EXPLANATORY MEMORANDUM TO

THE FINANCE ACT 2002, SCHEDULE 26, PARTS 2 AND 9 (AMENDMENT No. 3) ORDER 2005

2005 No. 3440

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.

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 further modify the provisions of Part 9 of the Schedule relating to derivative contracts which are embedded in other contracts.

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

3.1 The Order comes into force less than 21 days after the date on which it is made. The Order is the latest in a series of Orders made under paragraph 13 Schedule 26 dealing with "embedded derivatives" and recent developments in accounting standards dealing with such derivatives. International Accounting Standards (IAS) 32 and 39 provide for a complex basis of accounting for the derivative element of a contract, which taken as a whole is not a derivative. These Standards can be used by UK companies for the first time from 1 January 2005, and are by virtue of section 50 Finance Act 2004, followed for tax purposes. Section 94A of the Finance Act 1996, also inserted by the 2004 Act, provided the basis for dividing certain securities between their embedded derivative element and the underlying "host" contract" and permits the embedded derivative contract to be taxed in accordance with the rules of Schedule 26 FA 2002. The Orders made under paragraph 13 of that Schedule have for the most part given a special tax treatment for particular types of embedded derivative. The principal provisions of Part 9 Schedule 26 that have been inserted or amended by the Orders are paragraphs 45A to 45M.

3.2 HM Revenue and Customs has developed the Orders in conjunction with a working group comprising members of the accountancy and legal professions and representatives of major companies most affected. Many issues have been raised by members of the consultative group as they or their clients have come across issues in particular as they prepared their first interim accounts under IAS or as they move now to their first full year accounts. Many issues were not anticipated in the run up to adopting IAS.

3.3 Where issues have arisen then draft Orders have been prepared with a view to a period of consultation with the working group and a wider audience. This has been the case with this Order. The matters with which it deals are highly complex, both from an accounting and a tax standpoint. A near final draft was published on 5 December as that was the day of the Chancellor's Pre-Budget Report. Comments have continued to be received; and as the issues involved, could, if not dealt with correctly, have very substantial Exchequer impacts (probably exceeding £1 billion in lost tax), final settlement of the Order has been slightly delayed.

3.4 It is vital if the Exchequer impacts are to avoided for the Order to have effect before 2006 so as to apply to accounting periods covering 2005. There would also be substantial impact on companies who would face unexpected tax bills if the Order did not have effect for 2005.

4. Legislative Background

4.1 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 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 The Paymaster General has made the following statement regarding Human Rights:

> "In my view the provisions of the Finance Act 2002, Schedule 26, Parts 2 and 9 (Amendment No. 3) Order 2005 are compatible with the Convention rights."

7. Policy background

7.1 The main effect of the Order is to prevent a company from electing under paragraph 45L Schedule 26 Finance Act 2002 to follow its accounts for tax purposes if the embedded derivative is based on commodities or if the underlying contract is an insurance contract.

7.2 The Order also requires contracts where paragraph 45L(1) – disregarding the embedded derivative contract - applies to be treated as such contracts in the hands of both parties, whether or not one of them has elected under paragraph 45L to follow its accounts for tax purposes. It also requires symmetry of treatment as between the transferor and transferee of a relevant contract.

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

8. Impact

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

8.2 There is no impact on the public sector.

9. Contact

Richard Thomas at Her Majesty's Revenue & Customs Tel 020 7147 2558 or e-mail richard.thomas@hmrc.gsi.gov.uk can answer any queries regarding the instrument.