EXPLANATORY MEMORANDUM TO

THE LOAN RELATIONSHIPS AND DERIVATIVE CONTRACTS (DISREGARD AND BRINGING INTO ACCOUNT OF PROFITS AND LOSSES) REGULATIONS 2006

2006 No. 843

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 The regulations provide for the disallowance of exchange losses of a company where there are arrangements within a group of companies such that it is at the group's discretion whether to recognise an exchange gain or loss because of its ability to meet obligations under a loan or derivative contract by settling in alternative currencies. The arrangements are designed so that if particular exchange rates move in one direction, the group is flat from a tax point of view, but if they move in the other, the company has a loss but no corresponding gain.

2.2 They also prevent a loss arising on a derivative contract which is a synthetic hedge of currency risk (for example an option over US Treasury Bonds could give the same outcome as an option over US dollars). Since the rules for "pure" currency contracts" differ from those for "synthetic" contracts, the differences can be exploited to give an asymmetry – flat when rates go one way, a loss when they go the other.

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

3.1 The Regulations come into force less than 21 days after the date on which they were made. The Department regrets that compliance with the 21-day rule is not possible in this case. These Regulations form part of a significant anti-avoidance package announced by the Chancellor of the Exchequer on Budget Day, 22nd March 2005. Unless the Regulations come into force immediately, there is significant risk that transactions would be entered into to pre-empt the operation of the regulations. Other legislation which is complementary to and associated with these Regulations is to be included in the Finance Bill 2006 and was announced on Budget Day to have effect from that day.

4. Legislative Background

4.1 The power to make the regulations is in sections 84A(3A) and paragraphs 16(3A) and 17C(1)(a) 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.

5. Extent

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

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

7. Policy background

7.1 Exchange gains 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) or International Accounting Standards (IAS).

7.2 Where debt or derivative contracts are hedging assets such as shares in subsidiaries, the exchange gains and losses on the debt or contract are not brought into account (which matches the position that no corresponding exchange losses and gains on the shares are brought into account at all). This treatment is intended to be symmetrical, but schemes have been devised to give groups a one-way bet – matching of otherwise taxable gains on the debt or contract with non-allowable losses on the shares, but not matching a loss on debt or contracts with a non-taxable gain on shares, so that the exchange loss remains available to be used within the group. This is often achieved by having a debt which can be settled either in the currency in which the shares are denominated (the hedging currency) or the group's accounts currency.

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

9. Contact

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