

## Example 3: fixed to floating interest rate swap (designated fair value hedge of connected party debt)

### 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 between connected parties. 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 20X4, XYZ Ltd borrows £100 million from a fellow group 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 this means that as LIBOR changes the amount payable under the loan and swap, in net terms, will also change.

Cashflows				
Loan principal		100.0		(100.0)
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)

### Hedging relationship

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. 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 loan (the hedged item)

This is measured at amortised cost. The carrying value of the loan is then adjusted for the fair value risk being hedged by the swap with this movement recognised in the income statement.

The accounting is summarised below:

Accounting treatment	20X4	20X5	20X6
<b>Income statement</b>			
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>
<b>Balance sheet position</b>			
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. The fair value of the swaps, in practice, could normally be obtained from a finance house or bank.

### Tax treatment (irrespective of elections made)

The loan is with a connected company and hence section 349 CTA 09 applies to the loan. This requires an amortised cost basis of accounting to be used for tax purposes, without any fair value adjustments being taxed or relieved.

Regulation 9 will therefore have effect in respect of the swap because:

- there is a hedging relationship between the swap and the loan
- the fair value adjustments on the loan are not being brought into account for tax

Note that regulation 9 is assessed irrespective of whether the company has made an election under regulation 6(1) of the Disregard Regulations as this is a designated fair value hedge.

The tax results would be as follows:

<b>Tax treatment (irrespective of elections made)</b>	<b>20X4</b>	<b>20X5</b>	<b>20X6</b>
Interest payable on loan (including net payment on swap)	6.0	8.0	10.0
Fair value movement on swap - disregarded	-	-	-
Fair value adjustment on loan - prohibited (s349 CTA 2009)	-	-	-
Total tax deduction	<u>6.0</u>	<u>8.0</u>	<u>10.0</u>
<i>B/f</i>	-	3.0	(1.0)
<i>Current period fair value movement disregarded</i>	<u>3.0</u>	<u>(4.0)</u>	<u>1.0</u>
<i>C/f</i>	3.0	(1.0)	-

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:

<b>Accounting treatment</b>	<b>20X4 (restated)</b>	<b>20X5</b>	<b>20X6</b>
<b>Income statement</b>			
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>
<b>Balance sheet position</b>			
Loan payable	(97.2)	(100.8)	-
Derivative	(3.0)	1.0	-

### Tax treatment (irrespective of elections made)

The loan is required to be held on an amortised cost basis of accounting. As a result, the loan is treated as being held at £100 million and no transitional adjustment arises on the loan.

Regulation 9 will have effect in relation to the swap in this example. As a result, no 10-year spreading is needed in respect of the transitional adjustment on the swap of £3 million. (This amount is excluded under regulation 3C(2)(c) of the COAP Regulations (SI 2004/3271)). This transitional adjustment is effectively disregarded and will be dealt with under the Disregards Regulations.

The tax results will therefore be as follows:

<b>Tax treatment (irrespective of tax elections made)</b>	<b>20X5</b>	<b>20X6</b>
Interest payable on loan (including net payment on swap)	8.00	10.00
Fair value movement on swap - disregarded	-	-
Fair value adjustment on loan - prohibited (s349 CTA 2009)	-	-
Total tax deduction	<u>8.00</u>	<u>10.00</u>
<i>Transitional adjustment disregarded / b/f</i>	3.00	(1.00)
<i>Current period fair value movement disregarded</i>	<u>(4.00)</u>	<u>1.00</u>
<i>C/f</i>	<u>(1.00)</u>	-

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. This should include the transitional adjustment that was also 'disregarded'.