Corporation Tax: a new approach to the taxation of derivatives based on property and share values

Summary

1.1. This note sets out details of a possible new approach to the taxation of profits, gains and losses on derivatives held by companies which are currently excluded from the derivatives contracts regime (Schedule 26 Finance Act 2002). The main object of this approach is to provide a simpler and more certain tax treatment for such derivatives.

1.2. A market in property derivatives (derivatives based on property values) could have a positive effect on the overall efficiency and liquidity of the property investment market. A number of taxation issues have been identified which may be inhibiting the development of such a market. The approach set out in this note follows from discussions with the property industry on how these issues can be resolved.

1.3. The basis of this approach is to modify the existing derivative contracts regime, to cover all[1] derivative contracts. The modified regime would treat, where appropriate, non-trading profits, gains and losses on certain derivatives as capital gains and losses. The derivatives concerned are futures, options and similar contracts whose value derives essentially from an underlying that is chargeable to corporation tax on chargeable gains. Profits and losses on all swaps would be taxed or relieved as income. The changes would also allow simplification of the existing derivative contracts regime.

1.4. There are a number of ways this approach can be translated into legislation. This note includes an illustrative draft of legislation and supporting commentary (see below) showing in detail one way of doing this for **property derivatives**. Because the tax issues are not specific to property derivatives but exist also for **equity derivatives**, the model offers, for discussion purposes, a generic solution encompassing both types.

1.5. Any questions or comments regarding this note should be directed, ideally by 10 February 2004 and by email, to:

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[1] Other than the limited category of futures and options dealt with in the Intangible Fixed Assets regime in Schedule 29 FA 2002.

A brief outline of the model

1.6. The model is intended to offer a comprehensive regime for all derivative financial instruments held by companies, including life assurance companies, based on the derivative contracts regime introduced in FA 2002. That regime went some way to achieving this, but did not deal with those instruments whose values derived, in particular, from property or shares. The regime was designed, following extensive consultation with derivatives experts, to address a wide and varied range of derivatives including instruments that might be marketed in future. The proposed new model continues and enhances this approach.

1.7. The key features of the model are:

- All[2] derivative contracts held by companies are brought within a single regime which recognises the full economic profits, gains and losses on such contracts; section 143 Taxation of Capital Gains Act 1992 will no longer apply to such derivative contracts held by companies;
- The primary test of whether a contract is a "derivative contract" for this purpose is whether it is recognised as a derivative financial instrument under generally accepted accountancy principles;
- The amounts taxed or relieved in any accounting period follow the amounts recognised in the accounts for the same period, including certain contracts (see next bullet) whose profits and losses, are treated as capital gains or losses under the new regime;
- For futures and options whose value is derived from an asset which itself would be subject to tax on chargeable gains, the regime will treat profits and losses as chargeable gains and allowable losses (no indexation allowance would be available);
- For all swap contracts, all profits and losses will be within the derivative contracts rules;
- It allows the existing derivative contracts regime to be simplified;
- The tax treatment of normal sales and purchases of land or shares, including options forming part of such transactions is unaffected unless, exceptionally, the company chooses to account for the contract as a derivative, or the transaction is part of arrangements to provide a return similar to interest on a loan or deposit.

1.8. The proposed model offers a deregulatory approach to a framework within which markets can develop innovative contracts unhindered by tax uncertainties. Views on the compliance implications of such an approach are welcomed.

[2] See footnote 1

COMMENTARY ON ILLUSTRATIVE DRAFT LEGISLATION

The draft and illustrative Finance Act 2002, Schedule 26, Part 2 (Amendment) Order 2004.

2.1. **Part 1** is introductory.

2.2. Article 1 gives the commencement rule. A date will be decided if, and when, the Government decides to take forward legislation.

Amendments to the scope of Schedule 26: inclusion of derivatives over property and shares

2.3. **Part 2** of the Order, containing Articles 2 to 11, is the Part (together with Part 4) that is capable of being made under the existing power in paragraph 13 Schedule 26 FA 2002.

2.4. Article 2 provides for the amendment of Schedule 26 FA 2002 (derivative contracts) in accordance with the rest of Part 2.

2.5. Article 3(a) to (c) makes some minor tidying up amendments to paragraph 3(1) which sets out the "accounting test" for Schedule 26. The meaning of "relevant contract" in Schedule 26 (see paragraph 12 of that Schedule for a definition of "future" and "contract for differences" (CfDs)) is very wide and capable of encompassing a number of contracts that would not be regarded as derivative contracts by the financially informed person. For example, the definition of future would include any contract for the purchase of a house under normal conditions of sale, and even an order for paper clips.

2.6. Accordingly for most contracts there is a threshold test – the accounting test. If the contract would be disclosed in accounts under Financial Reporting Standard (FRS) 13 as a derivative financial instrument, it is a derivative contract for tax purposes – paragraph 3(1)(a). But there are certain contracts which behave more like debt assets and which may not be accounted for as derivative contracts (because for example FRS 5 requires them to be accounted for in accordance with their substance as financial assets). Paragraph 3(1)(b) provides that a contract that falls within paragraph 6 or 7 and is accounted for as a financial asset is a derivative contract. Contracts within paragraph 8 were accidentally omitted from this paragraph and Article 3(a) brings them in.

2.7. It is also conceivable that a contract within paragraphs 6, 7 or 8 is accounted for in yet another way, and not as a derivative contract or a financial asset. New paragraph 3(1)(ba) Schedule 26 inserted by Article 3(b) ensures that such a contract is within Schedule 26.

2.8. Accordingly, paragraph 3(1)(c), which provides for a second hurdle for cases excluded by the accounting test, is amended to refer to paragraph 3(1)(ba) as well as 3(1)(a) and (b).

2.9. That second test in paragraph 3(2) provides that a contract which fails the accounting test is nevertheless a derivative contract if it is a commodity contract of any sort, or a contract for differences whose underlying subject matter (USM) is one of the listed matters.

2.10. <u>Article 3(d)</u> inserts two further matters into the list – land, and tangible assets which are not commodities. CfDs may well be accounted for as derivative financial instruments even where their USM is a non-financial asset, but the new addition to the paragraph puts the point beyond argument.

2.11. <u>Article 4</u> substitutes a <u>new paragraph 4</u> for the old. The old paragraph excluded a number of contracts from Schedule 26 – including:

- land and tangible non-commodity assets in all cases; and
- shares (and share-like assets such as interests in a unit trust, securities falling within section 92 FA 1996 (convertibles) and section 93 FA 1996 (asset-linked securities)) in a limited number of cases.

It also excluded futures and option over intangible fixed assets (as they fell within another income regime – Schedule 29 FA 2002) but not CfDs.

2.12. The new paragraph 4 now only excludes futures and options over intangibles. Accordingly **no other USM will cause a contract to be excluded**. Instead new paragraph 45A (see <u>Article 13</u> below) provides for a non-standard tax treatment for certain contracts whose USM is land or shares and which were previously normally taxed as chargeable gains.

2.13. It may be worth stressing here that the distinction between a future or option on one hand, and a CfD on the other, remains of limited importance following the changes made by these draft regulations. The only relevant distinctions are -

- if the USM of a contract is an intangible fixed asset, a CfD is in Schedule 26 FA 2002 but a future or option is within Schedule 29 FA 2002 (which is also an "income" regime).
- if the USM is land or non-commodity tangible assets, a contract that fails the accounting test in paragraph 3 falls within Schedule 26 only if it is a CfD. It is unlikely that a contract whose USM is land or tangibles would be difficult to classify.
- if the contract is a CfD and a swap, it will not be capable of going through the mechanism of new paragraph 45A to produce a chargeable gains result – see paragraph 28 onwards below.

2.14. It follows that the rules (in paragraph 9) that determine whether a contract with more than one USM is within or outside Schedule 26 or is to be treated as of one USM only are no longer needed – the chances of a future or option over intangibles also having another USM is remote (and if it happens the rules in Schedule 29 FA 2002 will operate to divide the contract up). So paragraph 4(4) which refers forward to paragraph 9 is no longer needed, and Article 9 omits paragraph 9.

Consequential simplification of paragraphs 5 to 9 Schedule 26

2.15. Article 5 omits paragraph 5. That paragraph provided that contracts whose USM is shares etc. ("etc." covering the share-like assets mentioned in paragraph 11 above) are a derivative contract if the contract is held for the purposes of a trade (whether as a derivative trader, or in the course of portfolio management e.g. by a bank or insurance company). All contracts with shares etc. as their USM now fall within Schedule 26, so the distinction made by paragraph 5 is not needed.

2.16. Articles 6, 7 and 8 modify paragraphs 6, 7 and 8. The contracts that fall within those paragraphs are ones whose USM was shares etc. but which because of their nature (on their own or combined with other contracts or assets) gave a return akin to that on a deposit or a debt security. These paragraphs are anti-avoidance rules which re-admitted such contracts to the derivative contracts regime where they would otherwise have been excluded by paragraph 4. But since the paragraph 4 exclusion of shares etc has been removed, paragraphs 6, 7 and 8 no longer fall to be categorised as "qualified exclusions" and the conditions relating to the USM of these types of contract have been omitted.

2.17. Accordingly Articles 6(2), 7(2) and 8(2) amend the headings to each of the paragraphs.

2.18. Articles 6(3), 7(3) and 8(3) remove sub-paragraph (1) in each paragraph as they linked the paragraphs back to Article 4, and Article 6(4), 7(4) and 8(4) modify sub-paragraph (2) in each paragraph to remove the references to shares etc.

2.19. Articles 6(5) and 7(5) also remove the references to shares etc. from sub-paragraph (3)(b) in each paragraph.

2.20. Article 8(5) does a similar job to paragraph 8(2)(c).

2.21. Article 6(6) omits paragraph 6(9) which is redundant (it should have been removed as a consequence of a Committee stage amendment to paragraph 6 made in the passage of the Finance Bill 2002).

2.22. Articles 6(6), 7(6) and 8(5) remove paragraphs 6(10), 7(9) and 8(4) each of which applies paragraph 9 (which is also omitted).

Changes to definitions: rent and dividends are an income USM

2.23. Article 10 adds a new paragraph 11(7) (paragraph 11 explains what is meant by the USM in the case of each type of relevant contract). It puts beyond doubt a point that has caused some problems. There are differing views on whether the income from an asset is the same USM as the asset itself. The Inland Revenue's view is that it probably is not. In many cases it has been immaterial because the income element of a contract will be small or insubstantial by comparison with the asset element (e.g. in a total return equity swap, or a contract based on the index of an exchange such as the DAX where dividends are taken into account).

2.24. Paragraph 11(7) puts the point beyond doubt so far as land and shares etc. are concerned. Rent and dividends are separate USMs from land and shares. Land and shares (but not rent and dividends) are relevant USMs for the purposes of new paragraph 45A.

2.25. Article 11 amends the definition of "intangible fixed asset" in paragraph 12(10). It makes the definition more precise by not including those intangible fixed assets to which Schedule 29 does not apply, thus ensuring a closer fit between Schedule 26 and Schedule 29.

Amendment of Part 9 Schedule 26

2.26. **Part 3** sets out what amendments would be made to Part 9 Schedule 26 if there were a power to make the amendments. The Government may amend Schedule 26 in the Finance Bill 2004 so that paragraph 13 contains a power to amend Part 9.

Consequential simplification: omission of various special rules

2.27. Articles 12 and 14 omit paragraphs 44, 45, 46 and 47. They all depend on distinctions no longer being made. For example paragraph 45 deals with contracts outside Schedule 26 (because the USM is shares etc.) coming within it when the contract begins to be a trading contract (so that paragraph 5 applies). This distinction is no longer made as a result of the repeal of paragraphs 4(2) and 5. So paragraph 45 falls as does paragraph 44 which deals with the converse case.

2.28. Paragraphs 46 and 47 deal with contracts where there is more than one USM and one is either a fully excluded type or a partially excluded type. These distinctions are also no longer made and so the paragraphs fall.

Capital gains treatment of certain non-swap contracts

2.29. Article 13 inserts a new paragraph 45A. This gives effect to representations made by the property industry for a mechanism to take the profits and losses given by Schedule 26 (those shown by UK GAAP for a period, including unrealised gains and losses) and converting them into chargeable gains or allowable losses for the purposes of corporation tax on chargeable gains. Property index futures and exchange-traded futures or options over shares or shares indices are examples of contracts to which this treatment would apply.

2.30. Paragraph 45A(1) sets out the conditions for the application of the paragraph. There must be an option, a future or a CfD which is not a swap – paragraph 45A(1)(a):

- which does not fall within paragraphs 6, 7 or 8 – paragraph 45A(1)(b);
- which is not held for the purposes of a trade in the period – paragraph 45A(1)(c);
- whose USM is land, tangibles or shares etc. – paragraph 45A(1)(d) and (2).

"Swap" is not defined, and so takes its normal commercial meaning. The essence of a swap is that the two parties exchange a stream of cash flows of different characteristics, often calculated by reference to a notional principal amount: it is irrelevant that amounts may be netted so that only one payment is made at any one payment time. **If readers are aware of a watertight definition that might be used, the Inland Revenue would be happy to consider it.**

2.31. Paragraph 45A(3) gives the operative rule. The credits and debits given by paragraph 15 Schedule 26 in relation to the contract are not treated as provided by paragraph 14(3) (aggregated along with loan relationships credits and debits to form a Case III income amount or a non-trading deficit) but instead are treated as in paragraph 45A(4).

2.32. That paragraph provides that an excess of paragraph 15 credits over debits from that contract is treated as a chargeable gain accruing in the same period, and an excess of debits over credits as an allowable capital loss. The excesses (relevant excess) are defined in paragraph 45A(5).

2.33. The effect of paragraph 45A is to follow the accounts in recognising the amounts arising in each accounting period (on an accruals or mark-to-market basis rather than a realisation basis) and to tax those amounts to chargeable gains. Since the amounts taxed or relieved as chargeable gains or allowable losses are those given by the Schedule 26 provisions, all the special rules in Schedule 26 relating to bad debts, intra-group transfers etc, and the anti-avoidance provisions, apply to contracts within paragraph 45A.

2.34. As is the case for contracts currently within section 143 The Taxation of Chargeable Gains Act 1992 (TCGA), chargeable gains are not reduced by indexation allowance.

Transitional provision

2.35. **Part 4** contains a transitional provision. It is modelled closely on paragraph 4 Schedule 28 FA 2002, the transitional provision for chargeable assets becoming derivative contracts.

2.36. Article 15 applies where, immediately before the accounting period of the company beginning on or after the date determined as the commencement date, the contract was one to which the company was party and the contract was a chargeable asset, so long as on commencement day the contract was a derivative contract for the purposes of Schedule 26 – Article 15(1) to (4).

2.37. An asset is a chargeable asset if a gain on its disposal would be a chargeable gain – Article 15(8)(a). "Asset" includes a contract as described in section 143 TCGA – Article 15(9). A contract already within Schedule 26 cannot be a chargeable asset – paragraph 1(2) Schedule 26.

2.38. Where the Article applies, there is deemed to be a disposal immediately before commencement day for market value and any chargeable gains or allowable losses computed. The gain or loss is then brought into account when the company ceases to be a party to the contract – Article 15(5)

2.39. Article 15(6) allows an election to be made if there would be an allowable loss on the deemed disposal. The election is to treat the loss as a non-trading debit within Chapter 2 Part 4 FA 1996 (loan relationships) arising when the company ceases to be a party to the contract.

2.40. Article 15(7) gives the time limit for the election – 2 years from the end of the accounting period in which the company ceased to be party to the contract.

Other proposed amendments

2.41. On the basis of the proposals set out in the draft illustrative regulations, paragraphs 42(4) and 43 (and the definition of "non-life mutual business" in paragraph 54) would appear to be redundant.

2.42. On the basis of these illustrative regulations, it would be proposed to disapply, for the purposes of corporation tax only, certain parts of the TCGA insofar as they cover contracts which can, on the basis of these proposals, only fall within Schedule 26 FA 2002 and so, by virtue of paragraph 1(2) of that Schedule, not within the scope of the TCGA.

2.43. The relevant provisions are -

- Section 143
- Section 144(4), (8) and (9)
- Section 144A
- Section 146
- Section 147
- Section 148

It would also be proposed in consequence to repeal section 128(2) The Income and Corporation Taxes Act 1988 (ICTA).

INCOME TAX

The Finance Act 2002, Schedule 26, Part 2 (Amendment) Order 2004

Made - - - -

Laid before the House of Commons

Coming into force - -

The Treasury, in exercise of the powers conferred upon them by paragraph 13 of Schedule 26 to the Finance Act 2003([3]), hereby make the following Order:

PART 1

Introduction

Citation and commencement

1. This Order may be cited as the Finance Act 2002, Schedule 26, Part 2 (Amendment) Order 2004 and shall come into force on 2004.

PART 2

Amendment of Part 2 of Schedule 26 to the Finance Act 2002.

2. Schedule 26 to the Finance Act 2002 is amended as follows.

3. In paragraph 3—

(a) in sub-paragraph (1)(b)—

(i) for "paragraph 6 or 7" substitute "paragraph 6, 7 or 8"; and

(ii) at the end omit "or";

(b) after sub-paragraph (1)(b) insert—

"(ba) in the case of a relevant contract which is not treated as mentioned in paragraph (a) or (b) it falls within paragraph 6,7 or 8; or";

(c) in sub-paragraph (1)(c) after "paragraph (a) or (b)" insert "or falls as described in paragraph (ba),"; and

(d) after sub-paragraph (2)(b)(i) insert—

"(ia) land;

(ib) tangible movable property, other than commodities which are tangible assets;".

4. For paragraph 4 substitute—

([3]) 2002 c. 23.

"**Contracts excluded whose underlying subject matter is intangible fixed assets**

4. A relevant contract is not a derivative contract for the purposes of this Schedule if it is an option or future and its underlying subject matter consists wholly of intangible fixed assets.".

5. Omit paragraph 5.

6.—(1) Amend paragraph 6 as follows.

(2) For the heading substitute "*Contract producing guaranteed return*".

(3) Omit sub-paragraph (1).

(4) For sub-paragraph (2) substitute—

"(2) A relevant contract of a company falls within this paragraph if it satisfies the condition in sub-paragraph (3).".

(5) In sub-paragraph (3)—

(a) for "sub-paragraph (2)(b)" substitute "sub-paragraph (2)";

(b) for paragraph (b)(i) substitute—

"(i) one or more other relevant contracts,".

(6) Omit sub-paragraphs (9) and (10).

7.—(1) Amend paragraph 7 as follows.

(2) For the heading substitute "*Guaranteed amount payable on maturity*".

(3) Omit sub-paragraph (1).

(4) For sub-paragraph (2) substitute—

"(2) A relevant contract of a company falls within this paragraph if it satisfies the condition in sub-paragraph (3).".

(5) In sub-paragraph (3)—

(a) for "sub-paragraph (2)(b)" substitute "sub-paragraph (2)";

(b) for paragraph (b)(i) substitute—

"(i) one or more other relevant contracts,"

(6) Omit sub-paragraphs (9).

8.—(1) Amend paragraph 8 as follows.

(2) For the heading substitute "*Contracts held by company to provide insurance benefits*".

(3) Omit sub-paragraph (1).

(4) In sub–paragraph (2) for "This paragraph applies to a relevant contract of a company if—" substitute "A relevant contract of a company falls within this paragraph if—".

(5) Omit sub-paragraphs (2)(c) and (4).

9. Omit paragraph 9.

10. At the end of paragraph 11 add—

"(7) Where an underlying subject matter of a relevant contract is income from—

(a) land;

(b) shares; or

(c) rights of a unit holder under a unit trust scheme;

the underlying subject matter shall not be treated, solely by reason of that income, as being land, shares or such rights (as the case may be).".

11. In paragraph 12 in sub-paragraph (11) for the words from "has the same meaning as in Schedule 29" to the end substitute "has the same meaning as in Schedule 29 to this Act; and paragraphs 73 to 76 of that Schedule (and paragraph 72 of that Schedule so far as it relates to those paragraphs) have effect for the purposes of this Part as they have effect for the purposes of that Schedule".

PART 3

[AMENDMENTS TO PART 9 OF THE SCHEDULE

NB THESE AMENDMENTS *CANNOT* BE INCLUDED IN AN ORDER UNDER PARAGRAPH 13 BUT ARE SHOWN HERE PURELY FOR THE PURPOSES OF ILLUSTRATION]

12. Omit paragraph 44 and 45.

13. After paragraph 45 insert—

"*Contracts treated as ones under which chargeable gains accrue*

45A.—(1) This paragraph applies for an accounting period to a derivative contract of a company—

(a) which is—

(i) an option,

(ii) a future, or

(iii) a contract for differences which is not a swap contract;

(b) does not fall within paragraph 6,7 or 8;

(c) is not held at any time in the period for the purposes of a trade carried on by the company; and

(d) whose underlying subject matter falls within sub-paragraph (2).

(2) The underlying subject matter falls within this paragraph if it consists of wholly of one or more of—

(a) land (wherever situated);

(b) tangible movable property, other than commodities which are tangible assets;

(c) shares in a company;

(d) rights of a unit holder under a unit trust scheme; and

(e) any assets representing loan relationships to which section 92 or 93 of the Finance Act 1996 applies.

(3) Where this paragraph applies to a contract for an accounting period—

(a) paragraph 14(3) shall not apply to the credits and debits given in relation to the contract by paragraph 15, and

(b) sub-paragraph (4) shall apply.

(4) Where there is—

(a) a relevant excess of credits, a chargeable gain equal to the amount of the excess shall be treated as accruing in the accounting period in question to the company for the purposes of corporation tax;

(b) a relevant excess of debits, an allowable loss equal to the amount of that excess shall be treated as accruing in the accounting period in question to the company for the purposes of that tax.

(5) For the purposes of sub-paragraph (4)—

(a) a relevant excess of credits arises where the amount by which the non-trading credits that are brought into account in respect of the contract for the period exceeds the amount of non-trading debits that are so brought; and

(b) a relevant excess of debits arises where the amount by which the non-trading debits that are brought into account in respect of the contract for the period exceeds the amount of non-trading credits that are so brought.”.

14. Omit paragraphs 46 and 47.]

PART 4

Transitional provision

15.—(1) The amendments made by articles 2 to 14 of this Order have effect in relation to a contract of a company subject to the following provisions of this article if the conditions in paragraphs (2) to (4) are satisfied.

(2) The first condition is that the company is a party to the contract immediately before and on the company’s commencement day.

(3) The second condition is that from the company’s commencement day the contract is a derivative contract.

(4) The third condition is that the contract was, immediately before the company’s commencement day, a chargeable asset.

(5) Where this article applies, the company shall, when it ceases to be a party to the contract, bring into account for the accounting period in which it ceases to be a party to the contract, the amount of any chargeable gain or allowable loss which would have been treated as accruing to the company on the assumption that—

(a) the company had disposed of the asset immediately before its commencement day; and

(b) the disposal had been for a consideration equal to whatever, in relation to a disposal immediately before the company’s commencement day, would have been taken to be the market value of the asset for the purposes of the Taxation of Chargeable Gain Act 1992([4]).

This is subject to the following qualification.

(6) The company may elect that a debit representing the amount of any allowable loss, which by virtue of paragraph (5) is to be brought into account for the accounting period in which the company ceased to be a party to the contract, shall be brought into account for that accounting period as if it were a non-trading debit falling to be brought into account for the purposes of Chapter 2 of Part 4 of the Finance Act 1996([5]) in respect of a loan relationship of the company.

(7) An election under paragraph (6) may only be made within the period of two years following the end of the accounting period in which the company ceased to be a party to the contract.

(8) For the purposes of this article—

(a) an asset is a chargeable asset if any gain accruing on its disposal by the company would be a chargeable gain for the purposes of the Taxation of Chargeable Gains Act 1992; and

(b) a company’s commencement day is the first day of its first accounting period beginning on or after [date to be determined].

(9) For the purposes of this article the requirement in paragraph (4) that a relevant contract of a company be a chargeable asset is to be regarded as satisfied in relation to such a contract if—

([4]) 1992 c. 12.

([5]) 1996 c. 8.

(a) the contract is a futures contract (within the meaning of section 143 of the Taxation of Chargeable Gains Act 1992); and

(b) obligations under that contract are regarded by virtue of that section as assets to the disposal of which that Act applies.

Name
Two of the Lords Commissioners of Her Majesty's Treasury

EXPLANATORY NOTE

(This note is not part of the Order)

This Order amends Schedule 26 to the Finance Act 2002.

Article 1 provides for the citation and commencement of the Order

Article 2 introduces the amendments.

Articles 3 to 14 make the amendments. The effect is to clarify the treatment of derivatives whose subject matter is or includes land. [Articles 12 to 14 are purely illustrative, as they cannot be included in an Order under the existing powers in paragraph 13 of Schedule 26].

Article 15 contains a transitional provision.