

CORPORATION TAX ACT 2009

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 7: Derivative contracts

Overview

Chapter 11: Tax avoidance

Section 689: Overview of Chapter

1904. This section describes the content of the Chapter. It is new.

Section 690: Derivative contracts for unallowable purposes

1905. This section prevents certain credits and debits being brought into account for corporation tax purposes, whether under this Part or otherwise, if the derivative contract in question has an “unallowable purpose”. It is based on paragraph 23(1), (2), (3), (8), (9) and (10) of Schedule 26 to FA 2002.

1906. *Subsection (3)* prevents a company bringing into account all debits in respect of the derivative contract that are referable to the unallowable purpose. But *subsection (2)* only does so for credits that are “exchange credits” (defined in *subsection (6)*).

1907. *Subsection (4)* signposts the relief in section 692, which provides that some of the debits mentioned in subsection (3) may be brought into account in the shape of “excess accumulated net losses”.

1908. *Subsection (5)* makes clear that an amount that is not brought into account because of this section (or section 692) is nevertheless regarded as brought into account for the purposes of the priority rule in section 699. That rule provides that this Part exhausts the corporation tax treatment of an amount to which it applies, unless otherwise stated. The amounts in question are therefore not to be brought into account for corporation tax purposes in any other way.

Section 691: Meaning of “unallowable purpose”

1909. This section defines “unallowable purpose” and “has an unallowable purpose” for the purposes of sections 690 and 692. It is based on paragraph 24 of Schedule 26 to FA 2002.

1910. A purpose is unallowable if it is one of the purposes for which the company is a party to the contract (or enters into related transactions in relation to it) but it is not a business or other commercial purpose of the company.

1911. *Subsection (2)* excludes any activities in respect of which the company is not within the charge to corporation tax from the business and commercial purposes of the company that are relevant to this definition. For example, if a non-UK resident company is a party to the contract for the purposes of a permanent establishment it has in the United

Kingdom, the purposes of the activities of the company that are not part of the activities of the permanent establishment are disregarded.

1912. *Subsections (3) to (6)* exclude a tax avoidance purpose from the business and commercial purposes of the company for the purposes of this definition. The effect of this is that a tax avoidance purpose is an unallowable purpose unless it is a minor part of the company's motivation for being a party to, or entering into related transactions in relation to, the derivative contract.

Section 692: Allowance of accumulated net losses

1913. This section gives relief for some of the debits prevented from being brought into account by section 690. It is based on paragraph 23(1), (4), (5), (6) and (7) of Schedule 26 to FA 2002.
1914. The amount that is relieved under this section by being brought into account as a debit, by virtue of *subsection (4)*, is the amount of the "excess accumulated net losses" found in accordance with the method statement in *subsection (5)*.
1915. In effect, debits excluded for an accounting period because of section 690(3) are nevertheless relieved in that or a later period to the extent that there are non-excluded credits against which they can be set.
1916. The calculation of the amount to be relieved is on a cumulative basis and that amount is reduced by any debit already given under this section.

Section 693: Bringing into account adjustments under Schedule 28AA to ICTA

1917. This section brings into account under this Part credits and debits in respect of amounts treated under Schedule 28AA to ICTA (provision not at arm's length) as profits, losses or expenses. It is based on paragraph 31A of Schedule 26 to FA 2002.
1918. It brings credits and debits into account to the extent that actual amounts of such profits, losses or expenses would be brought into account.
1919. Schedule 28AA to ICTA identifies adjustments ("imputed amounts") to be made to return the profit or loss from a transaction between parties not at arm's length to what that profit or loss would be had the parties been at arm's length. This section ensures that such amounts are taken into account under this Part although they arise under Schedule 28AA rather than under this Part.
1920. *Subsections (3) and (5)* indicate that the credits and debits brought into account by this section are subject to the same rules as apply under this Part to credits and debits in respect of actual amounts. So, for example, debits brought into account in respect of expenses are those falling within the categories listed in section 595(4).

Section 694: Exchange gains and losses

1921. This section gives effect in this Part to adjustments or other treatment of exchange gains and losses prescribed by Schedule 28AA to ICTA, further to those in section 693. It is based on paragraph 8(1) and (4) of Schedule 28AA to ICTA and paragraph 27 of Schedule 26 to FA 2002.
1922. Under paragraph 1 of Schedule 28AA to ICTA, a company may be treated as not a party to a derivative contract. The actual exchange gains and losses on that contract are then disregarded. *Subsection (3)* provides that such exchange gains and losses are also left out of account in determining the credits and debits to be brought into account under this Part.
1923. Schedule 28AA to ICTA may also impute amounts of exchange gains and losses (the "adjusted amount") calculated on the basis that the parties to the derivative contract are

acting at arm's length although in fact they do not do so. *Subsection (5)* requires the "adjusted amount" to be brought into account under this Part.

Section 695: Transfers of value to connected companies

1924. This section treats as a credit the amount paid by a company for the grant of an option by a company connected with it if the option is allowed to expire to the benefit of the connected company. It is based on paragraph 26 of Schedule 26 to FA 2002.
1925. Value is transferred on the expiry of the option because the connected company retains the amount paid for the option and does not suffer the commercial loss that would have occurred had the option been exercised. The required assumption in *subsection (6)*, that the option would have been exercised had the parties not been connected, points to the fact that it would have been advantageous to the option holder to exercise it (and therefore disadvantageous to the company granting the option).
1926. The section applies only if the connected company is not within the charge to corporation tax in respect of the derivative contract under or because of this Part. For example, it applies if the connected company is not a UK resident company (and the derivative contract is not held for the purposes of a permanent establishment it has in the United Kingdom).
1927. *Subsection (7)* indicates that, for the purposes of this section, the definition of "option" in section 580 is shorn of its usual limiting conditions (that a cash-settled option is not an option).

Section 696: Derivative contracts with non-UK residents

1928. This section excludes a debit if a company within the charge to corporation tax makes payments of notional interest in excess of payments of notional interest to it by a company which is non-UK resident. It is based on paragraph 31(1), (2), (3), (4) and (9) of Schedule 26 to FA 2002.
1929. This section typically applies to a contract for differences which is an interest rate swap. It has some similarities with section 695 in that the flow of benefit in the direction of a company outside the charge to corporation tax is countered in taxing the other company.
1930. *Subsection (4)* defines "notional interest payment". The rate applied in calculating such a payment is not necessarily an interest rate as such but paragraph (c) of the definition requires that it matches the interest rate specified in the contract.

Section 697: Exceptions to section 696

1931. This section sets out three circumstances in which section 696 does not apply. It is based on paragraph 31(5), (6), (7), (8) and (9) of Schedule 26 to FA 2002 and section 153(2) of FA 2003.
1932. The third exception is if there is a double taxation agreement between the United Kingdom and the territory in which the non-UK resident is resident which covers payments of interest (whether by relief or otherwise). Unlike the first two exceptions, where the financial institution or non-UK resident must hold the derivative contract as principal, this exception can apply if the non-UK resident holds the derivative contract as agent or nominee of another person. But in that case, the relevant territory is that in which the principal is resident.
1933. "Permanent establishment" is defined in section 148 of FA 2003.

*These notes refer to the Corporation Tax Act 2009
(c.4) which received Royal Assent on 26 March 2009*

Section 698: Disposals for consideration not fully recognised by accounting practice

1934. This section brings into account that part of the consideration for a disposal of rights or liabilities under a derivative contract that is not fully recognised under applicable generally accepted accounting practice, if the company in question made the disposal with avoidance motives. It is based on paragraph 27A of Schedule 26 to FA 2002.
1935. *Subsection (5)* gives priority to paragraph 1(2) of Schedule 28AA to ICTA, if that provision would apply a tax charge on the disposal in question. That paragraph may operate in effect through section 693.