Example 4: undesignated interest rate swap

Background

Financial Reporting Standard (FRS) 101 and FRS 102 both introduce significant changes in the accounting for financial instruments compared to Old UK Generally Accepted Accounting Practice (GAAP) (where FRS 26 is not applied). Consequently for many users of FRS 101 or FRS 102 the interaction of the accounting and the tax in respect of financial instruments may be unfamiliar.

The purpose of this paper is to provide a brief introduction, using a worked example, to the Corporation Tax treatment for an undesignated interest rate swap and loan. The example goes through the

- assumed facts
- ongoing position
- transitional position

Scope

The paper assumes the following:

- a company within the charge to Corporation Tax
- applying the hedge accounting requirements contained in section 12 of FRS 102
- transitioning from Old UK GAAP without the application of FRS 26
- applying fair value accounting for the first time in 2015

It does not specifically deal with the requirements of FRS 26, FRS 101, International Accounting Standard (IAS) 39 or International Financial Reporting Standard (IFRS) 9. The mechanics of hedge accounting in those standards are similar to the requirements of section 12 of FRS 102 and companies applying those standards may also find this paper helpful. However, differences do exist between the standards which potentially affect the accounting and tax analysis.

The paper reflects amendments made to the Disregard Regulations (SI 2004/3256) in December 2014. The paper assumes that the company is applying fair value accounting for the first time in a period of account commencing on or after 1 January 2015. For companies which applied fair value accounting before this time, regulations 7, 8 and 9 apply by default.

This paper is concerned with the Corporation Tax rules, and therefore only applies to companies that are within the charge of Corporation Tax. It also assumes that the hedging instrument falls to be a derivative contract within part 7 of CTA 2009. Because of the specific nature of the tax rules, the commentary is unlikely to be of wider application.

The commentary provided in the paper is of a general nature. Companies should not rely on the commentary in isolation and it is not intended as a substitute for referring to the accounting standards and tax law. Hedge accounting can be a complex area and companies may wish to consider discussing the implications of hedging arrangements with their advisers and/or consult the detailed guidance in the HM Revenue and Customs (HMRC) manuals and in particular the Corporate Finance Manual.

It remains the responsibility of the company to ensure that it prepares accounts in accordance with relevant GAAP and submits a self-assessment in line with UK tax law.

Where HMRC considers that there is, or may have been, avoidance of tax the analysis as presented will not necessarily apply.

Assumed facts

Hedged item

On 1 January 2014, XYZ Ltd borrows £100 million under a 3 year loan which accrues interest at a floating rate of the London Interbank Offered Rate (LIBOR) plus 5%.

XYZ Ltd has a loan payable which bears interest at a floating rate. The cash flows payable under the loan will therefore fluctuate as interest rates change. This variability introduces uncertainty and potential volatility into the cash flows of the company. If LIBOR increases then the company will have to find additional funds to service the debt.

Hedging instrument

At the same time, the company also entered into an interest rate swap with the following terms:

- notional principal £100 million
- period 3 years
- fixed interest payable on notional principal at 7%
- floating interest receivable on notional principal at Libor plus 5%

Cashflows				
LIBOR		1.00%	3.00%	5.00%
		20X4	**20X5**	**20X6**
Interest payable on loan	L+5%	(6.0)	(8.0)	(10.0)
Receivable leg on swap	L+5%	6.0	8.0	10.0
Payable leg on swap	7%	(7.0)	(7.0)	(7.0)
Net (payment) / receipt under swap		(1.0)	1.0	3.0
Net cash payment		**(7.0)**	**(7.0)**	**(7.0)**

Hedging relationship

It is assumed that XYZ Ltd does not apply the requirements of section 12 on hedge accounting to the swap and loan payable (for example, it is not a designated hedge).

This example involves an undesignated cash flow hedge. However, the accounting and tax analysis for the swap is similar to that of an undesignated fair value hedge.

The ongoing position

Accounting treatment

The ongoing accounting treatment where FRS 102 is applied is as follows:

The loan
This is measured on amortised cost basis.

The interest rate swap

This is held at fair value through profit or loss, with all movements in the fair value recognised in the income statement (being the FRS 102 term used for the profit and loss account).

Accounting treatment	**20X4**	**20X5**	**20X6**
Income statement			
Interest payable on loan (including net payment on swap)	7.0	7.0	7.0
Fair value movement on swap	(3.0)	4.0	(1.0)
Loss before tax	4.0	11.0	6.0
Balance sheet position			
Loan payable	(100.0)	(100.0)	-
Derivative	3.0	(1.0)	-

The accrual of payments under the swap has been included within the interest payable line in the table to provide consistency with the other worked examples. It may be more appropriate, given that there is no designated hedging relationship for accountancy purposes, to present the net payments under the swap together with the fair value movements on the swap.

The fair value of the swaps, in practice, would can often be obtained from a finance house or bank.

Tax treatment: default position

If the company has not elected into regulation 9 then for tax purposes, XYZ Ltd would simply follow the amounts recognised in the income statement.

The tax result would be as follows:

Tax treatment: default position	**20X4**	**20X5**	**20X6**
Interest payable on loan (including net payment on swap)	7.0	7.0	7.0
Fair value movement on swap	(3.0)	4.0	(1.0)
Total tax deduction	4.0	11.0	6.0

In this case, the tax result is subject to significant volatility as it includes the fair value movements on the swap.

Tax treatment: XYZ Ltd elects into regulation 9

If XYZ Ltd elects into regulation 9, then this regulation will have effect because there:

- is a hedging relationship between the swap and the loan
- are no fair value movements on the loan that are being brought into account for tax

As a result, the fair value movements taken to the income statement on the swap are disregarded. Amounts under the swap are brought into account in line with an appropriate accruals basis of accounting. So the tax computation will include an accrual of the payments and receipts under the swap for the period in question.

Depending on the precise accountancy treatment adopted, this may well be (or close to) the amount of any swap payment included in the interest payable figure for the period.

The overall result is in line with Old UK GAAP (where FRS 26 is not applied).

Given all amounts that are disregarded under regulation 9 should at some point either reverse or be brought back into account, it can be essential to keep track of the cumulative position.

Transitional position

Accounting treatment

If you now assume that XYZ Ltd adopts FRS 102 for the first time in 20X5. Previously the company applied Old UK GAAP without the application of FRS 26. For accounting purposes the adoption of FRS 102 is applied retrospectively and therefore it restates its 20X4 figures (including in particular its balance sheet figures as at 31 December 20X4).

The accounting position is therefore:

Accounting treatment	20X4 (restated)	20X5	20X6
Income statement			
Interest payable on loan (including net payment on swap)	7.0	7.0	7.0
Fair value movement on swap	(3.0)	4.0	(1.0)
Loss before tax	4.0	11.0	6.0
Balance sheet position			
Loan payable	(100.0)	(100.0)	-
Derivartive	3.0	(1.0)	-

Tax treatment: default position

If the company has not elected into regulation 9 then its tax position will take into account a transitional adjustment under the 10-year spreading (as per The Change of Accounting Practice (COAP) Regulations 2004 (SI 2004/3271)).

Overall there is a transitional adjustment of £3 million under section 614 CTA 2009 as a result of the accounts recognising the fair value of the derivative of £3 million when previously it was not recognised. This transitional adjustment is dealt with as an adjustment to the company's accounting profit.

The tax position will therefore be as follows:

Tax treatment: default position	20X5	20X6
Interest payable on loan (including net payment on swap)	7.00	7.00
Fair value movement on swap	4.00	(1.00)
Loss before tax	11.00	6.00
COAP Regs - 10 year spreading	(0.30)	(0.30)
Total tax deduction	10.70	5.70
Transitional adjustment	*(3.00)*	*(2.70)*
10 year spreading	*0.30*	*0.30*
C/f	*(2.70)*	*(2.40)*

It can essential to keep a track of the remaining balance of the transitional adjustment that is being spread over the 10 years.

Tax treatment: XYZ Ltd elects into regulation 9

Regulation 9 will have effect in relation to the swap. No 10-year spreading is needed in respect of the transitional adjustment of £3 million as this amount is excluded under regulation 3C(2)(c) of the COAP Regulations. This transitional adjustment is effectively disregarded and will be dealt with under the Disregard Regulations.

The tax position will therefore be as follows:

Tax treatment: election made into regulation 9	**20X5**	**20X6**
Interest payable on loan (including net payment on swap)	7.00	7.00
Fair value movement on swap- disregarded	-	-
Total tax deduction	7.00	7.00
Transitional adjustment disregarded / b/f	*(3.00)*	*1.00*
Current period fair value movement disregarded	*4.00*	*(1.00)*
C/f	*1.00*	*-*

Given all amounts that are disregarded under regulation 9 should at some point either reverse or be brought back into account, it can be helpful to keep track of the cumulative position. This should include the transitional adjustment that was also disregarded.