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Tuesday, 10th February 2004

Dear Kunle Ogundele

Representations of the International Swap Dealers Association (“ISDA”) on the Proposed New Approach to the Taxation of Derivatives Based on Property and Share Values

ISDA welcomes the opportunity to take part in the consultation on the proposed new approach to the taxation of derivatives based on property and share values announced in the pre-Budget report.

As a general point ISDA notes that if CT reform takes place in a year or two it is likely that all derivatives will at that stage fall to be taxed under a follow -the-accounts income regime. Bearing that in mind ISDA believes that, absent compelling reasons to the contrary in particular contexts, it is desirable to keep change to the minimum necessary in the interim:

(a) so that companies and their advisers who have already familiarised themselves with the existing rules are not put to the time and trouble of having to absorb a second set of changes that are themselves likely to be superseded in short order;

(b) to minimise disruption in particular cases where derivatives move from regime to another and then to a third, no doubt with the possibility of transitional adjustments at each stage.

In addition to that general point, ISDA has the following specific points.

A: Equity Derivatives

ISDA notes the changes here cover two broad points:

First Point: computing CGT on an accounts basis for capital equity derivatives by subjecting them to a CGT charge within the computational rules of Schedule 26, and taking them out of ss.143 -4 TCGA:

Second Point: redefining the boundary between income and capital equity derivatives by, in particular, (i) bringing all “swaps” within the income regime, and (ii) abolishing the mixed and small and subordinated USM provisions:

Taking those points in turn:

First Point

ISDA is strongly opposed to this point for the following reasons:

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- the primary commercial use for capital equity derivatives is to hedge real equity positions. This change will render such hedges ineffective post-tax: the real position will be taxed on a realisations basis with indexation; the derivative on an accounts basis without indexation. Accordingly gains or losses on a hedging derivative may well arise earlier or later than the associated losses or gains on the underlying asset. In addition, since allowable losses cannot be carried back from one accounting period to the previous accounting period, non-traders holding derivatives across an accounting reference date could well be subject to tax on something other than their overall measure of profit and loss on the equity and derivative combined.
- ISDA believes the negative impact of the proposals on equity hedges is a point of considerable commercial significance, introducing a lack of neutrality to the detriment of both taxpayers and, potentially, the Exchequer.
- the secondary commercial use for capital equity derivatives is to create synthetic equity assets. The “correct” policy here is for such derivatives to be taxed on a symmetrical basis with actual equities – i.e. on traditional CGT lines (realisation plus indexation) for so long as real equities are taxed on that basis; and on a follow-the-accounts basis if and/or when real equities are taxed on that basis following CT Reform. ISDA sees no justification for introducing a non-symmetrical treatment that means returns from derivatives are taxed differently from equivalent returns from real assets. To do so seems to run counter to Government policy of minimising the impact of tax on commercial decisions, as set out in the CT Reform consultation documents.

In summary, ISDA believes this aspect of the proposed changes is detrimental in absolute terms, and in addition will also carry the costs of change already noted.

Second Point

ISDA is opposed to this second point for the following reasons:

- ISDA considers the existing rules demarcating the boundary between income and equity derivatives, while admittedly complex, function well enough to permit parties to hedge income with income derivatives and capital with capital derivatives
- ISDA is opposed to the introduction of the concept of a “swap” into legislation that already has specific definitions. ISDA believes that it is important that tax law definitions should be consistent across all types of derivative.
- ISDA considers the proposed changes will not achieve any greater simplicity. They will simply replace one relatively complex line with another relatively complex in broadly the same position. Bearing in mind ISDA’s initial comments regarding the costs of change, ISDA does not consider this change worthwhile in the equity context.
- ISDA also considers that, judged in absolute terms, the way in which the new proposals would demarcate the capital/income boundary in this context to be slightly inferior to how the current rules do so for two reasons:
 - ISDA consider the notion of a “swap” defined by market usage to be no clearer than the current rules and, on balance, probably a bit less clear;
 - at the margin, ISDA considers this aspect of the proposals may not be as flexible or work so well with complex derivatives with mixed USM as the current rules.

B: Property Derivatives

ISDA notes the proposed property derivatives changes:

- have been the subject of extensive consultation with the UK property industry

- are intended to facilitate the creation of a property derivatives market in the UK; an objective that ISDA supports. ISDA understands that there is considerable commercial interest in such a market, Accordingly ISDA considers this is an area where, if tax changes are necessary to facilitate the development of that market, they should be made now and the matter should not be left to rest until the advent of CT Reform, notwithstanding the general comments made in 1 above.

ISDA also notes that the proposed changes in relation to property derivatives fall under the same two broad headings as the proposed equity derivatives changes, viz:

First Point. computing CGT on an accounts basis for capital property derivatives by subjecting them to a CGT charge within the computational rules of Schedule 26, and taking them out of ss.143-4 TCGA:

Second Point. redefining the boundary between income and capital property derivatives by, in particular, (i) bringing all “swaps” within the income regime, and (ii) abolishing the mixed and small and subordinated USM provisions.

ISDA has the following comments in relation to these two points:

First Point

If the property sector is certain that it wishes this change for its own sector ISDA would support it. But:

(a) ISDA is not clear why this change should be thought desirable in that sector: as a general matter it seems to carry the same problems as in the equity derivatives field (see above);

(b) also as a general matter, ISDA considers it an undesirable additional complication to have special rules for property derivatives unless absolutely necessary.

ISDA would therefore welcome the opportunity to discuss further whether this change really is desirable for property derivatives. ISDA understands that the change may have been driven by the wish to ensure effective relief for losses on property derivatives. Obviously ISDA supports that objective. But ISDA is not clear why the current rules, if necessary supplemented at the margin with appropriate guidance, should not have been thought sufficient in this regard.

Second Point

ISDA understands that the changes here are intended to ensure that companies can with confidence achieve income treatment for rental hedges and capital treatment for hedges of the capital value of property.

ISDA supports that objective; which takes forward what it believes to be the correct overriding policy objective in this area, i.e. neutrality (see above).

ISDA believes that such changes were thought necessary to achieve this. But ISDA would again have thought that the existing rules (perhaps with a bit of extra guidance from the Revenue, and maybe minimal changes such as clarifying that rent is a separate USM from land) would have permitted parties to write their contracts to achieve the same result.

ISDA again considers it unhelpful for the rules for property derivatives to differ in this regard from those for other derivatives.

ISDA would be happy to offer its technical assistance in discussing more minimal changes to achieve the same objectives, if that is helpful.

1 C: Other/Specific Points

a) Property Derivatives and Withholding Tax

We would suggest that it be made clear that payments under property derivatives can be made without deduction of tax under the “non resident landlords scheme” contained in section 42A TA 1988 and regulations made thereunder.

Where a payment is made by a company (which computes its profits and losses under the derivative contract under Schedule 26 FA 2002), the existing paragraph 51 of Schedule 26 should prevent any obligation to withhold tax from arising. *It would be helpful, however, if this could be made clear in guidance.*

However, it may be that persons other than companies (for example pension funds), enter into property derivatives and these persons would not be able to benefit from paragraph 51 of Schedule 26. *We would, therefore, suggest that a separate exclusion be enacted preventing such persons from being obliged to deduct tax under the non-resident landlords scheme.*

The reasons for this representation are as follows:

- Assuming that property derivatives are likely to be documented under the ISDA Master Agreement which is intended to document transactions under which sums can be paid without deduction or withholding of tax, the parties to any transaction documented under an ISDA Master Agreement typically represent and warrant to each other that they can make any payments due without deduction of tax. In the event that tax does fall to be withheld, the paying party would typically be obliged to “gross up” the relevant payment, resulting in a significant extra cost
- Pursuant to paragraph 3 of the Taxation of Income from Land (Non-residents) Regulations 1995 (the “**Regulations**”) the Inland Revenue can issue a notice to any person who makes a payment to a non-resident, which constitutes income of a Schedule A business of that non-resident, requiring that person to withhold income tax from the payment.
- A counterparty to a derivative with a non-resident will probably not know whether the non-resident’s receipts under the derivative will be income of a Schedule A business or not. In addition, since it could in theory be issued with a direction under paragraph 3 of the Regulations, the counterparty will have difficulty giving the standard representation that no withholding is required. Even if the non-resident is entitled to receive Schedule A income gross under paragraph 17 of the Regulations, the Inland Revenue can withdraw this right at any time, and such withdrawal could expose the counterparty to a gross-up cost.
- In short, the existence of any circumstance in which payments under property derivatives could be subject to withholding will, in our view, introduce an unacceptable level of uncertainty which would significantly impair the growth of the market in this area. A very similar concern led us to make representations, when the derivative contract rules were originally introduced, to the effect that paragraph 51 of Schedule 26 FA 2002 had to confer an unequivocal right to make payments gross under derivative contract rules. The Inland Revenue took notice of this concern in 2002, and we hope that they can do so again in the context of this consultation.

(b) Substantial Shareholdings Derivatives

ISDA understands the Inland Revenue have previously discounted exempting from tax derivatives hedging substantial shareholdings for reasons, primarily, of complexity – even though in overall policy terms tax neutrality would suggest such derivatives should be exempt.

ISDA considers, however, that this question should be revisited in the light of upcoming developments:

(a) CT Reform – if so much other complexity is taken out of the system, it would seem to ISDA the system could cope with a little more complexity here, to achieve a “correct” neutral policy outcome in an important commercial context: ISDA considers the persistence of non – neutrality here represents a significant fetter on parties arranging their affairs on the basis that, absent tax considerations, is in their best commercial interests;

(b) IAS – ISDA understands that as part of this consultation the Revenue may consider introducing certain changes to the tax legislation that would identify areas, particularly in relation to hedge accounting, where it would not be appropriate to follow the new accounting standards. It would appear opportune to consider extending that to substantial shareholding hedges. In particular, during that consultation the Inland Revenue will no doubt need to solve the anti-avoidance considerations that might otherwise militate against exemption for substantial shareholdings derivatives. And in principle one would have thought that answering those questions in that context should answer them in the substantial shareholdings context as well.

(c) Miscellaneous Drafting Points on Proposed Changes

- Article 3(a)(i) - agreed
- Article 3(b) - agreed
- Article 3(d) – agreed
- Article 6(6) – agreed

The other changes relate to the more general points made above.

2 Et Cetera

Should you wish to discuss any of these representations in more detail, we would be delighted to attend a meeting, or to discuss them over the phone. Please contact either Rachel Short, Chair of the European Tax Committee on (020) 7986 6213 or Ed Duncan at ISDA on 020 7330 3573 if you think this would be helpful.

Yours sincerely,



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