EXPLANATORY MEMORANDUM TO

THE LOAN RELATIONSHIPS AND DERIVATIVE CONTRACTS (CHANGE OF ACCOUNTING PRACTICE) REGULATIONS 2004

2004 No. 3271

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 The regulations provide for the deferral for tax purposes of profits and losses arising as a result of a company's moving from following existing UK Generally Accepted Accounting Practice (GAAP) to following International Accounting Standards (IAS) or revised UK GAAP. They also deal with the consequences of a company ceasing to treat certain assets as held-to-maturity for accounting purposes.

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

3.1 None

4. Legislative Background

4.1 The power to make the regulations is in 85B(3) and (5) and 90A of, and paragraph 19B of Schedule 9 to, the Finance Act 1996 and paragraph 17C of Schedule 26 to the Finance Act 2002. These provisions allow certain profits and losses from loan relationships and derivative contracts to be left out of account, to be brought into account in a different way or to be brought into account at a later date.

4.2 This is the first use of the powers cited, but regulations have been made under predecessor provisions of section 84A(3A) Finance Act 1996 and paragraph 16(3A) of Schedule 26 to the Finance Act 2002.

5. Extent

5.1 The instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 This instrument is subject to annulment and does not amend primary legislation, so no certificate under the ECHR is required.

7. Policy background

7.1 Profits and losses on debts and derivative contracts are generally brought into account as they are recognised in accounts drawn up using UK Generally Accepted Accounting Practice (GAAP). From 2005 all companies will be permitted to use International Accounting Standards (IAS) to draw up their

accounts, and such accounts will be an acceptable basis for tax purposes – section 50 Finance Act 2004.

7.2 Where a company changes it accounting basis, any difference between the carrying value of the asset or liability between the period of change and the previous period are brought into account for tax purposes in the period of change. In this particular case, the change to IAS in 2005, the amounts involved are both potentially very large and also presently unquantifiable. The Government has decided to defer the tax effect of the adjustments until reliable figures are known. It will then consider what, if anything, to do about the transitional adjustments.

7.4 IAS also affects certain assets which a company would account for using a cost basis under UK GAAP. These are ones which are designated as "held to maturity". IAS provides that such assets are accounted for at cost. But it also provides that if more than an insignificant amount of such assets are sold, that action "taints" all the others, with the result that a fair value basis must be used. The regulations allow this tainting not to affect the tax treatment so long as it includes less than 10% of the value of the assets.

7.5 There has been consultation with relevant bodies on parts of these regulations and drafts of those parts have been published on the Inland Revenue's website for comments.

8. Impact

8.1 A Regulatory Impact Assessment has not been prepared for this instrument as it has no impact on business, charities or voluntary bodies.

8.2 The impact on the public sector is nil, because the regulations maintain the status quo.

9. Contact

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