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Dear Richard

Representations of the International Swap Dealers Association ("ISDA") on the latest draft of the Disregard Regulations

I enclose our comments on the latest draft of the Disregard Regulations, which were issued for comment on 18 June 2004.

If you have any questions on the content of the attached paper please contact:

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Yours sincerely,

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Regulation 2

1 It should be made clear that hedging relationships have to be between assets and liabilities, etc. held by the same company. We assume that is the intent. At present the regulations appear to permit hedging between assets and liabilities in different companies. While not objectionable per se, this would raise issues that would require additional thought.

2 The reference to "(such as all or some future interest payments on variable rate debt)" should be deleted to avoid any confusion as to whether Regulation 2(3) applies to a derivative which is used to hedge a fixed rate loan.

3 The scope of the Regulation 2(3) should be extended to derivatives which are used to hedge future cash flows, forecast transactions or firm commitments.

4 Regulation 2(3) should apply to cases where a loan or derivative is used as a partial hedge so that it will, for example, cover portfolio hedging. Generally, the operative regulations also need to cope with hedging outside a simple 1:1 hedge/hedged item relationship. See below.

Regulation 3

1 We are not sure that Regulation 3 (and 5(2)) should only permit FX matching where there is an effective hedge for IFRS purposes. The IFRS hedging criteria are tight. Is it clear they are not too tight for these purposes?

2 Regulation 3(2) (excluding FX matching) should only apply where (i) the company uses fair value accounting in relation to the asset, *and* (ii) the asset is accounted for on a fair value basis for tax purposes, *and* (iii) the asset is treated as an income item for tax purposes.

3 Ignoring the point at 1 (i.e. assuming Regulation 3 is written to piggy-back off IFRS "FX matching"); is the consolidation hypothesis in the current draft the correct one? We understand IFRS only permits "FX matching" at the consolidated level (para 32 IAS 21 and para 102 IAS 39). Should not the hypothesis therefore be not that the liability is not eliminated on consolidation but that IFRS permits solus matching …. otherwise how does the tailpiece to Regulation 3(1)(b) work in the context of solus accounts?

4 The wording of Regulation 3(b) would in any case be clearer were the words "the liability were one of" should be moved to the start of 3(b)(i).

5 It should be made clear that Regulation 3 is only intended to apply when the asset and liability are in the same company (assuming this is the Inland Revenue's intention see above).

6 Does the Regulation work properly where there is not a 1:1 hedging ration between liability and assets? Or does there need to be apportionment language to deal with partial hedges, hedges relating to different items, etc.?

Regulation 5

1 The wording of Regulation 5(1)(a) and (2) need to track the opening wording of Regulation 3 (i.e. the company is entering into the currency contract to enable it to reduce or eliminate the effect of changes in exchange rates in relation to an asset).

2 The comments at 1 – 6 on Regulation 3 apply mutatis mutandis to Regulation 5(2).

3 The comments at 2, 5 and 6 on Regulation 3 also appear to apply mutatis mutandis to Regulation 5(3).

4 There needs to be provision to deal with the interaction of Regulation 5 and 7 in a case where a currency swap is (say) used to "match" an asset and the swap is accounted for on a fair value basis under IAS 39. In such cases a mechanism is required to determine how the fair value movements on the contract are to be split between exchange movements and movements in respect of the fair value of future periodic payments due under the terms of the contract. Presumably the intention is FX matching should take priority over Regulation 7? This suggests the need for a definition of exchange gains and losses for Regulations 3 and 5 and a rule that Regulation 7 does not apply to the extent these earlier regulations do.

Regulation 6

1 The Regulation perhaps needs to be amended to make it clear that it only applies *to the extent* that there is a hedging relationship between the contract and the hedged item (i.e. again to deal with non 1:1 hedging, assuming this is the intention).

2 The Regulation should not apply to the extent that the hedged item is accounted for on a fair value basis and this treatment is followed for tax purposes (and perhaps also in this case if the asset is not an income asset – see below).

3 The definition of "fair value profit and loss" appears to have the effect of eliminating all profits from the hedge from charge in all periods when it is fair valued. Presumably the intention is they are brought into charge at some point and on some basis? Is it still intended to achieve this by separate Regulations?

Regulation 7

1 Regulation 7(1)(a) should be redrafted to read as follows:

(a) there is a hedging relationship between the contract or a portion of the contract and the whole or any portion (the "relevant proportion") of the risks arising in respect of an asset, liability, receipt or expense (the "hedged item"); and

(b) the hedged item is not one to which, or to the relevant portion of which, profits and losses are recognised for tax purposes on a fair value basis for that period.

2 The opening words of Regulation 7(2) should be amended to read “to the extent paragraph (1) applies”.

(Both points 1 and 2 deal with the issue of non 1:1 hedging which we have already touched on a few times. This may arise in a variety of different ways. E.g. a single derivative hedging a number of different items (e.g. a portfolio swap relating to fair valued bonds and equities and amortised cost loans and receivable). E.g. more than one derivative hedging different risks in a single hedged item (e.g. a currency swap of an amortised cost loan and then a further interest swap of the interest on the loan). E.g. a partially effective fair value hedge of a single asset where more than one accounting treatment applies even though there is a single asset or liability.

The general principle here is presumably that the Regulation should iron-out timing differences between a derivative fair valued under IFRS and risks in hedged items that are not fair valued.

Against that objective there appear in principle two ways of dealing with non 1:1 hedging; either:

(a) apportioning the hedges and hedged items

(b) writing out a comprehensive set of rules to deal both with the entirety of the hedge and hedged items whenever there is a non 1:1 hedge.

To us (a) seems simpler; see suggested wording in 1 above. Further thought needs to be given as to whether the apportionment over time will ensure profits are taxed once and once only; but the same thought process would have to be gone through with (b) anyway.)

3 Regulation 7 should be extended to cover currency contracts as well as other derivatives which are used to hedge income assets and liabilities (i.e. excluding capital gains items) as well as future payments and receipts.

(If the principle is that timing differences between income hedges and income hedged items should be ironed out there is no need, and it appears wrong in principle, to limit Regulation 7 to interest rate contracts, even widely defined so as to include any contract that includes an interest rate amongst its underlying subject matter.

Query, if Regulation 7 is generalised in this way, whether there is a need for Regulation 6?

We assume Regulation 7 would not apply where the hedge relates to a capital gain or loss on a CGT item. Post-tax effective hedges of CGT items require the use of CGT hedges. There is little additional benefit having accruals income treatment for a hedge of such items rather than fair value income treatment for the hedge. We suggest adding “but are taxable as income rather than as capital gains for tax purposes” at the end of our suggested 7(1)(b) to deal with this point. Contrast this with FX matching in Regulations 3 and 5 where the hedged item may of course be a CGT asset. We would note that this is generally only likely to be an issue with property derivatives as derivatives over most CGT assets would be excluded from the derivative contracts legislation)

4 If Regulation 7 were to stay in its current form we would be grateful for confirmation that the RPI would be treated as being a rate of interest.

5 Where an "appropriate accruals basis" is not used, it seems to us be easiest by far to provide that payments and receipts due under the contract, as well as exchange movements on the contract, should be recognised for tax purposes on the same basis as they would have been recognised under an authorised accruals basis of accounting within the meaning of paragraph 17 of Schedule 26 to the Finance Act 2002, as it had effect for accounting periods beginning before 1 January 2005. Notwithstanding the possible prejudice against perpetuating historic accounting concepts, this would provide some certainty of treatment in the short term; have the benefit of familiarity for taxpayers and tax inspectors; largely be what taxpayers want at the substantive level; and have the ballast of the existing accounting methodology to protect both taxpayers (and the Inland Revenue) from the vagaries of a free floating concept which exists only in the words of the statutory instrument, particularly given that there has been little time to think through those words. Doubtless examples could be included in the Corporate Finance Manual in order to provide guidance for the future on what would be an acceptable treatment.

6 If the existing wording is to be retained then the reference in 2(3)(a) to "periodical" payments should perhaps be changed to "periodic". Secondly, the wording would need to be expanded to cover, for example, any premiums or discounts receivable on entering into the contract as well as any termination payments in circumstances where, for example, the termination payment might be spread over future accounting periods (as is currently permitted under the derivative contracts legislation). There are likely to be other possible payments under a derivative contract and the Regulations would need to be drafted in such a way so as to apply to all possible payments.

7 It will be necessary to include wording to deal with the interaction of Regulations 5 and 7 where a currency swap is used to hedge an asset (for example shares). In such cases the Disregard Regulations should ensure that the periodic (income) payments can be dealt with on an accruals basis (see comment 4 on Regulation 5 above).