

CORPORATION TAX ACT 2009

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 7: Derivative contracts

Overview

Chapter 2: Contracts to which this Part applies

Section 575: Overview of Chapter

1510. This section describes the purpose and content of the Chapter. It is new.

Section 576: “Derivative contract”

1511. This section sets out the conditions under which a contract of a company is a derivative contract. It is based on paragraph 2(1) of Schedule 26 to FA 2002.

1512. The first condition, that it is a “relevant contract” (defined in section 577), limits the application of the term “derivative contract” to contracts that derive their value from underlying subject matter (defined in section 583) which is subject to changes in market prices or other factors.

1513. The second condition, that it meets the “accounting conditions” in section 579, means that the contract either:

- is treated by the relevant accounting standards as a derivative or as a financial asset or liability; or
- has underlying subject matter within certain categories.

1514. The third condition, that section 589 (contracts excluded because of underlying subject matter: general) or “any other provision of the Corporation Tax Acts” does not prevent it being a derivative contract, cuts down the scope of this Part, particularly in relation to contracts whose underlying subject matter is land or shares. Section 226(3) of FA 1994 (Lloyd’s underwriters: relevant contract forming part of a premium trust fund not to be a derivative contract) is an example of such another provision.

Section 577: “Relevant contract”

1515. This section defines the term “relevant contract”. It is based on paragraph 2(2) of Schedule 26 to FA 2002.

1516. In this Part, the term is used to refer generically to a contract within one of the three categories of contract listed here. In many contexts it is immaterial whether the relevant contract is an option, a future or a contract for differences.

1517. See also sections 584 to 586, under which some of the rights and liabilities under a contract are themselves *treated* as a relevant contract. The deemed relevant contract is a derivative contract if it meets the other conditions in section 576(1).

Section 578: Relevant contracts of a company and being party to such contracts

1518. This section explains what references in this Part to a company's relevant contracts, or to a company being a party to such a contract, mean. It is based on paragraphs 2(2A) and 53(1) and (2) of Schedule 26 to FA 2002.
1519. A relevant contract is "of" a company if that company has entered into or acquired the contract. A reference to a company being a party to a contract means the company has entered into or acquired the contract.
1520. *Subsection (2)* explains what "acquires" means in relation to a contract for the purposes of this Part. The words "whether by assignment or otherwise" in the source legislation have not been reproduced as they add nothing.

Section 579: The accounting conditions

1521. This section sets out the conditions mentioned in section 576(1)(b). It is based on paragraph 3 of Schedule 26 to FA 2002.
1522. Most derivative contracts meet the first of the conditions in *subsection (1)*, that the relevant contract is treated for accounting purposes as a derivative. *Subsections (3) and (5)* explain when a relevant contract is treated for accounting purposes as a derivative. Financial Reporting Standard 25 ("FRS 25") deals with the presentation of financial instruments in accounts.
1523. The second condition has two legs. The first covers a contract that does not meet a particular requirement of Financial Reporting Standard 26 (measurement in accounts of financial instruments) ("FRS 26") that must be satisfied if the contract in question is to be treated as a derivative under FRS 25. Paragraph 9(b) of FRS 26 prescribes that the "financial instrument or other contract within the scope of this Standard... requires no initial net investment or an initial net investment that is smaller than would be required for other types of contract that would be expected to have a similar response to changes in market factors".
1524. The second leg of the second condition is that the contract is nevertheless treated for accounting purposes as a financial asset or financial liability. *Subsections (4) and (5)* have the same function in relation to the second condition as have subsections (3) and (5) in relation to the first condition.
1525. The third condition brings in contracts that fail the first or second condition but have underlying subject matter within one of the categories prescribed in *subsection (2)*. If the underlying subject matter is commodities, it does not matter what category of relevant contract the contract is. But only a contract for differences can meet the condition by reference to the other prescribed categories of underlying subject matter. So an option or future whose underlying subject matter is one or more of the categories in subsection (2) (b) is only a derivative contract if it meets one of the other accounting conditions.

Section 580: "Option"

1526. This section defines the term "option". It is based on paragraph 12(1), (8) and (10) of Schedule 26 to FA 2002.
1527. Subject to the non-exhaustive definition in *subsection (1)* and the limitation in *subsection (2)* (itself limited by *subsection (3)*), the word takes its ordinary meaning. "Warrant", in subsection (1), is defined in section 710 (other definitions).

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1528. The limitation in subsection (2) excludes cash-settled options from the meaning of “option”. Contracts so excluded fall within the definition of contracts for differences and are therefore subject to the rules applying to relevant contracts generally and those applying specifically to contracts for differences.
1529. *Subsection (4)* lists a number of provisions that dispense with this limitation and so do not exclude cash-settled options from the meaning of “option” in that context.

Section 581: “Future”

1530. This section defines the term “future”. It is based on paragraph 12(1), (6), (7) and (10) of Schedule 26 to FA 2002.
1531. *Subsections (3)* and *(4)* exclude cash-settled futures from the scope of the definition in the same way that section 580(2) and (3) does for cash-settled options in relation to the definition of “option”. Contracts so excluded also fall within the definition of contracts for differences.

Section 582: “Contract for differences”

1532. This section defines the term “contract for differences”. It is based on paragraph 12(1), (3), (4) and (5) of Schedule 26 to FA 2002.
1533. This is the broadest category of relevant contract and the definition is expressed initially in wide-ranging terms. *Subsection (2)* therefore excludes a number of categories of contract from the scope of the definition, in particular an option and a future, but also a loan relationship and a number of other types of financial instrument. Section 710 has definitions of “contract of insurance” and “capital redemption policy”. For the meaning of “loan relationship”, see section 302.
1534. *Subsection (3)* emphasises the wide-ranging nature of the indices or factors that may be designated in a contract for differences. The words in the source legislation “and, for those purposes, a numerical value may be attributed to any variation in a matter”, have not been rewritten as they add nothing. It is of the essence of any index or factor used in a contract for differences that it has such a numerical value.

Section 583: “Underlying subject matter”

1535. This section defines the term “underlying subject matter” for each category of relevant contract. It is based on paragraph 11 of Schedule 26 to FA 2002.
1536. *Subsection (5)* echoes section 579(2)(b) in explaining that certain factors may be the underlying subject matter of a contract for differences. One of those factors is interest rates. *Subsection (6)* provides that interest rates are not regarded as the underlying subject matter of a contract for differences if such rates are only used incidentally in determining the variable amount of a payment due under the contract at a variable date. That is, in such a case an interest rate or rates are a factor in the operation of the contract but are not themselves what its outcome depends on.
1537. *Subsection (7)* applies to all categories of relevant contract. It stops certain types of property from being regarded as the underlying subject matter of the contract just because *income* from that property is included in that underlying subject matter. Contracts to which this provision applies are therefore, as regards this aspect of their underlying subject matter, not excluded as derivative contracts under section 589.

Sections 584 to 586: Cases where companies treated as parties to relevant contracts

Overview

1538. These three sections treat certain rights and liabilities under a contract (an “embedded derivative”) as themselves constituting a relevant contract independent of the remaining

rights and liabilities under the main contract. The deemed relevant contract is a derivative contract if it meets the conditions in section 576(1)(b) and (c).

1539. All three cases cater for the provision in accounting standards for a financial or other instrument to be treated as divided between:
- the rights and liabilities that constitute one or more derivatives or one or more derivative financial instruments or equity instruments; and
 - the remaining rights and liabilities under the instrument.
1540. All three cases provide for the deemed relevant contract to be treated as an option, future or contract for differences if that is what a contract having only the rights and liabilities of the deemed relevant contract would be. So references in this Part to an option, future or contract for differences include a reference to the deemed relevant contract unless the context requires otherwise. And provisions dealing with a “relevant contract” or “derivative contract” apply to an embedded derivative that is treated as a relevant contract or qualifies as a derivative contract unless the context requires otherwise.
1541. A number of provisions in this Part make special provision for one or other category of embedded derivative (see in particular Chapters 7 and 8 (chargeable gains arising in relation to derivative contracts)).

Section 584: Hybrid derivatives with embedded derivatives

1542. This section treats a relevant contract divided in accordance with generally accepted accounting practice between one or more embedded derivatives and a host contract as a number of relevant contracts for the purposes of this Part. It is based on paragraph 2B of Schedule 26 to FA 2002.
1543. It applies if a relevant contract that is not itself a derivative for accounting purposes is so divided into one or more embedded derivatives and the remaining rights and liabilities (“the host contract”) which by themselves amount to a relevant contract.
1544. The host contract is also treated as a relevant contract with the same consequences as for the embedded derivative (in this respect, this section differs from its two successors).
1545. A relevant contract which may be treated as containing such deemed relevant contracts is called a “hybrid derivative” (*subsection (4)*). *Subsection (5)* lists the provisions which apply in relation to a hybrid derivative.

Section 585: Loan relationships with embedded derivatives

1546. This section treats the embedded derivative or embedded derivatives in a company’s loan relationship as relevant contracts. It is based on section 94A of FA 1996.
1547. It applies if a loan relationship is treated under generally accepted accounting practice as divided between rights and liabilities under one or more derivative financial instruments or equity instruments (the embedded derivative(s)) and the remaining rights and liabilities which by themselves constitute a loan relationship.
1548. For the meaning of “equity instrument”, see section 710 (that is, it has the meaning it has for accounting purposes). It is defined in paragraph 11 of International Accounting Standard 32 as follows: “an equity instrument is any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities”.
1549. *Subsection (4)* is a signpost to section 415 in Part 5 (loan relationships) which deals with the remaining rights and liabilities which by themselves constitute a loan relationship.
1550. *Subsection (5)* includes a signpost to section 416 which provides for a company to elect that certain of its loan relationships shall be split as mentioned in section 415 and this section, if they would not be so split under the accounting practice the company uses.

Section 586: Other contracts with embedded derivatives

1551. This section provides for the embedded derivative or embedded derivatives in a contract that is neither a hybrid derivative nor a loan relationship to be treated as relevant contracts. It is based on paragraph 2A of Schedule 26 to FA 2002.
1552. It applies if such a contract is divided under generally accepted accounting practice between one or more embedded derivatives and the remaining rights and liabilities under the contract.
1553. *Subsection (2)(a)* is written in terms of the rights and liabilities of the embedded derivative rather than, as in the source legislation, simply referring to the embedded derivative. This aligns the rule here with the expression of the similar rule in the preceding two sections.
1554. The source legislation for subsection (2)(b) refers at the equivalent point to a contract “whose rights and liabilities consist only of one of the *non-financial* embedded derivatives”. “Non-financial” is part of the label “non-financial embedded derivative” in paragraph 2A of Schedule 26 to FA 2002, which applies to the relevant contract to which the company is deemed to be a party under this provision. It is not appropriate to the embedded derivative itself by virtue of which the company is treated as a party to a relevant contract. That is, the embedded derivative has first to be identified before there is a deemed relevant contract to which such a label can be applied. “Non-financial” has therefore not been rewritten in subsection (2)(b).

Section 587: Contract relating to holding in OEIC, unit trust or offshore fund

1555. This section treats as a derivative contract a relevant contract that is not otherwise such a contract if its underlying subject matter consists wholly or partly of a holding in a collective investment scheme and that scheme fails to meet a “qualifying investments test”. It is based on paragraph 36(1), (2), (3) and (4) of Schedule 26 to FA 2002.
1556. A number of the contracts to which this section would appear to apply are in fact already derivative contracts because their underlying subject matter does not qualify as “excluded property” under section 589. This section therefore sweeps up any relevant contract that fails to meet the conditions for a derivative contract despite its underlying subject matter consisting wholly or partly of a “relevant holding”.
1557. The words “but for this section”, at the end of paragraph (a) in *subsection (1)*, avoid conflict between the effect of the section (the contract is a derivative contract) and the condition for the section to apply (the contract is not a derivative contract).
1558. If *subsection (2)* applies to treat the relevant contract as a derivative contract in a particular accounting period, that treatment persists for so long as the contract is a relevant contract of the company (even if the circumstances that first led to it being treated as a derivative contract no longer apply).
1559. *Subsection (3)* describes what a “relevant holding” is for the purposes of the section. It is drafted in terms of the underlying subject matter of the contract rather than, as in the source legislation, referring to a relevant holding of a “person”. This corrects a misfiring of the provision that arose from adapting a similar provision for loan relationships (see paragraph 4(1) of Schedule 10 to FA 1996, rewritten in section 490 of this Act). See *Change 63* in Annex 1. (This Change also applies to section 601; see the signpost to that section in *subsection (6)*.)
1560. The meaning of “material interest in an offshore fund” in subsection (3)(a)(iii) is provided by reference to Chapter 3 of Part 6 of this Act, where the definition is based on paragraph 7 of Schedule 10 to FA 1996, to which the source legislation for this section refers. But that definition pleads into the meaning given to “offshore fund” in section 489(1), which is slightly wider in scope than that given in section 756A of ICTA. See *Change 60* in Annex 1.

1561. *Subsection (5)* refers to the power to amend the definition of “relevant holding”, by regulations under section 17 of F(No 2)A 2005, in relation to the source legislation for both this section and its loan relationships equivalent (section 490 in Part 5). The power has not yet been exercised.
1562. The provisions mentioned in *subsections (6) and (7)* are those that deal specifically with contracts to which this section applies. But a contract treated as a derivative contract by this section is subject to other provisions that operate on derivative contracts so far as the context permits.

Section 588: Associated transaction treated as derivative contract

1563. This section treats an “associated transaction” in respect of shares held by an “investing company” as either a derivative contract or a transaction in respect of a derivative contract, if it would not already be such a contract or transaction. It is based on section 91B(5) of FA 1996.
1564. If the section does so, credits and debits arising from the associated transaction are then brought into account under this Part under section 603.
1565. Chapter 7 of Part 6 (shares with guaranteed returns etc) deals with certain shares which in substance are equivalent to loan relationships. It provides that the same consequences follow for tax purposes as if the company’s holding of shares were a loan relationship.
1566. **Section 523** (which is also based on section 91B of FA 1996) applies to “non-qualifying shares”. A share is “non-qualifying” if one of various conditions is met. One of those conditions (see section 532) is that there is a scheme or arrangement under which the share and “one or more associated transactions” are designed to equate to an investment yielding a commercial rate of interest. An “associated transaction” is one of entering into, or acquiring rights and liabilities under, a derivative contract or contracts having some similarity to a derivative contract or a contract of insurance or indemnity.
1567. *Subsection (4)* applies if there is such an associated transaction (the “associated transactions condition”).

Section 589: Contracts excluded because of underlying subject matter: general

1568. This section, supplemented by the next four, provides that a relevant contract is not a derivative contract if its underlying subject matter falls wholly into certain categories (or is treated as doing so) and one or more conditions applies. It is based on paragraph 4(1), (2), (2ZA) and (4) of Schedule 26 to FA 2002.
1569. Profits and losses arising in relation to such contracts are therefore not brought into account under this Part but are taxed as appropriate under other provisions, primarily as chargeable gains.
1570. *Subsection (1)* introduces the term “excluded property” to describe underlying subject matter that causes the relevant contract not to be a derivative contract. *Subsection (2)*, supplemented by *subsections (3) to (6)* defines the term, with further detail appearing in sections 590 to 592.
1571. Intangible fixed assets are excluded property, but only in the case of an option or future. Profits and losses in respect of such a contract are dealt with primarily under Part 8.
1572. The major categories of excluded property, in relation to any type of relevant contract, are (a) shares in a company and (b) rights of a unit holder under a unit trust scheme. But in such cases the relevant contract must both satisfy one of the conditions in section 591 and not have the characteristics of a commercial investment.
1573. *Subsection (3)* takes certain types of share out of the excluded category. These are:
- shares dealt with by Chapter 7 of Part 6 (shares with guaranteed returns etc); and

- shares in an open-ended investment company if that company fails to meet the qualifying investments test for the purposes of the loan relationships provisions.

1574. For more on the qualifying investments test, see the commentary on section 587.

Section 590: Disregard of subordinate or small value underlying subject matter

1575. This section provides that the parts of a relevant contract's underlying subject matter that are subordinate or of small value are ignored in determining for the purposes of section 589 whether its underlying subject matter consists wholly of excluded property. It is based on paragraph 9 of Schedule 26 to FA 2002.

1576. A relevant contract may contain a number of minor elements in addition to its main purpose. For example, there may also be an option to settle the contract in one or more currencies by reference to a particular exchange rate or there may be some minor leeway as to the settlement date.

1577. *Subsection (3)* provides that any question of whether part of the underlying subject matter is "subordinate" or of "small value" is determined by reference to the time the company enters into or acquires the contract. But the section does not otherwise provide any definition of "subordinate" or "small value". Paragraph CFM13120 of HMRC's Corporate Finance Manual (and the examples in CFM13120a) provides guidance.

1578. See also section 593 which deals with the case of an option or future where the part of the underlying subject matter that is not excluded property is neither subordinate nor of small value.

Section 591: Conditions A to E mentioned in section 589(5)

1579. This section provides the conditions mentioned in section 589(5)(a) which govern whether shares in a company or rights of a unit holder under a unit trust scheme are excluded property under that section. It is based on paragraphs 4(2A) to (2D) and 12(1) and (11A) of Schedule 26 to FA 2002.

1580. Condition A applies to certain relevant contracts entered into or acquired by life insurers that are an "approved derivative" within the meaning of Rule 3.2.5 of the Insurance Prudential Sourcebook issued by the Financial Services Authority on 25 October 2006 or, in the case of an overseas life insurance company which is a European Economic Area firm or a "treaty firm", are derivative instruments falling within article 23.3 of the EC Consolidated Life Directive (EC/2002/83).

1581. Rule 3.2.5 of the Insurance Prudential Sourcebook sets out a number of conditions to do with the purposes for which the derivative is held, how the risk under the derivative is managed and the circumstances in which it is entered into or acquired. See the definition of "Insurance Prudential Sourcebook" in section 431(2) of ICTA.

1582. Condition A does not apply to a relevant contract that meets the condition in section 579(1)(b) (one that is treated by accounting standards as a financial asset or liability, but is not treated as a derivative by accounting standards because of the size of the initial outlay).

1583. The source legislation for condition A applies only to cases where the contract is "entered into" by the company. But the source legislation for conditions B to D in this section applies if the company enters into *or acquires* the contract. This condition has been brought into line with those conditions. See *Change 64* in Annex 1.

1584. See also section 592 which extends the application of condition A to certain rights and liabilities that are treated as a relevant contract by section 584.

1585. Condition B applies if the company is not a party to the relevant contract for the purposes of its trade and there is a "hedging relationship" (defined in section 707)

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between the relevant contract and either (a) shares or rights of a unit holder in a unit trust scheme or (b) the company's share capital or related liability.

1586. Condition B does not apply if the relevant contract is one treated as such by section 585 (that is, it is an embedded derivative in a loan relationship).
1587. Condition C applies if the company is not a party to the relevant contract for the purposes of its trade and the contract is a quoted option to subscribe for shares.
1588. Condition D deals with a relevant contract that relates to the acquisition by company A of a major investment in the share capital of company B other than for the purposes of core activities of company A's trade. The reference to "activities forming an integral part of a trade" ensures that the condition is not disappplied in the case of, say, a financial trader. For a financial trader, the particular contract may be relevant to its structural assets, which might be regarded as held in the course of its trade, but may not actually be relevant to its core trading activities. The contract must be an option or future for the acquisition or delivery of shares. As with condition B, condition D does not apply if the relevant contract is one treated as such by section 585.
1589. Condition E applies if there is a hedging relationship between the relevant contract and an asset or liability representing a loan relationship to which section 585 applies. The second leg of condition E is that each of the relevant contracts to which the company is treated as a party under that section is a derivative contract to which one of the provisions specified in paragraph (b) of *subsection (6)* applies. Under the provisions listed in *subsection (7)*, credits and debits are brought into account in calculating chargeable gains rather than as income. Part 10 of Schedule 2 extends that list in respect of certain rules in that Part.
1590. The section does not rewrite those parts of paragraph 4(2B)(a), (2C)(a) and (2CA) (a) of Schedule 26 to FA 2002 that refer to the trading activities of an insurance company or mutual trading company. They are redundant following changes in the source legislation for sections 633 and 634.

Section 592: Embedded derivatives treated as meeting condition in section 591 etc

1591. This section extends the ability to satisfy one of the conditions in section 591 to certain embedded derivatives within the meaning of section 584. It is based on paragraphs 2B(3), 45M and 54(1) of Schedule 26 to FA 2002.
1592. If this section applies, the underlying subject matter of the embedded derivative may satisfy the definition of "excluded property" in section 589(2). The embedded derivative may thereby not be a derivative contract for the purposes of this Part.
1593. The section applies only if the "hybrid derivative" (within the meaning of section 584) is a relevant contract within section 579(1)(b). That is one that is not treated as a derivative by accounting standards because of the size of the initial outlay (for example, a prepaid equity forward) but is treated as a financial asset or liability. Also, the "host contract" (*subsection (5)*) must be treated for accounting purposes as (or as part of) a financial asset.
1594. The embedded derivative must itself satisfy section 579(1)(a) (a relevant contract that is treated for accounting purposes as a derivative). And its underlying subject matter must be wholly shares in a company or rights of a unit holder in a unit trust scheme. *Subsection (4)* indicates that section 590 applies if appropriate to determine whether the "wholly" test in paragraph (c) of *subsection (1)* is met.
1595. If the section applies, the embedded derivative is treated as satisfying one of the conditions in section 591, and therefore meets one element of the meaning of "excluded property" in section 589(2). In the source legislation the embedded derivative is treated as meeting condition A in section 591 because this rule is expected to be relevant primarily (although not exclusively) to insurance companies (and condition

A specifically applies to such companies). But it is sufficient to deem the embedded derivative to meet any one of the conditions in section 591 for the purposes of section 589(2).

1596. The section does two more things. First, it treats the embedded derivative (which in all likelihood is not now a derivative contract, because of section 589) as a “chargeable asset” for the purposes of this Part and TCGA. See the definition of that term in section 703.
1597. Second, the host contract is treated as a “creditor relationship” of the company for the purposes of the Corporation Tax Acts. That primarily affects the operation of Parts 5 and 6 (loan relationships). But it also affects those sections in this Part that operate by reference to a creditor relationship (for example, section 631(4)). See the definition of “creditor relationship” in section 704.

Section 593: Contracts where part of underlying subject matter is excluded property

1598. This section provides for an option or future to be treated in certain cases as divided between a relevant contract whose underlying subject matter consists wholly of excluded property within the meaning of section 589 and one whose underlying subject matter consists wholly of other underlying subject matter. It is based on paragraph 46 of Schedule 26 to FA 2002.
1599. See the commentary on section 589 for the significance of the underlying subject matter of a contract being or not being “excluded property”.