EXPLANATORY MEMORANDUM TO

THE DISREGARD AND BRINGING INTO ACCOUNT OF PROFIT AND LOSSES ON DERIVATIVE CONTRACTS HEDGING ACQUISITIONS AND DISPOSALS OF SHARES REGULATIONS 2022

2022 No. 239

1. Introduction

1.1 This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs (HMRC) on behalf of Her Majesty's Treasury and is laid before House of Commons by Command of Her Majesty.

2. Purpose of the instrument

2.1 This instrument brings certain derivative contracts entered into on or after 1 April 2022 within the scope of the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004 (SI 2004/3256) (the "Disregard Regulations"). The derivative contracts in point are entered into to hedge foreign currency risk in relation to an anticipated future acquisition or disposal of a substantial shareholding.

2.2 This instrument also amends the Exchange Gains and Losses (Bringing into Account Gains or Losses) Regulations 2002 (SI 2002/1970) (the "EGLBAGL Regulations"), so that, where appropriate, disregarded amounts are brought back into account for Corporation Tax on disposal of the shareholding in the same manner as a gain or loss on disposal of that shareholding.

2.3 The effect of these changes is to align the tax treatment of a gain or loss on the derivative contract with that of the shares.

3. Matters of special interest to Parliament

Matters of special interest to the Select Committee on Statutory Instruments

3.1 None.

4. Extent and Territorial Application

4.1 The territorial extent of this instrument is the United Kingdom.

4.2 The territorial application of this instrument is the United Kingdom.

5. European Convention on Human Rights

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

6. Legislative Context

6.1 The instrument is made by the Treasury in exercise of the powers conferred by sections 598 and 606 of the Corporation Tax Act 2009 (CTA 2009) to extend the cases in which the Disregard Regulations and EGLBAGL Regulations may apply to derivative contracts used to hedge foreign exchange risk arising in connection with acquisitions and disposals of shareholdings.

6.2 These statutory powers are found within Part 7 of the CTA 2009, which contains the rules on the taxation of derivative contracts.

6.3 The Disregard Regulations provide detailed rules to disregard for tax certain amounts that would otherwise be brought into account in respect of derivative contracts or loan relationships.

6.4 The EGLBAGL Regulations make provision to bring into account for tax certain amounts previously disregarded under the Disregard Regulations, primary legislation or earlier secondary legislation. The manner in which amounts are brought into account may be changed, so as to align better with the tax treatment of the hedged item. In particular, where the trigger for the application of the EGLBAGL Regulations is the sale of shares, the regulations adjust the amount that is brought into account in computing the chargeable gain or allowable loss on the disposal. Where the substantial shareholdings exemption in Schedule 7AC to the Taxation of Chargeable Gains Act 1992 or the qualifying asset holding company rules in Paragraph 14, Schedule 2 to the Finance Act 2022 are in point, the effect is that no amount is brought into account by the EGLBAGL Regulations.

7. Policy background

What is being done and why?

7.1 During the second stage of the consultation on the tax treatment of asset holding companies, respondents observed that current tax rules can lead to a mismatch in tax treatment when derivative contracts are entered into to hedge currency risks on acquisitions and disposals of shares. Under current rules, profits and losses on such derivative contracts are taken into account as taxable or deducible income items over the lifetime of the contract. This gives rise to a temporary or permanent tax mismatch, as the offsetting loss or gain on the shares (the hedged item) will not be taxed or relieved before the shares are disposed of, if at all. Companies take out these derivative contracts as hedging instruments to remove volatility in their results arising from fluctuations in foreign exchange rates. The current tax rules mean that these hedges are not fully effective in removing such volatility, because the companies' tax liabilities are still exposed to exchange rate fluctuations. This is a source of uncertainty for businesses.

7.2 As part of the work on asset holding companies, the government announced that it was examining the possibility of legislating to ensure that the treatment of gains and losses on the hedging instrument are aligned with the treatment of the shares (the hedged item). The government has continued to take account of stakeholders' views on this matter. This instrument introduces rules which have that effect.

7.3 The new rules will apply to all companies, not just asset holding companies. They will take a profit or loss on the hedging instruments out of the scope of Corporation Tax and create a fair and internationally competitive hedging regime for foreign exchange risks on share transactions. Amounts will only be brought back into charge, if at all, in the event of a disposal of the shareholding in question and then in manner that matches the taxation of the disposal. If there is no tax on the disposal, because of the application of the substantial shareholding exemption or the asset holding company rules, no amount will be brought into account for tax. Also, where the instrument hedges a relevant dividend in relation to a disposal of shares or the entering into of a

loan to fund an acquisition of shares, no amount will be subsequently brought into account for tax.

Explanations

What did any law do before the changes to be made by this instrument?

7.4 Current rules allow companies to disregard profits and losses on derivative contracts used to hedge foreign currency risks on existing share holdings. But they do not specifically cover similar profits and losses arising from derivative contracts that hedge foreign exchange risks on a forecast transaction or firm commitment relating to an anticipated future acquisition or disposal of shares. In the case of disposals of shareholdings, the current rules may afford some assistance, but complicated arrangements may be needed and the extent to which the existing regulations can be applied may be limited.

Why is it being changed?

7.5 It is desirable for companies and the Exchequer to reduce tax volatility by ensuring that the tax treatment of derivative contracts used to hedge foreign exchange risk on acquisition and disposal of shareholdings is consistent with the treatment of gains and losses on the shareholding in question. This will create a fairer and more competitive hedging regime, which will also support the new asset holding company regime.

What will it now do?

7.6 The new rules will apply to certain hedging instruments entered into on or after 1 April 2022 which hedge the foreign currency risk on a forecast transaction or firm commitment relating to an anticipated future acquisition or disposal of shares. The profits and losses arising from such derivatives will be disregarded throughout the lifetime of the hedging instrument while there is a relevant hedging relationship. Amounts may be disregarded where amounts arising from such derivatives are initially recognised in cash flow hedge reserve and are subsequently recycled to the income statement or to the carrying value of an asset, where there is a relevant hedging relationship during the life of the hedging instrument. For deal-contingent forwards and options, the entire profit and loss on the derivative, including any fees or premiums, will be disregarded.

7.7 The new rules ensure that, from 1 April 2022, derivative contracts used to hedge foreign exchange risks on a forecast transaction or firm commitment relating to an anticipated future acquisition or disposal of shares are covered and override existing regulations to the extent that both might otherwise be applicable. The existing regulations will continue to apply unchanged as regards hedging of foreign exchange risks arising from other underlying assets, such as existing holdings of shares, where the new rules are not in point.

7.8 The new rules only apply where the anticipated acquisition or disposal is of a substantial shareholding, as defined in paragraph 8 of Schedule 7AC to the Taxation of Chargeable Gains Act 1992 or is a holding of qualifying shares where the company is a qualifying asset holding company under Schedule 2 to the Finance Act 2022.

7.9 The hedging of the foreign currency risk may be between (i) the currency of the future acquisition cost, disposal proceeds, share subscription or the entering into a creditor loan relationship and (ii) either the company's relevant currency (its functional

currency or an elected designated currency) or the currency in which the expected debt or equity financing for the anticipated share transaction is denominated.

7.10 For acquisitions, the economic risk the derivative contract is hedging can include the subscription of shares or the entering into a creditor loan relationship (as defined in section 302(5) CTA 2009) for the purposes of financing, directly or indirectly, an anticipated acquisition of shares. There can be a series of share subscriptions or debt issues, and a combination of debt and equity. The EGLBAGL Regulations only bring previously disregarded amounts back into account to the extent they relate to a share subscription by the company with the hedging relationship; any amounts relating to a creditor relationship are permanently disregarded.

7.11 If a hedging instrument is entered into to hedge the foreign currency risk on a future share transaction, but the anticipated share transaction does not complete, then amounts would still be disregarded. In cases where the instrument was hedging a share disposal, the amounts disregarded would be brought back into account on any future disposal of the shares, assuming the chargeable gain is not exempt.

7.12 The company may enter into a derivative contract with a connected company to hedge the economic risk. For the new rules to apply, this derivative contract must be on equivalent terms to a corresponding third-party contract.

7.13 In circumstances where amounts may be paid to a company prior to the disposal of the shares through a pre-sale dividend, the anticipated disposal proceeds that could be hedged and covered by this regulation will include the pre-sale dividend. However, the dividend must either be exempt from Corporation Tax under Part 9A of the CTA 2009 or only taxable as a result of an election under section 931R of that Act. Amounts which relate to the hedging of a relevant dividend will not be brought into account under the EGLBAGL Regulations, except in cases where the dividend is reflected in the chargeable gains calculation under the value shifting or depreciatory transaction rules.

7.14 The disregarded amounts will be brought into account on disposal of the substantial shareholding or the subscription of shares where regulation 5ZA(2)(a)(iii) of the Disregard Regulations applied. However, it is expected that in many cases, the substantial shareholdings exemption or the asset holding company rules will apply to the chargeable gain or allowable loss on disposal, in which case adjustments that arise under the EGLBAGL Regulations also fall outside the scope of tax.

7.15 Whether there is a relevant hedging relationship will depend on a question of fact as to whether the company has the necessary hedging intention. This will be for the company to demonstrate, for example through contemporaneous documentary evidence.

8. European Union Withdrawal and Future Relationship

8.1 This instrument does not relate to withdrawal from the European Union.

9. Consolidation

9.1 This instrument amends existing regulations. There are no plans to consolidate this instrument.

10. Consultation outcome

10.1 Draft regulations were published for comment on 16 December 2021 seeking comments until 24 January 2022. Changes were made to this instrument to incorporate the comments received. In particular, changes were made to the way the rules operate where a company enters a hedging instrument in respect of an anticipated transaction being made by another company, to ensure that the rules can operate effectively in practice.

11. Guidance

11.1 HMRC plans to amend guidance at CFM60000 in the Corporate Finance Manual by 1 April 2022.

12. Impact

12.1 The impact on business, charities or voluntary bodies is expected to be positive as the instrument removes undesirable tax volatility identified during the recent consultation on the tax treatment of asset holding companies. The measure is not expected to have a significant impact on administrative burdens or business costs.

12.2 There is no, or no significant, impact on the public sector.

12.3 A Tax Information Impact Note covering this instrument will be published on the website at https://www.gov.uk/government/collections/tax-information-and-impact-notes-tiins.

13. Regulating small business

13.1 The legislation is not expected to apply to activities that are undertaken by small business.

14. Monitoring & review

14.1 The approach to monitoring of this legislation is through information contained in tax returns and communications with affected stakeholders.

14.2 In accordance with section 28(3)(a) of the Small Business, Enterprise and Employment Act 2015, this instrument does not include a statutory review clause because it is made in relation to the imposition of a tax, duty, levy or other charge.

15. Contact

15.1 Chris Waite at HMRC Telephone: 03000 525413 or email: financialproductsbai@hmrc.gov.uk can be contacted with any queries regarding the instrument.

15.2 Richard Thomas, Deputy Director for Financial Products and Services at HMRC can confirm that this Explanatory Memorandum meets the required standard.

15.3 The Rt Hon Lucy Frazer QC MP, Financial Secretary to the Treasury, can confirm that this Explanatory Memorandum meets the required standard.