

Example 2: fixed to floating interest rate swap (designated fair value hedge)

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 a designated fair value hedge. The example goes through the:

- [assumed facts](#)
- [ongoing position](#)
- [transitional position](#)

Scope

The paper assumes the following fact pattern:

- 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 20X4, XYZ Ltd borrows £100 million from an unconnected company under a 3 year loan which accrues interest at a fixed rate of 7%.

XYZ Ltd has a loan payable which bears interest at a fixed rate. The cash flows payable under the loan are therefore fixed and will not vary with changes in the London Interbank Offered Rate (LIBOR).

However, because of the fixed rate interest the fair value of the loan will vary as LIBOR changes. For example, if LIBOR decreased to 0.5% then the fair value liability of a loan with fixed terms at 7% would increase - in effect XYZ Ltd would be holding a loan which was more expensive than an equivalent floating rate loan. This means that should XYZ Ltd wish to terminate the debt early it may be required to pay the lender a substantial premium. Also, XYZ Ltd could be incurring a higher interest expense compared to companies that have borrowed on a floating rate basis.

Hedging instrument

Separately XYZ Ltd also enters into an interest rate swap which has the following terms:

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

The critical terms of the swap match those of the loan (for example, notional, maturity dates, payment dates, etc).

This swaps the overall interest rate profile from a fixed rate to a floating rate so that XYZ is now hedged against the fair value implications of future movements in LIBOR. As shown in the table below this means that as LIBOR changes the amount payable under the loan and swap, in net terms, will also change.

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

Hedging relationship

For purposes of this example it is assumed that XYZ Ltd meets the conditions for hedge accounting as set out in section 12 of FRS 102 and designates the interest rate swap as a fair value hedge of interest rate risk on the £100 million loan.

The ongoing position

Accounting treatment

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

The swap (the hedging instrument)

This is measured at fair value. The fair value movements on the hedging instrument are recognised in the income statement (being the FRS 102 term used for the profit and loss account).

The carrying value of the loan (the hedged item)

This is adjusted for the change in fair value attributable to the hedged risk with a corresponding entry recognised in the income statement.

The accounting is summarised below:

Accounting treatment	20X4	20X5	20X6
Income statement			
Interest payable on loan (including net payment on swap)	6.0	8.0	10.0
Fair value movement on swap	3.0	(4.0)	1.0
Fair value adjustment on loan	(2.8)	3.6	(0.8)
Loss before tax	<u>6.2</u>	<u>7.6</u>	<u>10.2</u>
Balance sheet position			
Loan payable	(97.2)	(100.8)	-
Derivative	(3.0)	1.0	-

The effective/ineffective element and the fair values assigned to the swap have been assumed for the purposes of this example. In practice a company would be required to determine the effective/ineffective amounts in accordance with relevant accounting practice while the fair value of the swaps, in practice, would most likely be obtained from a finance house or bank. The accounts may sometimes show the ineffective portion of the hedging relationship as a separate line item.

Tax treatment (irrespective of elections made)

In this example it does not matter whether XYZ has elected into regulation 9 or not. In particular, regulation 9 does not typically have effect with a simple designated fair value hedge because the fair value movements on the loan (the hedged item) in respect of the hedged risk are taxed in line with the accounts. (As a result, the condition in regulation 9(1)(b) is not satisfied). For tax purposes, XYZ Ltd would simply follow the amounts recognised in the income statement.

The tax result would be as follows:

Tax treatment (irrespective of elections made)	20X4	20X5	20X6
Interest payable on loan (including net payment on swap)	6.0	8.0	10.0
Fair value movement on swap	3.0	(4.0)	1.0
Fair value adjustment on loan	(2.8)	3.6	(0.8)
Total tax deduction	<u>6.2</u>	<u>7.6</u>	<u>10.2</u>

While this is close to the position that would be presented under Old UK GAAP (assuming FRS 26 had not been applied) there are likely to be some fluctuations over time to the extent of any hedge ineffectiveness.

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 figure will therefore be as follows (no change to the ongoing position):

Accounting treatment	20X4 (restated)	20X5	20X6
Income statement			
Interest payable on loan (including net payment on swap)	6.0	8.0	10.0
Fair value movement on swap	3.0	(4.0)	1.0
Fair value adjustment on loan	(2.8)	3.6	(0.8)
Loss before tax	<u>6.2</u>	<u>7.6</u>	<u>10.2</u>
Balance sheet position			
Loan payable	(97.2)	(100.8)	
Derivative	(3.0)	1.0	-

Tax treatment: XYZ Ltd (irrespective of any elections made)

Going forwards, therefore, the tax treatment will simply follow the income statement. However, it may be necessary to bring a net transitional adjustment into account under the 10-year spreading. This will particularly be the case where there is hedge ineffectiveness.

Overall in this example there is a net transitional adjustment of £200,000 under sections 316 and 614 CTA 2009 as a result of the accounts recognising the fair value of the derivative of £3 million and the fair value of the loan of £2.8 million when previously the respective fair values were not recognised.

The tax position will therefore be as follows:

Tax treatment (irrespective of elections made)	20X5	20X6
Interest payable on loan (including net payment on swap)	8.00	10.00
Fair value movement on swap	(4.00)	1.00
Fair value adjustment on loan	3.60	(0.80)
Loss before tax	<u>7.60</u>	<u>10.20</u>
COAP Regs - 10 year spreading	0.02	0.02
Total tax deduction	<u>7.62</u>	<u>10.22</u>
<i>Transitional adjustment</i>	<i>0.20</i>	<i>0.18</i>
<i>10 year spreading</i>	<i>(0.02)</i>	<i>(0.02)</i>
<i>C/f</i>	<i>0.18</i>	<i>0.16</i>

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