

ISDA

International Swaps and Derivatives Association, Inc.
One New Change
London EC4M 9QQ
United Kingdom
Telephone: 44 (20) 7330 3550
Facsimile: 44 (20) 7330 3555
email: isdaeurope@isda.org
website: www.isda.org

David Garlick
HM Customs and Excise
Business Services and Taxes
Thomas Paine House
Angel Square, Torrens Street
London
EC1V 1TA

March 14th, 2005

CC Edward Troup, Ian Spence

Dear Sirs

Swap Premia

We refer to certain correspondence and forthcoming meetings between HM Customs & Excise and various banks and derivatives houses concerning the VAT treatment of a premium paid to enter into a currency swap contract documented on standard-form ISDA documentation.

While that correspondence and those meetings concern swaps derived from a particular context that ISDA understands the Inland Revenue to consider abusive, ISDA's concern is that the arguments presented by Customs affect a much wider range of derivative transactions that are both entirely commercial and commonplace in the market, such that they may affect many persons who have not participated in these particular swaps at all. This is a matter of significant market concern.

Our understanding of the position is as follows:

- a) the contracts in question are documented on standard-form ISDA documentation, with the relevant payments under the swap specified in Confirms under the relevant ISDA Master, in the same way as any other ISDA derivative;
- b) as with typical currency swaps, these swaps involve an exchange of currency principals at maturity of the swap and the payment of interim interest-related flows in the meantime;
- c) these swaps may or may not involve an initial exchange of currency principals, in the same way as typical currency swaps;

- d) their noteworthy feature lies in the fact that a significant premium is paid by one party to the other to enter into the swap, with a correlative adjustment to the FX implied in the final (and, presumably, where relevant, initial) exchange of currency principals, such that the swap overall remains on arm's length terms taking into account the premium;
- e) from the correspondence sent out, it appears the premium is documented in the Confirm for the swap in the same way as the other swap payments and is expressed to be in consideration of the entry into of the swap.

The existence of a premium of this sort is, of course, somewhat unusual in the context of a paradigm currency swap contract. But it is entirely unremarkable in the context of many types of cash-settled derivatives encountered in the markets and documented on ISDA documentation; e.g. option premia, swaption premia, premia for forward contracts, etc. And as a general matter, of course, the ISDA documentation permits parties to configure their payments in any pattern they wish to suit their circumstances.

Legal Analysis

There appears to be no relevant legal difference at general law between the nature of the payment obligation for the premia in this case and the premia one encounters in those other cases. In each instance the premia are payable under the terms of the relevant Confirm. That payment obligation has the same quality as any other cash-payment obligation under ISDA documentation: namely an obligation to pay cash in accordance with the terms of the contract, conditional upon no close-out netting event having occurred (1992 ISDA Multi-Currency Cross Border Master Section 2(a)(iii)). Each Confirm in turn forms part of a single legal contract consisting of the relevant ISDA Master between the parties and all Schedules, Annexes and Confirms (Section 1(c)). In the correspondence sent out it appears to be the case that the drafting explicitly styles the premia to be in consideration of the entry into of the swap documented in the Confirm, but it is hard to see any significance in this for present purposes because, as a legal matter, each and every payment obligation in a cash-settled derivative is of course in consideration of the obligation on the counterparty to make payments in return.

VAT Treatment

Based on the above legal analysis, we can see no basis to distinguish the premia in this case from any other premia for or payment under any other type of cash-settled derivative where it is long-since established for VAT purposes that those payments are either exempt dealings in money or, depending on the circumstances, outside the scope of VAT.

In this regard we note that Customs current practice (see paragraph 2.3.1(i) of notice 701/9/02) is that "...the supply of cash settled contracts for a consideration as a principal is exempt from VAT". We would say that we are in complete agreement with the correctness of Customs' statement on this point.

In our view the correct position is very clear indeed, tantamount to axiomatic. VAT is generally concerned with the substance of economic relations and the substance of any cash-settled

derivative is that cash payments are made in return for other cash payments. On this basis the services supplied are correctly viewed as consisting of a dealing in money for the purposes of VATA 1994, Schedule 9 Group 5 Item 1. And we also note that the relevant head of exemption under the Sixth Directive is for transactions concerning currency (Article 13, B, (d) 4. On this basis in our view it is clear the relevant supplies are either exempt or outside the scope.

Given the novelty of the argument and the width of its potential application, we are concerned that any suggestion that premia or other payments under a derivative contract are subject to VAT, or any uncertainty as to the VAT treatment of such contracts, would have a significant adverse affect on our members and on the London derivative market as a whole.

We should add that we have seen, and fully support, the letter addressed to you from LIBA dated March 2005.

We would be happy to discuss this further, if you wish, please contact Ed Duncan, Director of European Policy at ISDA on 020 7330 3574.

Yours faithfully



Rachel Short
Citigroup
Chair of the ISDA Committee



Ed A. Duncan
Director of European Policy
ISDA.