EXPLANATORY MEMORANDUM TO

THE TAX TREATMENT OF FINANCING COSTS AND INCOME (CORRECTION OF MISMATCHES) REGULATIONS 2010

2010 No. 3025

1. This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs ("HMRC") 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. Purpose of the instrument

2.1 Part 7 of the Taxation (International and Other Provisions) Act 2010 ("TIOPA 2010") includes provisions which set a ceiling (known as the "debt cap") on the total interest and other specified financing expenses for which corporation tax deductions are available to the UK members of a worldwide group of companies that are subject to corporation tax.

2.2 The ceiling is calculated by reference to the difference between the financing expenses of the members of the worldwide group which are subject to corporation tax and the amount (called the "available amount") disclosed in the accounts of the worldwide group in respect of specified financing costs. The purpose of these Regulations is to address a number of specific cases of mismatches between financing expense amounts and the available amount in respect of the same financial arrangements.

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

3.1 This is the first exercise of the powers conferred by sections 336A and 353B of TIOPA 2010. Section 336A(4) permits regulations under that section to have effect in relation to periods of account of the worldwide group beginning on or after the beginning of the calendar year in which the regulations are made. These Regulations have effect in relation to periods of account beginning on or after 1st January 2010. However, a group may elect that one or more regulations (or in certain cases, pairs of regulations) do not apply to a specified company at all, or that the Regulations in their entirety apply only for periods of account of the worldwide group beginning on or after the day on which they are made.

4. Legislative Context

4.1 Part 7 of TIOPA 2010 (originally Schedule 15 to the Finance Act 2009) is one of several measures introduced as part of the Government's review of the taxation of the foreign profits of companies.

4.2 Section 332(1) of TIOPA 2010 describes those matters in respect of which amounts disclosed in the accounts of the worldwide group are included in the available amount.

4.3 Section 336A(1) TIOPA 2010 enables regulations to be made to alter the way in which the available amount is calculated in a case in which a financing cost set out in the accounts of the worldwide group is not equal to the corresponding financing expense of a member of the group which is subject to corporation tax.

5. Territorial Extent and Application

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

7. Policy background

- ***What is being done and why***

7.1 The policy underlying the debt cap is to restrict the deductions that the members of a worldwide group of companies which are subject to corporation tax (that is, the UK companies and those non-UK companies carrying on a trade in the UK through permanent establishments) are permitted to make for financing expenses incurred in transactions between members of the group. This is done by disallowing a deduction for the financing expenses of the companies which are subject to corporation tax, to the extent that the total of their net financing expenses exceeds the financing costs disclosed in the consolidated accounts of the group as a whole. Where a deduction is disallowed for an amount of financing expenses, a corresponding amount of financing income may be exempt from corporation tax. The worldwide group is required to allocate disallowances and exemptions among members of the group.

7.2 These Regulations alter the way in which the available amount is calculated in specified circumstances where in relation to a financial arrangement an amount disclosed, if any, in the consolidated accounts of the worldwide group in respect of a financing cost is not equal to the financing expense amount brought into account for corporation tax purposes. The Regulations thereby target the disallowance of deductions more closely on excessive financing expenses incurred in transactions between group members.

8. Consultation outcome

8.1 A working group consisting of representatives from corporate groups and their advisers has been consulted by HMRC on the debt cap legislation and regulations made under it, including these Regulations. The draft Regulations were published on the HMRC website on 2 November 2010 and comments were invited. Comments were received from five accountancy firms and an Industry Representative body.

8.2 The Regulations were well received. A number of changes have been made in response to comments made. The most significant changes are as follows.

8.3 Regulation 2 (dealing with definitions) was amended to ensure that fair value adjustments made as a result of applying hedge accounting would be covered by regulation 3. Regulations 7 and 8 and 11 and 12 were added to enable the available amount to be adjusted for periods of account in which debits accrue but no relief is given for the debits in the computation of profits subject to corporation tax. Regulations 13 and 14 were added to cater for mismatches where a financial instrument includes a derivative element. Regulations 15 and 16 were added to cater for mismatches which arise where debts are restructured.

9. Guidance

9.1 In spring 2011, HMRC will publish guidance on the operation of the Regulations on its website (www.hmrc.gov.uk).

10. Impact

10.1 An Impact Assessment has not been prepared for this instrument as it has a negligible impact on business, charities and voluntary bodies.

10.2 The instrument has no impact on the public sector.

11. Regulating small business

11.1 The Regulations will not apply to small business.

12. Monitoring & review

12.1 HMRC intends to monitor the legislation for further instances of mismatches between financing costs set out in the accounts of the worldwide group and financing expense amounts brought into account for corporation tax purposes and make further regulations if necessary. HMRC will review the Regulations in 2012 to determine whether they operate as intended.

13. Contact

Lesley Hamilton at HM Revenue and Customs (Tel: 020 7147 2564 or email: lesley.hamilton@hmrc.gsi.gov.uk) can answer any queries regarding the instrument.