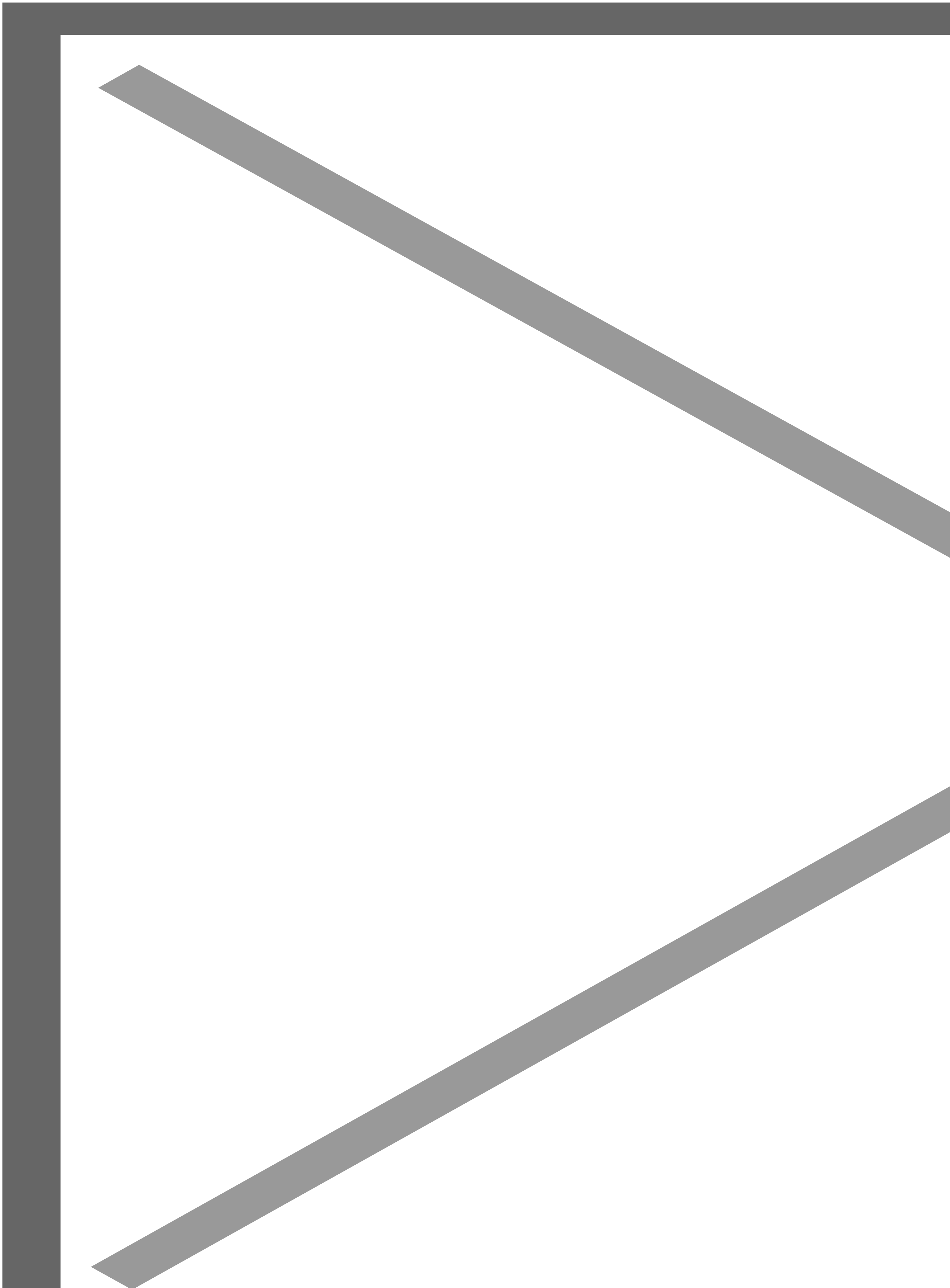
To elect or not?

Large Corporate OMB



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John Lindsay explains why companies that have not previously accounted for their derivatives on a fair value basis should be thinking about making an election for disregard regulations 7–9 to apply

Key Points

What is the issue?

A company that starts to account for derivatives on a fair value basis for accounting periods beginning on or after 1 January 2015 and uses them for hedging will need to make an election if it wishes to continue to recognise profits or losses on the derivatives for tax purposes on an accruals basis

What does it mean to me?

Advisers will need to discuss with their clients whether they wish to elect for regulations 7, 8 and/or 9 of the Disregard Regulations to apply

What can I take away?

There is a deadline for making the election. For most companies this is 12 months after the end of the first accounting period for which they begin to account for derivative contracts to which any of regulations 7, 8 and/or 9 would apply using a fair value basis of accounting. Where, however, a company is subject to the Senior Accounting Officer reporting regime the deadline is the later of 6 months after the start of the company's first accounting period for which it begins to account for derivative contracts to which any of these regulations would apply using a fair value basis accounting, or six months after the date that the company first becomes a party to a derivative contract to which any of these regulations would apply

Many companies have recently moved, or are about to move, from preparing their accounts in accordance with UK GAAP (excluding FRS 26) ('Old UK GAAP') to preparing their accounts in accordance with IFRS, FRS 101 (IFRS with reduced disclosure) or FRS 102. Equally a small company that currently prepares its accounts in accordance with the FRSSE will be required to prepare its accounts in accordance with FRS 102 for accounting periods beginning on or after 1 January 2016, unless it is a micro-entity that is permitted to apply FRS 105.

Where such companies use derivatives, such as interest rate swaps, currency swaps, or forward purchases of foreign currency, as hedges they will need to consider how to ensure that profits and losses on such hedges continue to be recognised for tax purposes on the same basis as losses or profits on the item that is being hedged.

Under Old UK GAAP, where a derivative contract was used as a hedge, typically, profits and losses on the derivative were recognised in the relevant company's accounts on an accruals basis and on the same basis as losses or profits on the item that was being hedged. Since a company's tax treatment usually follows its accounting treatment, generally there was no mismatch between the recognition of profits or losses on the derivative and the item being hedged. Where a company prepares its accounts in accordance with IFRS, FRS 101 or FRS 102 the 'default' treatment is that profits or losses on derivative contracts will have to be accounted for on a fair value basis. This can lead to accounting and tax mismatches if the item that is being hedged is accounted for on an amortised cost basis.

There are two ways in which a company can avoid such mismatches for corporation tax purposes. First, it can designate the derivatives that it uses for hedging purposes as hedges for accounting purposes. As the starting point for computing a company's profits for the derivative contracts legislation is amounts recognised in profit or loss (for accounting periods beginning on or after 1 January 2016) or amounts recognised in profit or loss or reserves (for earlier accounting periods), hedge accounting may reduce or eliminate fair value volatility for both accounting and tax purposes. The accounting conditions that have to be satisfied depend on the relevant accounting standard that a company adopts. Even if a company designates all of its derivatives that it uses for hedging purposes as hedges in its accounts, however, this will only achieve symmetry to the extent that each hedge is fully effective. If there is hedge ineffectiveness this could still result in some fair value profits or losses arising on a hedge in a company's accounts that are not offset by equal and opposite movements on the hedged item.

A second approach operates for corporation tax purposes only, although it may be combined with the use of hedge accounting, should a company wish. This would be for a company to elect for regulations 7, 8 and/or 9 of the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004 (SI 2004/3256) ('Disregard Regulations') to apply – all references relate to SI 2004/3256 unless otherwise stated. These regulations were introduced to permit companies that account for derivatives on a fair value basis to continue to recognise profits and losses on an accruals basis for tax purposes. For accounting periods beginning before 1 January 2015 these regulations applied automatically unless a company elected to disapply them. Where a company begins to account for derivative contracts to which regulations 7, 8 and/or 9 would apply on a fair value basis for an accounting period beginning on or after 1 January 2015 it has to make an election in order for these regulations to apply.

The deadline for making an election depends on whether a company is subject to the senior accounting officer reporting regime that is contained in FA 2009 Schedule 46. If it is, the deadline for making the election is six months after the start of the company's first accounting period for which it begins to account for derivatives to which any of regulations 7, 8 or 9 would apply using a fair value basis or, if later, six months after the date that it first becomes a party to a derivative contract to which any of these regulations would apply (reg 6A(2)(a), (3)(a), (b), (5)). Such companies, for the most part, have been contacted by HMRC to remind them of the deadline for making this election.

In other cases the deadline for making an election is 12 months after the end a company's first accounting period for which it begins to account for derivatives to which any of regulations 7, 8 or 9 would apply using a fair value basis of accounting (reg 6A(2)(a), 3(c), (5)). This is where problems might arise in practice because smaller companies may be unaware of the need to make an election. Indeed, tax advisers to such companies may be unaware that a company has entered into derivative contracts if, for example, historically any profits or losses arising on an interest rate swap have been included as part of interest expense in its accounts. Advisers may need to question their clients carefully to establish whether a company has entered into any derivative contracts.

If a company does not make an election then, generally, subject to certain exceptions considered below, the profits and losses arising on its derivative contracts will be recognised for tax purposes on the basis on which they are recognised in its accounts. It is possible for a company to make an election at a later date but this election cannot take effect until two years after the end of its first accounting period for which it begins to account for derivatives to which regulations 7, 8 or 9 would apply on a fair value basis. Further, it only has effect for contracts entered into on or after the date that the election takes effect (reg 6A(2)(b), (5)).

It is possible for an election to be revoked with effect for derivative contracts entered into on or after the date specified in the notice of revocation, which must be later than the date that the notice of revocation is given. Unless an election is revoked before it takes effect it cannot be revoked earlier than two years after the end of the company’s first accounting period for which it began to account for derivatives to which regulations 7, 8 or 9 would apply using a fair value basis of accounting (reg 6A(4(b)).

Where a company had already begun to account for its derivative contracts to which regulations 7, 8 and/or 9 would apply using a fair value basis of accounting before the start of its first accounting period beginning on or after 1 January 2015 the treatment that applied in earlier periods continues to apply. That is if it had not elected to disapply regulations 7 and 8 and/or 9 it is automatically deemed to have elected for the relevant regulation(s) to apply for accounting periods beginning on or after 1 January 2015. Equally, if it had elected to disapply regulations 7 and 8 and/or 9, it is not deemed to have elected for the relevant regulation(s) to apply for accounting periods beginning on or after 1 January 2015 (SI 2014/3188, reg 9). Such companies can elect for a different treatment for accounting periods beginning on or after 1 January 2015 but only for derivative contracts to which they become a party on or after the date specified in the election, which must be later than the date that it is made (reg 6A(2)(b)).

What treatment applies if a company makes an election?

Where a company elects for regulation 7 and/or 8 to apply to its currency and/or commodity and debt contracts that it uses to hedge forecast transactions or firm commitments any profits or losses arising on such contracts, as recognised in its accounts in accordance with generally accepted accounting practice, will normally be disregarded in determining its profits or losses for tax purposes. Instead profits and losses arising on such contracts will generally be brought into account for tax purposes when the company ceases to be a party to the derivative contract or, if earlier, when the hedged item begins to affect profit or loss. Regulations 7 and 8 do not apply to a particular contract where profits or losses arising on the hedged item are brought into account for tax purposes on a fair value basis (regs 7(1)(a)(ii), 8(1)(a)(ii)). This is because in such cases the fair value profits and losses arising on the contract should be offset by fair value losses or profits arising on the hedged item.

Regulation 9 applies to an interest-rate contract that is used to hedge an asset or liability, receipt or expense, unless profits or losses arising on the hedged item are recognised for tax purposes on a fair value basis. Where regulation 9 applies, profits and losses arising on an interest rate contract are recognised for tax purposes on an ‘appropriate accruals basis’ (reg 9(1), (2)). This is intended to encapsulate the accounting treatment that applied for UK GAAP purposes for accounting periods beginning before 1 January 2015 where a company did not adopt FRS 26. For example, where a company borrowed on floating-rate terms but wanted fixed rate funding and entered into a fixed: floating interest rate swap, the profits and losses arising on the interest rate swap would be recognised on an accruals basis for tax purposes. The effect was that the company’s cost of borrowing became the fixed rate that it was paying under the terms of the fixed leg of the interest rate swap.

What happens if a company does not elect for regulations 7, 8 and/or 9 to apply?

Where a company does not elect for regulations 7, 8 and/or 9 of the Disregard Regulations to apply then generally any profit or loss arising on derivative contracts to which these regulations would apply will be recognised for tax purposes on a fair value basis. There are a number of exceptions to this rule.

First, if the relevant contract is accounted for as a cash flow hedge in the company’s accounts, any profits or losses arising on the derivative contract that are taken to other comprehensive income (cash flow hedge reserve) will be disregarded. Instead they will be brought into account for tax purposes when they are recycled from other comprehensive income to profit or loss, or are taken to the carrying value of an asset or liability, the profits or losses on which are not recognised for tax purposes on the basis on which they are recognised in accordance with generally accepted accounting practice (eg where the profits and losses are included as part of a fixed capital asset) (reg 9A, and for accounting periods beginning on or after 1 January 2016, CTA 2009 ss 597(1A), 604).

Second, where the derivative contract is designated as a fair value hedge and profits or losses arising on the hedged item are not recognised on a fair value basis for tax purposes.

Third, where the hedged item is a loan relationship in relation to which the company uses fair value accounting where profits and losses on the loan relationship are not recognised on a fair value basis for tax purposes.

Finally, where the contract forms part of an arrangement the main purpose, or one of the main purposes, of which is to obtain a tax advantage (as defined for the purposes of CTA 2010 s 1139) in relation to the contract that would not arise if regulation 7, 8 or 9 applied) (reg 6).

Should a company elect for regulations 7, 8 or 9 to apply?

Ultimately, whether or not a company should make an election is something that will have to be considered on a case by case basis. In general, unless a company is intending to designate derivative contracts to which these regulations would apply as cash flow or fair value hedges in its accounts and unless there will be little hedge ineffectiveness, it should give serious consideration to making an election for the relevant regulation(s) to apply. If it does not elect and it does not adopt hedge accounting in its accounts, in most cases it will be required to include fair value profits and losses arising on its derivative contracts as part of its derivative contract profits. Whilst, superficially, it might seem attractive for a company's tax treatment to track its accounting treatment, where a contract is 'in the money' (ie has increased in value) this could result in the company being liable to tax on fair value profits which it has yet to realise and could give rise to cash flow difficulties. It could also become an absolute tax cost if there are insufficient profits to absorb any losses arising on the contract in future periods.

Table – What do regulations 7,8 and 9 cover?

Regulation 7 covers contracts (currency contracts) for the forward purchase and sale of a currency other than the company's functional currency, which are used to hedge a forecast transaction or firm commitment. (The definition of a currency contract does not cover a cross-currency swap that includes interest-based periodic payments. These contracts are dealt with in regulation 9.) Regulation 7 applies the accounting definition of a forecast transaction and a firm commitment but there is no requirement that the contract is designated as a hedge in a company's accounts or that the contract is an effective hedge.

A forecast transaction is defined for accounting purposes as an uncommitted but anticipated future transaction. A firm commitment is defined as a binding agreement for the exchange of a specified quantity of resources at a specified price on a specified future date or dates. An example of a case in which regulation 7 could apply would be where a company that has a sterling functional currency enters into dollar currency contracts to fix in sterling terms anticipated future sales proceeds in US dollars.

Regulation 8 covers commodity and debt contracts that are used to hedge forecast transactions and firm commitments. The same definitions apply as discussed above in the case of regulation 7.

Regulation 9 covers interest rate contracts. The definition of an interest-rate contract goes wider than what would generally be considered to be interest rate contracts, such as interest rate swaps, and encompasses any contract the underlying subject matter of which includes interest rates and in the case of a swap also an index determined by reference to income or retail prices (reg 9(4)).