These notes refer to the Finance (No. 2) Act 2010 (c.31) which received Royal Assent on 27 July 2010

FINANCE (NO. 2) ACT 2010

EXPLANATORY NOTES

Section 8Schedule 5: Amounts Not Fully Recognised for Accounting Purposes

Summary

1. Section 8 introduces Schedule 5, which amends the corporation tax rules on loan relationships and derivative contracts that apply to amounts that are not fully recognised for accounting purposes. Where a company 'derecognises' a loan or derivative (and its associated cash flows) in accordance with generally accepted accounting practice (GAAP), in specified circumstances amounts are brought into account for tax purposes as if the accounts had in fact recognised them. The Schedule amends these rules to extend the circumstances in which 'derecognition' is overridden for tax purposes.

Details of the Schedule

2. Paragraph 1 amends section 311 of the Corporation Tax Act 2009 (CTA). Section 311 currently applies in three cases (referred to as Conditions A, B and C) where a company is, or is treated as being, party to a creditor loan relationship in respect of which it does not fully recognise amounts in its accounts. The three cases are, respectively, where the company is also a party to a debtor loan relationship, or has received a capital contribution, or has issued securities. Where one of the conditions applies, the company is required to recognise for tax purposes the full amount of the credits and debits on the creditor loan relationship.

3. Paragraph (1)(2) amends section 311(2) CTA by adding a new condition ("Condition D") to the circumstances in which the rule in section 311 of CTA applies. Paragraph 1(6) inserts the new condition as new section 311(4B), which specifies that it applies where a company at any time acquires or varies a "relevant interest" in a company, partnership or trust.

4. Paragraph 1(8) inserts new section 311(5A) which defines "relevant interest" as an interest in a company's shares, or a partnership's profits or capital, or a trust's property.

5. Paragraphs 1(3), 1(4) 1(5) and 1(7) amend each of Conditions A, B and C so that they apply whenever the company is party to the debtor loan relationship, or receives the capital contribution, or issues securities. At present, these Conditions only apply where these circumstances occur in the same accounting period as that in which the creditor loan relationship is derecognised.

6. Paragraph 2 makes consequential changes to section 312 of CTA to reflect the fact that as a result of the changes made by paragraph 1, section 311 now applies where the Conditions in that section are met in "any period".

7. Paragraph 3 makes equivalent changes to section 599A of CTA which currently applies in two cases, (referred to as Conditions A and B), where a company is, or is treated as being party to a derivative contract in respect of which it does not fully recognise amounts in its accounts. The two cases are, respectively, where the company has

received a capital contribution, or has issued securities. Where one of the conditions applies, the company is required to recognise for tax purposes the full amount of the credits and debits on the derivative contract.

8. Paragraph (3)(2) amends section 599A(2) of CTA by adding a new condition ("Condition C") to the circumstances in which the rule in section 599A CTA applies. Paragraph 3(7) inserts the new condition as new section 599A(5A), which specifies that it applies where a company at any time acquires or varies a "relevant interest" in a company, partnership or trust. New section 599A(5B) defines "relevant interest" as an interest in a company's shares, or a partnership's profits or capital, or a trust's property.

9. Paragraph 3(3), 3(4), 3(5) and 3(6) amend each of Conditions A and B so that they apply whenever the company receives the capital contribution, or issues securities, rather than as now only where these circumstances occur in the same accounting period as that in which the derivative contract is derecognised.

10. Paragraph 4 sets out the commencement provisions for the changes, which have effect for accounting periods beginning on or after 22 June 2010. An accounting period beginning before and ending after this date is treated as two separate periods ending and beginning on this date respectively.

Background Note

11. The corporation tax rules that apply to loan relationships and derivative contracts are based on the principle that amounts brought into account for tax purposes as credits and debits under those rules are those that, in accordance with GAAP, are recognised in determining a company's profit or loss for the period.

12. In certain circumstances, where a company holds a loan or derivative that is matched with another financial instrument issued by it then it may be permissible under GAAP for the loan or derivative or amounts arising in respect of the loan or derivative not to be recognised in determining the company's accounting profits or losses for the period. For example, a company may have made a loan or hold securities from which it receives income in the form of interest, and have issued fixed rate preference shares under which matching amounts are paid as dividends. While the interest income and dividend expense match each other economically, following the accounting treatment in such a case gives rise to a tax advantage, since interest is normally fully taxable and the dividends are not deductible.

13. It is HM Revenue & Customs' (HMRC) view that such non-recognition or de-recognition is not to be observed for tax purposes where the accounting treatment does not fairly represent the profits. But sections 311 and 312 (for loan relationships) and 599A and 599B of CTA (for derivative contracts) codify the treatment, and prevent companies arguing that where a receipt under a loan relationship (or derivative contract) is matched with a payment (such as a dividend), there is no net liability to tax, even though no deduction is due for the payment under the Corporation Tax Acts.