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STATUTORY INSTRUMENTS

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**2005 No. 3440**

**CORPORATION TAX**

The Finance Act 2002, Schedule 26 (Parts  
2 and 9) (Amendment No. 3) Order 2005

<i>Made</i>	- - - -	<i>13th December 2005</i>
<i>Laid before the House of Commons</i>	- - - -	<i>14th December 2005</i>
<i>Coming into force</i>	- -	<i>31st December 2005</i>

The Treasury make the following Order in exercise of the powers conferred by paragraph 13 of Schedule 26 to the Finance Act 2002<sup>(1)</sup>:

**Citation, commencement and effect**

1. This Order may be cited as the Finance Act 2002, Schedule 26 (Parts 2 and 9) (Amendment No.3) Order 2005, shall come into force on 31st December 2005 and shall have effect in respect of accounting periods ending on or after that date.

2. Schedule 26 to the Finance Act 2002 (derivative contracts) is amended as follows.

**Amendment of Part 2 of Schedule 26**

3. Part 2 is amended as follows.

4. In paragraph 2(5) (derivative contracts and relevant contracts)<sup>(2)</sup> after “sub-paragraph (4)” insert “(an “embedded derivative contract”)”.

5.—(1) Amend paragraph 4 (contracts excluded by virtue of their underlying subject matter) <sup>(3)</sup> as follows.

(2) In sub-paragraph (2)(b)(i) for the words from “other than shares” onwards substitute insert “other than shares excluded by sub-paragraph (2ZA); or”.

(3) In sub-paragraph (2)(b)(ii) at the end add “other than a scheme to which paragraph 4 of Schedule 10 to the Finance Act 1996 applies”.

(4) After sub-paragraph (2) insert—

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(1) [2002 c. 23](#). Paragraph 13 has been amended by paragraphs 1 and 2 of Schedule 9 to the Finance Act [2004 \(c. 12\)](#).

(2) Sub-paragraph (5) was inserted by article 3 of S.I.[2004/2201](#).

(3) Sub-paragraphs (2), (2A) and (3B) were substituted for sub-paragraph (2) of paragraph 4 by article 4 of S.I. [2005/646](#). Sub-paragraph (2)(b) was amended by article 5 of S.I. [2005/2082](#).

“(2ZA) The shares excluded by this sub-paragraph are—

- (a) shares in relation to which section 91A or 91B of the Finance Act 1996(4) has effect;
- (b) shares in an open-ended investment company to which paragraph 4 of Schedule 10 to the Finance Act 1996(5) applies.”.

(5) In sub-paragraph (2B)(b)—

- (a) after “the contract and” insert “—(i)”; and
- (b) after “unit trust scheme,” insert—

“or

(ii) any share capital of the company,”.

(6) In sub-paragraph (2D)(a)(ii) after “an asset” insert “or liability”.

**6.—(1)** Amend paragraph 12 (definition of terms relating to derivative contracts) as follows.

(2) In sub-paragraph (1)(6)—

- (a) after paragraph (b) insert—

“(bza) a contract of long-term insurance (see sub-paragraph (16));”

- (b) in paragraph (cc)—

- (i) before “hedging” insert “a”; and
- (ii) after “an asset” insert “or a liability”; and

(3) In sub-paragraph (14)—

- (a) in the words before paragraph (a) after “an asset” insert “or a liability”;
- (b) in paragraph (b) after “asset”, in both places, insert “or liability”; and
- (c) after paragraph (b) add—

“For the purposes of this sub-paragraph the liabilities of a company include its own share capital.”.

(4) In sub-paragraph (16), for “has” substitute “and “contract of long-term insurance” have”.

### **Amendment of Part 9 of Schedule 26**

**7.** Part 9 (miscellaneous) is amended as follows.

**8.—(1)** Amend paragraph 45C (derivative contracts relating to land or certain tangible movable property) (7) as follows.

(2) For paragraph (1)(d) substitute—

“(d) sub-paragraph (1A) does not apply.”.

(3) After sub-paragraph (1) insert—

“(1A) This sub-paragraph applies if—

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(4) Sections 91A and 91B were inserted by paragraph 10 of Schedule 7 to the Finance (No. 2) Act 2005 (c. 22).

(5) 1996 c. 8. There are amendments to paragraph 4, but none is relevant for present purposes. Regulation 3 of S.I. 1997/1154 provides that the Tax Acts have effect in relation to open-ended investment companies as they have effect in relation to authorised unit trusts. References in those Acts to companies are (by virtue of that provision) to have effect in relation to open-ended investment companies as they have effect in relation to authorised unit trusts.

(6) Sub-paragraph (1) was substituted by article 13 of S.I. 2004/2201 and has been amended. The relevant amendments are those made by article 9 of S.I. 2005/646 and article 8 of S.I. 2005/2082/

(7) Paragraphs 45A to 45 I were inserted by article 15 of S.I. 2004/2201

- (a) paragraph 45F applies to the derivative contract, or would apply to it but for sub-paragraph (2)(f) of that paragraph, or
- (b) paragraph 45K applies to derivative contract, or would apply to it but for sub-paragraph (2)(e) of that paragraph.”.

**9.**—(1) Amend paragraph 45H (treatment of net gains and losses on terminal exercise of option) as follows.

(2) In sub-paragraph (1)(b), for “exercised to any extent” substitute “to any extent exercised or otherwise disposed of”.

(3) In sub-paragraph (2)(b) for paragraphs (i) and (ii) substitute—

“(i) as a result of the exercise of rights mentioned in sub-paragraph (1)(b); and

(ii) in circumstances where a disposal is deemed not to occur by virtue of section 127 of the Taxation of Chargeable Gains Act 1992(8).”.

**10.** In paragraph 45HA(4)(9) (treatment of credits and debits on terminal exercise of option) in the definitions of G and L for “paragraph 14(2)” substitute “paragraph 14(3)”.

**11.** In paragraph 45J(8) (issuers of securities with embedded derivatives)(10) in paragraph (a) of the definition of F, after “paid” insert “by the debtor”.

**12.**—(1) Amend paragraph 45L (derivative not embedded in a loan relationship)(11) as follows.

(2) In sub-paragraph (1)—

(a) for “Where” substitute “This paragraph applies where”;

(b) in paragraph (a) for “a relevant contract” substitute “an embedded derivative contract”; and

(c) omit the words following paragraph (c).

(3) For sub-paragraph (2) substitute—

“(1A) In this paragraph “the original contract” means the contract mentioned in paragraph 2(3) to which the company is party and as a result of which the company falls to be treated by virtue of paragraph 2(4) as a party to the derivative contract.

(1B) Where this paragraph applies—

(a) paragraph 14(2) and (3) (trading and non-trading credits and debits) do not apply in relation to the derivative contract, but

(b) sub-paragraph (1C) or (2) applies in relation to the original contract, according to whether or not that contract is a derivative contract.

(1C) If the original contract is a derivative contract, profits and losses are to be computed for the purposes of this Schedule as if that contract—

(a) were not one where the rights and liabilities are treated as divided as mentioned in paragraph 2(3), and

(b) were not one in relation to which a fair value basis of accounting is used.

(2) If the original contract is not a derivative contract, profits and losses are to be brought into account for the purposes of the Corporation Tax Acts in relation to that contract as if that contract—

(8) 1992 c. 12.

(9) Paragraph 45HA was inserted by article 17 of S.I. 2005/2082.

(10) Paragraph 45J was inserted by article 10 of S.I. 2004/3270 and relevantly amended by article 18(5)(b) of S.I. 2005/2082.

(11) Paragraph 45 L was inserted by article 10 of S.I. 2004/3270 and amended by article 21 of S.I. 2005/2082.

- (a) were not one where the rights and liabilities are treated as divided as mentioned in paragraph 2(3), and
- (b) were not one in relation to which a fair value basis of accounting is used.

This sub-paragraph has effect notwithstanding paragraph 1(2).”.

(4) At the end of sub-paragraph (2A)(12) add—

“unless—

- (a) the contract is a contract of long-term insurance, or
- (b) the underlying subject matter of the embedded derivative contract is, or includes, commodities.

Paragraph 45LA contains further provisions about elections under this sub-paragraph.”.

13. After paragraph 45L insert—

**“Elections under paragraph 45L(2A): further provisions**

**45LA.**—(1) In this paragraph “a disapplication election” means an election under paragraph 45L(2A).

(2) Where—

- (a) a company makes a disapplication election in relation to its contracts, and
- (b) another company, which is a member of the same group as the company making the election, is a party to a contract to which the election applies,

the other company shall be treated, in relation to that contract, as if it had also made a disapplication election.

(3) Where—

- (a) a company (“the electing company”) makes a disapplication election in relation to its contracts,
- (b) another company (“the transferee”) becomes party to a contract, to which paragraph 2(3) applies, in place of the electing company (whether before or after the disapplication election is made), and
- (c) the transferee is a member of the same group of companies as the electing company at the time of the transfer,

the transferee shall be treated, in relation to the contract referred to in paragraph (b), as if it had also made a disapplication election.

(4) Where—

- (a) a company (“A”) is treated under paragraph 2(4) as party to a relevant contract to which paragraph 45L(1) applies,
- (b) another company (“B”), becomes a party to that contract in place of A,
- (c) A and B are members of the same group of companies when B becomes a party to the contract, and
- (d) paragraph 45L(1) does not apply to B’s other relevant contracts by reason of a disapplication election (whenever made),

sub-paragraph (5) applies, unless A, subsequent to B’s becoming party to the contract, makes a disapplication election.

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(12) Sub-paragraph (2A) was inserted by article 21(4) of S.I. [2005/2082](#).

(5) Where this sub-paragraph applies B shall be treated, in relation to the contract referred to in sub-paragraph (4)(b), as if paragraph 45L(1) applied to it.

(6) In this paragraph references to companies being members of the same group of companies shall be construed in accordance with section 170 of the Taxation of Chargeable Gains Act 1992(13).”.

14. In paragraph 45M(1)(a) (treatment of host contract as a loan relationship)(14) for “relevant contract” substitute “embedded derivative contract”.

### **Consequential amendment**

15. In paragraph 54(1) (interpretation)(15) at the appropriate points in the alphabetical list insert the following definitions—

““embedded derivative contract” shall be construed in accordance with paragraph 2(5);”;

““open-ended investment company” has the meaning given by section 468A(2) of the Taxes Act 1988(16);”.

13th December 2005

*Joan Ryan*  
*Gillian Merron*  
Two of the Lords Commissioners of Her  
Majesty’s Treasury

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(13) 1992 c. 12.

(14) Paragraph 45M was inserted by article 18 of S.I. 2005/646 and amended by article 22 of S.I. 2005/2082.

(15) There are amendments to this paragraph, but none is relevant for present purposes.

(16) Section 468A was inserted by section 16 of the Finance (No. 2) Act 2005 (c. 22).

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## EXPLANATORY NOTE

*(This note is not part of the Order)*

This Order further amends Parts 2 and 9 of Schedule 26 to the Finance Act 2002, which deals with the taxation of derivative contracts.

Article 1 provides for the citation, commencement and effect of the Order.

Article 2 introduces the amendments to Schedule 26.

Article 3 introduces the amendments to Part 2.

Article 4 makes a drafting amendment to provide a definition of “embedded derivative contract”.

Article 5 amends paragraph 4 of Schedule 26 extending the scope of the concept of excluded types of property. Contracts whose subject matter consists wholly of one or more of the excluded types of property are not derivative contracts for the purposes of Schedule 26.

Article 6 makes amendments to paragraph 12 (which defines terms related to derivative contracts for the purposes of the Schedule), extending the concept of a hedging relationship to include a relationship between a relevant contract and a liability of the company (including its own share capital).

Article 7 introduces the amendments to Part 9.

Article 8 amends paragraph 45C (derivative contracts relating to land or certain tangible movable property) extending its application to derivatives which would fall within paragraph 45F but for sub-paragraph (2)(f) of that paragraph or within paragraph 45K but for sub-paragraph (2)(e) of that paragraph.

Article 9 extends the scope of paragraph 45H (treatment of net gains and losses on terminal exercise of an option) to cover cases where rights treated as comprised in the derivative are (to any extent) disposed of. It also clarifies the effect of the interaction between the paragraph and section 127 of the Taxation of Chargeable Gains Act 1992 (which deems a disposal not to occur on the restructuring of a company).

Article 10 corrects a cross-reference in paragraph 45HA.

Article 11 makes an amendment to the definition of F in paragraph 45J(8) to make it clear that references to amounts paid in fulfilment of the obligations under a debtor relationship are to amounts paid by the debtor.

Article 12 amends paragraph 45L. Paragraphs (2) and (3) of Article 12 make amendments clarifying the scope of paragraph 45L. Paragraph (4) amends sub-paragraph (2A) of paragraph 45L, preventing elections that the paragraph is not to apply in the case of contracts of long-term insurance or of an embedded derivative contract whose underlying subject-matter is commodities.

Article 13 inserts paragraph 45LA which contains further provisions about elections under paragraph 45L(2A).

Article 14 makes an amendment to paragraph 45M(1) consequential on the introduction of the concept of an “embedded derivative contract”.

Article 15 makes consequential amendments to the paragraph 54(1) which contains definitions applying for the purposes of the Schedule, inserting definitions of “embedded derivative contract” and “open-ended investment company”.

These Regulations do not impose new costs on business.

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