EXPLANATORY MEMORANDUM TO

THE LOAN RELATIONSHIPS AND DERIVATIVE CONTRACTS (DISREGARD AND BRINGING INTO ACCOUNT OF PROFITS AND LOSSES) (AMENDMENT) REGULATIONS 2014

2014 No. 3188

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

2. Purpose of the instrument

2.1 These Regulations amend the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account Profits and Losses) Regulations 2004 (S.I. 2004 / 3256: 'the Disregard Regulations') the purpose of which is to provide specific tax treatment for particular instruments especially in the context of hedging relationships.

2.2 These Regulations make certain technical changes to the Disregard Regulations to ease the impact of accountancy changes that become mandatory for many companies from 1 January 2015, particularly in respect of the elections that can be made under the Disregard Regulations.

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

None.

4. Legislative Context

4.1 The Regulations are made by the Treasury under powers conferred by sections 310 and 328 of the Corporation Tax Act 2009 in relation to loan relationships, and sections 598 and 606 of that Act in relation to derivative contracts.

4.2 The Disregard Regulations provide detailed rules that were introduced in 2004 following the introduction of International Accounting Standards. They provide specific treatment to alter the amounts brought into account in respect of particular instruments. The main elements of the Disregard Regulations are as follows.

4.3 Regulations 3 to 5 provide rules to exclude exchange movements from tax where a company is party to a loan relationship or derivative contract to hedge the exchange risk from holding ships, shares or aircraft. Regulation 4A currently provides companies with an option to irrevocably elect to use an alternative basis for calculating the value of the hedged asset.

4.4 Regulations 7, 8 and 9 provide rules where a company is party to a derivative contract as part of a hedging relationship. Fair value movements on the derivative are 'disregarded' and are instead brought into account in-line with the hedged risk. Regulation 6 currently provides companies with certain options to irrevocably elect-out of regulations 7, 8 and 9. Where a company makes an election, regulation 9A applies to provide an alternative basis for dealing with designated cash flow hedges.

5. Territorial Extent and Application

This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

- What is being done and why

7.1 At Budget 2013, the Government announced consultation on a package of proposals to modernise the corporation tax rules governing the taxation of corporate debt and derivative contracts, with a view to legislating in Finance Bill 2014 and Finance Bill 2015. This work supports the Government's aim of promoting a tax system which is efficient, competitive, predictable, simple and fair.

7.2 Over the next few years UK companies are likely to see changes to the accounting standards used to prepare financial statements. In particular, for periods commencing on or after 1 January 2015 many UK companies will be required to apply one of EU-Endorsed International Financial Reporting Standards (IFRS), Financial Reporting Standard 101 (FRS 101) or Financial Reporting Standard 102 (FRS 102).

7.3 One of the significant areas of change with the new accounting standards is the treatment of financial instruments, which will bring UK accounting standards much closer to International Accounting Standards. Many more companies may therefore be required to apply the detailed provisions of the Disregard Regulations.

7.4 As part of the consultation process for corporate debt and derivative contracts, HMRC have been seeking the views of external stakeholders as to the impact of these accountancy changes. Respondents generally saw that the current tax rules deal with the accounting standards satisfactorily. HMRC are not therefore making substantial changes to the rules ahead of the accounting changes. However, following specific points raised by respondents, some limited changes are being made with a view to easing the transition to FRS 101 and FRS 102.

7.5 The elections under regulation 6 will be substantially modified as follows:

- There will now be a single election which companies can make. This election will be to 'elect-in' to the computational rules in regulations 7, 8 and 9, rather than the 'elect-out' approach as at present.

- Where a company adopts fair value accounting for the first time in a period of account commencing on or after 1 January 2015, they will have a longer period in which to make the election. This will be six months from the start of the period for very large companies or twelve months from the end of the period for other companies. These companies will then be subject to an initial lock-in period of three years.

- Thereafter, and for companies that already apply fair value accounting in respect of affected instruments, the company will be able to make, amend or revoke an election at any time. This will have effect for derivative contracts entered into on or after the date specified in the election or notice, but this cannot be before the date of the election or notice.

- There will be an anti-avoidance provision to prevent companies claiming relief for fair value losses in cases where they would not be taxable on corresponding fair value profits. In these circumstances, regulation 7, 8 or 9 will apply to the affected derivatives.

7.6 The changes to the elections under regulation 6 is to enable businesses to make an informed choice as to the most appropriate computational basis for them in respect of derivative financial instruments. In most cases, it is expected that companies will either adopt a policy of designating hedging relationships in their accounts or electing into regulations 7, 8 and 9 of the Disregard Regulations.

7.7 Exceptionally, companies may decide to neither designate hedging relationship in their accounts nor elect into the Disregards Regulations. This may be the case where a company has a large number of derivative financial instruments. In this case, the company will be taxed on fair value profits, and obtain relief for fair value losses.

7.8 The anti-avoidance rule is intended to be invoked where a company seeks tax relief for a fair value loss and takes any steps to avoid being taxed on fair value profits. For example, where it applies different strategies based on whether derivatives give rise to a profit or a loss, or claiming a fair value loss and undertaking planning to ensure fair value profits do not arise in the future.

7.9 The restriction in regulation 3(1A) will be removed. This will mean that where a company holds a non-lending money debt as an intended hedge of holding ships, shares and aircraft, it will be afforded the same treatment as with loan relationships and derivative contracts.

7.10 The election under regulation 4A will be modified. Companies will be able to make and revoke elections under regulation 4A at any time. These will have effect from the time specified in the elections or revocation, but this cannot be before the date the election or revocation is made.

7.11 The statutory references to primary legislation in the Disregard Regulations will be updated.

7.12 This measure will have effect for periods of account commencing on or after 1 January 2015. For companies that already apply fair value accounting in respect of derivatives which potentially fall within the scope of the Disregard Regulations transitional provisions will preserve their current status without any action being required. They will be able to revise their status on a prospective basis under the new rules.

- Consolidation

7.13 The Government is continuing to consult on modernising the legislation governing the taxation of loan relationships and derivative contracts. Following the outcome of that consultation, consideration will be given to consolidating the Disregard Regulations.

8. Consultation outcome

This instrument was published for comment for 4 weeks through to 12 September 2014. Minor amendment have been made following representations received.

9. Guidance

HMRC guidance in the Corporate Finance Manual will in due course be amended.

10. Impact

10.1 This measure looks to ease the impact of accountancy changes that become mandatory for many companies from 1 January 2015. This measure only applies to entities within the scope of corporation tax and so it should have no impact on charities or voluntary bodies.

10.2 There is negligible impact on the public sector.

10.3 A Tax Information and Impact Note (TIIN) covering this instrument was published on 7 August 2014 alongside draft legislation and is available on the GOV.UK website at www.gov.uk/government/collections/tax-information-and-impact-notes-tiins. It remains an accurate summary of the impacts that apply to this instrument.

11. Regulating small business

The legislation applies to small business. However, the impact on small business is expected to be minimal given the accountancy changes principally affects medium and large companies with non-basic financial instruments.

12. Monitoring & review

This policy will be monitored through information obtained through clearance applications and enquiries into self-assessments.

13. Contact

Richard Daniel at HMRC Tel: 03000 569 408 or email: richard.daniel@hmrc.gsi.gov.uk can answer any queries regarding the instrument.