# EXPLANATORY MEMORANDUM TO

# THE LOAN RELATIONSHIPS AND DERIVATIVE CONTRACTS (DISREGARD AND BRINGING INTO ACCOUNT OF PROFITS AND LOSSES) (AMENDMENT No 2) REGULATIONS 2007

**2007 No. 3431**

**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 The Regulations amend the tax rules in the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004 (SI 2004/3256) that apply where a company uses a liability or derivative to hedge its net investment in a foreign operation, such as shares in an overseas subsidiary.

2.2 The Regulations allow companies, on making an election, to value a shareholding for this purpose at the value of the net assets underlying the shares, rather than being restricted to the cost of the shares as at present.

2.3 They also make extended provision for companies, which have made such an election, to review the extent to which liabilities or derivatives are "matched" with shares during the course of an accounting period.

2.4 The Regulations have effect for accounting periods beginning on or after 1 January 2008.

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

None

## 4. Legislative Background

4.1 As part of the 2007 Pre Budget Report, the Chancellor announced that the tax rules on the hedging of net investment in a foreign operation would be amended in order to align the tax treatment more closely with the company's economic reality. This would be done in two stages: a short-term fix to have effect for 2008 and only, and consultation in 2009 on a more extensive solution.

4.2 These Regulations amend SI 2004/3256 to provide the "short-term fix". It is expected that, for periods beginning on or after 1 January 2009, the parts of SI 2004/3256 dealing with net investment hedging will be replaced by a new set of Regulations, developed in consultation with industry.

## 5. Extent

This instrument applies to all of the United Kingdom.

## 6. European Convention on Human Rights

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

## 7. Policy background

7.1 Primary legislation (section 84A(3) FA 1996 and paragraph 16(3) Schedule 26 FA 2002) allows companies which use SSAP 20 (the 1985 accounting standard dealing with foreign exchange translation) to disregard exchange gains or losses on loans or derivatives that hedge the exchange risk arising from (or are "matched" with) a company's investment in a foreign operation. This allows the tax treatment to replicate the accounting treatment. Companies that account for their financial instruments under IAS 39 or FRS 26 can, in most cases, no longer use hedge accounting in these circumstances. However, Regulations (SI 2004/3256 – the so-called "Disregard Regulations") have, for periods beginning on or after 1 January 2005, allowed companies – in broad terms – to continue to disregard exchange differences on liabilities or derivatives that are "matched" with shares. This means that companies continue to be taxed in accordance with the economic reality of their arrangements.

7.2 There has been extensive consultation on the workings of SI 2004/3256 with relevant bodies, especially a Consultative Working Group, and a number of amendments have been made to the detailed rules to eliminate uncertainties and anomalies in their application, and to provide a better "fit" between tax treatment and economic reality.

7.3 In particular, the provisions on "forex matching" have been criticised on the grounds that they allow only the book value of shares to be hedged, whereas for its commercial purposes a company is likely to hedge exchange risk arising on the value of the net assets underlying the shareholding. These Regulations permit a company to elect to "match"for tax purposes the net asset value underlying shares, but allow companies to continue to match the book value if they choose to do so.

7.4 The Regulations modify the loan relationships and derivative contracts tax law in the light of practical experience of, in particular, the application of IAS. It is not appropriate to amend tax law otherwise than through legislative change, so no alternative avenues of achieving the objective have been explored.

7.6 Guidance on the Disregard Regulations generally is provided in HMRC's Corporate Finance Manual and on its website under the heading "Accounting Standards - the UK tax implications".

**8. Impact**

8.1 A Regulatory Impact Assessment has not been prepared for this instrument as it has no impact on charities or voluntary bodies, and a negligible impact on business.

8.2 The impact on the public sector is nil.

**9. Contact**

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