

CORPORATION TAX ACT 2009

EXPLANATORY NOTES

COMMENTARY ON SECTIONS

Part 7: Derivative contracts

Overview

Chapter 3: Credits and debits to be brought into account: general

Section 594: Overview of Chapter

1600. This section describes the purpose and content of the Chapter. It is new.
1601. The Chapter provides in particular for the application of generally accepted accounting practice in determining the profits and losses to be brought into account under this Part. In some cases, it provides for departure from generally accepted accounting practice for that purpose. Chapter 4 contains provisions about credits and debits for a number of special situations.

Section 595: General principles about the bringing into account of credits and debits

1602. This section specifies for the identification of the credits and debits to be brought into account under this Part. It is based on paragraphs 15(1), (4) and (9) and 17A(1) of Schedule 26 to FA 2002.
1603. *Subsections (1) and (2)* make general statements on the part played by accounts prepared in accordance with generally accepted accounting practice in identifying credits and debits for the purposes of this Part. “Generally accepted accounting practice” is defined by section 832(1) of ICTA by reference to section 50(1) of FA 2004. If a company prepares accounts in accordance with international accounting standards, those standards constitute generally accepted accounting practice. Otherwise UK generally accepted accounting practice applies.
1604. The general statement in subsection (2) refers to credits and debits which are amounts “recognised in determining the company’s profit or loss” for the period. For the meaning of “recognised” in this context, see section 597.
1605. But that statement is qualified by the more specific rule in *subsection (3)* that those credits and debits must “fairly represent” profits, losses and expenses that arise in respect of the derivative contract or arise from certain transactions in respect of the contract (labelled “related transactions”).
1606. There is a further significant rule in *subsection (7)* that makes both the general statement in subsection (2) and the rule in subsection (3) subject to the qualifying effect of “the following provisions of this Part”.

Section 596: Meaning of “related transaction”

1607. This section provides the meaning of “related transaction” for the purposes of this Part. It is based on paragraph 15(7) and (8) of Schedule 26 to FA 2002.
1608. The term is used extensively in this Part in provisions which may apply to or involve consideration of the acquisition or disposal of a derivative contract.

Section 597: Amounts recognised in determining a company’s profit or loss

1609. This section explains what “an amount recognised in determining a company’s profit and loss” means. It is based on paragraph 17B of Schedule 26 to FA 2002.
1610. The various statements listed in paragraphs (a) and (b) of *subsection (1)* are those mentioned in UK generally accepted accounting practice or international accounting standards. But subsection (1)(c) caters for amounts recognised in any accounting statement not among those listed.
1611. The statements listed in paragraphs (a) and (b) of subsection (1) include a “statement of comprehensive income”, “statement of recognised income and expense” and “statement of income and retained earnings”. These statements are not mentioned in the source legislation but are the equivalents in more recently applying accounting standards of the statements listed there.
1612. So far as the terms in those paragraphs derive from accounting standards, they are defined in section 710 as having the meaning they have for accounting purposes.
1613. *Subsection (2)* brings in prior period adjustments for this purpose but *subsection (3)* excludes amounts recognised “by way of correction of a fundamental error”. Such amounts are brought into account in the prior period affected by the error (so that the amounts so brought into account “fairly represent” profits and losses etc in respect of the contract in that period).
1614. See also sections 613 to 615 for the treatment of adjustments shown in accounts on a change of accounting policy.

Section 598: Regulations about recognised amounts

1615. This section provides powers for regulations that amend the amounts regarded as “recognised” in one or other of the various statements mentioned in section 597(1). It is based on paragraph 17C of Schedule 26 to FA 2002 and paragraph 52 of Schedule 4 to FA 2005.
1616. For regulations made under this power, see the [Loan Relationships and Derivative Contracts \(Disregard and Bringing into Account of Profits and Losses\) Regulations 2004 \(SI 2004/3256\)](#), as amended, and the [Loan Relationships and Derivative Contracts \(Change of Accounting Practice\) Regulations 2004 \(SI 2004/3271\)](#), as amended.

Section 599: Meaning of “amounts recognised for accounting purposes”

1617. This section defines “amounts recognised for accounting purposes” by reference to the case of a company that has not prepared accounts in accordance with generally accepted accounting practice. It is based on paragraph 17A(2), (3) and (4) of Schedule 26 to FA 2002.
1618. This section is particularly relevant to the application of section 595 and the interpretative provision in section 597.
1619. See the commentary on section 595(2) for the relevance of “generally accepted accounting practice”. Unless a company uses international accounting standards for a period, the default meaning of “generally accepted accounting practice” is UK generally accepted accounting practice (see section 50(1) of FA 2004). When this section applies,

it therefore uses UK generally accepted accounting practice (as defined in section 50(4) of FA 2004).

Section 600: Contract which is or forms part of financial asset or liability

1620. This section provides that fair value accounting is used in the case of certain contracts for the purposes of the general rule in section 595(2). It is based on paragraph 17A(1A) of Schedule 26 to FA 2002.
1621. The contracts to which this section applies are those that are not treated as a derivative for accounting purposes because they fail the requirement of the relevant accounting standard as regards the initial net investment required by the contract but are nevertheless treated as a financial asset or liability. See the commentary for section 579.

Section 601: Contract relating to holding in OEIC, unit trust or offshore fund

1622. This section applies fair value accounting in determining the credits and debits to be brought into account in respect of a contract that is treated as a derivative contract because of section 587. It is based on paragraph 36(1) and (2A) of Schedule 26 to FA 2002.
1623. [Section 587](#) applies if the underlying subject matter of a contract includes a holding in a collective investment scheme that fails to meet a “qualifying investments” test. Because this section operates by reference to section 587, *Change 63* in Annex 1 (reference to a “relevant holding” is to a holding which is the underlying subject matter of the contract rather than a holding of the company which is a party to the contract) applies here as well.

Section 602: Contract becoming one relating to holding in OEIC, unit trust or offshore fund

1624. This section determines the opening valuation of a derivative contract for the purposes of section 601. It is based on paragraph 37(1), (2), (3), and (4) of Schedule 26 to FA 2002.
1625. The accounting period to which this section applies is that in which a relevant contract is treated as a derivative contract because of section 587 if that period immediately follows another in which it was not so treated. The section applies only if the relevant contract was a “chargeable asset” (defined in section 703) at the end of the earlier period.
1626. For the meaning of “market value” for the purposes of corporation tax on chargeable gains, see in particular section 272 of TCGA.

Section 603: Associated transaction treated as derivative contract

1627. This section applies fair value accounting in determining the credits and debits to be brought into account by virtue of section 588 in respect of an “associated transaction” that is treated as a derivative contract because of that section. It is based on section 91B(5) of FA 1996.
1628. For the circumstances in which section 588 applies and for the meaning of “associated transaction”, see the commentary on that section.
1629. *Subsection (1)* provides that this section must be construed as if it were part of Chapter 7 in Part 6 (shares with guaranteed returns etc). That Chapter rewrites sections 91A to 91G of FA 1996.

Section 604: Credits and debits treated as relating to capital expenditure

1630. This section brings a credit or debit that is treated in the accounts as part of a fixed capital asset or project into account under this Part in the same way as a credit or debit

that is brought into account in determining the company's profit or loss. It is based on paragraph 25 of Schedule 26 to FA 2002.

1631. Generally accepted accounting practice may permit a credit or debit of an income nature to be included in the value of a fixed capital asset or project. If this happens, the credit or debit bypasses the statements mentioned in section 597. This section overrides that treatment, except in the cases mentioned in *subsections (3) and (5)*.
1632. Subsection (5) prevents any debit being taken into account under this Part that writes down the value of the asset or project in question, or creates a reserve for amortisation or depreciation of that asset or project, so far as the write down etc is attributable to a debit brought into account under this section. As this section overrides the accounts treatment of the capitalised debit, this rule in this subsection prevents a double deduction should the asset or project be written down, or a reserve created for its amortisation or depreciation, whether in the same or a later period, if the amount taken to profit and loss is attributable to the amount brought into account under this section.
1633. The source legislation for subsection (5) refers to "so much of any amortisation or depreciation as represents *a writing off of the interest component of the asset*". The rule is identical to that in the equivalent rule for loan relationships (section 320(6)). But the "interest component" of the asset refers to something that is dealt with by the loan relationships provisions and has no relevance to the derivative contracts provisions. The emphasised words have therefore not been reproduced in this section. See *Change 65* in Annex 1.

Section 605: Credits and debits recognised in equity

1634. This section brings a credit or debit that is recognised in equity or shareholders' funds, rather than in one of the statements mentioned in section 597(1), into account for the purposes of this Part in the same way as a credit or debit that is brought into account in determining the company's profit or loss. It is based on paragraph 25A of Schedule 26 to FA 2002.
1635. As in the case of section 604, this section overrides the accounts treatment.

Section 606: Exchange gains and losses

1636. This section provides that exchange gains and losses arising from a derivative contract are included in the profits and losses mentioned in section 595(3). It is based on paragraph 16 of Schedule 26 to FA 2002.
1637. *Subsection (1)* does not rewrite the words "and related transactions" in paragraph 16(1) of Schedule 26 to FA 2002. They are not considered to add to the effect of this provision.
1638. *Subsection (3)* excludes exchange gains and losses arising in two circumstances from the basic rule in subsection (1) if those gains and losses are recognised in the company's "statement of total recognised gains and losses", "statement of recognised income and expense", "statement of changes in equity" or "statement of income and retained earnings". Those terms are defined in section 710 as having the meaning they have for accounting purposes. Some are taken from UK generally accepted accounting practice and the others from international accounting standards, but are otherwise equivalent terms. This subsection is subject to the effect of any regulations made under the power in *subsection (5)*.
1639. The section contains two regulatory powers. The first is in *subsection (4)*. It concerns exchange gains and losses from a derivative contract whose underlying subject matter is wholly or partly currency. Regulations may exclude such gains from the scope of subsection (1). For regulations made under this power, see the [Loan Relationships and Derivative Contracts \(Disregard and Bringing into Account of Profits and Losses\) Regulations 2004 \(SI 2004/3256\)](#), as amended.

1640. The second is in subsection (5). Regulations may countermand the effect of the rule in subsection (3) or of regulations made under subsection (4). Where the regulations apply, the affected amounts are brought into account under this Part as credits or debits arising from a company's derivative contracts or for the purposes of corporation tax on chargeable gains. (The [Exchange Gains and Losses \(Bringing into Account Gains or Losses\) Regulations 2002 \(SI 2002/1970\)](#), as amended, are made partly under the power rewritten in subsection (5). But, as amended by regulation 5 of [SI 2005/2013](#), [SI 2002/1970](#) now has no direct impact on the source legislation for this section.)
1641. The source legislation for this section was repealed by paragraph 9 of Schedule 6 to F(No 2)A 2005, subject to the making of an order for the repeal to have effect. That prospective repeal is preserved by the paragraph "repeal of provisions concerning exchange gains and losses from derivative contracts" in Part 10 of Schedule 2.

Section 607: Pre-contract or abortive expenses

1642. This section adds pre-contract and abortive expenses to the expenses that are taken into account under section 595(3) in determining a company's profits and losses under this Part. It is based on paragraph 15(5) of Schedule 26 to FA 2002.

Section 608: Company ceasing to be party to derivative contract

1643. This section brings into account amounts recognised in accounts in respect of a derivative contract after the accounting period in which the company ceases to be a party to that contract. It is based on paragraph 53(3), (4), (5) and (6) of Schedule 26 to FA 2002.
1644. The accounting policies of a company may treat part of the profit or loss in respect of a contract as deferred income or loss to be brought into account in accounting periods later than that in which the company ceased to be a party to the contract. This section identifies amounts to be treated as credits and debits in subsequent periods until all the deferred income or loss has been brought into account under this Part.
1645. *Subsections (3) to (6)* set out how certain conditions in this Part may be treated as satisfied in respect of the former derivative contract. Those are conditions that may need to be satisfied for a particular provision to apply in respect of post-cessation credits or debits. For examples of the conditions to which subsection (3) or (5) may apply, see sections 573 and 690.
1646. *Subsection (7)* makes clear that the deeming effect of subsections (3) to (6) carries through for any question of what a company's derivative contracts are or whether a company is a party to a derivative contract (see section 578).

Section 609: Company ceasing to be UK resident

1647. This section and the next apply if a derivative contract moves out of the scope of corporation tax because the company holding it is no longer within the charge to tax in respect of it. This section treats a company as making a deemed disposal and reacquisition of the contract at its fair value immediately before the company ceases to be UK resident. It is based on paragraph 22A(1), (2) and (3) of Schedule 26 to FA 2002.
1648. "Fair value" is defined in section 710.
1649. *Subsection (1)* provides that the company is treated for the purposes of this Part as reacquiring the derivative contract for the same amount. This deemed value will be taken into account should the derivative contract re-enter the scope of corporation tax because of a further change in the residence status of the company or otherwise.
1650. *Subsection (2)* has an exception to the general rule. This applies if a company moves abroad but leaves behind such a business operation as amounts to a permanent establishment and that operation includes at least some of the rights and liabilities under

the derivative contract. In effect, the contract has not left the scope of corporation tax. (“Permanent establishment” is defined in section 832(1) of ICTA by reference to the meaning provided by section 148 of FA 2003.)

1651. *Subsection (3)* provides an order of priority if this section would apply in relation to the same circumstances as trigger section 631 or 632. There is an equivalent order of priority in section 333 in Part 5. There is no reason for the two sets of provisions to differ in this respect. This subsection brings the provisions for loan relationships and derivative contracts into line. See *Change 66* in Annex 1.

Section 610: Non-UK resident company ceasing to hold derivative contract for UK permanent establishment

1652. This section treats a non-UK resident company as making a deemed disposal and reacquisition of a derivative contract at its fair value if and to the extent that some or all of the rights or liabilities under a contract held or owed for the purposes of a permanent establishment of that company cease to be so held or owed. The section is based on paragraph 22A(1) and (4) of Schedule 26 to FA 2002.
1653. The circumstances in which this section applies include where the contract is now held for the purposes of another part of the company’s business (which is not a permanent establishment) or where the permanent establishment ceases to be such. In those cases the derivative contract has left the scope of corporation tax.
1654. A significant difference between the conditions for the application of this section and those for the preceding section is that this section does not apply if the rights and liabilities under the contract cease to be held or owed for the purposes of the permanent establishment because of a “related transaction” (defined in section 596). That is, it does not apply when the contract ceases to be held because it is disposed of. That disposal is itself an occasion leading to amounts being brought into account under this Part.
1655. *Subsection (3)* introduces the same priority rule as is introduced in the preceding section. See again *Change 66* in Annex 1.

Section 611: Release under statutory insolvency arrangement of liability under derivative contract

1656. This section exempts from the scope of this Part any credit arising on the release of a company’s liability to pay an amount under a derivative contract, if the release is part of a statutory insolvency arrangement. It is based on paragraph 22(5) of Schedule 26 to FA 2002.
1657. A “statutory insolvency arrangement” is defined in section 834(1) of ICTA by reference to the Insolvency Act 1986 and other provisions having a similar effect.