part in the following case.
- (2) The case is where:
- (a) the company is, or is treated as, a party to a creditor relationship in the period, and
  - (b) as a result of arrangements to which the company is at any time a party, an amount is (in accordance with generally accepted accounting practice) not fully recognised for the period in respect of the creditor relationship
- (6) For the purposes of this section an amount is not fully recognised for a period in respect of a creditor relationship of a company if:
- (a) no amount in respect of the relationship is recognised in determining its profit or loss for the period, or
  - (b) an amount is so recognised in respect of only part of the relationship
- (7) In this section 'arrangements' includes any arrangements, scheme or understanding of any kind, whether or not legally enforceable, involving a single transaction or two or more transactions.

### **Section 312 Determination of credits and debits where amounts not fully recognised**

- (1) In determining the credits and debits which a company is to bring into account for the period referred to in Section 311(1) for the purposes of this Part in respect of:
- (a) the creditor relationship mentioned in Section 311(2)
  - (b) the assumption in sub-section (2) is to be made
- (1A) Sub-section (1B) applies in a case where:
- (a) pursuant to the arrangements mentioned in Section 311(2)(b), the company becomes, or is treated as becoming, a party to a debtor relationship, and
  - (b) an amount is (in accordance with generally accepted accounting practice) not fully recognised or any period in respect of the debtor relationship
- (1B) In determining the debits and credits which a company is to bring into account for any period for the purposes of this part in respect of the debtor relationship, the assumption in sub-section (2) is to be made.
- (2) The assumption is that an amount in respect of the whole of the relationship in question is recognised in determining the company's profit or loss for the period.
- (3) But the amount of any debits to be brought into account by the company for a period as a result of this section applying in respect of its debtor relationships must not exceed the amount of any credits to be brought into

account by it for the period as a result of this section applying in respect of its creditor relationships.

- (4) Sub-section (5) applies in any case where:
  - (a) apart from this section any credits or debits are brought into account for a period for the purposes of this Part by the company in respect of a loan relationship, and
  - (b) the relationship is a creditor relationship within sub-section (1) or a debtor relationship within sub-section (1B)
- (5) The credits and debits which are to be so brought into account as a result of this section are to be determined on the same basis of accounting as that on which the credits or debits mentioned in sub-section (4)(a) are determined.
- (6) In any other case, the credits and debits which are to be so brought into account as a result of this section are to be determined on an amortised cost basis of accounting.

**Section 599A: Amounts not fully recognised for accounting purposes: introduction**

- (1) Section 599B applies for the purpose of determining the credits and debits which a company is to bring into account for a period for the purposes of this Part in the following case.
- (2) The case is where:
  - (a) the company is, or is treated as, a party to a derivative contract in the period, and
  - (b) as a result of arrangements to which the company is at any time a party, an amount is (in accordance with generally accepted accounting practice) not fully recognised for the period in respect of the contract
- (6) For the purposes of this section an amount is not fully recognised for a period in respect of a contract of a company if:
  - (a) no amount in respect of the contract is recognised in determining its profit or loss for the period, or
  - (b) an amount is so recognised in respect of only part of the contract
- (7) In this section 'arrangements' includes any arrangements, scheme or understanding of any kind, whether or not legally enforceable, involving a single transaction or two or more transactions.

**Section 599B: Determination of credits and debits where amounts not fully recognised**

- (1) In determining the credits and debits which a company is to bring into account for the period referred to in Section 599A (1) for the purposes of this Part in respect of the derivative contract mentioned in Section 599A(2), the assumption in sub-section (2) is to be made.
- (2) The assumption is that an amount in respect of the whole of the contract in question is recognised in determining the company's profit or loss for the period.
- (3) The credits and debits which are to be so brought into account for the purposes of this Part by the company in respect of the contract are to be determined on the basis of fair value accounting.