

2005 No. 646

INCOME TAX

**The Finance Act 2002, Schedule 26, Parts 2 and 9
(Amendment) Order 2005**

Made - - - - - 11 a.m. on 16th March 2005

Laid before House of Commons 16th March 2005

Coming into force - - - -at 3.00 p.m. on 16th March 2005

The Treasury, in exercise of the powers conferred upon them by paragraph 13 of Schedule 26 to the Finance Act 2002(a) make the following Order:

Citation, commencement and effect

1.—(1) This Order may be cited as the Finance Act 2002, Schedule 26, Parts 2 and 9 (Amendment) Order 2005 and shall come into force at 3.00 p.m. on 16th March 2005.

(2) This Order has effect in relation to periods of account beginning on or after 1st January 2005 and ending on or after 16th March 2005.

Amendment of Part 2 of Schedule 26 to the Finance Act 2002

2. Part 2 of Schedule 26 to the Finance Act 2002 is amended as follows.

3.—(1) Amend paragraph 3 as follows.

(2) In sub-paragraph (1)—

- (a) at the end of paragraph (a) add “or”;
- (b) omit paragraph (b);
- (c) in paragraph (c) omit “or (b)”.

(3) In sub-paragraph (5)—

- (a) in paragraph (a)—
 - (i) after “period” insert “beginning before 1st January 2005”;
 - (ii) omit “or”;
- (b) after paragraph (a) insert—
 - “(aa) in relation to any accounting period for which it is required or permitted to be used by the company, Financial Reporting Standard 25 issued in December 2004 by the Accounting Standards Board, or”;
- (c) in paragraph (b) for “13” substitute “25”.

4.—(1) Amend paragraph 4 as follows.

(2) Omit sub-paragraph (1A).

(a) 2002 c. 23, paragraph 13 is amended by paragraph 2 of Schedule 9 to the Finance Act 2004 (c. 12).

(3) For sub-paragraph (2) substitute—

- “(2) For the purposes of this paragraph the excluded types of property are—
- (a) in relation to an option or future, intangible fixed assets; and
 - (b) in relation to relevant contracts which satisfy the conditions specified in sub-paragraph (2A) or (2B)—
 - (i) shares in a company, or
 - (ii) rights of a unit holder under a unit trust scheme.

(2A) The conditions specified in this sub-paragraph are—

- (a) the relevant contract is entered into by a company carrying on life assurance business;
- (b) the relevant contract is an approved derivative for the purposes of Rule 4.3.5 of the Integrated Prudential Sourcebook; and
- (c) there is a hedging relationship between the relevant contract and shares or rights of a unit holder under a unit trust scheme held by the company as assets of its long-term insurance fund.

(2B) The conditions specified in this sub-paragraph are—

- (a) the relevant contract is entered into or acquired by a company otherwise than for the purposes of a trade carried on by it or the company is a mutual trading company, and
- (b) there is a hedging relationship between the contract and an asset of the company which consists of shares or rights of a unit holder under a unit trust scheme.”.

(4) Omit sub-paragraphs (3) and (5).

5. After paragraph 4 insert—

“Contracts which become derivative contracts: chargeable assets

4A.—(1) This paragraph applies to a company if the conditions in sub-paragraph (2) are satisfied in relation to a relevant contract.

(2) The conditions are—

- (a) the company is a party to the relevant contract both immediately before and at 3.00 p.m. on 16th March 2005;
- (b) the relevant contract—
 - (i) was not a derivative contract immediately before 3.00 p.m. on 16th March 2005, but
 - (ii) as from that time is a derivative contract; and
- (c) the relevant contract was, immediately before 3.00 p.m. on 16th March 2005, a chargeable asset.

(3) Where this paragraph applies, the company shall, when it ceases to be a party to the contract, bring into account, for the accounting period in which it ceased to be a party to the contract, the amount of any chargeable gain or allowable loss which would have been treated as accruing to the company on the assumption—

- (a) that it had made a disposal of the asset immediately before 3.00 p.m. on 16th March 2005, and
- (b) that the disposal had been for a consideration equal to the value (if any) given to the contract in the accounts of the company at the end of the company’s accounting period immediately before its first new period.

(4) For the purposes of this paragraph an asset is a chargeable asset if any gain accruing on the disposal of the asset by the company would be a chargeable gain for the purposes of the Taxation of Chargeable Gains Act 1992^(a) (and includes any obligations under futures contracts which, by virtue of section 143 of that Act^(b), are regarded as assets to the disposal of which that Act applies.”.

6. Omit paragraphs 5, 5A, 6, 7 and 8.

7.—(1) Amend paragraph 9 as follows.

(2) In sub-paragraph (2)(a)—

- (a) for “(c) to (e)” substitute “(a) or (b)”, and
- (b) omit the words in parenthesis.

(3) In sub-paragraph (4)(a) for “paragraphs (d) and (e)” substitute “paragraph (b)”.

8. Omit paragraph 10.

9.—(1) Amend paragraph 12 as follows.

(2) In sub-paragraph (1)—

(a) after paragraph (b) insert—

“(bb) designated (see sub-paragraph (13));”

(b) after paragraph (c) insert—

“(cc) hedging relationship between a relevant contract and an asset, in the case of any company (see sub-paragraph (14));”

(c) after paragraph (d) insert—

“(dd) Integrated Prudential Sourcebook (see sub-paragraph (15));

(de) long-term insurance fund (see sub-paragraph (16));”.

(3) At the end add—

“(13) “Designated” has the same meaning as for accounting purposes.

(14) A company has a hedging relationship between a relevant contract on the one hand (“the hedging instrument”) and an asset on the other (“the hedged item”) if and to the extent that—

- (a) the hedging instrument and the hedged item are designated by the company as a hedge; or
- (b) in any other case the hedging instrument is intended to act as a hedge of the exposure to changes in fair value of a hedged item which is a recognised asset or an identified portion of such an asset that is attributable to a particular risk and could affect profit or loss of the company.

(15) “Integrated Prudential Sourcebook” means the Integrated Prudential Sourcebook made by the Financial Services Authority under the Financial Services and Markets Act 2000^(c).

(16) “Long-term insurance fund” has the meaning given in section 431(2) of the Taxes Act 1988.”.

Amendment of Part 8 of Schedule 26 to the Finance Act 2002

10. Part 8 of Schedule 26 to the Finance Act 2002 is amended as follows.

11. Omit paragraph 42(4).

12. Omit paragraph 43.

(a) 1992 c. 12.

(b) Section 143 was amended by section 95 of, and Part V(9) of Schedule 26 to, the Finance Act 1994 (c. 9) and articles 61 and 64 of S.I. 2001/3629.

(c) 2000 c. 8.

Amendment of Part 9 of Schedule 26 to the Finance Act 2002

13. Part 9 of Schedule 26 to the Finance Act 2002 is amended as follows.

14.—(1) Amend paragraph 45(1)(a) as follows.

(2) In sub-paragraph (i) after “company” insert “or”.

(3) In sub-paragraph (ii) omit “or”.

(4) Omit sub-paragraph (iii).

15. Omit paragraph 45F(2)(b).

16. Omit paragraph 45J(2)(b).

17. Omit paragraph 45K(2)(b).

18. After paragraph 45L insert—

“Treatment of host contract as a loan relationship

45M.—(1) This paragraph applies where—

- (a) a company is treated under paragraph 2(4) as party to a derivative contract,
- (b) that contract is (within the meaning of paragraph 3(3)) treated for accounting purposes as a derivative financial instrument, and
- (c) the underlying subject matter of that contract consists, or is treated as consisting, wholly of—
 - (i) shares in a company, or
 - (ii) rights of a unit holder under a unit trust scheme.

(2) Where this paragraph applies—

- (a) the host contract shall be treated for the purposes of the Corporation Tax Acts as if it were a creditor relationship of the company which is a zero coupon bond, and
- (b) the derivative contract shall be treated as satisfying the conditions in paragraph 4(2A).

(3) For the purposes of this paragraph a “zero coupon bond” is a security—

- (a) whose issue price is less than the amount payable on redemption, and
- (b) which does not provide for any amount to be payable by way of interest.

(4) Paragraph 9 applies for the purpose of determining whether the underlying subject matter is to be treated as consisting wholly of property referred to in sub-paragraph (1)(c).”.

19. In paragraph 46(2)(a) for “(c) to (f)” substitute “(a) and (b)”.

20. Omit paragraph 48.

*Jim Murphy
Nick Ainger*

16th March 2005

Two of the Lords Commissioners of Her Majesty’s Treasury

EXPLANATORY NOTE

(This note is not part of the Order)

This Order amends Parts 2, 8 and 9 of Schedule 26 (derivative contracts) to the Finance Act 2002 (c. 23).

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

Article 2 introduces the amendments to Part 2 which are made by articles 3 to 9. The effect of these amendments is to restrict the cases of relevant contract whose underlying subject matter is of shares or rights of a unit holder under a unit trust scheme which are prevented from being derivative contracts. A transitional provision is introduced in relation to contracts which become derivative contracts in consequence of this Order.

Article 10 introduces the amendments made to Part 8 which are consequential amendments made by articles 11 and 12.

Article 13 introduces the amendments to Part 9 which are made by articles 14 to 20. These make consequential amendments and insert a new provision to clarify the tax treatment in relation to host contracts and embedded derivatives where the underlying subject matter is of shares or rights of a unit holder under a unit trust scheme.

This Order does impose new costs on business and is expected to have significant Exchequer impact by closing avoidance schemes that would otherwise have cost substantial amounts in terms of tax yield and by protecting revenues in the future.

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£3.00

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under the authority and superintendence of Carol Tullo, Controller of
Her Majesty's Stationery Office and Queen's Printer of Acts of Parliament.
E0564 4/2005 150564 19585

ISBN 0-11-072595-6



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