

**EXPLANATORY NOTE**

**CLAUSE 80 AND SCHEDULE 4: ACCOUNTING PRACTICE  
AND RELATED MATTERS**

**SUMMARY**

1. Part 1 of Schedule 4 makes a number of changes to existing legislation to reflect the “impairment loss” terminology used by International Accounting Standards to describe debts that are unlikely to be paid. The Schedule also amends the application of the connected party rules for impairment losses where loans are waived or released. Part 2 of the Schedule makes a number of amendments to the Tax Acts as a result of the ability of Great Britain and Northern Ireland companies to use International Accounting Standards (“IAS”) in preparing their individual accounts.

**DETAILS OF THE CLAUSE**

2. Subsection (1) gives effect to Schedule 4, and subsection (2) explains that the Schedule is divided into two parts: Part 1 about bad debts and impairment, and Part 2 about other accounting-related matters.
3. Subsection (3) explains that the amendments in Part 1 to legislation that applies both to income tax (“IT”) and corporation tax (“CT”) have effect only for CT purposes
4. Subsection (4) gives the start date for the provisions as periods of account beginning on or after 1 January 2005, unless the Schedule provides for a different start date (see paragraphs 35, 43, 64 and 99 below)

## **DETAILS OF THE SCHEDULE**

### **Introduction: Part 1 – Bad debts and related matters**

5. Many of the changes are to the rules for relief for impairment losses in a range of situations not covered by the loan relationships, derivative contracts and intangible fixed assets rules on impairment losses. These situations include impairment losses on trade debts, debts that may be settled in kind rather than money and debts that go bad after a trade has ceased. The rules that restrict relief for provisions against and losses on disposal of sovereign debt are also repealed, with transitional provisions, by this Schedule.
6. Part 1 of the Schedule also amends a number of references to relief for bad debts in connection with finance leases and intangibles to include relief for impairment losses. Finally, Part 1 of the Schedule introduces a general definition of ‘statutory insolvency arrangement’ to replace the several references to and definitions of bankruptcy, insolvency and voluntary arrangements in different places in the Taxes Acts.
7. Paragraph 1 repeals subsections (1)(j) and (2) of section 74 ICTA 1988. These set out the existing rules for relief for all bad and doubtful debts and debts released as part of insolvency proceedings for income tax purposes, and for trade debts for corporation tax purposes. The repeal has effect, as a result of clause 80(3), for CT purposes. For IT purposes, section 74(1)(j) and 74(2) is replaced by section 35 Income Tax (Trading and Other Income) Act 2005 (“ITTOIA”) with effect for the year 2005/06.
8. Paragraph 2 introduces a new section 88D ICTA 1988 that sets out rules for relief for impairment losses that arise on certain types of debt. The rules mirror the effects of the rules formerly in section 74(1)(j) ICTA, but using the IAS terminology of ‘impairment losses’ in place of references to bad and doubtful debts. The debts to which this new section applies are set out in new section 88D(1) and are debts not already covered by loan relationships, derivative contracts and intangibles legislation. Note that as a result of paragraph 9 of the Schedule, debts which are money debts will come within section 100 Finance Act (“FA”) 1996 for the purposes of relief for impairment.
9. The operative rule, new section 88D(2) echoing section 74(1)(j), is that in working out the profits of a company’s trade, no deduction

is allowed for debts owed to the company other than for impairment losses and releases as part of insolvency proceedings.

10. New section 88D(3) makes it clear that this rule applies to debts that are settled other than in money, and section 88D(4) imports the extended definition of trade, which includes vocation, office or employment, from section 6(4) ICTA.
11. Paragraph 3 amends section 89 ICTA, which deals with debts that become irrecoverable after a company's trade has ceased. Section 89 allows, as a deduction, any amount that becomes irrecoverable after the trade ceased.
12. Paragraph 3(2) deals with amendments to section 89 ICTA before ITTOIA comes into force. This will apply for corporation tax purposes only to accounting periods beginning on or after 1 January 2005 and ending before 6 April 2005.
13. Sub-paragraph 3(2)(a) renumbers the existing section 89 ICTA as new subsection (1) and sub-paragraph 3(2)(b) replaces the reference in those words to deduction for bad debts that arose before the trade ceased with 'relevant deduction'. Sub-paragraph 3(2)(c) adds a new section 89(3) which defines 'relevant deduction' for the purposes of section 89 as a tax deduction for impairment loss or release of liability.
14. Sub-paragraph 3(2)(c) also adds a new section 89(2). This makes it explicit that debts settled other than in money are included in the types of debt to which section 89 applies.
15. Paragraph 3(3) deals with amendments to section 89 ICTA as it will be amended once ITTOIA comes into force. Sub-paragraph 3(3)(a) replaces the reference to 'deduction allowed' with 'relevant deduction in respect of them' and sub-paragraph 3(3)(b) adds two new subsections that do the same as the two new subsections added to the pre-ITTOIA version of section 89.
16. Paragraph 4 amends section 94 ICTA. This section charges to tax the release of any amount of debt for which a deduction has previously been allowed, other than when the release is part of insolvency etc proceedings. Sub-paragraph 4(2) replaces the reference to 'relevant arrangement or compromise' with 'statutory insolvency arrangement' and sub-paragraph 4(3) removes the definition of 'relevant arrangement etc' that applied for the purposes of section 94. A new definition of 'statutory insolvency

arrangement' is inserted into section 834 ICTA by paragraph 8 of this Schedule.

17. Paragraph 5 amends section 103 ICTA. This section deals with the tax treatment of amounts received after a trade has discontinued where the 'earnings' basis was used to compute the profits. The amendments relate to the parts of the section that covers release of debts that take place after discontinuance.
18. Paragraph 5(2) replaces the reference in section 103(4) to 'relevant arrangement or compromise' with 'statutory insolvency arrangement' and paragraph 5(3) removes the definition in section 103(4A) of 'relevant arrangement etc' that applied for the purposes of section 103(4).
19. Section 103(5) ICTA excludes from charge as a post-cessation receipt amounts received for debts written off before cessation. Paragraph 5(4) amends section 103(5) as it had effect before ITTOIA. It updates the reference to deductions for bad debts etc to reflect IAS impairment loss terminology. Paragraph 5(5) makes similar changes to section 103(5), as amended by ITTOIA.
20. Paragraph 6 amends section 109A ICTA. This section allows for relief for certain types of trade expenditure incurred after a trade has ceased. This relief is extended to certain releases of trade debts. The amendments relate to the parts of section 109A that extend relief to releases that happen after cessation as part of an insolvency etc arrangement.
21. Paragraph 6(2) replaces the reference in section 109A(4) to 'relevant arrangement etc.' with 'statutory insolvency arrangement'. This takes its meaning from the new definition introduced at paragraph 8 of this Schedule.
22. Paragraph 6(3) adds a new section 109A(4B), which explicitly includes for the purposes of section 109A(4A) debts that are settled other than in cash.
23. Paragraph 7 amends section 799 ICTA, which sets out rules for computing the amount of foreign tax underlying dividends that is available for relief against UK tax. One element of this measure is the distributable profits of the foreign company paying the dividend. Section 799(6)(b) prohibits the deduction of certain provisions in working that out. Paragraph 7 adds impairment losses to the provisions that cannot be deducted.

24. Paragraph 8 introduces a new definition of ‘statutory insolvency arrangement’ for the purposes of corporation tax, included in section 834(1) ICTA. The definition covers
- a voluntary arrangement under Insolvency Acts,
  - similar voluntary arrangements in Scottish and Northern Irish law,
  - a compromise or arrangement under the Companies Act 1985 and the Northern Ireland Companies Order 1986; and
  - similar arrangements under the laws of other countries.

This new term and its definition are introduced in a number of places by this Schedule.

25. Paragraph 9(1) introduces the paragraph as amending section 100 FA 1996, which makes provision for interest and exchange gains and losses on debts that do not arise from the lending of money. Paragraph 9(2) simplifies the heading to reflect just the type of debt affected, dropping any reference to the nature of the amounts involved.
26. The categories of money debt covered by the section are set out in section 100(1) FA 1996. Paragraph 9(3) adds a new category, money debts that have given rise to an impairment loss or a credit when an impairment loss has been reversed. The types of money debt to which the sub-paragraph applies are limited to trading receipts and receipts of a property business, i.e. those types of debts for which relief was previously allowed by virtue of the non-application of section 74(1)(j) ICTA.
27. Section 100(2)(a) and (b) FA 1996 set out a rule to bring interest and exchange gains and losses arising from the debts defined in section 100(1) within the loan relationships rules in Chapter 2 Part 4 FA 1996. Paragraph 9(4) replaces subsections (2)(a) and (b) with a similar rule that brings in impairment losses and reversals of impairment losses as well as interest and exchange gains and losses on those debts into that Chapter. Note that paragraph 11(4) Schedule 13 amends the new subsections (2)(a) and (b).
28. Paragraph 9(5) gives priority, in a new section 100(14), to the derivative contracts (Schedule 26 FA 2002) or intangibles rules

(Schedule 29 FA 2002) for any money debt which may also fall within the section 100(1) FA 1996 definition.

29. Paragraph 10 inserts a new paragraph 4A into Schedule 9. This operates to bring into account on a debtor company a deemed release of debt in two circumstances. The first – new paragraph 4A(1) - is where a company connected with the debtor acquires debt from a third party creditor and the amount payable on the debt (i.e. the original amount due less any amount that has been released by the unconnected creditor) exceeds the price paid for the debt by the new connected creditor (new paragraph 4A(2)(d)). This is the circumstance in which, before the changes made by Schedule 10 FA 2004, the new creditor company must write up the debt to its face value, generally over the remaining term of the debt. The repeal by FA 2004 of section 85(3)(c) removed this requirement. In this case there is a deemed release.
30. New paragraph 4A(3) provides an exception for this case. It is the scenario currently set out in paragraph 6B(6) Schedule 9, namely that:
  - the new creditor company acquired the impaired debt in an arm's length transaction;
  - for the accounting period in which it acquired the debt, there was no connection between it and the person from whom it acquired the debt; and
  - there was no connection between it and the debtor company at any time in the period which begins 4 years before the date on which the company acquired the debt and ends twelve months before that date.
31. New paragraph 4A(4) gives the second circumstance. It is where the creditor starts off being unconnected with the debtor but becomes connected at some point and the amount payable on the debt (i.e. the original amount due less any amount that has been released by creditor before connection) exceeds the carrying value of the debt at the point of connection (new paragraph 4A(4) second sentence).
32. Where the paragraph applies, then in the first case, new paragraph 4A(5) and (6) provide that an amount equal to the difference between face value and the amount paid for the debt is treated as released and hence a taxable credit for the debtor. In the second

case, new paragraph 4A(5) and (7) provides that the amount taxed on the debtor is the difference between the face value and the carrying value of the debt in the creditors accounts at the point when it becomes connected.

33. The rationale for imposing a charge where a connected company acquires impaired debt is that, without such a charge, the debtor company is effectively released from ever paying the face value of the debt but avoids paying tax on the profit thus made (because of the rule in paragraph 5(5) Schedule 9 that a release of connected party debt is not taxable), even though the arm's length original creditor will have recognised a doubtful debt or an impairment loss. Thus the normal symmetry between the treatment of both unconnected creditors and debtors and connected creditors and debtors is broken.
34. Taxing the debtor will often mean that the charge is mitigated by losses that the debtor has – since the reason that the debt is impaired will often be because the debtor has made losses to such an extent that it is unable to pay its debts as they fall due.
35. Paragraph 10(2).provides that this rule applies where the acquisition, or the becoming connected, happens on or after 16 March 2005.
36. Paragraph 11 amends paragraph 5 Schedule 9 FA 1996. This sets out rules for taxing the borrower when a debt is released. Paragraph 11(2) amends the heading to show more clearly what the paragraph does.
37. Paragraph 11(4) replaces the reference in paragraph 5(4) Schedule 9 to “relevant arrangements etc.” with the term ‘statutory insolvency arrangement’. This takes its meaning from the general definition introduced by paragraph 8 of this Schedule.
38. Paragraph 11(5) amends paragraph 5(5) – no taxation on debtor of releases of connected party debt– by qualifying it in the case where the new paragraph 4A rule applies (see paragraph 29 onwards).
39. Paragraph 11(6) inserts a fifth exception to the charge on releases, by adding a new paragraph 5(8) – where there is a debt/equity swap. There may be circumstances where the new paragraph 14A Schedule 9 FA 1996 (see paragraph 71) would charge a release of debt in a debt/equity swap, and this paragraph overrides that paragraph were it to apply. Paragraph 11(3) accordingly amends

paragraph 5(3) by changing “four” to “five” to reflect the new condition.

40. Paragraph 12 inserts a new paragraph 5ZA into Schedule 9 FA 1996. This extends the rules that apply to restrict relief for impairment losses in paragraph 5A and in paragraphs 6, 6A and 6C of paragraph 5 Schedule 9 to include releases of liability. This change blocks a number of avoidance schemes notified to the Inland Revenue under Part 7 FA 2004 before they can purport to have effect.
41. Paragraph 13 amends paragraph 6 Schedule 9 FA 1996, which restricts relief for impairment losses where the parties to the loan relationship are connected. Paragraph 13(2) and (3) amends the wording of paragraph 6(2) Schedule 9 to reflect the changes to the paragraphs and sub-paragraphs made by Part 1 Schedule 10 FA 2004 to which the operative rule is subject.
42. Where a debt is released and the parties to the debt were connected, paragraph 6(6) and (7) Schedule 9 FA 1996 prevent the lender from getting any bad debt relief or impairment loss previously denied because of the connection. This restriction was being side-stepped by lenders disposing of only a part of the debt. Paragraph 13(4) replaces sub-paragraphs (6) and (7) with similar provisions that extends the restriction to cover all related transactions including part as well as full disposals. This change also blocks a number of avoidance schemes notified to the Inland Revenue under Part 7 FA 2004.
43. Paragraph 13(5) sets a commencement date for the changes made by paragraph 11. The extended rule applies to disposals that takes place on or after 2 December 2004 (the day the measure was announced).
44. Paragraph 14 provides for the repeal of paragraph 6B Schedule 9 which has become redundant. Paragraph 15 similarly repeals paragraph 6C(2).
45. Paragraph 16 inserts a new paragraph 6D into Schedule 9 FA 1996. New paragraph 6D(1) ensures that a where a lender revalues its debts, a deduction is due only for impairment losses and releases of debt. Thus merely applying the lower of cost or net realisable value approach to debts will not give rise to a deduction – and this reproduces the effect of section 85(2)(c) FA 1996 repealed by Part 1 Schedule 10 FA 2004.

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46. New paragraph 6D(2) then makes corresponding exclusion for credits that represent reversals of any revaluation debits which have been disallowed by virtue of this rule, or by the previous rule in paragraph 5(1) Schedule 9 or by section 74(1)(j) ICTA.
47. New paragraph 6D(3) glosses the meaning of revaluation of debts to include the case where a general provision for bad or doubtful debts has been made.
48. New paragraph 6D(4) excludes debits arising from exchange losses from the disallowance for revaluation.
49. New paragraph 6D(5) provides that the rule in paragraph 6D(1) does not apply to debts accounted for using a fair value basis of accounting.
50. Paragraph 17 deals with rules in paragraphs 8 and 9 Schedule 9 FA 1996 that restrict provisions against and losses on disposal of sovereign debt. Paragraph 17 (1) repeals the two rules.
51. Paragraph 17(2) provides relief for sovereign debt provisions that have been restricted by paragraph 8 Schedule 9 (or its predecessor sections) in previous accounting periods. The balance of any provisions not already allowed for tax may be brought into account in the company's first accounting period after paragraph 8 Schedule 9 cease to have effect.
52. Paragraph 17(3) provides relief for losses on disposals of sovereign debts that have been restricted by paragraph 9 (or its predecessor sections) in previous accounting periods. To the extent that any losses on loans disposed of at any time before the start of the company's first accounting period after paragraph 9 cease to have effect, they continue to be brought into account as if paragraph 9 had not been repealed.
53. Paragraph 18 amends Schedule 12 FA 1997, which deals with finance leases. Paragraph 18(2) and (3) replaces the existing definitions of 'bad debt deduction' in paragraphs 9(7) and 10(7) Schedule 12 with new definitions that reflect the IAS terminology of impairment loss.
54. Paragraph 19 replaces the phrase 'relevant arrangement etc.' in paragraph 22(5) Schedule 26 FA 2002 (derivative contracts: release of liability) with 'statutory insolvency arrangement'. This

takes its meaning from the new definition introduced by paragraph 8 of this Schedule.

55. Paragraph 20(1) introduces the paragraph as amending paragraph 115 Schedule 29 FA 2002. This paragraph sets out rules for allowing relief for bad debts in connection with gains and losses of a company from intangible fixed assets.
56. Paragraph 20(2) replaces the reference in paragraph 115(1) Schedule 29 to bad debt relief under the intangibles regime with a similar rule couched in IAS 'impairment loss' terminology.
57. Paragraph 20(3) removes the definition of 'insolvency arrangement' that appeared in the original wording of paragraph 115(1)(c) Schedule 29 FA 2002 and the equivalent phrase now takes its meaning from the new definition introduced by paragraph 8 of this Schedule.
58. Paragraph 20(4) changes the reference to sub-paragraph (1)(c) to sub-paragraph (1)(b) in paragraph 115(3) Schedule 29, to align with the re-numbering in sub-paragraph (1)(b) to reflect IAS terminology.
59. Paragraph 20(5) adds a new sub-paragraph (6) to paragraph 115 Schedule 29, to extend the application of paragraph 115 to debts that can be settled in kind.

**Introduction: Part 2 – Other provisions connected with  
accounting practice**

60. Part 2 of the Schedule makes a number of amendments to the Tax Acts as a result of the ability of Great Britain and Northern Ireland companies to use International Financial Reporting Standards (IAS) in preparing their individual accounts.
61. Paragraph 21 amends section 43A(3) ICTA (rent factoring: definition of financing arrangement) to generalise the reference to “consolidated group accounts”. This is because many groups of companies will not in future be required by the Companies Act 1985 or the Companies (Northern Ireland) Order 1986 to draw up such accounts, but will be required or permitted to do so in accordance with IAS as a result of EC Regulation 1606/2002 which has direct effect in the UK.

62. Paragraph 22 amends section 75A ICTA (expenses of management of company with investment business). Section 38 FA 2004 changed the treatment of such expenses so that the amounts in question are taken from accounts drawn up in accordance with generally accepted accounting practice and as disclosed in a profit and loss account or statement of recognised gains or losses (STRGL). The sub-paragraph adds reference to the IAS equivalents, the “income statement” and the “statement of changes in equity”.
63. Paragraph 23 amends section 501A – supplementary charge for ring-fence trades in the North Sea – to generalise the reference to accounts drawn up in accordance with GB or NI companies legislation with the more general term “in accordance with GAAP” which term also includes IAS.
64. Paragraph 24 repeals section 747A ICTA. That section set out specific rules for dealing with accounts of a CFC drawn up in a currency other than sterling. This rule is no longer needed following the enactment of the new sections 92 to 92E FA 1993 by FA 2004. Those provisions will therefore apply to CFCs as to any other company. In addition a number of other CFC currency provisions are repealed. The changes apply for accounting periods beginning on or after 16 March 2005.
65. Paragraph 25 repeals section 836A ICTA. That section was replaced by section 50 FA 2004 for periods beginning on or after 1 January 2005 but was not repealed by that Act.
66. Paragraph 26 amends provisions in Chapter 2 Part 4 FA 1996 (loan relationships).
67. Paragraph 26(2) and (3) amends section 85B FA 1996. This section explains what is meant by “recognised in computing profit or loss” in section 85A, amounts so recognised being the only amounts (subject to the other provisions of the Chapter) that may be brought into account for a particular period. As currently set out it includes three levels of statement:
- profit and loss account (subsection (1)(a));
  - statement of recognised gains or losses (STRGL) and statement of changes in equity, the IAS near equivalent (section 85B(1)(b)); and
  - any other statement in which amounts taken into account in determining profit and loss are shown (section 85B(1)(c)).

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68. In IAS the principal statement in which profits and loss is recognised is called the “income statement”. Such a statement would be included in the section 85B(1)(c) “sweep up” provision, but to put IAS on an equal footing with UK GAAP, paragraph 26(2) adds to section 85B(1)(a) a reference to the “income statement”.
69. Paragraph 26(3) replaces section 85B(2) with a revised version. This is to make it clear that any prior period adjustment disclosed in accounts for a period is brought into account for that period, but not when it is to correct a fundamental error.
70. Paragraphs 26(4) and (5) makes consequential amendments to section 85B(3) and (4).
71. Paragraph 27 restores section 94 FA 1996 (taxation of indexed linked gilt-edged securities) to the statute book. Paragraph 12 Schedule 10 FA 2004 repealed section 94 FA 1996 which gave a particular tax treatment to index-linked gilt-edged securities. At the time of this repeal it was believed that indexed-linked gilts would be treated as bifurcatable securities to which section 94A FA 1996 applied. Accountancy advice has shown that this is not the case where the index related to the economic environment of the currency of the security. But it will still be that case where for example the company holding the gilts uses a currency other than sterling as its functional currency. Accordingly section 94A FA 1996 and paragraph 45I Schedule 26 FA 2002 will remain applicable to any such index linked gilts
72. Paragraph 27(1) treats the repeal of section 94 as never having happened. It also nullifies the repeal of a provision in FA 2002 that amended section 94. Paragraph 27(2) then introduces some amendments to section 94.
73. Paragraph 27(3) replaces section 94(1) to (3A) with new rules.
74. New section 94(1) says that where there is an indexed-linked security, credits and debits are to be given on the basis of fair value accounting. Most such gilts are already accounted for using an authorised mark to market method and will continue to use fair value accounting, so this represents very little change. Section 94(1) also provides for adjustments to be made.
75. New section 94(2) provides for an adjustment to be made wherever fair value is to be found at two different times, whether at the

beginning and end of a period of account, or on acquisition or disposal, and there is a movement in the RPI between those times.

76. New section 94(3) makes the adjustment to the opening fair value.
77. The existing sections 94(4) to (7) remain in place to determine how the adjustment is calculated.
78. Paragraph 28 amends section 94A FA 1996. That section as currently in force makes a company “bifurcate” certain securities with embedded derivatives into a loan relationship part (“the host contract”) and a derivative contract, where GAAP either permits or requires this treatment. In order to remove any confusion about the circumstances in which this rule applies, section 94A(1) is amended by paragraph 28(2) to simply provide that bifurcation is required for tax where it is done for accounting purposes. This means that companies which treat certain assets as at fair value through profit or loss are not required to bifurcate.
79. Companies which do not in fact use either IAS 39 or FRS 26 are not required or permitted to bifurcate. This could act harshly in cases where a company in those circumstances has a security to which section 92 or 93 FA 1996 applies, as it will not be entitled to the chargeable gains treatment given by paragraph 45A Schedule 26 FA 2002.
80. Paragraph 28(3) – as a result such companies are permitted to elect to follow section 94A for all such assets held at the end of the period immediately before a company’s first period to begin on or after 1<sup>st</sup> January 2005.
81. Paragraph 28(4) – the election must be made before 1<sup>st</sup> August 2005, cover all the relevant assets and be irrevocable.
82. Paragraph 29 adds a new section 103(1AA) into FA 1996. This makes it clear what is meant by exchange gains and losses in a case where fair value accounting is used. The exchange gains and losses in such a case are the amounts that would be given by an amortised cost method of accounting. This is what happens in a case where assets are treated as “available for sale”, since exchange gains and losses in such a case are taken to profits and losses account or income statement while other movements in value are taken to the Statement of Total Recognised Gains and Losses (STRGL) or Statement of Changes in Equity (SCE).

83. Paragraph 30 inserts a new paragraph 14A into Schedule 9 FA 1996. It complements paragraph 14 which allows amounts added directly to the cost of a fixed capital asset to be brought into account for the period in which they are added, even though the amounts are not recognised in one of the section 85B(1) statements. Paragraph 14A does the same for amounts taken to equity or shareholders' funds where the amounts are not recognised in one of the section 85B(1) statements. This includes amounts taken to share premium account. It also includes interest which, in accordance with IAS 32 or FRS 25, is treated for accounting purposes as a dividend on equity. This may be the case with some types of debt instrument which qualify as "Innovative Tier 1 capital" for banking and insurance groups.
84. Paragraph 31 amends paragraph 19A Schedule 9 FA 1996 dealing with a change of accounting policy, especially on the move to IAS. Paragraph 19A will not usually apply on a change within UK GAAP as such a change will give rise to a prior period adjustment falling within section 85B(2) FA 1996 (see paragraph 69 above).
85. Sub-paragraph 31(2) makes the definition of "carrying value" in paragraph 19A(4) now subject to sub-paragraph (4B).
86. Sub-paragraph 31(3) inserts new sub-paragraphs (4A) to (4D) into paragraph 19A. New paragraph 19A(4A) clarifies the meaning of "carrying value" of an asset or liability representing a loan relationship. It also includes certain amounts which may be shown in accounts separately from the "net" carrying value of the asset or liability, including accruals (especially of interest), prepayments and any separate allowances or provisions for bad debts or impairment losses.
87. New paragraph 19A(4B) adjusts the carrying value where particular provisions in Chapter 2 Part 4 FA 1996 and elsewhere in that Act make tax adjustments to the carrying value. They are—
- section 87(2) (cost basis and not fair value to be used where parties have a connection),
  - section 88A(4) (fair value accounting to be used for reset bonds),
  - section 94 (index-linked gilts adjustment),
  - section 94A(2) (loan relationships with embedded derivatives – host contract to be accounted for without derivative contract elements),

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- section 96(2) (no taxation of value movements for certain gilts),
  - section 154(6) (FOTRA securities: certain amounts not to be brought into account,
  - paragraph 1 of Schedule 9 (no credits or debits given in relation to distributions),
  - paragraph 1A of Schedule 9 (no credits and debits given in relation to loan relationships which are life assurance contracts or capital redemption contracts)
  - paragraph 2 of Schedule 9 (no debits given for accruals of late paid interest),
  - paragraph 6 of Schedule 9 (no debits given for impairment or on related transactions involving connected party debt),
  - paragraph 12 of Schedule 9 (transferee to adjust credits and debits by reference to tax history of transferor),
  - paragraph 18 of Schedule 9 (no debits given for discount until paid.
88. This change also blocks a number of avoidance schemes notified to the Inland Revenue under Part 10 FA 2004.
89. New paragraphs 19A(4C) and (4D) deal with the case where a loan relationship has been brought to a premature termination, and where the profits or loss arising is spread for the purposes of UK GAAP over the remaining term of the loan. Section 103(6) FA 1996 permits the credits or debits to be spread so that they can be brought into account despite there being no outstanding loan relationship.
90. New paragraph 19A(4C) treats the amounts outstanding at the end of the period immediately before the change of accounting policy as the carrying value of a loan relationship for the purposes of the comparison in paragraph 19A(3) and requires a comparison of the amount then outstanding with the amount in the opening IAS accounts.
91. New paragraph 19A(4D) defines “amounts outstanding” to mean the section 103(6) profit or loss which has so far not been brought into account, is shown as deferred income or loss in the balance sheet of the company.
92. Sub-paragraph 31(4) inserts a reference to sub-paragraph (4C) into paragraph 19A(5). Sub-paragraph 31(5) omits paragraph 19A(6) which has been found to be not needed.

93. Paragraphs 32 and 33 amend paragraph 30(1) Schedule 12 FA 1997 and section 219 Capital Allowances Act 2001 (finance leases) to generalise the references to “consolidated group accounts”. This is because many groups of companies will not in future be required by the Companies Act 1985 or Companies (Northern Ireland) Order 1986 to draw up such accounts, but will be required or permitted to do so in accordance with IAS as a result of EC Regulation 1606/2002 which has direct effect in the UK.
94. Paragraph 34 amends provisions in Schedule 26 FA 2002 (derivative contracts).
95. Paragraph 34(2) and 34(3) amends paragraph 17B Schedule 26. This paragraph explains what is meant by “recognised in computing profit or loss” in paragraph 17A. Amounts so recognised are the only amounts (subject to the other provisions of the Schedule) that may be brought into account for a particular period. As currently set out it includes three levels of statement:
- profit and loss account (sub-paragraph (1)(a));
  - statement of recognised gains or losses (STRGL) and statement of changes in equity, the IAS near equivalent (sub-paragraph (1)(b)); and
  - any other statement in which amounts taken into account in determining profit and loss are shown (sub-paragraph (1)(c)).
96. In IAS the principal statement in which profits and loss is recognised is called the “income statement”. Such a statement would be included in the paragraph 17B(1)(c) “sweep up” provision, but to put IAS on an equal footing with UK GAAP, paragraph 34(2) adds to paragraph 17B(1)(a) a reference to the “income statement”.
97. Paragraph 34(3) replaces paragraph 17B(2) with a revised version. This is to make it clear that any prior period adjustment disclosed in accounts for a period is brought into account for that period, unless it is to correct a fundamental error.
98. Paragraph 35 inserts a new paragraph 25A into Schedule 26 FA 2002. It complements paragraph 25 which allows amounts added directly to the cost of a fixed capital asset to be brought into account for the period in which they are added, even though the amounts are not recognised in one of the paragraph 17B(1) statements. Paragraph 25A does the same for amounts taken to equity or shareholders’ funds where the amounts are not

recognised in one of the section 85B(1) statements. This includes amounts taken to share premium account.

99. Paragraph 36 corrects minor errors in paragraphs 38 and 38A Schedule 26 FA2002 (investment trusts and venture capital trusts) to change a reference to “creditor loan relationships” to “derivative contracts”. They are treated as always having had effect.
100. Paragraph 37 adds a new paragraph 54(2A) into Schedule 26 FA 2002. This makes it clear what is meant by exchange gains and losses in a case where fair value accounting is used. The exchange gains and losses in such a case are the amounts that would be given by an amortised cost method of accounting.
101. Paragraphs 38 to 47 amend Schedule 29 FA 2002 (gains and losses of a company from intangible fixed assets).
102. Paragraph 38(1) provides for amendments to paragraph 6 Schedule 29. This allows resort to be had to consolidated accounts in considering the life of an asset or its economic value. Paragraph 38(2), by omitting paragraph 6(2) of that Schedule, generalises the references to “consolidated group accounts”. This is because many groups of companies will not in future be required by the Companies Act 1985 or Companies (Northern Ireland) Order 1986 to draw up such accounts, but will be required or permitted to do so in accordance with IAS as a result of EC Regulation 1606/2002 which has direct effect in the UK.
103. Paragraph 38(3) introduces a new paragraph 6(2A) Schedule 29. Previously paragraph 6(3) prevented resort to consolidated accounts only if they were prepared under the law of another territory and were dissimilar to UK GAAP. That restriction is retained, but the effect of the new paragraph 6(2A) is also to prevent resort to the consolidated accounts if they are prepared under a different accounting framework which substantially diverges from that used in the individual accounts, even if the consolidated accounts are prepared under UK law. For example, where the individual accounts are prepared under UK GAAP and the consolidated accounts under IAS, it would not be possible for the Revenue to argue that, for example, goodwill should not be amortised because it is not amortised under IAS.
104. Paragraphs 39 to 41 and 47 amend the language of Schedule 29 to bring it into line with Chapter 2 Part 4 FA 1996 and Schedule 26 FA 2002 as far as looking at what is meant by “recognised in

determining a company's profit or loss" is concerned. At present Schedule 29 refers only to a company's "profit and loss account" in the main computational provisions (Parts 2 to 4) and then defines that in paragraph 134 to include the other types of performance statement such as the STRGL. Paragraphs 39 to 41 and 47 change references to "a company's profit and loss account" to say "determining a company's profit or loss" in paragraphs 8, 9, 12, 13, 14, 16, 17, 26, 103 and 143.

105. Paragraph 46 amends paragraph 134 Schedule 29 more substantially. Paragraph 46(2) amends the heading to reflect the new approach. Paragraph 46(3) makes paragraph 134 becomes paragraph 134(1), while paragraph 46(4) amends the newly formed sub-paragraph in line with the amendments mentioned in paragraph 104 and also omits the words about fundamental error inserted by Part 3 Schedule 10 FA 2004 (see below).
106. Paragraph 46(5) then inserts a new paragraph 134(2). This is to make it clear that any prior period adjustment disclosed in accounts for a period is brought into account for that period, except when it is to correct a fundamental error.
107. Paragraph 45 inserts a new Part 13A into Schedule 29 consisting of paragraphs 116A to 116H and replacing the existing paragraph 116A inserted by Schedule 10 FA 2004. Paragraphs 42, 43 and 44 make some consequential amendments. See paragraph 148 onwards for notes about these paragraphs
108. The new paragraphs 116A to 116H cover the tax effects of a change of accounting policy where it affects assets within the intangible asset regime of Schedule 29. In particular they apply where a company changes from UK GAAP to IAS. Except where a fixed rate writing-down election has been made they ensure that any change in accounting value of the assets resulting from the change will be brought into account for tax purposes, subject to a cap limiting the amount brought into charge to the amount of any previous allowable debits within the regime.
109. The rules for recognition of intangible assets under IAS are to some extent different from those under UK GAAP, and this may result in intangible fixed assets such as goodwill being further analysed into component assets (disaggregated). The new paragraphs set out rules for attributing tax written down values and costs to the disaggregated assets. The new paragraphs also cover the attribution of values to assets where fixed rate writing down

elections under paragraph 10 Schedule 29 are in place or may still be possible.

110. Paragraph 116A sets out when the new Part 13A of Schedule 29 will apply.
111. New paragraph 116A(1) requires there to be a change of accounting policy between two periods of account and for each accounting basis to be in accordance with the law and practice of the period.
112. New paragraph 116A(2) indicates that it applies in particular to changes from UK GAAP to IAS or vice versa.
113. Paragraph 116B deals with the position where there is a change in value of an intangible fixed asset as a result of the change of accounting policy and provides for that change in value to be brought into account for tax purposes. Where the change in value arises from the disaggregation of an asset paragraph 116C applies instead (see paragraph 121 onwards below).
114. New paragraph 116B(1) says that where there a change in value of an intangible fixed asset as a result of the change of accounting policy, a corresponding debit or credit shall be brought into account, as though it arose at the beginning of the accounting period.
115. New paragraph 116B(2) provides that the resulting debit or credit is treated as arising at the beginning of the later period.
116. New paragraph 116B(3) identifies the amount of difference to be brought into account for tax purposes by reference to accounting difference adjusted by the ratio of the tax value to the accounting value at the end of the earlier period.
117. New paragraph 116B(4) provides that the tax written down value of the asset at the beginning of the later period shall be taken to be the tax written down value at the end of the earlier period adjusted for any credits or debits arising from the change in accounting policy.
118. New paragraph 116B(5) identifies the cost recognised for tax purposes (other than for the purposes of reinvestment relief – see paragraph 149 below) and the tax written down value subsequently. The tax written down value computed under sub-

paragraph (4) is treated as the cost of the asset and subsequently adjusted only for debits and credits arising after the change.

119. New paragraph 116B(6) provides that this paragraph does not apply where a fixed rate election has been made under paragraph 10 of Schedule 29 FA 2002 in respect of the asset.
120. New paragraph 116B(7) makes the paragraph subject to paragraph 116F (which places a cap on the amount of any credit under this paragraph) and paragraph 116G (which covers the position where debits or credits are brought into account under other provisions of the Schedule).
121. Paragraph 116C sets out the consequences where the change in accounting policy results in the disaggregation of an intangible fixed asset. It identifies how to compute the tax adjustment arising where the total value of the disaggregated assets is different from that of the original asset, and explains how to attribute tax written down values and cost for tax purposes to the disaggregated assets going forward.
122. New paragraph 116C(1) identifies the need for there to be a disaggregation of an intangible fixed asset on a change of accounting policy before the paragraph applies.
123. New paragraph 116C(2) provides that where there is a difference between the accounting value of the old intangible fixed asset and the aggregate accounting values of the disaggregated intangible fixed assets, a corresponding debit or credit shall be brought into account for tax purposes.
124. New paragraph 116C(3) provides that the corresponding debit or credit is treated as arising at the beginning of the later period of account.
125. New paragraph 116C(4) provides that the amount of difference brought into account for tax purposes is to be computed by reference to the ratio of the tax value to the accounting value at the end of the earlier period.
126. New paragraph 116C(5) provides a means for apportioning the former tax written down value of the original intangible fixed asset to the disaggregated assets, on the basis of their new accounting values at the beginning of the later accounting period. This will be

adjusted to include a proportionate share of any adjustment under paragraph 116C(3).

127. New paragraph 116C(6) sets out how the tax written down value and cost recognised for tax purposes (other than for the purposes of reinvestment relief – see paragraph 148 below) will be identified subsequently.
128. New paragraph 116C(7) provides that the paragraph will not apply where a fixed rate writing down election under paragraph 10 Schedule 29 FA 2002 is made in respect of the original or of any of the disaggregated intangible fixed assets.
129. New paragraph 116C(8) provides the paragraph is subject to paragraph 116F (which places a cap on the amount of any credit under this paragraph) and paragraph 116G (which covers the position where debits or credits are brought into account under other provisions of the Schedule).
130. Paragraph 116D covers the position where an intangible fixed asset which is subject to a fixed rate writing down election under paragraph 10 Schedule 29 FA 2002 is disaggregated as a result of a change in accounting policy.
131. New paragraph 116D(1) provides that the paragraph applies where there is a disaggregation of an intangible fixed asset on a change of accounting policy, and a fixed rate writing down election has been made (or is subsequently made) under paragraph 10 Schedule 29 FA 2002 in respect of the original asset.
132. New paragraph 116D(2) provides that any such election in respect of the original intangible fixed asset applies to that asset for the period prior to the change and to each of the disaggregated assets thereafter.
133. New paragraph 116D(3) apportions the former tax written down value of the original intangible fixed asset to each disaggregated asset on the basis of the ratio of their new accounting values at the beginning of the later accounting period.
134. New paragraph 116D(4) sets out how tax written down value and cost recognised for tax purposes (other than for the purposes of reinvestment relief – see paragraph 149 below) will be identified subsequently.

135. Paragraph 116E deals with the more complicated position where:
- an intangible fixed asset is disaggregated as a result of a change in accounting policy
  - there is no paragraph 10 Schedule 29 FA 2002 fixed rate writing down election in respect of the original asset
  - a paragraph 10 Schedule 29 FA 2002 fixed rate writing down election is made in respect of one, or more, of the disaggregated assets.
136. New paragraph 116E(1) provides that the paragraph applies where the conditions described in the first two bullet points above are met.
137. New paragraph 116E(2) permits an election to be made in respect of any of the disaggregated assets so long as it is made within the time limits under which an election could have been made for the original intangible fixed asset.
138. New paragraph 116E(3) sets out the computational consequences of such an election. Essentially, the original intangible fixed asset is treated as though in the accounting periods prior to the change in accounting policy it had already been subdivided into parts (notional original assets) corresponding with the resultant disaggregated assets. Each notional original asset then has apportioned to it parts of every amount under Schedule 29 taken into account with regard to the old asset. The provisions of Schedule 29 are then applied to each notional original asset (and to the corresponding disaggregated assets) accordingly, as though they were the same assets. So, for example, when dealing with a disaggregated asset which is not subject to a fixed rate election, if there is a change in accounting values on the change of accounting policy the rules in paragraph 116B will apply to this asset.
139. New paragraph 116E(4) provides that amounts are allocated in respect of the original intangible fixed asset to the notional original assets in the ratio of the opening accounting values of the corresponding disaggregated assets in the new accounting period.
140. Paragraph 116F places a cap on the credits to be brought into account for tax purposes under paragraphs 116B or 116C. That cap is the net aggregate amount of any debits previously brought into account in respect of the asset. This corresponds with the approach used for revaluations under paragraph 15 Schedule 29 FA 2002.

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141. New paragraph 116F(1) provides that the amount of credits to be brought into account for tax purposes under paragraph 116B or 116C is limited to the net aggregate amount of relevant debits previously brought into account.
142. New paragraph 116F(2) sets out what is meant by the net aggregate amount of relevant debits for paragraph 116B purposes. It is necessary to arrive at a net figure by setting any earlier credits in respect of the assets against the earlier debits.
143. New paragraph 116F(3) sets out what is meant by the net aggregate amount of relevant debits for paragraph 116C purposes. Where there has been a disaggregation, but there are no disaggregated assets subject to a fixed rate write down election under paragraph 10 of Schedule 29, the amount of previous debits and credits taken into account are those in respect of the original intangible fixed asset.
144. New paragraph 116G provides that debits or credits arising from an accounting differences do not need to be brought into account under Part 13A to the extent that they are already brought into account under paragraphs 12, 15 or 17 of Schedule 29 FA 2002.
145. New paragraph 116H covers subsequent accounting adjustments to intangible fixed assets which have already been subject to the provisions of Part 13A.
146. New paragraph 116H(1) indicates that if there are further changes of accounting policy affecting an asset to which Part 13A has applied, then Part 13A shall apply again.
147. New paragraph 116H(2) provides that where there is a subsequent part realisation of an asset which has been subject to the provisions of Part 13A, then paragraph 29 of Schedule 29 FA 2002 applies.
148. Paragraphs 42 and 43 modify the rules for the computation of the tax written down value of an intangible asset paragraphs 27, 28 and 29 of Schedule 29 to make them subject to the new part 13A of Schedule 29.
149. Paragraph 44 introduces a new paragraph 42A to Schedule 29 FA2002.
150. New paragraph 42A provides for the purposes of Part 7 of Schedule 29 (reinvestment relief) that references to the cost of the

asset in that Part are adapted to ensure that they continue to give the right result. The cost of an asset is relevant for Part 7 purposes because only gains representing an excess of realisation proceeds over the original cost of an asset can be rolled over.

151. New paragraph 42A(1) identifies the circumstances in which the provisions of the paragraph apply.
152. New paragraph 42A(2) ensures that the cost of an asset subject to the rules in paragraph 116B is unaffected by Part 13A.
153. New paragraph 42A(3) sets out how the cost of an asset subject to the rules in either paragraphs 116C or 116D (disaggregation) is to be calculated for the purposes of reinvestment relief. The cost of a disaggregated asset is to be taken as a proportion of the cost of the original asset, arrived at by multiplying that cost by the same fraction as is applied in arriving at the written down value of the asset under paragraph 116C(5) or 116D(3). These fractions are based on the opening accounting values of the disaggregated assets at the start of the new period of account.
154. New paragraph 42A(4) provides that the rules in subparagraphs (2) and (3) also apply where paragraphs 116B to 116D operate by virtue of the provisions of paragraph 116E (see in particular paragraph 138 above). The notional original assets deemed into existence by paragraph 116E, are then dealt with under one of these paragraphs.
155. Paragraph 48 amends the Income Tax (Earnings and Pensions) Act 2003 to change a reference to section 836A ICTA (definition of GAAP) to become one to section 50 FA 2004 which replaced it.
156. Paragraph 47 amends the FA 2004 provisions relating to IAS.
157. Paragraph 49(2) replaces section 50(2) and (3) FA 2004. Subsection (2) defined IAS as those Standards etc endorsed by the European Commission. The new subsection (2) now simply denies IAS as the full set of Standards, interpretations etc issued by the IASB or adopted by it.
158. Subsection (3) originally provided what was to happen if the EC did not endorse a Standard. This was enacted at a time when it was possible that EC would not adopt IAS 39 at all. Now however the EC has adopted IAS 39 but with modifications. So the new subsection (3) now provides what is to happen as a result of this

eventuality. For tax purposes companies may either use EC adopted IAS 39 or the full IAS 39 and still comply with section 50. This change also means that where a controlled foreign company, or a non-resident company with a UK permanent establishment, uses full IAS, it conforms with the requirement to follow GAAP.

159. Paragraph 50 amends the commencement rules in sections 50, 51, 52 and 54 to remove the rule permitting the provisions of those sections and Schedule 10 to have effect for period beginning before 1 January 2005 where company law permitted it. That was put in on the basis that the draft regulations amending the Companies Act for IAS published by the DTI included such a provision. The final regulations as now made exclude that provision.
160. Section 46 FA 2004 (R&D) did not have a commencement rule, but has been brought into force by commencement order (SI 2004/3268) prescribing 1 January 2005 as the commencement date.
161. Paragraph 51 inserts a new paragraph 78 into Schedule 10 FA 2004. Part 4 of that Schedule amended the rules for translating accounts where a company's functional currency or presentation currency is not sterling. They provide that non-sterling figures are always translated using the relevant exchange rate for the period. The predecessor provisions provided for losses of various types to be carried forward without translation in the year they were made, and they only fell to be translated when they were deducted from profits in a succeeding period. As this is no longer possible there needs to be a rule for translating the losses carried forward to the first periods beginning on or after 1 January 2005. New paragraph 78 gives the rule – the losses are to be transferred using the closing rate at the end of the period immediately preceding the first period to begin on or after 1 January 2005.
162. Paragraph 52 allows regulation making powers in Chapter 2 Part 4 FA 1996 and Schedule 26 FA 2002 to have a limited retrospective effect. Regulations may be made so as to have effect for periods of account beginning on or after the first day of the calendar year in which they are made, if that is before the day they are made.

**BACKGROUND NOTE**

163. In 2002 the European Union approved a Regulation (having direct effect in member states) that requires the consolidated (group) accounts of listed (on a stock exchange) companies to be drawn up using International Accounting Standards (IAS) from 2005. These consolidated accounts are not used for tax purposes. In 2003 the DTI announced that the UK would take up an option in the Regulation to permit, but not require, all UK companies to use IAS to draw up their accounts, also from 2005.
164. Finance Act 2004 introduced legislation which allowed accounts, prepared by individual companies, using IAS to be used for tax purposes. It also contained provisions which maintained the tax position under UK Generally Accepted Accounting Practice (GAAP) where the treatment differed significantly under IAS.
165. IAS differ from UK GAAP in a number of specific areas. The main area where there is a difference is in the field of financial instruments where IAS 39 applies. There is no UK Standard dealing with the holder of financial instruments.
166. Many of the changes in the clause and schedule are to the rules for relief for impairment losses in a range of situations not covered by the loan relationships, derivative contracts and intangible fixed assets rules on impairment losses. These situations include impairment losses on trade debts, debts that may be settled in kind rather than money and debts that go bad after a trade has ceased. The rules that restrict relief for provisions against and losses on disposal of sovereign debt are also repealed, with transitional provisions, by this Schedule.

## **EXPLANATORY NOTE**

### **CLAUSE 81: COMPUTATION OF PROFITS: CHANGE OF ACCOUNTING BASIS**

#### **SUMMARY**

1. Clause 81 ensures that a prior period adjustment arising on a change of accounting basis from UK Generally Accepted Accounting Practice (UK GAAP) to International Accounting Standards (IAS) is treated in the same way as an adjustment arising from a change of basis within UK GAAP. It also changes the date on which the adjustment is treated as arising. The clause applies for periods beginning on or after 1 January 2005.

#### **DETAILS OF THE CLAUSE**

2. Subsection (1) expands the meaning of “relevant change of accounting approach” in section 64(3) Finance Act (“FA”) 2002. It substitutes a new section 64(3) to include a change from using UK GAAP to using IAS, whether or not a prior period adjustment is disclosed. UK GAAP and IAS are defined in section 50 Finance Act 2004.
3. Subsection (2) ensures, by amending paragraph 4(3) and 5(3) Schedule 22 FA 2002 that there is no deferral in taxing or relieving the uplift or loss arising from the prior period adjustment for companies with a period of account lasting more than one year.
4. Subsection (3) provides that the changes have effect for periods of account beginning on or after 1 January 2005.

#### **BACKGROUND NOTES**

5. In 2002 the European Union approved a Regulation (having direct effect in member states) that requires the consolidated (group)

accounts of listed (on a stock exchange) companies to be drawn up using International Accounting Standards (IAS) from 2005. These consolidated accounts are not used directly for tax purposes. In 2003 the DTI announced that the UK would take up an option in the Regulation to permit, but not require, all UK companies to use IAS to draw up their accounts, also from 2005.

6. Finance Act 2004 introduced legislation which allowed accounts, prepared by individual companies, using IAS to be used for tax purposes. It also contained some provisions, and allowed for regulations to be made to enact others, which maintained the tax position under UK Generally Accepted Accounting Practice (GAAP) where the treatment differed significantly under IAS. This is particularly the case in relation to hedging.
7. The Companies Act 1985 and the Companies (Northern Ireland) Order 1986 have been amended to take into account the changes required on the introduction of IAS for Great British and Northern Ireland companies. These amendments can be found in the Companies Act 1985 (International Accounting Standards & Other Accounting Amendments) Regulations (SI 2004/2947) and the Companies (1986 Order) (International Accounting Standards and Other Accounting Amendments) Regulations (Northern Ireland) Regulations 2004 (SR 2004/496).
8. International Reporting Standard 1 (IFRS1) on the First-time Adoption of International Financial Reporting Standards sets out the way in which a company must prepare its accounts on first adopting IAS. It produces results which would mean that any prior period adjustments would not fall within the requirements of section 64 FA 2002.

**EXPLANATORY NOTE**

**CLAUSE 82: CHANGE OF ACCOUNTING PRACTICE:  
DEFERMENT OF TRANSITIONAL ADJUSTMENTS**

**SUMMARY**

1. Clause 82 defers relief for loan relationship debits that arise when a company enters into artificial arrangements for the early crystallisation of losses on financial instruments in anticipation of changing from one basis of accounting to another. The clause applies to arrangements entered into on or after 14 December 2004.

**DETAILS OF THE CLAUSE**

2. Subsection (1) changes the tax treatment of certain loan relationship debits. The subsection sets out three conditions to be met for the different treatment to apply.
3. The first condition in subsection (1)(a) is that on or after 14 December 2004, the company has entered into a transaction involving loan relationships or derivative contracts which is not one entered into in the ordinary course of its business
4. The second condition in subsection (1)(b) as a result of that transaction, it has a loss which would be recognised for tax purposes in an accounting period beginning before 1 January 2005, but for the section.
5. The third condition in subsection (1)(c) is that the sole or main purpose of the company's entering into the transaction was to create a debit for tax purposes.
6. The fourth condition in subsection (1)(d) is that if the company had continued to hold the relevant asset or liability and had not entered into the transaction, there would have been a debit which would

have been deferred under regulation 3 of the Loan Relationship and Derivative Contracts (Change of Accounting Practice) Regulations 2004 (SI 2004/3271). These regulations normally apply to debits that arise on transition from one basis of accounting to another. In making this assumption and in computing the transitional debit it is assumed that the value of the asset or liability when the transaction was entered into remains the same – subsection (4).

7. Where these four conditions are met, instead of being brought into account for tax purposes in the accounting period when it arises, subsection (2) provides that the debit is treated as one to which regulation 3 of the Change of Accounting Practice Regulations 2004 applies.
8. Subsection (3) sets out additional matters which can be taken into account in deciding what the sole or main purpose of the company is (subsection (1)(c)). As well as looking at the actions and purpose of, and consequences for, the company that incurs the loss, those of connected companies must also be taken into account. For the purposes of this subsection, companies are connected if they are connected persons for the purposes of section 839 Income and Corporation Taxes Acts 1988.
9. Subsection (5) makes an exception where the transaction, though taking place on or after 14 December 2004 was entered into under a binding arrangement before that date.
10. Subsection (6) glosses “entering into a transaction”. It includes a decision taken by the company or its directors that affects the treatment of the asset or liability for accounting purposes, but does not include a decision to adopt International Accounting Standards).

### **BACKGROUND NOTES**

11. Companies can adopt International Accounting Standards (IAS) for accounting periods beginning on or after 1 January 2005, and from that date, IAS is an acceptable basis for computing taxable profits. When a company moves from UK Generally Accepted Accounting Practice (UK GAAP) to IAS, there can be differences between the tax value of financial instruments on the change-over date under the two accounting practices.

12. These differences (transitional adjustments) are treated as loan relationship debits or credits under paragraph 19A Schedule 9 Finance Act 1996. They are relievable or taxable in the first accounting period for which a company uses IAS, but subject to powers to alter when and how they are taken into account for tax purposes.
13. The Loan Relationship and Derivative Contracts (Change of Accounting Practice) Regulations 2004 (SI 2004/3271) were laid on 10 December 2004 under these powers. Under regulation 3, the debits and credits from transitional adjustments are not brought into account until the company's first accounting period beginning on or after 1 January 2006. This deferral applies to both credits, that would increase taxable profits, and debits, which reduce them.
14. By taking certain steps (which vary depending on the financial instrument involved), a company can crystallise differences between UK GAAP tax values and what would be the IAS tax values in the accounting period before it first uses IAS, typically year ended 31 December 2004. Typically, this would be where the asset had a current value less than its carrying cost under UK GAAP and would produce a tax-deductible loss.
15. Had the steps not been taken, these financial instruments would have given rise to transitional adjustment debits. Under the Change of Accounting Practice Regulations, tax relief for these debits would have been delayed until the first accounting period beginning on or after 1 January 2006, two accounting periods later than relief for the debits on the losses crystallised early.
16. This clause withdraws the two-year advantage that would otherwise have followed from entering into arrangements with the main purpose of crystallising these losses in the last accounting period before IAS is adopted.

**EXPLANATORY NOTE**

**CLAUSE 83: APPLICATION OF ACCOUNTING  
STANDARDS TO SECURITISATION COMPANIES**

**SUMMARY**

1. Clause 83 allows certain companies involved in securitisations to continue to use UK Generally Accepted Accounting Practice (“GAAP”) as it stood on 31 December 2004 for a further year.

**DETAILS OF THE CLAUSE**

2. Subsection (1) provides for a special rule for special purpose companies used in securitisation transactions (“securitisation companies”). They are required to use UK GAAP as it stood for a period ending on 31 December 2004 in determining their taxable profits for periods beginning on or after 1 January 2005 and ending on or before 31 December 2006.
3. Subsection (2) defines securitisation company to cover five types of company, each of which is defined in subsections (3) to (7)
4. Subsection (3) defines a “note-issuing company”. It is defined in similar terms to those used in paragraph 7B Schedule 28AA ICTA 1998 (transfer pricing). The company must be a debtor in respect of a capital market investment which is part of a capital market arrangement of at least £50 million and where the creditors are wholly or mainly “independent persons” (see paragraph 12). The £50 million limit is taken to be a reference to the issue price of the capital market instruments issued.
5. “Capital market investment” and “capital market arrangement” have the meaning given by section 72B Insolvency Act 1986 – subsection (8).

6. Subsection (4) defines an “asset-holding company”. This is one whose only business is acquiring, holding and managing assets (including any relevant contract – an option, future or contract for differences – subsection (8)) which are security for a capital market arrangement, and whose liabilities are owed wholly or mainly to a note-issuing company or to an intermediate holding company.
7. Purely incidental activities such as the disposal of an asset because it is of insufficient quality to be used in the securitisation will not prevent the holding etc. of assets from being regarded as the only business.
8. An “intermediate borrowing company”, defined in subsection (5), is, as its name implies, a company inserted between an asset holding company and a note issuing company. This company must be one whose only business is to lend to an asset-holding company with funds borrowed wholly or nearly so from a note issuing company.
9. A “warehouse company” is defined in subsection (6) as one whose business is the acquiring of financial assets with a view to either transferring them to a securitisation company (which need not necessarily exist at the time) or to itself becoming a note-issuing or asset-holding company as defined.
10. “Financial assets” has the meaning it has for accounting purposes. It covers cash, bank deposits, trade debts, notes, loans and bonds, and shares in another company (see Accounting Standards FRS 25 UK & International Accounting Standard 32).
11. Finally a “commercial paper funded company” is defined in subsection (7) as one which has been an asset-holding company or an intermediate holding company, but whose obligations to a note-issuing or intermediate holding company have been transferred to a bank or been replaced by bank borrowings.
12. Subsections (8) and (9) define “independent persons” as being ones who are not connected within section 839 ICTA 1998, ignoring participation by virtue only of being a loan creditor.

**BACKGROUND NOTE**

13. Securitisation companies are special purpose vehicles (SPVs) involved in structures under which at least one such company is used to issue securities or commercial paper into the market which are backed by charged assets, the cash flows from which are used to meet liabilities under the securities. Such SPVs are usually 'bankruptcy remote' so that they are insulated from any insolvency risks within the group (the 'sponsoring group') that transferred the assets into the structure. Often there is more than one SPV in a chain of companies ending with an issuer SPV, or an SPV may be used to 'warehouse' assets prior to transfer into a structure involving an issuer SPV.
14. The effect of IAS and revised UK GAAP (especially IAS 39 and FRS 26) on the profits and hence the tax of SPVs is still the subject of debate among accountants. But SPVs are peculiarly dependent on an appropriate rating of the debt, in particular one that is higher than the rating of the sponsoring group, because the higher rating means a lower cost of finance. But if rating agencies are unsure of the potential tax liabilities of an SPV they may be unwilling to grant a rating or may wish to downgrade ratings previously granted to SPVs that were set up before the recent accounting changes came into effect.
15. Allowing SPVs to continue using UK GAAP as it stood on 31 December 2004 for a specified period removes the uncertainty of tax treatment associated with the change to IAS for at least this period, and provides time for an appropriate longer term tax treatment for SPVs to be considered – see note on clause 84.

## **EXPLANATORY NOTE**

### **CLAUSE 84: TAXATION OF SECURITISATION COMPANIES**

#### **SUMMARY**

1. Clause 84 provides for regulations to be made setting out a new tax regime for certain companies involved in securitisations.

#### **DETAILS OF THE CLAUSE**

2. Subsection (1) provides that the Treasury may make regulations for the purposes of applying the Corporation Tax Acts to special purpose companies used in securitisation transactions (“securitisation companies” or “SPV”).
3. Subsection (2) defines securitisation company to cover what clause 105 defines as note-issuing companies and any other company in a relationship with a note-issuing company. It is envisaged that all the types of SPV defined in clause 83 will be included in this regime. Subsection (6) defines certain terms used in this subsection.
4. Subsection (3) sets out, without entrenching on the generality of subsection (1), what the regulations may in particular do. They may:
  - provide that the amount of profits may be a particular amount or calculated in a particular way. For example it may be that profits could be calculated by taking a percentage (e.g. a basis point or 0.01 per cent) of the interest payable by the company. Alternatively a fixed amount might be taken. Such an amount could replace the computation of profits under the Corporation Tax Acts. There is some resemblance here with the scheme of “tonnage tax” in Schedule 22 Finance Act 2000;

- make adjustments to the amount of profits, for instance the usual disallowances for entertaining expenses;
  - provide for the application or non-application of the CT Acts, e.g. the transfer pricing rules or anti-avoidance legislation;
  - make the scheme elective and irrevocable and provide for the scheme to start from 1 January 2005;
  - impose conditions that a company must meet to stay in the scheme and impose sanctions for failing to meet those conditions, such as recalculating profits without regard to the scheme.
5. Subsection (4) provides that different provision can be made for different cases. The different types of SPV mentioned in clause 113 might have different tax treatments.
  6. Subsection (5) allows the regulations to have a limited retrospective effect.
  7. Subsection (7) requires the first use of regulations (i.e. those establishing the scheme) to be affirmative resolution regulations and so subject to debate in the House of Commons. Subsequent regulations e.g. to modify the scheme will be negative resolution.

### **BACKGROUND NOTE**

8. Securitisation companies are special purpose vehicles (SPVs) involved in structures under which at least one such company is used to issue securities or commercial paper into the market which are backed by charged assets, the cash flows from which are used to meet liabilities under the securities. Such SPVs are usually 'bankruptcy remote' so that they are insulated from any insolvency risks within the group (the 'sponsoring group') that transferred the assets into the structure. Often there is more than one SPV in a chain of companies ending with an issuer SPV, or an SPV may be used to 'warehouse' assets prior to transfer into a structure involving an issuer SPV.
9. The effect of IAS and revised UK GAAP (especially IAS 39 and FRS 26) on the profits and hence the tax of SPVs is still the subject of debate among accountants. But SPVs are peculiarly dependent

on an appropriate rating of the debt, in particular one that is higher than the rating of the sponsoring group, because the higher rating means a lower cost of finance. But if rating agencies are unsure of the potential tax liabilities of an SPV they may be unwilling to grant a rating or may wish to downgrade ratings previously granted to SPVs that were set up before the recent accounting changes came into effect.