HMRC - CFM95650 - x-Interest: Relevant Derivative Contract Amounts

TIOPA10/S384 and TIOPA10/S387

In calculating the tax-interest amount, debits and credits from certain derivative contracts are included because such contracts often play an important role in how a company is financed.

The legislation makes separate provision for debits (s384) and credits (s387) arising from derivative contracts but these are similar in nature. They broadly define a relevant derivative contract debit or credit as any amount that would be brought into account under the derivative contract provisions, whether by CTA09/PT3 or CTA09/PT5. This is subject, however, to further rules which look at the underlying subject matter of the derivative and exclude certain other amounts.

Underlying subject matter

Only derivatives with specified underlying subject matters give rise to relevant debits and credits. This ensures the rules target financing expenses as intended. The underlying subject matters which will be included are:

Interest rates

Any index determined by reference to income or retail prices

Currency

Corporate debt

Subordinate or small value underlying subject matters

A derivative with any other subject matter will still be a relevant derivative contract provided that subject matter is either subordinate in relation to any of the above or of small value in comparison with the value of the underlying subject matter as a whole. This is determined at the point at which the company either enters into or acquires the contract.

Example

A Ltd holds a £200m share portfolio which it shows in its accounts at fair value. It decides to hedge against any changes in the fair value of its investment by entering into a total return swap with a bank.

Under the terms of the swap, A Ltd will pay to the bank the ‘total return’ on the shares, essentially any dividends received as well as any capital growth on the shares. The bank will pay to A Ltd an amount equal to any decrease in the share’s value and payments of interest at a floating rate (say LIBOR plus 1%) based on a £200m nominal value.

All amounts in respect of the swap should be excluded from the tax-interest amount because one of the key legs of the contract is related to the value of the shares which is not one of the underlying subject matters listed above.

{#}Exchange gains or losses

A derivative contract debit or credit will be excluded if it is in respect of an exchange gain or loss.

Impairment losses and reversals

Debits will also be excluded if they arise from an impairment loss, and symmetry is ensured by also excluding credits which arise from the reversal of a previous impairment.

Hedging a risk in a course of a trade

The rules also give consideration as to the context of why the company is party to the derivative contract. This is necessary because some derivatives entered into are entirely unrelated to the financing of the company and are taken out in the normal course of trade.

Amounts arising from a derivative will therefore be excluded where it is both:

Hedges a risk arising in the ordinary course of a trade (other than a risk arising in a financial trade)

Was entered into for reasons wholly unrelated to the capital structure of the worldwide group.

The term capital structure is taken to include both loans and share investments. This provision looks at the overall group position and the exclusion could therefore apply to a derivative entered into by one group company to hedge the position of another.

Example

A company intends to purchase stock from an American company in six months’ time with payment due in US Dollars on delivery. To mitigate its exchange rate exposure, the company enters into a currency forward contract whereby it agrees to purchase a certain amount of US Dollars in six months for a fixed Sterling price.

The derivative is hedging a risk which arises in the ordinary course of trade and is entirely unrelated to the capital structure of the worldwide group. Debits from the forward will therefore be excluded from the tax-interest amount.

Example

A company borrows £1bn to fund an investment in a US subsidiary which is worth $2bn (exchange rate of £1:$2). To hedge the currency risk, the company enters into a currency forward to sell $2bn for £1bn in one years’ time.

The derivative here is part of the capital structure of the company and, as such, relevant debits and credits arising from the forward will be included in the tax-interest amount.

Risks arising in the ordinary course of a financial trade

Special provision is made for derivatives which hedge a financial trade. Where this is the case, any relevant debit or credit arising from the derivative will not be excluded where the risk relates to an amount which is included in the tax-interest amount. This means the treatment of the hedged item for tax-interest purposes should align with the treatment of the hedging instrument.

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