EXPLANATORY MEMORANDUM TO

THE CHANGES IN ACCOUNTING STANDARDS (LOAN RELATIONSHIPS AND DERIVATIVE CONTRACTS) REGULATIONS 2014

2014 No. 3325

1. This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs and is laid before the House of Commons by Command of Her Majesty.

This memorandum contains information for the Select Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 These Regulations amend the Exchange Gains and Losses (Bringing into Account Gains and Losses) Regulations 2002 (S.I. 2002 /1970); the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account Profits and Losses) Regulations 2004 (S.I 2004 / 3256: the 'Disregard Regulations'); and the Loan Relationships and Derivative Contracts (Change of Accounting Practice) Regulation 2004 (S.I. 2004 / 3271: the 'Change of Accounting Practice Regulations').

2.2 These Regulations make new provision to preserve the existing treatment in cases where a company holds 'permanent as equity' loans.

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

3.1 The Regulations will have effect for periods of account commencing on or after 1 October 2012, where there has been a change in accounting policy in relation to permanent as equity loans in those periods.

3.2 This commencement date has been selected to cover companies and periods for which accounts may not yet have been finalised. It is expected that very few, if any, companies will be affected by this use of an early commencement date.

3.3 The effect of the Regulations is to preserve the treatment that the affected companies would have received had they continued to apply the previous accounting treatment.

4. Legislative Context

4.1 The Regulations are made by the Treasury under powers conferred by section 465A of the Corporation Tax Act 2009.

4.2 Under Part 5 of the Corporation Tax Act 2009 a company is generally taxable on profits and losses from loan relationships based on the amounts recognised in determining the company's profit or loss for the period.

4.3 Section 328(1) of the Corporation Tax Act 2009 makes it clear that references to profits and losses from loan relationships includes exchange gains and losses. However, where exchange gains and losses are recognised in the Statement of Total Recognised Gains and Losses (STRGL) these are excluded from tax under section 328(3).

4.4 Where amounts are excluded under section 328(3) in respect of a loan asset, regulation 13 of the Exchange Gains and Losses (Bringing into Account Gains and Losses) Regulations 2002 will bring those amounts into account on disposal of the loan asset.

4.5 The Disregard Regulations provide detailed rules that were introduced in 2004 following the introduction of International Accounting Standards. They provide specific treatment to alter the amounts brought into account in respect of particular instruments.

5. Territorial Extent and Application

This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Financial Secretary to the Treasury has made the following statement regarding Human Rights:

In my view the provisions of the Changes of Accounting Standards (Loan Relationships and Derivative Contracts) Regulations 2014 are compatible with the Convention rights.

7. Policy background

- What is being done and why

7.1 At Budget 2013, the Government announced a consultation on a package of proposals to modernise the corporation tax rules governing the taxation of corporate debt and derivative contracts, with a view to legislating in Finance Bill 2014 and Finance Bill 2015. This work supports the Government's aim of promoting a tax system which is efficient, competitive, predictable, simple and fair.

7.2 Over the next few years UK companies are likely to see changes to the accounting standards used to prepare financial statements. In particular, for periods commencing 1 January 2015 many UK companies will be required to apply one of EU-Endorsed IFRS, FRS 101 or FRS 102.

7.3 One of the significant areas of change with the new accounting standards is the treatment of financial instruments, which will bring UK accounting standards much closer to International Accounting Standards.

7.4 As part of the consultation process for corporate debt and derivative contracts, HMRC have been seeking the views of external stakeholders as to the impact of these accountancy changes. Respondents generally saw that the current tax rules dealt satisfactorily with the accounting standards. HMRC are therefore not making substantial changes to the rules ahead of the accounting changes. However, following specific points raised by respondents, some limited changes are being made with a view to easing the transition to FRS 101 and FRS 102.

7.5 Permanent as equity loans are where a company formally lends money in a foreign currency to an overseas subsidiary but where there are no plans for it to be repaid. Under current UK GAAP, where Statement of Standard Accounting Practice 20 (SSAP 20) is applied, it was possible to treat such loans it in a similar way to equity. As a result, exchange movements would only have been brought into account on disposal of the debt. Under new accounting standards, many companies will be required to translate the foreign currency amount based on the prevailing rates at the end of each period, with the exchange movements being taxed or relieved in the period.

7.6 The Regulations will apply to where a loan was held at historic cost or translated at each period end with exchange gains and losses recognised in the STRGL. The effect of the Regulations is to preserve the existing treatment. As such, the company will be excluded from bringing a credit or debit into account on transition. In addition, the company will not bring into account exchange gains and losses on such instruments that are recognised to profit or loss. These amounts will instead be brought into account on the disposal of the loan asset.

7.7 Regulation 3 of the Change of Accounting Practice Regulations is amended to clarify that transitional amounts that are disregarded under the Disregard Regulations are not brought into account under the Change of Accounting Practice Regulations.

7.8 To discourage companies adopting the new accounting treatment early to circumvent the effect of the Regulations, the amendment will have effect for periods commencing on or after 1 October 2012. This is timed to cover companies and periods for which accounts may not yet have been finalised.

- Consolidation

7.9 The Government is continuing to consult on modernising the legislation governing the taxation of loan relationships and derivative contracts. Following the outcome of that consultation, consideration will be given to consolidating the principal Regulations.

8. Consultation outcome

This instrument was published for comment for 4 weeks through to 12 September 2014. Minor amendments have been made following representations received.

9. Guidance

HMRC guidance in the Corporate Finance Manual will be amended in due course.

10. Impact

10.1 This measure looks to ease the impact of accountancy changes that become mandatory for many companies from 1 January 2015. This measure only applies to entities within the scope of corporation tax and so it should have no impact on charities or voluntary bodies.

10.2 There is negligible impact on the public sector.

10.3 A Tax Information and Impact Note (TIIN) covering this instrument was published on 7 August 2014 alongside draft legislation and is available on the GOV.UK website at www.gov.uk/government/collections/tax-information-and-impact-notes-tiins. It remains an accurate summary of the impacts that apply to this instrument.

11. Regulating small business

The legislation applies to small business. However, the impact on small business is expected to be minimal given the accountancy changes principally affect medium and large companies with long term lending to overseas operations.

12. Monitoring & review

This policy will be monitored through information obtained through clearance applications and enquiries into self-assessments.

13. Contact

Richard Daniel at HMRC Tel: 03000 569 408 or email: richard.daniel@hmrc.gsi.gov.uk can answer any queries regarding the instrument.