

CHAPTER 11

DERIVATIVE CONTRACTS

11.1 Introduction

Derivative Contracts are defined as:

- options;
- futures;
- contracts for differences (CFDs).

A contract for differences is a contract the purpose or pretended purpose of which is to **make a profit from fluctuations** in:

[CTA 2009, s.582\(1\)](#)

- (i) the **value or price of the property** described in the contract;
- (ii) **an index or other factor designated in the contract.**

The legislation in CTA 2009 is full of definitions and sub definitions. In this chapter we are going to outline the main definitions and exclusions, the accounting treatment and then look at each type of contract in more detail, followed by a look at the anti-avoidance rules.

11.2 Definition of Derivatives

[CTA 2009, s.576](#)

A contract will only be a derivative contract if it is a relevant contract.

Contracts will only be treated as relevant contracts if:

- (i) they are treated as financial derivatives in the accounts under the relevant accounting standard;
- (ii) they are a commodity contract, a contract where the underlying subject matter is land, tangible moveable property (other than commodities which are tangible assets) or a CFD relating to intangible fixed assets, weather conditions or creditworthiness.

Derivative contracts include futures, options, forward contracts, interest rate and currency swaps, interest rate caps, collars and floors, forward interest agreements, commitments to purchase shares or bonds and letters of credit.

[CTA 2009, s.581](#)

[CTA 2009, s.582](#)

IAS 39 defines a derivative as a financial instrument or other contract with the following three characteristics:

- Its value changes in response to a change in a specified interest rate, FI price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided that (in the case of a non financial variable) that variable is not specific to a party to the contract;
- It requires no initial investment or an initial net investment that is smaller than would be required for other types of contract that would be expected to have a similar response to changes in market factors; and
- It is settled at a future date.

11.3 The exclusions

Contracts where the underlying contract subject matter consists wholly or partly of the following, will not be treated as derivatives for tax:

[CTA 2009, s.589](#)

- a) Certain shares;
- b) unit trust holdings;
- c) intangible fixed assets.

Underlying subject matter is defined as follows:

- (1) For an option - the property that would be delivered if the option was exercised. Where that property is a derivative contract it is the underlying subject matter of that contract;
- (2) For a future - the property that would fall to be delivered if the future were to run to delivery at the date and price agreed at the outset. Where the property is a derivative contract, it is then the underlying subject matter of that contract;
- (3) For a CFD - the value or price of the property described in the contract, or where an index or factor is designated in the contract, the matter by which the index or factor is calculated.

[CTA 2009, s.583](#)

11.4 Taxation of Derivatives

All profits and losses on derivative contracts are taxed or relieved as income. They will be part of trade profits where they relate to contracts entered into for the purposes of the trade and as non trading profit (LR) otherwise.

[CTA 2009, s.573](#)

[CTA 2009, s.574](#)

The credits and debits to be brought into account will be:

[CTA 2009,
s.595\(3\)](#)

- (a) **all profits and losses** of the company which arise to the company from its derivative contracts or related transactions; and
- (b) **all charges and expenses** incurred by the company under or for the purpose of its derivative transactions.

Related transactions are the acquisition and disposal of derivative contracts, including aborted acquisitions, where the expense or charge would have qualified had the contract been entered into.

[CTA 2009,
s.596\(1\)](#)

Profits and losses also include exchange differences unless those exchange differences fall within the matching provisions.

[CTA 2009, s.606](#)

The amounts to be brought in are those recognised in determining the profit or loss in accordance with GAAP. This is subject to the requirement that the debits and credits must fairly represent the profits and losses made.

[CTA 2009,
s.592\(3\)&\(7\)](#)

Where a contract is treated as a derivative as a result of its classification in the accounts according to section 600 then fair value accounting is to be used.

[CTA 2009,
s.600](#)

Where GAAP is not used in drawing up the accounts, the rules will be applied as if it were so applied.

[CTA 2009,
s.599\(1\),\(2\)&\(3\)](#)

The definition of "recognised" in determining the profit and loss is expanded to include an income statement, the statement of recognised gains and losses (SRGL) - a statement of changes in equity and any other similar statement such as a revenue account. Prior year adjustments will be brought in but not correction of fundamental errors.

[CTA 2009,
s.597\(1\)](#)

The Treasury can make regulations to disregard amounts that have been recognised and to deal with the tax treatment of such amounts.

[CTA 2009,
s.604](#)

Amounts taken to fixed assets or share premium account can be brought in provided they have not been recognised in calculating the profit or loss.

All derivatives except those which are used as effective hedging instruments are classified by IAS 39 as held for trading, this means they are accounted for at fair value through the profit and loss account.

Derivatives are recognised on the balance sheet under IAS 39. As they are accounted for using fair value the original recognition will normally be nil.

The move from UK GAAP to IAS will have a large impact on many companies, as they will move from accruals accounting to fair value accounting for derivative contracts.

[SI 2004/3256](#)

We saw in the Loan Relationships chapter in the Corporation Tax Manual that the Loan Relationships and Derivative Contracts (change of accounting practice) regulations 2004 defer the recognition of the transitional adjustments until accounting periods beginning on or after 1 January 2006.

The deferral does not apply to derivative contracts already covered by the disregard regulations and certain hybrid contracts.

The Loan Relationships and Derivative Contract (Disregard and Bringing into Account) Regulations 2004 allow certain exchange gains and losses from derivative contracts to be disregarded where the contract is matched with shares, ships or aircraft. The regulations also allow certain fair value profits and losses to be disregarded. It is possible for a company to elect out of these disregard regulations. (See below.)

11.5 Options

Options are the **right to buy or sell financial instruments**. Note there is **no obligation on the holder to buy or sell**. A premium is normally charged for this right and is paid when the option is bought. An **option to buy** a financial instrument is called a **call option**. The **right to sell** is called a **put option**.

If the company decides to go ahead and exercise the option, then it may for example in the case of a currency contract give rise to a FOREX gain or loss on the contract, which will fall within the derivative contract rules described above.

Note that an option includes a warrant. A warrant is an instrument which entitles the holder to subscribe for shares in a company or an asset representing a loan relationship of a company. It is immaterial whether the shares or assets to which the warrant relates exist or are identifiable.

[CTA 2009, s.710](#)

Options do not include any contracts that can be settled in cash. However a contract that provides for the future delivery of foreign currency is an option, as the property to be delivered is the foreign currency.

[CTA 2009, s.580\(2\)&\(3\)](#)

[CTA 2009, s.581\(3\)&\(4\)](#)

Let's consider an option for foreign currency:

Illustration 1

A company with a September year end enters into an option on 1 July 2009 to sell £600,000 for U.Sch 1,400,000 on 30 June 2010. It cost £4,500 to take out the option. The option is worth £8,000 on 30 September 2009.

Looking at the option on an accruals basis - IAS 39/FRS 26 not adopted:

30 September 2009:
Fees £4,500 x 3/12 £1,125

30 September 2010:
Fees £4,500 x 9/12 £3,375

The company will decide whether to exercise the option - assume the exchange rate is U.Sch 3:

Value per contract	£600,000
Value on rate at date of exercise U. Sch 1,400,000/3	£466,667

The company will not exercise the option as it can buy the currency for a lower rate in the market.

If the option is accounted for using fair value accounting the result would be:

30 September 2009:	£
Fees	(4,500)
Increase in value of the contract	<u>8,000</u>
Total gain	<u>£3,500</u>

N.B. The fair value of a derivative when it is first entered into is always NIL.

30 September 2010:	
Fall in value = loss	(8,000)

The overall position is £4,500 loss using either accruals or fair value. The difference is when the loss is recognised in the accounts and thus for tax as we follow the accounting treatment.

Example 1

On 1 October 2009 a company with a 31 March year end pays £6,500 for an option to enter a currency contract on 30 September 2010. The option is the right to sell R\$700,000 for £450,000. The value of the option at 31 March 2009 was £14,000. The exchange rate on 30 September 2010 was R\$2.

You are required to show the amounts that will be recognised using:

- a) **amortised cost;**
- b) **fair value.**

State whether the company will exercise the option and show any FOREX gain.

11.6 Futures

A futures contract is an alternative to an option as a way of hedging risk. The main difference is that under a future there is an immediate **commitment to buy or sell a stated quantity of the underlying product at an agreed price on an agreed date**. Thus they are riskier than options and no premium is payable on entering into a future.

Futures include forward contracts, for example to buy or sell foreign currency, and swap agreements. Swap agreements are a very similar to forwards - the main difference is that the parties pay each other interest on the sums.

The terms of the instrument will determine whether it is a future or a swap.

Commonly a company will enter a currency contract when it knows it is going to be paid in a foreign currency at some point in the future or if it has an obligation to make a payment in a foreign currency at a future date.

Illustration 2

A UK resident company has sold some goods to a company in Italy. It is agreed that the Italian company will pay €300,000 in three month's time. The UK company may enter a currency contract agreeing to pay over €300,000 for an agreed amount of sterling, say £190,000. Once entered into, the contract is binding and the UK company must deliver the €300,000. By entering the contract the company has achieved certainty over the amount of sterling it will receive for the Euros.

The above illustration was in fact a simple forward contract. These are normally entered into with banks. However some forward contracts can be traded.

The tax treatment of a forward contract will depend on how it is accounted for. For accounting periods beginning on or after 1 January 2005 forward contracts will be accounted for using fair value accounting unless the company is not applying IAS 39/FRS 26. If the contract is translated in the accounts using accruals and the **spot rate method**, then the contract will only give rise to exchange gains and losses and an **implied forward difference**. The implied forward difference is calculated as:

	£
Value of contract at spot rate at start of contract	X
Value of contract at implied future rate at start of the contract	<u>(X)</u>
Implied premium or discount	<u>X</u>

A forward premium is a **financial cost** of the contract which will be spread over the life of the contract on an accruals basis. A forward discount is taxable over the life of the contract.

Note forward premiums and discounts are not recognised where fair value accounting is used.

Under fair value accounting the contract will be initially recognised at nil value. Subsequent measurement will be at fair value which can be affected by:

- price changes in the underlying forward rate;
- the interest rate;
- the time to expiration of the contract;
- the amount of foreign currency specified in the contract.

Changes in fair value will be recognised in the profit and loss account unless the contract is used for hedging purposes.

Currency swaps are similar to forward contracts, however the main difference is that **periodic payments** and receipts are required under the contract. These periodic amounts are normally based on the London Inter-Bank Official Rate (**LIBOR**). A currency swap includes more elements in the contract than a forward contract.

11.7 Contracts for differences

[CTA 2009, s.582](#)

Contracts for differences are most commonly seen in the interest rate market. Where companies are concerned about future interest rates they enter agreements based on target rates of interest, then settle the contracts by paying the difference between the target level and the actual level in the future.

Illustration 3

Migcal Ltd agrees a target rate of interest of 4.5% six months ahead on a notional principal of £1,500,000. If in six months time the interest rate is 4.5% then nothing has to be paid under the contract. If rates are 4% then Migcal Ltd will pay the bank $0.5\% \times £1,500,000$ (however, it will have lower borrowing costs elsewhere). If rates are 5% the bank will pay Migcal Ltd $0.5\% \times £1,500,000$ which will help offset the increased borrowing cost that Migcal Ltd will have.

The advantage here is that there is less credit risk as the company and bank are neither borrowing nor lending £1,500,000. The only accounting required is for the difference from the target or agreed rate of 4.5%

The difference may be accounted for using accruals or fair value depending on whether IAS39/FRS26 has been adapted. In any case the tax treatment will follow the accounting treatment.

Where fair value accounting is used the contract will be revalued at replacement cost. These revaluations will be posted to the profit and loss account.

An outline of the definition of a contract for differences is given in the introduction to this chapter. In addition index or factor can be determined by reference to any matter and for those purposes a numerical value may be attributed to any variation in matter.

[CTA 2009, s.582\(2\)](#)

[CTA 2009, s.649\(2\)](#)

Contracts for differences do not include futures, options, a contract of insurance, a capital redemption policy, a contract of indemnity, a guarantee, a warranty or a loan relationship.

11.8 Property Derivatives

[CTA2009, s.640](#)

[CTA2009, s.641](#)

Where a company is a party to a contract for differences, at least one or more of the indices designated in the contract is an index of changes in the value of land (wherever situated) and the underlying subject matter of the contract also includes interest rates, any credits and debits arising in respect of movements in the index of changes in the value of land are treated as giving rise to chargeable gains or allowable losses for the purposes of corporation tax on chargeable gains. Such credits or debits are determined by applying the relevant percentage change for the accounting period.

Any other payments that are due under the terms of the contract continue to be dealt with under the normal provisions of the derivative contracts legislation.

Such treatment does not apply where:

- (a) the company is a party to the contract at any time during an accounting period for the purposes of a trade carried on by it; this exclusion does not apply where the company is a party to the contract for the purposes of life assurance business or if it is carrying on a mutual trade; or
- (b) the company is an authorised unit trust, investment trust, open-ended investment company or a venture capital trust.

Illustration 4

In year ended 31 March 2011 Kelvan Ltd, a property company, enters into a contract for differences based on a reference portfolio of commercial property. The contract has a maturity of two years and a strike of 8%. The portfolio is professionally valued at the start and end of the contract. Its initial value is £12 million.

The company accounts for the contract at fair value, and in the year ended 31 March 2010 its accounts show an increase of £250,000 in the fair value of the contract.

The non-trading credit of £250,000 is - under section 641 - brought into account as a chargeable gain for year ended 31 March 2011.

Where a net allowable loss arises in an accounting period on contracts which fall to be treated as giving rise to chargeable gains a company may elect within two years of the end of that accounting period to carry the loss back for relief against net chargeable gains arising on such derivative contracts in the preceding 24 months on a later period first basis.

When a company elects to carry back a net loss, the net chargeable gains against which the carried back loss may be relieved have first to be reduced by other allowable losses available to the company in such periods, to the extent that such other allowable losses remain unrelieved after taking account of other chargeable gains arising to the company in the relevant accounting period(s).

As losses arising on contracts which give rise to chargeable gains are treated as allowable losses, a company may relieve such losses against chargeable gains arising on any assets, whether in the current accounting period or any future accounting period (to the extent that a loss remains unrelieved).

11.9 Interaction with loan relationship rules

[CTA 2009, s.700](#)

The rules provide that the loan relationship rules will take priority over the derivative contract rules. There will be an overlap between the two sets of rules where contracts are expected to go to delivery and thus give rise to a money debt. Once there is a loan relationship the loan relationship rules take priority.

11.10 Anti-avoidance

The new legislation includes anti avoidance provisions similar to those for loan relationships. If a derivative contract is entered into for a disallowable purpose, then no deduction will be allowed for debits.

Derivatives are subject to transfer pricing rules.

Provisions apply to transfers of derivatives within a capital gains group. These will be treated as tax neutral, using the same principles as are used for the transfer of loan relationships.

Where a company emigrates on or after 17 March 2004 a PE ceases to hold rights within a derivative contract they will be treated as having sold and reacquired the derivative at fair value.

[CTA 2009, s.609](#)

There are provisions to allow relief for bad debt on similar lines to those for loan relationships. However, in the case of derivatives, there are no restrictions in relation to connected parties. For accounting periods beginning on or after 1 January 2005 the rules relating to bad debts will deal with releases only.

As with loan relationships the FA2005 has introduced anti avoidance rules for transactions entered into on or after 14 December 2004 which seek to gain a tax advantage by bringing to an end a derivative contract.

Anti avoidance rules exist to prevent companies from transferring value by allowing an option to a connected company to expire. In such cases a credit representing the value transfer will be brought in. This rule applies to past exercises from 6 April 2007.

[CTA 2009, s.695](#)

11.11 Hedge Accounting

Hedging is a way of reducing risk such as foreign currency risk, interest rate risk and equity price risk. For example, a company which has sold goods to a company in Italy for €300,000 may borrow the same sum to reduce the risk arising as a result of a fall in the pound against the euro. Interest rate swaps, futures or forward contracts are examples of hedging instruments.

Hedge accounting allows a company to depart from the normal rule of recognising all gains and losses in the profit and loss account. Under IAS 39 there are two types of hedge, a fair value hedge, which hedges against changes in fair value or a cash flow hedge.

Fair value hedges are taken to the profit and loss account. To the extent it is effective, cash flow hedges can be taken to equity. Most fair value hedges can be designated as cash flow hedges as they contain a vulnerability to cash flow changes.

To qualify for hedge accounting IAS 39 requires the hedge to be highly effective; the range permitted is 80 - 125%. In addition the hedge must be formally designated.

Answer 1

a) Amortised cost

31 March 2010:
Fees $6,500 \times 6/12$ 3,250

31 March 2011:
Fees $6,500 \times 6/12$ 3,250

The company will exercise the option as

	£
Value per contract	450,000
Value at date of exercise $700,000/2$	<u>(350,000)</u>
Gain	<u>£100,000</u>

b) Fair value

31 March 2010:
Fees (6,500)
Increase in value 14,000
Gain £7,500

31 March 2011:
Fall in value so loss £(14,000)

Again, the company will exercise the option making a FOREX gain of £100,000