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By Post & Email

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Ref: Response to the consultation on possible changes to income tax rules on interest published on 27 March 2012

The International Swaps and Derivatives Association's (ISDA[1]) European Tax Committee welcomes the opportunity to respond to the consultation on possible changes to income tax rules on interest published on 27 March 2012.

We understand that a number of other industry bodies operating in the financial markets and in other sectors, as well as professional bodies and advisers and other interested parties, are going to respond to the consultation. As a result, ISDA will not respond specifically to each question set out in the consultation but only to those issues pertaining to the derivatives markets.

With that in mind we would like to focus on three aspects of the consultation that we consider could impact adversely on the UK derivatives market, as follows:

1. The proposal in Chapter 4 of the Consultation to abolish the distinction between yearly and short interest and its impact on payments of interest on cash collateral.
2. How those changes and the proposed changes to Chapter 5 might impact administratively on the selection of eligible collateral.
3. The pitfalls to be avoided in relation to the disguised interest rules in Chapter 7.

[1] Since its founding in 1985, ISDA has worked to make over-the-counter (OTC) derivatives markets safe and efficient. ISDA's pioneering work in developing the ISDA Master Agreement and a wide range of related documentation materials, and in ensuring the enforceability of their netting and collateral provisions, has helped to significantly reduce credit and legal risk. ISDA has been a leader in promoting sound risk management practices and processes, and engages constructively with policymakers and legislators around the world to advance the understanding and treatment of derivatives as a risk management tool. Today, ISDA has more than 800 members from 55 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on OTC derivatives to efficiently manage the financial market risks inherent in their core economic activities. ISDA's work in three key areas – reducing counterparty credit risk, increasing transparency, and improving the industry's operational infrastructure – show the strong commitment of ISDA toward its primary goals; to build robust, stable financial markets and a strong financial regulatory framework.

A party to a swap may have to put up collateral depending on various factors such as risk and the relative credit ratings of the parties as is recognised in HMRC's Corporate Finance Manual (see e.g. CFM13240 and CFM13250).

1. Cash collateral

Such collateral may be in any form agreed between the parties but often it is high grade assets of cash or bonds. Where cash is posted as collateral, it is understood that an obligation to withhold UK income tax from interest payments may arise under current law depending on whether the interest is yearly or short interest. This is the case even though there is a specific exemption from the obligation to deduct any income tax from derivative payments under s 980 Income Tax Act 2007 (ITA 2007). If a more holistic approach were taken as we have understood might be the case, we would propose a similar broad exemption for withholding tax for interest on cash collateral. Nevertheless, given our understanding of current law, it can be relevant whether the interest is short or yearly and this question is determined according to basic principles and depends on the intention of the parties at the time of the transaction. Where the interest is short interest, there will be no withholding as respects interest on the cash collateral as it is not 'yearly' for the purposes of s 874 ITA 2007. In this situation, there is no need to consider whether exemptions may be available.

We would strongly oppose the distinction between short and yearly interest being dropped unless this change is simultaneously accompanied with a broad introduction of an exemption for payments of interest on cash collateral.

If interest on cash collateral which is short interest were to be subject to a withholding tax, conceivably, exemption may be available for interest paid by a bank or an authorised dealer in financial instruments in the ordinary course of business (s 878 ITA 2007 and s 885 ITA 2007) or for interest paid to a UK resident company or a non-UK resident company within the charge to UK corporation tax or certain entities enjoying a special tax status or partnerships of the same (s 930 ITA 2007) or for interest paid to a treaty-entitled counterparty pursuant to an applicable double taxation treaty.

The first two exemptions are limited in scope and would not be available to most corporates and, even for banks and financial instrument dealers to which they do apply, would involve some additional administration to ensure that the conditions are satisfied.

The second two exemptions are even more administratively burdensome requiring, for the s 930 exemption, adequate evidence to found a reasonable belief that the exemption is available, and in the case of treaty relief the need to claim treaty relief with the inherent delays involved in that process (even if the passport scheme is available which may not be the case as a general matter irrespective of whether the counterparty holds a passport) and the possibility that the relevant double tax treaty does not fully exempt interest payments.

Reliance on the absence of a requirement to withhold tax from "short" interest is relatively certain and straightforward and whilst less attractive than a blanket exemption from interest on cash collateral it is infinitely preferential to the situation where an exemption would be needed.

2. Eligible collateral

The second area which we have comments relates to which securities may be considered as eligible collateral by the parties and the concern is that the tax rules may increase in relevance if the "short" v "yearly" distinction is removed, and the Eurobond exemption is amended. When determining which types of securities are eligible as collateral, in addition to its quality, as an administrative matter the collateral taker wants to be satisfied that there will be no tax obligations on the receipt of any income on the collateral or the payment on of any income on the collateral (as we have noted above in relation to cash collateral). Where collateral is bonds, the collateral taker will want to ensure there is no withholding tax on those bonds and will need to have procedures to identify that this is the case. Currently, for UK commercial paper and longer dated securities which are Eurobonds, tax rules do not impact the determination of whether those securities are eligible collateral. We strongly believe that no adverse changes to the withholding tax treatment of securities with a UK source should occur as, at best, it would add further administrative burdens, and at worse, those types of securities may become less attractive as eligible collateral.

On a positive note, we welcome a statutory definition on source which would be limited to UK resident issuers or those securities issued by a UK branch.

3. Disguised interest rules

We have a concern regarding the potential impact of the proposal in Chapter 7 of the Consultation to introduce a disguised interest rule for income tax purposes, in Part 4 of Income Tax (Trading and Other Income) Act 2005, which would be modelled broadly on the provisions in Part 6 of the Corporation Tax Act 2009. We strongly recommend that any new rules introduced should contain an exemption that payments under a derivative contract will not be re-categorised as "disguised interest". Finally, are we correct to assume that the disguised interest proposals will affect only the treatment for the recipient of affected amounts, and will not affect the position as regards withholding tax on such amounts?

We hope you find ISDA's comments useful and informative. Should you have any questions or would like clarification on any of the matters raised in this letter please do not hesitate to contact the undersigned. We would be happy to meet with you to discuss these points.

Yours faithfully,

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