EXPLANATORY MEMORANDUM TO

THE LOAN RELATIONSHIPS AND DERIVATIVE CONTRACTS (DISREGARD AND BRINGING INTO ACCOUNT OF PROFITS AND LOSSES) (AMENDMENT) REGULATIONS 2006

2006 No. 936

1. This explanatory memorandum has been prepared by Her Majesty's Commissioners of 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. Description

2.1 Regulation 5 of the Loan Relationships and Derivative Contracts (Disregard and Bringing Into Account of Profits and Losses) Regulations 2006 (SI 2006/843) was intended to prevent a loss arising on a derivative contract which is a synthetic hedge of currency risk (for example an option over US Treasury Bonds could give the same outcome as an option over US dollars), where there is also a "pure" currency contract (one whose only underlying subject matter is currency) hedging the same risk. Since the rules for "pure" currency contracts" differ from those for "synthetic" contracts, the differences can be exploited to give an asymmetry – flat when rates go one way, a loss when they go the other.

2.2 That regulation is capable of being construed so as to disallow a loss on any synthetic contract whether or not there is also a pure contract hedging the same risk and whose treatment permits the asymmetry. These regulations make it clear what are the precise circumstances in which the loss on the synthetic contract is disallowed.

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

3.1 The Regulations come into force less than 21 days after the date on which they were made. The Department regrets that compliance with the 21-day rule is not possible in this case. These Regulations amend SI 2006/843 which forms part of a significant anti-avoidance package announced by the Chancellor of the Exchequer on Budget Day, 22nd March 2005. Unless the Regulations come into force as soon as possible, there is a risk that companies recognising exchange losses on synthetic contracts in the next few weeks will fall foul of regulation 5 of SI 2006/843 in a way that was not intended.

3.2 Authority for the retrospective effect of these Regulations is conferred by paragraph 54(2A) of Schedule 26 to the Finance Act 2002.

4. Legislative Background

4.1 The power to make the regulations is in 17C(1)(a) of Schedule 26 to the Finance Act 2002. This provision allows certain profits and losses from derivative contracts to be left out of account, to be brought into account in a different way or to be brought into account at a later date.

5. Extent

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

7.1 Exchange gains and losses on debts and derivative contracts are generally brought into account as they are recognised in accounts drawn up using UK Generally Accepted Accounting Practice (GAAP) or International Accounting Standards (IAS).

7.2 Where derivative contracts are hedging the currency risk in assets such as shares in subsidiaries, the exchange gains and losses on the contracts are not generally brought into account (which matches the position that no corresponding exchange losses and gains on the shares are brought into account at all). This treatment is intended to be symmetrical, but schemes have been devised to give groups a one-way bet – by using a derivative contract whose subject matter is such that any exchange gain or loss will be disregarded together with another contract whose underlying subject matter is not currency but is of a nature that it gives rise to the same gains or losses as would arise were it to be a pure currency contract. The two contracts will give opposite treatment so that if exchange movements go one way, one will give gain and the other a loss, and vice versa.

8. Impact

8.1 A Regulatory Impact Assessment has not been prepared for this instrument as it has no impact on business, charities or voluntary bodies.

8.2 The impact on the public sector is nil

9. Contact

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