EXPLANATORY MEMORANDUM TO

THE LOAN RELATIONSHIPS AND DERIVATIVE CONTRACTS (CHANGE OF ACCOUNTING PRACTICE) (AMENDMENT) REGULATIONS 2014

2014 No. 3187

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.

2. Purpose of the instrument

2.1 These Regulations amend the Loan Relationships and Derivative Contracts (Change of Accounting Practice) Regulations 2004 (S.I. 2004 / 3271: 'the COAP Regulations') the purpose of which is to provide specific tax treatment for loan relationships and derivative contracts on a change of accounting policy.

2.2 These Regulations amend certain technical provisions in the COAP Regulations to ease the impact of accountancy changes that become mandatory for many companies from 1 January 2015. In particular, they make new provision to preserve the existing treatment in cases where distressed debt is modified as part of a corporate rescue.

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

None.

4. Legislative Context

4.1 The Regulations are made by the Treasury under powers conferred by section 319 of the Corporation Tax Act 2009 in relation to loan relationships, and section 598 of that Act in relation to derivative contracts.

4.2 The COAP 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 a change of accounting policy. In particular, they can provide for certain amounts to be spread over ten years and for other specified amounts not to be brought into account at all.

5. Territorial Extent and Application

This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

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

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 on or after 1 January 2015 many UK companies will be required to apply one of EU-Endorsed International Financial Reporting Standards (IFRS), Financial Reporting Standard 101 (FRS 101) or Financial Reporting Standard 102 (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 with the accounting standards satisfactory. HMRC are not therefore 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 Under the current UK GAAP where FRS 26 is not applied, it is possible for companies to modify the terms of their debt without this having an immediate effect on its accounts. In particular, the conditions of a distressed loan may be relaxed, including the extension of the term, to avoid a default. Under the new accounting standards, it may be necessary in such cases for the company to recognise a large profit in its accounts where there is a substantial modification to the terms of the debt.

7.6 In the technical note published on 8 April 2014, HMRC indicated that one of the main priorities of its work as part of the wider review of the taxation of corporate debt will be to introduce a corporate rescue exemption to facilitate restructuring of distressed debt. It is envisaged that this will be introduced in Finance Bill 2015 and will cover this type of 'amend and extend' restructuring going forwards.

7.7 There is, however, a transitional issue where a debt has previously been modified and the company subsequently adopts the new accounting treatment. In such cases it may be required to bring the profit into account for tax on transition. The effect of the amendment is to preserve the existing treatment in cases of severe financial distress such that no taxable profit arises on transition, with a corresponding restriction on corresponding losses going forwards.

7.8 The statutory references to primary legislation in the COAP Regulations will also be updated.

7.9 This measure will have effect for periods of account commencing on or after 1 January 2015.

- Consolidation

7.10 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 COAP Regulations.

8. Consultation outcome

This instrument was published for comment for 4 weeks through to 12 September 2014. The wording of what constitutes financial distress has been amended. The relief will be available where there is a material risk that, within 12 months, the company will be unable to settle its debts. This aligns the treatment with the wording proposed for inclusion in Finance Bill 2015, and follows detailed discussions with stakeholders as part of one of the working groups.

9. Guidance

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

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 affects medium and large companies.

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.