

**EXPLANATORY MEMORANDUM TO
THE FINANCE ACT 2002, SCHEDULE 26, PARTS 2 AND 9 (AMENDMENT) (No
2) ORDER 2004**

2004 No.3270

1. This explanatory memorandum has been prepared by the Commissioners of Inland Revenue and is laid before the House of Commons by Command of Her Majesty.
2. **Description**
 - 2.1 This Order provides amendments to Schedule 26 to the Finance Act 2002 (derivative contracts). The main purpose of the amendments is to exclude certain profits and losses on some derivative contracts from the charge to corporation tax as income and, in certain cases, instead to provide for them to be charged to corporation tax as chargeable gains. The derivative contracts to which the amendments apply are those which are deemed to exist as a result of section 94A Finance Act 1996 which provides for the accounting treatment applicable to complex financial instruments to be followed for tax purposes by the bifurcation of the instrument into a debt component and a derivative component. The amendments also apply to derivative contracts deemed to be embedded in contracts which are not themselves financial assets or liabilities
3. **Matters of Special interest to the Select Committee on Statutory Instruments**
 - 3.1 None.
4. **Legislative Background**
 4. These regulations are being made under powers conferred by paragraph 13 Schedule 26 Finance Act 2002. The power was amended so as to apply to Part 9 as well as Part 2 by paragraph 2 Schedule 9 Finance Act 2004.
5. **Extent**
 - 5.1 The instrument applies to all of the United Kingdom.
6. **European Convention on Human Rights**
 - 6.1 The Paymaster General (Dawn Primarolo) has confirmed that advice provided to her confirms that the provisions of this draft Order are compatible with the European Convention on Human Rights.
7. **Policy Background**
 - 7.1 The main effect of the Order is to provide an appropriate tax treatment for the issuer of a security containing “embedded derivatives”. Since 1996 the tax treatment of “hybrid” financial instruments such as convertible securities has been governed by Chapter 2 Part 4 FA 1996 (loan relationships). This legislation, in section 92A FA 1996, provided for no

relief to be given in respect of the “equity” element of convertibles and other hybrid securities. Section 92A was repealed by the Finance Act 2004 and replaced by section 94A which divides a contract with and “embedded derivative” into a “host contract” treated as debt and an embedded derivative treated as an option or other contract whose underlying subject matter is shares

7.2 The Order sets out how deemed derivatives created by section 94A is taxed so far as relates to the issuer of the security. It also provides for the tax treatment of derivatives embedded in contracts which are not debt contracts, and makes other minor amendments to the legislation in Schedule 26 Finance Act 2002 about derivative contracts.

7.3 There has been consultation on this Order with relevant bodies.

8. Impact

8.1 A Regulatory Impact Assessment has not been published for this instrument.

8.2 The regulations are expected to have negligible Exchequer impact as they generally maintain the status quo.

9. Contact

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