

# IFRS and Derivatives Taxation

**The United Kingdom operates a broadly accounts-based regime for the taxation of derivative contracts. Significant adjustments to figures shown in the profit and loss account may be required, however, and in some cases the legislation deliberately preserves the position under UK generally accepted accounting practice (UK GAAP) as it stood prior to 1 January 2005, even for companies that account under IFRS. The proposed introduction of IFRS 9 means that further development of the UK tax code is likely.**

## 1. Introduction

### 1.1. Adoption of IFRS in the United Kingdom

Some, but not all, UK tax-resident companies are obliged to account under IFRS.<sup>1</sup> The Accounting Standards Board of the United Kingdom also pursues an ongoing programme of convergence between UK generally accepted accounting practice (UK GAAP) and IFRS.<sup>2</sup> Relevantly to the present discussion, current UK GAAP incorporates financial reporting standards (FRS) 25, 26 and 29 (which correspond to IAS 32 and 39 and IFRS 7, respectively). FRS 26 is mandatory for many companies accounting under UK GAAP for periods beginning after 1 January 2006.<sup>3</sup> There is, however, a residual class of companies that have not yet adopted FRS 26 (referred to below as companies accounting under “old UK GAAP”).<sup>4</sup>

### 1.2. Accounting and corporation tax generally<sup>5</sup>

Observers have identified a contemporary trend in UK law towards harmonizing the tax treatment of transactions with their accounting treatment. To date, steps in that direction have been somewhat piecemeal. By way of overview:

Corporation taxpayers are obliged to compute any trade profits or profits of a UK property business, in accordance with “generally accepted accounting practice” (GAAP).<sup>6</sup> “GAAP” means *either* IFRS (in relation to a company that prepares its actual accounts under IFRS) *or* UK GAAP (in relation to any other company, including one that accounts under an overseas GAAP).<sup>7</sup>

This general rule is, however, expressly subject to “any adjustment required or authorized by law”, of which there are numerous instances. To cite two (random) examples: the United Kingdom has a separate statutory code giving tax relief on revenue account for certain types of capital expenditure;<sup>8</sup> and UK corporates are obliged to self-assess transfer pricing adjustments to transactions entered into otherwise than on arm’s length terms.<sup>9</sup>

In addition, where one group company accounts under IFRS and another accounts under UK GAAP, and there is a transaction between them which, as a result of their adopting different accounting practices, confers a tax advantage on one or both of them, then the company accounting under IFRS is obliged, as regards that transaction, to compute its taxable profits as though it accounted under UK GAAP.<sup>10</sup>

For non-traders, the Corporation Tax Act 2009 contains three explicitly accounts-driven tax regimes, in Part 5 (dealing with profits and losses from loan relationships), Part 7 (dealing with profits and losses from derivative contracts) and Part 8 (dealing with profits and losses from intangible fixed assets). The general rule in each case is that the credits and debits brought into account for tax purposes are those that are recognized in determining the company’s profit or loss for the period in accordance with GAAP. In each case, however, there are detailed rules that require deviation from the company’s actual (GAAP-compliant) accounts in certain circumstances. Part 7 naturally forms the focus of much of the rest of this article.

Following changes made to the Corporation Tax Act 2009 by Finance Act 2009, distributions received by UK corporation taxpayers from other companies (whether resident in the United Kingdom or overseas) are *prima facie* taxable, unless (broadly speaking) they fall into one

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1. Companies listed on the main market of the London Stock Exchange are, for periods commencing on or after 1 January 2005, required (in compliance with EC Regulation 1606/2002) to prepare their consolidated accounts under IFRS; this requirement is now extended by the listing rules of the alternative investment market of the London Stock Exchange to alternative investment market-listed companies for periods commencing after 1 January 2007.

2. UK GAAP is adopted by many UK privately held companies and some subsidiaries of UK listed companies. Sec. 407 of the Companies Act 2006 (CA 2006) provides, broadly, that where the parent company of a group prepares its individual entity accounts under UK GAAP, it is obliged to ensure that its subsidiaries also prepare their accounts under UK GAAP unless there are good reasons for not doing so. Conversely, where the parent prepares its entity accounts under IFRS, it is not obliged to ensure that its subsidiaries also account under IFRS.

3. All companies are permitted to apply FRS 26, but it is mandatory only for those companies pursuing accounting policies that are consistent with the fair value measurement rules now contained in the Large and Medium-Sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008/410).

4. This is in addition to small companies accounting under FRS for smaller entities (the UK GAAP equivalent of IFRS for small and medium-sized enterprises), which are not dealt with in this article.

5. This article deals only with the UK tax treatment of companies, not individuals.

6. Secs. 46 and 210 Corporation Tax Act 2009 (CTA).

7. Sec. 50 Finance Act (FA) 2004.

8. Capital Allowances Act 2001 (CAA).

9. Sec. 770A and Schedule 28AA Income and Corporation Taxes Act 1988 (ICTA).

10. Sec. 51 FA 2004.

of a number of fairly widely drawn “exempt classes” and are not excluded therefrom by anti-avoidance measures.<sup>11</sup> This contrasts with the previous position, whereby there was a blanket exemption for distributions from UK-resident companies,<sup>12</sup> while overseas distributions were taxable on an arising basis (i.e. when they became due and payable, rather than as they accrued).<sup>13</sup> Neither the old nor the new regime for the taxation of company distributions, therefore, follows the company’s accounts.

It is worth remarking that some recent legislative activity on the part of HM Revenue & Customs (HMRC) explicitly makes use of IFRS terminology and definitions: see for example Schedule 15 to Finance Act 2009, which introduces the so-called “worldwide debt cap” designed to restrict interest deductions in circumstances where the UK members of a group are more highly geared than the group viewed on a consolidated basis. The financial tests therein largely run off IFRS-compliant accounts (although UK and overseas GAAPs are also relevant in applying the “gateway tests” in Part 2 Schedule 15).

To summarize, therefore:

- IFRS is generally relevant to the computation of a company’s profits for UK tax purposes only where the company in question prepares its statutory accounts in accordance with IFRS; but
- UK GAAP is converging with IFRS, such that any differences in practice are diminishing (this is perhaps particularly so in the field of derivatives and financial instruments; there remain important differences in other areas); and
- statutory modifications affecting a company’s tax profits generally apply regardless of whether the company accounts under IFRS or UK GAAP.

### 1.3. Corporation tax treatment of derivatives

Part 7 of the Corporation Tax Act 2009 derives from Schedule 26 of Finance Act 2002 (Schedule 26).<sup>14</sup> Prior to the enactment of Schedule 26, the UK corporation tax treatment of derivatives did not reflect a unified approach. A detailed consideration of the pre-Finance Act 2002 regime is outside the scope of this article, but in broad terms, derivative transactions entered into by financial traders would generally be taxed in accordance with the accounting results to which they gave rise,<sup>15</sup> while for non-traders, most futures and options would attract capital treatment,<sup>16</sup> unless they fell within a special regime prescribing treatment on revenue account.<sup>17</sup> Schedule 26 was designed to simplify the tax treatment of derivatives for companies and to bring it into line with the rules for the taxation of corporate debt then contained in Part 4 of Finance Act 1996:<sup>18</sup> i.e. to tax profits and losses from such contracts as income, under a broadly accounts-driven regime. Certain derivatives were, however, deliberately excluded from the Schedule 26 regime *ab initio* on policy grounds, as further discussed below.

## 2. Recognition of Derivatives for Tax Purposes

### 2.1. Stand-alone derivatives

Chapter 2 of Part 7 sets out the conditions for a derivative to fall within the provisions of Part 7. These are that the contract (1) is a “relevant contract”, (2) meets certain “accounting conditions” for the period and (3) is not excluded from the regime by virtue of its “underlying subject matter”.<sup>19</sup> A “relevant contract” is an option, a future or a contract for differences.<sup>20</sup> The terms “option”, “future” and “contract for differences” are defined broadly,<sup>21</sup> based on the corresponding definitions for regulatory purposes,<sup>22</sup> and potentially encompass a variety of contracts that would not fall within the definition of “derivative” in Para. 9 of IAS 39.<sup>23</sup>

Sec. 579 of the Corporation Tax Act 2009 therefore contains a number of “accounting tests” that act as a gateway to determine whether relevant contracts will be treated as “derivative contracts” for tax purposes. The basic rule is that a contract will be so treated if it is treated for accounting purposes as a derivative.<sup>24</sup> “For accounting purposes” means, where the company applies FRS 25 or a successor standard, that the contract is treated by the company as a derivative; or, where the company does not apply FRS 25 or a successor standard, that the contract would be so treated if the company applied that standard.<sup>25</sup>

Part 7 does not, therefore, expressly incorporate the definition of “derivative” in Para. 9 of IAS 39, but because Para. 12 of FRS 25 incorporates the definition of “derivative” in Para. 9 of FRS 26, and the definition in FRS 26 is identical to the definition in IAS 39, the basic rule is, in effect, that a relevant contract will be a derivative contract for tax purposes if it constitutes a derivative under IAS 39, regardless of whether the company in question actually adopts IFRS (or FRS 26).

The basic rule is not, however, the end of the story, as a series of other rules operates – on the one hand – to include within the Part 7 regime contracts that would

11. Part 9A CTA.

12. Sec. 1285 CTA. This was subject to certain anti-avoidance rules including Sec. 704 ICTA (“transactions in securities”) and Sec. 523 CTA (“shares as debt”).

13. Sec. 933 CTA, Sec. 834(3) ICTA and *Potel v. IRC* (1970) 46 TC 658.

14. The CTA is a rewrite Act (i.e. it is generally intended to consolidate and codify the existing law without substantive change).

15. Under Sec. 42 FA 1998 (the statutory precursor of Sec. 46 CTA).

16. Sec. 128 ICTA precluded taxation as income under Schedule D, case VI for commodity and financial futures and qualifying options.

17. The special regimes being the financial instruments rules in FA 1994 (applying to certain interest rate, currency and debt contracts) and the “guaranteed returns” provisions of Schedule 5AA ICTA, which sought to tax financing-type returns from combined derivative transactions as income.

18. Now Part 5 CTA.

19. Sec. 576(1) CTA.

20. Sec. 577 CTA.

21. At Secs. 580-582 CTA.

22. In the Financial Services and Markets Act 2000 (FSMA).

23. Such as a straightforward sale for completion at a future date (which would constitute a “future” as defined by Sec. 581 CTA).

24. Sec. 579(1)(a) CTA.

25. Sec. 579(3) CTA.

not qualify as derivatives under IFRS (referred to below as deemed derivatives); and – on the other – to exclude certain contracts from the regime on policy grounds because of their underlying subject matter (referred to below as excluded contracts).

## 2.2. Deemed derivatives

Sec. 579(1)(b) of the Corporation Tax Act 2009 provides that a relevant contract will be a derivative contract for tax purposes if:

- it is not treated as a derivative for accounting purposes for the sole reason that it does not satisfy the condition in Para. 9(b) of FRS 26 that it requires no net investment (or a smaller net investment than would be required for other types of contract that would be expected to have a similar response to changes in market factors); and
- it is or forms part of a financial asset or liability for accounting purposes.

“For accounting purposes” again means pursuant to FRS 25 or a successor standard. The definitions of “financial asset” and “financial liability” in Para. 11 of FRS 25 are identical to those in Para. 11 of IAS 32. This rule is designed to bring certain prepaid contracts that are not accounted for as derivatives under IFRS, such as prepaid forwards or swaps, within the scope of Part 7.

Paras. 5-7 of IAS 39 determine whether a contract for the physical delivery of goods that can be cash settled falls within IAS 39, the test being whether the entity holds the contract for the purpose of the receipt or delivery of a non-financial item in accordance with the entity’s expected purchase, sale or usage requirements (in which case it is excluded from IAS 39). For UK corporation tax purposes, however, Sec. 579(1)(c) of the Corporation Tax Act 2009 provides that a contract will always be deemed to satisfy the Part 7 “accounting tests” if (1) its underlying subject matter is commodities or (2) it is a contract for differences the underlying subject matter of which is land, tangible movable property, intangible fixed assets, weather conditions or creditworthiness.<sup>26</sup> This rule is intended to eliminate subjectivity in determining whether such contracts will be treated as derivatives for tax purposes, thereby reducing uncertainty for the taxpayer and HMRC.

Finally, Sec. 587 of the Corporation Tax Act 2009 deems a relevant contract that is not treated as a derivative for accounting purposes, but the underlying subject matter of which consists of an interest in an open-ended investment company, unit trust scheme or offshore fund that does not meet certain qualifying investment conditions throughout the period, to be a derivative contract for tax purposes.

## 2.3. Excluded contracts

The rules that apply to exclude certain contracts from the scope of Part 7 are fairly complex; over time, the shape of the legislation has changed and the current position may be summarized as follows:

- (1) A future or option (but not a contract for differences) the underlying subject matter of which is intangible fixed assets is excluded from Part 7. This is because such contracts constitute interests in intangible fixed assets for the purposes of the intangibles regime in Part 8 (i.e. they are in any event taxed on revenue account).
- (2) Certain contracts the underlying subject matter of which consists wholly of equities (or where any other underlying subject matter is “subordinate or of small value”) are prima facie excluded from Part 7. These are:
  - certain equity derivatives held by life assurance companies;<sup>27</sup>
  - equity derivatives (other than embedded derivatives) that hedge shares held by a company, or that company’s own share capital;<sup>28</sup>
  - a quoted option to subscribe for shares in a company;<sup>29</sup>
  - an option or future that may result in delivery of shares that would constitute a “substantial shareholding”,<sup>30</sup> and
  - equity derivatives that hedge convertible or asset-linked securities.<sup>31</sup>

In each case, the contract must be held for non-trading purposes to be excluded. The broad aim is to tax these derivatives in line with the taxation of their underlying subject matter.

- (3) However, contracts that otherwise fall within one of the exclusions detailed under (2) will be brought back within the scope of the regime if the shares to which they relate are treated as debt for tax purposes,<sup>32</sup> or if the contract is itself designed to produce an interest-like return.<sup>33</sup>

Where a contract is an option or future (but not a contract for differences) the underlying subject matter of which falls only partly into one of the categories enumerated above, the contract is treated for tax purposes as though it were two separate contracts<sup>34</sup> (unless it is determined that the non-excluded underlying subject matter is “subordinate or of small value”).<sup>35</sup>

## 2.4. Embedded derivatives

Secs. 584-586 of the Corporation Tax Act 2009 contain rules for identifying embedded derivatives for tax purposes. These rules apply in the following three situations:

26. Sec. 579(2) CTA.

27. Sec. 591(2) CTA.

28. Sec. 591(3) CTA.

29. Sec. 591(4) CTA.

30. Sec. 591(5) CTA. A “substantial shareholding” is one meeting the quantitative threshold for the application of Schedule 7AC Taxation of Chargeable Gains Act 1992 (TCGA) – the United Kingdom’s participation exemption for disposals of (broadly) at least a 10% interest in trading companies. It is not necessary that the qualitative conditions for that exemption to apply are also met.

31. Sec. 591(6) CTA.

32. Under Chapter 6A, Part 6 CTA.

33. Sec. 589(5) CTA.

34. Sec. 593 CTA.

35. Sec. 590 CTA.

- where a company bifurcates a relevant contract (a “hybrid derivative”) which is not treated for accounting purposes as a derivative *in toto*, into (1) one or more derivatives and (2) residual rights and liabilities. In those circumstances each derivative, and the residual rights and liabilities, is treated as a relevant contract for the purposes of Part 7.<sup>36</sup> The residual rights and liabilities may also be taxed as a derivative contract, depending on whether they satisfy the accounting tests;
- where a company bifurcates a debt contract in its accounts into rights and liabilities under a debt contract and rights and liabilities under a derivative or equity instrument (or where a company is permitted to treat such a contract as bifurcated for tax purposes, even though it does not bifurcate it in its accounts).<sup>37</sup> In those circumstances, the derivative or equity instrument is treated as a stand-alone relevant contract for Part 7 purposes.<sup>38</sup> It may be taxed as a derivative contract, depending on whether it satisfies the accounting tests; and
- where a company bifurcates any other contract (such as a lease) into a host contract and one or more embedded derivatives. The company is treated as being party to a relevant contract that consists only of the rights and liabilities under the derivative.<sup>39</sup>

Broadly speaking, therefore, embedded derivatives are recognized for tax purposes in accordance with their accounting treatment under IFRS, save that the exclusions described above may apply to take the deemed relevant contract out of the Part 7 regime. Furthermore, fair value accounting for embedded derivatives is disappplied for tax purposes in certain circumstances, as discussed below.

### 3. Tax Treatment of Gains and Losses on Derivatives

#### 3.1. Basic rule

The basic computational rule for contracts falling within the Part 7 regime is that the amounts to be brought into account by the company as credits or debits for any period are those which are recognized in accordance with GAAP in determining its profit or loss for the period.<sup>40</sup> Where the contract is held for trading purposes, profits and losses will be taxed or relieved on trading account.<sup>41</sup> Where the contract is not held for the purposes of a trade, the amounts are brought into account as non-trading loan relationship credits or debits.<sup>42</sup> The relevant amounts include capital profits and losses,<sup>43</sup> exchange differences<sup>44</sup> and profits and losses in respect of “related transactions”.<sup>45</sup> A “related transaction” is any disposal or acquisition of rights or liabilities under the contract, including their extinguishment by way of sale gift, surrender or release, and any discharge of the contract in accordance with its terms.<sup>46</sup>

On its face, this is a very straightforward “follow the accounts” rule. Under IAS 39 or FRS 26, most derivatives will be accounted for at fair value through profit and loss.<sup>47</sup> By contrast, under old UK GAAP, most derivatives

would, unless held for trading purposes, be held at historic cost and accounted for on an accruals basis (if, indeed, they appeared on the balance sheet at all). UK tax law therefore *prima facie* replicates the volatility that accounting for derivatives at fair value through profit and loss can produce in a company’s statutory accounts.

At a slightly more nuanced level, however, the position is considerably more complicated than simply looking at amounts reflected in a company’s IFRS income statement (or the profit and loss account under UK GAAP). Circumstances are outlined below in which a company’s tax treatment may depart from the profit or loss in respect of derivatives recognized in its statutory accounts.

#### 3.2. Amounts taken to reserves or recognized in equity

Taxable amounts under Part 7 include amounts taken to reserves, including the statement of recognized income and expense (“statement of total recognized gains and losses” in UK GAAP terms).<sup>48</sup> UK statute law lags the latest developments in IFRS terminology, but this would also include amounts recorded in the “other comprehensive income” section of the statement of comprehensive income (such as gains and losses on derivative contracts to the extent they represent an effective cash flow or net investment hedge and are accounted for under Paras. 95 or 102 of IAS 39). (The tax treatment of hedging is discussed in greater detail below.)

The extension of the tax charge to amounts taken to reserves does not apply to exchange gains and losses arising on derivative contracts the underlying subject matter of which is currency, or where the exchange difference arises on retranslation,<sup>49</sup> except to the extent that the exchange difference is calculated otherwise than by reference to spot rates.<sup>50</sup>

In addition, amounts in respect of derivative contracts that are not recognized in profit and loss but are capital-

36. Sec. 584(2) CTA.

37. By Sec. 416 CTA. This provision applies where a company’s actual accounting is under old UK GAAP, but IFRS would oblige the company to bifurcate the contract.

38. Sec. 585(2) CTA.

39. Sec. 586(2) CTA.

40. Sec. 595(2) CTA.

41. Under Part 3 CTA: Sec. 573 CTA.

42. Under Part 5 CTA: Sec. 574 CTA.

43. Sec. 595(6) CTA.

44. Sec. 606(1) CTA. Special provision is made, where a company fair values a contract and does not separately identify exchange differences arising in respect of it, by SI 2005/3422 (the Fair Value Regulations).

45. Sec. 595(3) CTA.

46. Sec. 596 CTA. This is a somewhat narrower range of circumstances than those in which a company is permitted to derecognize a derivative under IFRS: the focus here is on the legal rights and liabilities to which the company is subject rather than the economic effects of the transaction. That said, where a company transfers the risks and rewards of a contract, so that amounts in respect of it are no longer recognized in the company’s accounts, there would be no amounts that were recognized for tax purposes under the basic rule.

47. Unless they fall within the exception in Para. 47(a) of IAS 39, or constitute a designated cash flow or net investment hedge.

48. Sec. 597(1) CTA.

49. Sec. 606(3) CTA.

50. Sec. 606(4D) CTA.

ized in connection with fixed capital assets or projects, or recognized in equity or shareholders' funds, are taken into account for tax purposes in the same way as amounts recognized in determining profit or loss.<sup>51</sup> (HMRC does, however, indicate that the "fairly represents" override (discussed below) may exclude such amounts from taxation on revenue account.<sup>52</sup>)

### 3.3. "Fairly represents"

The credits and debits brought into account for tax purposes in respect of a company's derivative contracts must be those which "fairly represent" all profits and losses arising to the company for the period in respect of those contracts.<sup>53</sup> There is ongoing debate in the UK tax profession as to the extent to which this requirement may oblige a company to depart from its statutory accounts in preparing its corporation tax computations:<sup>54</sup> in other words, as to whether it imports any broader notion that tax should be levied in respect of the company's "true" economic profit from transactions, rather than that shown in its accounts.<sup>55</sup>

### 3.4. Mandatory fair value accounting for deemed derivatives

In the case of a deemed derivative (discussed above), the company is obliged for tax purposes to bring in credits or debits on a fair value basis of accounting.<sup>56</sup> This is regardless of whether the company actually accounts for such contracts at amortized cost.

### 3.5. Changes of accounting policy/company migrations

Part 7 contains rules designed to ensure that where a company adopts IFRS for the first time without bringing in any prior period adjustment on transition, amounts brought forward in equity or reserves are treated in the same way as if a prior period adjustment had been made.<sup>57</sup>

A company ceasing to be UK resident is deemed to dispose of and immediately reacquire all derivative contracts to which it is party at their fair value at the point of migration (the intention being to tax any increase in value while such contracts were within the UK tax net).<sup>58</sup>

### 3.6. Embedded derivatives not contained in debt contracts

Not all embedded derivatives are subject to fair value accounting for tax purposes. Where a company bifurcates a contract other than a debt contract into a host contract and an embedded derivative, that bifurcation is reversed out for tax purposes, with the company being subject to tax as though the embedded derivative were part of the host contract and the host contract were accounted for at amortized cost.<sup>59</sup> A company may, however, elect out of this treatment in respect of most of its embedded derivatives, i.e. may elect back into taxation in accordance with its accounts.<sup>60</sup> There are rules to ensure

that the election is applied consistently as regards companies within the same group.<sup>61</sup>

### 3.7. Transactions within groups

Chapter 5 of Part 7 contains special provisions designed to ensure continuity of tax treatment where derivative contracts are transferred between members of the same group of companies. The expression "transfer" covers the situation in which a company becomes party to a derivative with rights and liabilities equivalent to those to which another group company ceases to be party,<sup>62</sup> and cases in which a company indirectly replaces another as party to a contract by means of a series of transactions.<sup>63</sup>

The general rule in such circumstances is that the transferor is deemed to dispose of, and the transferee to acquire, the contract at an amount equal to its carrying value in the transferor's accounts (assuming an accounting period of the transferor to have ended on the date of transfer).<sup>64</sup> In many cases, both parties to the transfer will account for the contract at fair value through profit and loss, such that this rule will make no difference, and it is expressly disappplied where the *transferor* uses fair value accounting (and the parties are deemed to have entered into a transaction at fair value).<sup>65</sup> Its application is therefore restricted to circumstances in which a company applying IFRS or FRS 26 acquires a contract from a group member that accounts under old UK GAAP, or where the transferor applies a deemed amortized cost basis of accounting to an interest rate contract by virtue of Regulation 9 of SI 2004/3256 (the Disregard Regulations; see below).<sup>66</sup>

51. Secs. 604(2) and 605(2) CTA.

52. Para. 52050 HMRC Corporate Finance Manual.

53. Sec. 595(3) CTA.

54. As it is in any event a requirement of UK companies legislation that individual and consolidated accounts give a "true and fair view" of the company's financial position, Sec. 393(1) CA 2006.

55. See *HMRC v. DCC Holdings (UK) Ltd* [2009] EWCA Civ 1165, a case concerning the corresponding provision of the United Kingdom's loan relationships code (governing the taxation of corporate debt). The case was decided against the taxpayer by a majority of the Court of Appeal, which rejected the notion that the statute was intended to tax the company's true economic profit, but nonetheless attached significant importance to the words "fairly represents" in determining that the taxpayer was not entitled to an (admittedly artificial) tax loss in respect of certain repo transactions. Should the judgment of the Court of Appeal stand, it may be of concern mainly in the context of structured transactions that seek to exploit a mismatch of one sort or another between the tax statute and the accounting treatment.

56. Secs. 600(2) and 601(2) CTA.

57. Sec. 614 CTA.

58. Sec. 609(1) CTA.

59. Sec. 616(3) and (4) CTA.

60. Sec. 617 CTA (the election is not available for contracts whose underlying subject matter is commodities).

61. Sec. 618 CTA. "Group" is a legal, rather than an accounting term; it is not determinative for these purposes that the companies in question prepare consolidated accounts under IFRS. Part 7 of the CTA employs the chargeable gains grouping concept (broadly, a company and its effective 51% subsidiaries; Sec. 170 TCGA).

62. Sec. 626(3) CTA.

63. Sec. 627 CTA.

64. Sec. 625(3) and (4) CTA.

65. Sec. 628 CTA.

66. Similar rules apply to companies involved in a European cross-border reconstruction or merger: Chapters 9 and 10 Part 7 CTA.

The group continuity rule is disappplied where there are arrangements for a transfer of the contract to occur outside the group, and a main purpose of those arrangements is tax avoidance.<sup>67</sup> Where the group continuity rule has applied to defer the recognition of a profit on a derivative contract, anti-avoidance rules apply on any subsequent degrouping of the transferee.<sup>68</sup>

### 3.8. Hedging

As a general observation, the UK tax rules are considerably more generous than IAS 39/FRS 26 in their approach to hedging. This is because they seek, as a policy matter, to replicate the position under old UK GAAP, thereby mitigating for tax purposes some of the more wide-reaching effects of mandatory fair value accounting. Under old UK GAAP, some hedging contracts were left off-balance sheet: the company simply reflected the result of the overall transaction (e.g. a fixed-rate borrowing swapped for floating rate would be accounted for as a synthetic floating-rate borrowing), and the rules permitting hedging were generally less restrictive.

Para. 88 of IAS 39 narrowly defines the circumstances in which a hedge will be permitted under IFRS. In particular, the hedge must be expected to be highly effective, and the company must have a reliable means of measuring that effectiveness.

Where a company is permitted by IAS 39 to designate a derivative the underlying subject matter of which is currency as a cash flow or net investment hedge of exchange rate risk, Part 7 of the Corporation Tax Act 2009 disregards amounts taken to reserves in respect of exchange gains and losses on the derivative.<sup>69</sup> (This rule was designed for companies accounting under old UK GAAP, which permits net investment hedging of a foreign subsidiary, and is of limited application under IFRS.) The disregard of exchange gains and losses referred to here is not available to the extent that the company is party to arrangements that produce a “one-way exchange effect” and permit the company to obtain a tax advantage.<sup>70</sup> This provision is targeted at certain schemes that exploit the matching rules by disregarding an exchange gain in circumstances where a corresponding exchange loss is relievable for another group company.

The Disregard Regulations provide for a wider range of circumstances in which matching is permitted for tax purposes, whether or not hedging is applied in the company’s accounts. The essential purpose of the Disregard Regulations is to replicate the accounting treatment under old UK GAAP for tax purposes, even where the company accounts under IFRS/FRS 26. A very broad overview of these provisions is as follows:

Regulation 4 applies to exchange gains and losses arising in respect of a derivative contract that are recognized in profit and loss where there is either (1) a designated fair value hedge of exchange rate risk for accounting purposes as between the contract and any shares, ships or aircraft or (2) the company intends by entering into and remaining party to the contract, to eliminate or substan-

tially reduce its economic risk attributable to exchange rate fluctuation in respect of any shares (including the company’s own share capital), ships or aircraft (the legislation refers to this latter, looser, condition as a “hedging relationship”). Exchange gains and losses disregarded under Regulation 4 may be brought back into account in certain circumstances as chargeable gains items under SI 2002/1970 (the Bringing into Account Gains or Losses, or BAGL, Regulations), where the company disposes of the hedged asset. The anti-avoidance rule in Sec. 606(4E) of the Corporation Tax Act 2009 disappplies the Regulation 4 disregard to the extent that the company is party to arrangements that produce a “one-way exchange effect” and permit the company to obtain a tax advantage.

Regulation 7 applies to fair value profits and losses on contracts the underlying subject matter of which consists wholly of currency, where there is a “hedging relationship” between the contract and any forecast transaction or firm commitment of the company, and that transaction or commitment does not itself give rise to fair value profits or losses for tax purposes.

Regulation 8 contains a similar rule to that found in Regulation 7, but for commodity and debt contracts (excluding interest rate contracts).

Regulation 9 applies to interest rate contracts (including cross-currency swaps), where there is a “hedging relationship” between the contract and an asset or liability that is accounted for at amortized cost. Regulation 9 seeks to replicate the synthetic liability treatment that was available under old UK GAAP by providing that the contract must be accounted for on an “appropriate accruals basis”. In essence, this means that all fair value profits and losses on the contract are disregarded; the contract is treated as though it were recognized at cost and periodic payments are aggregated with the coupon payments made or received on the hedged item and accounted for using an effective interest rate method.

Companies may elect out of treatment under Regulations 7, 8 and 9 in certain circumstances (essentially to permit them to reduce their tax compliance burden at the cost of accepting tax volatility). Regulation 9A will then apply, where the contract is accounted for as a cash flow hedge, with the effect that fair value movements are recognized for tax purposes only when they reach the profit and loss account.

Further provision is made by Regulation 7A in respect of currency contracts intended to hedge the proceeds of a future share issue.

Regulations 10 and 10A contain rules for the bringing back into account of amounts disregarded under Regulations 7 and 8. Broadly this will occur where the company ceases to be party to the contract or the hedged item begins to affect the company’s profit and loss

67. Sec. 629 CTA.

68. Sec. 630 CTA.

69. Sec. 606(3) CTA.

70. Sec. 606(4E) CTA.

account, or a deduction is given in respect of it for tax purposes.

### 3.9. Anti-avoidance

A company may also be obliged to depart from its actual accounting treatment where one or more of a number of anti-avoidance rules applies. The most important of these concern:

- contracts for unallowable purposes. An “unallowable purpose” is a main purpose of tax avoidance. Where the contract is held for an unallowable purpose, no deduction is given for such proportion of the debits arising in relation to that contract as, on a just and reasonable apportionment, is attributable to the unallowable purpose;<sup>71</sup>
- contracts not at arm’s length. This provision applies where the terms of a contract between parties under common control differ from those that would be entered into at arm’s length, in such fashion as to confer a potential UK tax advantage on either party. The “advantaged party” is then required to compute its derivative contract credits and debits as though an arm’s length, rather than the actual, provision had been made;<sup>72</sup>
- amounts not fully recognized for accounting purposes. These rules apply where a company enters into transactions to satisfy a liability, or crystallize a gain, in respect of a contract and the consideration is provided in the form of assets that are credited to equity or otherwise not recognized in determining profit or loss. The company is obliged to compute its tax liability as though such amounts had been so recognized;<sup>73</sup> and
- transfers of value. This is a targeted rule directed at the failure of the grantee of an option to exercise its rights in a controlled situation, in circumstances where the value thus transferred is not charged to corporation tax.<sup>74</sup>

### 3.10. Chargeable gains and residual tax treatment

Part 7 itself contains a separate regime for taxing certain derivative contracts on capital, rather than revenue account.<sup>75</sup> This regime is primarily of importance in the context of equity derivatives embedded in convertible or exchangeable securities.<sup>76</sup> The treatment of such contracts is a topic in itself, and there is insufficient space here to do it justice. Very broadly, however, Chapter 7, Part 7 applies to holders of equity options embedded in convertible or exchangeable securities, the basic rule being that credits and debits are computed on the basis of the Part 7 rules (i.e. broadly in accordance with the accounts), but then aggregated and brought into account as a chargeable gain or allowable loss for the period, as opposed to being taxed on revenue account.<sup>77</sup> Chapter 8, Part 7 contains further specific computational rules applicable to chargeable gains (including to issuers of certain convertible or exchangeable securities).

Where a contract falls outside the Part 7 regime (by reason of failing the accounting tests, or being an excluded

contract), two alternative residual bases of taxation may apply. In the case of a “financial future”, “traded option” or “financial option”, taxation as income under the “miscellaneous” head in Chapter 8, Part 10 of the Corporation Tax Act 2009 is expressly excluded.<sup>78</sup> Such contracts are taxed under the chargeable gains regime.<sup>79</sup> Other contracts may also fall to be taxed as capital on principles established by case law,<sup>80</sup> or will otherwise give rise to “miscellaneous” income taxable under Part 10 of the Corporation Tax Act 2009. HMRC indicate that in certain very limited circumstances, contracts may give rise to neither a profit nor a loss for tax purposes, but this would be extremely rare for a company.<sup>81</sup>

## 4. Conclusion

IAS 39 (or its UK equivalent, FRS 26) is the starting point for the taxation of derivative contracts in the United Kingdom, but that is about it. Notable divergences include the recognition of certain deemed derivatives for tax purposes, the fact that some companies are still permitted to account for derivatives under old UK GAAP, the much wider circumstances in which hedging is accepted for UK tax purposes when compared with the restrictive IFRS conditions, and the range of anti-avoidance rules that may apply.

The authors note that the International Accounting Standards Board is consulting on a replacement for IAS 39 (IFRS 9) that may incorporate a much wider application of fair value accounting (with corresponding simplification by, for example, removing the need to bifurcate and account separately for embedded derivatives). As the UK legislation is fundamentally predicated on the accounting treatment under IAS 39, it is a fair bet that the tax rules will need to be revised to accommodate any such changes.<sup>82</sup> Whether they will themselves be rendered any more straightforward to navigate in the process is anybody’s guess.

71. Sec. 690 CTA.

72. Sec. 693 CTA.

73. Secs. 599A and 698 CTA.

74. Sec. 695 CTA.

75. Chapters 7 and 8 CTA.

76. The other contracts to which it applies are certain contracts relating to land or tangible moveable property, “exactly tracking” contracts for differences embedded in share-linked securities and property-based total return swaps.

77. Sec. 641 CTA.

78. Sec. 981 CTA.

79. Secs. 143 et seq. TCGA.

80. Essentially in circumstances where the contract involves some initial investment, and is not held on trading account. See e.g. *Cooper v. Stubbs* 15 TC 29 and *Leeming v. Jones* 15 TC 333.

81. Para. 50070 HMRC Corporate Finance Manual. HMRC refers to *Lupton v. FA & AB Ltd* 47 TC 580, a case in which a purported trading transaction was held to be “fiscally denatured” because it was entered into for no purpose other than tax avoidance.

82. In this connection, the authors note that HMRC announced, in a press release accompanying the Chancellor of the Exchequer’s Pre-Budget Report speech on 9 December 2009, that the Finance Bill 2010 will include a regulation-making power permitting HMRC to amend Part 7 of the CTA through secondary legislation to respond to changes in the accounting rules.