PO-CH/NL/0510
PART A

PO CH/NL/0510
PART. A

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PART. A

1989 BUDGET
INTEREST RATE
SWAPS

20-2-89

THIS FOLDER HAS BEEN
REGISTERED ON THE
REGISTRY SYSTEM

Inland Revenue

Policy Division
Somerset House

FROM M A JOHNS

DATE 1 SEPTEMBER 1988

FINANCIAL SECRETARY

INTEREST SWAPS

Mr Gray's note below asks for your authority to start consultations on the tax treatment of interest swap payments with a view to introducing a new system. Our present practice was devised to fit a new financial instrument into old law but it is clear that it is neither consistent with a correct interpretation of the law nor very satisfactory in itself. What we propose broadly is that swap payments should be assimilated to the taxation of interest which is for most purposes what companies see these payments as. The main exception is that we would not require the payer to deduct tax at source from the net swap payment.

We think this should be generally acceptable to the taxpayers involved (mainly banks and corporate treasurers). It is very similar in effect to proposals made by the BBA. The main gainers would be financial firms which are not treated as banks for tax purposes who are at present unable to arrange swaps without the requirement to deduct tax under our practice. But the cost would be small because at present they are either out of the market or disregarding the rules (and no one is catching

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cc Chancellor of the Exchequer
Chief Secretary
Economic Secretary
Paymaster General
Mr Scholar
Mr Peretz
Mr Ilett
Mr Gilhooly
Mr Cropper
Mr A Clark (Bank of England)

Mr Painter
Mr Beighton
Mr Johns
Mr J R Calder
Mr Bush
Mr J F Hall
Mr K Skinner
Mr I Hunter
Mr Bryce
Mr Moule
Mr Spence
Mr Templeman
Mr J W Calder
Mr Keith
Mr Gray

them). We will need defences to stop multinationals exploiting the arrangements by cross boarder swaps (similar to the problems on thin capitalisation). We suggest we go into the consultations

proposing the same safeguards as for interest plus anything that comes out of the thin capitalisation consultation exercise. The representative bodies may use the consultations as an opportunity to ask for other changes on swaps, in particular, changes on exchange gains and losses on currency swaps but we would expect them to accept the two issues can be kept separate.

If you agree to this approach and it meets favour in consultations it will require legislation: an extra statutory concession would leave us unable to charge tax in some circumstances where a charge would be appropriate and would also leave us unable to enforce any safeguards. However, it will take a bit of time to draft a paper for circulation to the interested parties and we do not see it very likely that we can complete consultations in time for the 1989 Finance Bill. In the meantime, as we have come to the conclusion that our present practice is extra statutory, we need to mention it to the NAO, but publication does not seem appropriate until the consultation process is complete.

If you agree we will draft a consultation document for your agreement. You may want to discuss now or when we have a draft.

'M. Scofield'
for M A JOHNS

Inland Revenue

Policy Division
Somerset House

FROM: A C GRAY

DATE: 31 August 1988

See covering note

1. MR JOHNS MAJ 31/8

2. FINANCIAL SECRETARY

TAX TREATMENT OF INTEREST SWAP PAYMENTS

OUTLINE

1. This note is about the tax treatment of a financial instrument called the "swap". It is explained in detail at paragraphs 4-7 below but broadly, it allows a company to substitute one kind of interest flow for another - for example, fixed rate interest for floating rate interest; or interest paid in sterling (at sterling rates) for interest expressed in another currency - say dollars (at rates which are relevant to dollar borrowing).

2. Swaps have grown enormously during the current decade. The market currently involves hundreds of billions of dollars. The tax law on interest (much of it dating back

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into the last century) is not well adapted to deal with swaps. A Revenue practice has evolved to stop tax problems stifling the market in the UK. However, in the course of a recent review we have concluded that:

a. It is not consistent with the strict letter of the law, so if it is to be continued it would have to be incorporated in new legislation or published as an extra-statutory concession.

b. If it were applied rigorously, some key operators in the swaps market might be unable to do business because of a need to deduct tax at source from the swap payments, but

c. we think that the firms concerned are probably ignoring the requirement under our practice to deduct tax and that tax offices are not picking up the failure.

3. Because our practice mainly gives companies what they want, and where it does not appears largely to be ignored, there is no great outside pressure for change. The subject of swaps has, however, been raised in discussions we have been having with the British Bankers Association (BBA) on the tax treatment of new financial instruments and, separately, some swap dealers who are not banks have expressed concern about the discrimination in favour of banks which our current practice involves. Given its unsatisfactory state, we have no option but to revise it, and our conclusion is that legislation - after consulting the major representative bodies (not just the BBA) - is required to achieve this. Our suggested solution is to treat swap payments broadly as if they were payments of interest but with more limited requirements to deduct tax at source.

SWAPS

4. Swap transactions can and do occur without being directly associated with any underlying borrowing. But the most commonly met swaps do involve substituting a more suitable interest or currency liability for that on an existing debt. Interest rate swaps are now a widespread, even commonplace, device for corporate borrowers to borrow on finer terms. They make use of the varying ratings of companies in different market sectors, reflected in the borrowing terms they are offered, - eg. one company may be able to obtain fine fixed interest terms, whereas another has a prime rating in the floating rate market. Currency swaps however are not primarily a device for borrowing more cheaply, but of reducing long-term exchange risk.

Interest rate swaps

5. A borrower who has borrowed at fixed rates of interest may prefer to pay floating rates (or vice versa). He therefore agrees with a counterparty (often a bank) that he will make a stream of payments, calculated by reference to floating rates, to the counterparty who will in turn make a stream of payments to the borrower equal (in timing as well as amount) to the fixed rate interest which the borrower must pay to the original lender. Thus for the borrower the interest payable is cancelled by the swap amounts receivable, and he is left making payments equal to interest at floating rates. (See ANNEX A for a simple example.)

Currency swaps

6. Currency swaps involve an exchange of capital sums and usually include an exchange of interest payments as well, on which the same issues arise as for pure interest swaps. For example, a borrower who wants sterling but has borrowed dollars, enters into an agreement with a counterparty under which he swaps the dollar proceeds of the loan for sterling,

and undertakes to swap the sterling back for dollars at the original rate of exchange at the end of the agreement, to coincide with the date when the loan becomes repayable. As with the interest rate swap, where the parties also exchange interest flows, these are set off against each other so that only the net balance generally changes hands. This paper deals only with the treatment of these interest type flows. The tax consequences of the exchange of capital sums also raise difficulties, described in Mr Keith's note on the Tax Treatment of Exchange Gains and Losses sent to the Financial Secretary on 21 March 1988. But these can be addressed independently as part of any consultative exercise on exchange gains and losses.

Asset-based swaps

7. In addition to the widespread form of swaps entered into by borrowers to change the currency and/or the interest payable on borrowings, swaps have also developed to meet investors' needs. For example a financial dealer (often a bank) sells an investor a fixed rate bond, but the investor swaps the fixed rate interest payable with the bank in return for a floating rate payment. Alternatively, as with currency exchange swaps for borrowers, the asset swap can be used to provide an investor with a floating rate investment in a currency which he would not be able to obtain so easily or cheaply himself.

TAX TREATMENT OF SWAP PAYMENTS

8. There are several aspects to be considered on the tax treatment of swap payments made under any of the different types of swap described above:

d. whether these payments are deductible for the payer, and, if so, whether on an accruals basis, or only as and when paid.

e. Whether tax is deductible at source on making payment.

f. Whether they are chargeable on recipients.

These aspects are now considered by reference to:

i. Strict law.

ii. Our present practice.

iii. The BBA's proposals.

iv. Our recommended option.

9. **(i) Strict Law**

(a) **Deductibility**

Relief for sums incurred by a company is available if they are either 'trading expenses' ('management expenses' for an investment company) or 'charges'. To be a trading expense a sum has to be incurred by a trading company for the purposes of its trade and on revenue as distinct from capital account (eg. for current operating and not for investment purposes). If it is a trading (or management) expense, a sum is deductible in computing the paying company's profits as it accrues rather than only when paid.

Allowability as a charge depends on the expenditure being an 'annual payment' which is "ultimately borne" by the company - and not for example offset by an equivalent counterpayment. To be an annual payment the sum paid must be regarded as "pure income profit" in the recipient's hands, that is, must not be a payment for goods or services nor simply a receipt item in an overall profit/loss computation. Charges are allowable against profits only as and when paid and tax has to be deducted upon payment.

Swap payments (whether in an interest or a currency swap) can therefore be allowable as trading expenses only if incurred by a trading company for trading purposes on revenue account (and in currency swaps, because an exchange of capital sums takes place, the likelihood of swap payments qualifying as trading expenses is slight). Generally swap payments by non-trading companies or on capital account would only be relievable (as charges) if they could be regarded as annual payments. Here however the "pure income profit" criterion is not met, since the swap payments will be no more than an item in the payee's overall receipts, from which its net profits are calculated. So no relief is strictly due.

(b) **Tax deduction at source**

Deduction of tax at source does not apply to trading/management expenses. It would only apply if swap payments were annual payments. But they are not and so deduction of tax cannot, in strictness, be required.

(c) **Chargeability**

The counterparty arranging a suitable swap for a corporate borrower will often be a bank or other financial trader, and the swap payment it receives will generally form part of its trading receipts, from which its Case I trading profit will be derived (just as the swap payment it makes would usually be a trading expense). Assessability under Case I would similarly apply to the (non-financial trader) borrower on the swap receipt from the counterparty, where its own swap payment was an allowable trading expense. But where the swap payments are received by an investment company or on capital account, in so far as no relief would be available for the payer, it is doubtful if the recipient would be strictly assessable on his swap receipt.

Inland Revenue stated practice

10. The absence of allowability in many cases would have effectively aborted the swaps market. The Revenue therefore stated (in 1977) that we were prepared to treat swap payments as if they were annual payments and to allow relief as a charge from which tax should be deducted. In September 1979 it was also agreed, following discussions with the BBA, that swap payments to and from UK banks could be made without deduction of tax. (This broadly mirrors the special statutory gross treatment which applies to such banks as regards interest paid and received.)

11. The current Revenue practice is as follows:

a. **Deductibility**

Swap payments made by banks (and other financial concerns actively engaged in the swaps business) as part of their normal business will normally be allowed as a trading expense on the accruals basis. (This reflects strict law.) For other companies interest rate swap payments are generally allowable as a charge (on a payments basis) - as are currency swap payments, except where paid gross to a UK bank by a trading company for trading purposes, when they can be allowed as an expense.

This practice therefore gives relief beyond that strictly allowable by statute. The beneficiaries here are investment companies (since only exceptionally might swap payments qualify as management expenses under existing law), and trading companies in those circumstances where the swap payments cannot be treated as trading expenses.

b. **Deduction at source**

Payment gross is permitted

i. where made by or to a UK bank acting as principal in the ordinary course of its banking business

ii. where made by (other) financial concerns who would treat the payment as a trading expense.

Otherwise tax should be deducted at source.

c. **Chargeability**

Swap payments received gross by a UK bank (or other financial concern) as part of its normal business operations are treated as taxable trading receipts. In other cases the payments are taxed as annual payments under Case III of Schedule D.

BBA representations

12. As the Financial Secretary will be aware, we are currently involved in discussions with the BBA on the tax treatment of a whole range of financial instruments. These essentially concern clarifying the treatment that should properly apply under existing law. But interest rate and currency swaps are among the topics and the BBA have asked for changes in our practice.

(a) **Deductibility**

The BBAs current representations seek deductibility as a trading expense for swap payments made by financial trading companies generally, and by (other) trading companies where made for trading purposes. For swap payments made by

investment companies or on capital account they suggest deductibility as a charge on a payments basis would be appropriate.

(b) **Deduction of Tax**

The BBA do not want deduction of tax to apply to swap payments in any circumstances. It would not, anyway be in point where the payments are treated as trading expenses/receipts, and the BBA ask that, even where swap payments are (under their proposal) to be treated as charges, deduction of tax should not apply either.

(c) **Chargeability**

The BBA ask that swap payment receipts of a financial trader or of a trading company on trading account should (always) be regarded as taxable trading receipts. In non-trading cases, eg investment companies, swap receipts would be assessable as annual payments under Case III.

Recommended Option

13. A number of issues arise in considering the revised treatment that should operate in this area. One is to take account of realities in the market. First, swaps would not take place if the payer could not obtain relief for his swap payments and in any case there is no reason in principle for denying relief for what are, usually, genuine business outgoings. Second, we understand from swaps practitioners that swaps, in particular interest swaps, would not be economic with the cash flow disadvantages caused by deduction of tax. Insofar as our existing practice, in providing relief for swap payments - where not available as trading expenses under existing law - as charges, requires deduction of tax, participants in the market who are not banks are put at a disadvantage because, where companies can only get relief by paying under deduction of tax, they will not do business on these terms.

14. There are a number of active participants in the market who do not qualify as banks under tax law - in particular some investment banks which do not have retail accounts (see my note of 28 April for a discussion of the issue of which banks can be recognised for tax). The likelihood is that in practice the deduction of tax requirement is largely ignored by these bodies. And the Bank of England now insist on more stringent conditions on capital provision by banks for their off-balance sheet activities (which includes swaps). So the involvement of non-bank financial traders in swaps is likely to increase. (And we have received representations from non-banks that our current practice is unfair to them.)

Outline of revised swaps treatment

15. All this points to a solution which allows the payer a deduction against his profits in most circumstances but does not require him to deduct tax from payments to the swap counterparty. But, while ensuring a workable and flexible framework for swaps to operate, any solution must at the same time ensure that the swap receipts are properly chargeable on recipients, incorporate adequate protection against abuse, and should also, if possible, avoid undue distortions compared with the tax treatment of ordinary borrowing costs.

16. Our conclusion is that these various and occasionally divergent considerations could best be met by generally treating swap payments as if they were payments of interest. Legislation would be required in order that this solution could be effectively implemented. This would apply - subject to specified exceptions - the normal interest charging and relieving sections, and also enable the established anti-avoidance interest provisions to be invoked if necessary. It also caters for swap payments made and received by individuals.

17. Going into the details of this preferred solution, indicating where the proposed treatment will differ from that for interest:

a. **Deductibility**

The position in present law whereby swap payments, when payable on revenue account for trading purposes, are deductible as trading expenses on the accruals basis would effectively be preserved. Here swap payments would be treated rather more generously than interest, but more uniformly, in that there would be no distinction between 'annual' and 'short' swap payments where made for trading purposes. At present interest lasting less than a year ('short' interest) is, if a trading expense, fully deductible on the accruals basis whoever it is paid to. But 'annual' interest, that is interest capable of lasting a year or more, is only deductible on the accruals basis as an expense if paid to a UK recognised bank. Otherwise it is deductible on the payments basis as a charge (and tax generally has to be deducted upon payment). Since our recommendation is that deduction of tax should not generally apply to swap payments, it makes sense to treat all swap payments for trading purposes in the same way, no matter who they are paid to. As a safeguard here however we propose making deductibility dependent on being made for bona fide commercial purposes and being no more than the interest that would be payable in an arm's length transaction between independent parties.

Where payable otherwise than as a trading expense, swap payments would be, like annual interest, allowable as a charge as and when paid. This would in fact be done by offsetting the swap payment received against that paid, and giving relief only to the extent that the payment exceeded the receipt.

b. **Deduction of tax**

Except when payable to a recognised UK bank, annual interest paid by companies generally has to be paid under deduction of tax. However, as indicated above, we recommend that exceptionally, in order not to undermine the swaps market gross payment be permitted here generally. It is true that any underlying interest flows (on the original borrowing) would still be subject to deduction of tax; but in allowing gross payment for swaps we would be giving up the cashflow advantage of deduction of tax at source only on the net payment between swap parties where neither of them is a recognised bank. There is a risk that this could lead to pressure for gross payment of interest more widely. But we think this pressure may have to be faced anyway, and the alternative of shutting non-banks out of the swaps market would be more unacceptable.

An exception to gross payment may however have to be considered for swap payments to non-residents whose profits are not chargeable to tax in the UK (ie. where the payment is not connected with a UK branch). Otherwise there is a possibility - despite existing avoidance safeguards - of gross payment being exploited by international groups (in similar situations, interest as such would often be subject to deduction of tax). We suggest this should be left open during consultation and only decided after we have heard outsiders' views by which time the state of play on "thin capitalisation" (see paragraph 20 below) may also be clearer.

c. **Chargeability**

As for deductibility the position in current law whereby swap payments receivable on revenue account for trading purposes are taxable as a trading receipt on

the accruals basis would remain. For other swap payments only the net receipt would be assessable, as if it were interest, when received.

18. This proposed solution therefore seeks to minimise the risk of arbitrage at the Exchequer's expense which might occur, notably if relief were given on an accruals basis but the swap receipt was only chargeable when received. As far as possible, to the extent that relief is given on an accruals basis, chargeability will follow that, and similarly where the relief is on a payments basis. It is not possible to achieve complete timing symmetry, but our proposed solution at least ensures that the scope for such arbitrage will be no greater than the position as regards interest payments.

Definition and scope of swaps

19. We would need to define a swap for this purpose. The main features we suggest are:

i. swap payments are deemed to be interest (annual interest where the period of payment can be a year or more) payable by reference to the original borrowing

ii. deductibility is <u>only</u> available if

  a. the amount of the swap payment, as measured for example by reference to the underlying principal sum borrowed, is no more than a commercial and an arm's length interest rate, and

  b. the charging and payment dates of each swap under any swap transaction are simultaneous (ie. to avoid relief/chargeability mismatches and scope for exploitation, eg. deep discount securities, see paragraph 21. below)

iii. deduction of tax is not to apply to swap payments within ii. except possibly to payments to non-residents where the swap payment is not attributable to a UK permanent establishment

iv. swap payments made wholly and exclusively for trading purposes will always be deductible (on the accruals basis) in computing trading profits; in such circumstances the corresponding swap payment received will be a trading receipt (ie. chargeable on the accruals basis)

v. swap payments that did not meet the deductibility criteria would nevertheless remain chargeable on the recipient (as for interest).

Other aspects of recommended option

Avoidance and international aspects

20. A major consideration in assimilating swap payments to interest is to be able to invoke the various provisions applying to interest which give protection against avoidance and abuse, notably through cross-frontier payments. These include being able to treat interest as a distribution and so refuse deductibility (Section 209 ICTA 1988), denying relief where the essential purpose of the transaction is not commercial but to obtain relief (Section 787), and bringing swap payments within the scope of the Interest Article in the UK's network of double taxation agreements, where the agreement permits this. One particular need is to be able to counteract the tax-free extraction of UK profits to overseas associates via payments of deductible interest. Our powers here are currently being reviewed in a separate Revenue consultative exercise on "thin capitalisation" and it is important that, whatever additional/revised measures may emerge from that exercise, they should be applicable to swap payments as well. (Otherwise swap payments might be

used as a way round interest relief safeguards.) The precise implications of this can be reviewed after the consultation period when it is clearer what approach is being taken to "thin capitalisation".

Deep-discounted securities and swaps

21. Swaps involving securities issued at a deep discount, notably zero coupon stocks where no interest is payable, (all the return being contained in the difference (discount) between issue price and redemption price), pose a potential problem for our present practice. This would arise if a company issued a zero coupon bond and then entered into a swap with (typically) a bank whereby the company made floating rate payments to the bank each year, in return for a lump sum payable by the bank on maturity of, and used to repay, the zero coupon bonds. If our existing swaps practice applied to this situation the company would be able to claim relief each year for both the accruing discount (under the 1984 deep discount legislation) and (under swaps practice) for the floating rate payment to the bank. The bank would be taxable on its swap receipts but could probably claim relief each year (under established tax case law) for the accruing portion of the lump sum to be paid at redemption. We have so far refused to extend our practice to these swaps. Our proposed scheme would solve the problem by restricting relief to swaps when both payment flows were made at the same time excluding cases where one part of the swap was deep discount.

Individuals

22. Swap transactions have to-date largely been confined to the corporate sector. But we are now faced with a case involving individuals. It contains no features which would warrant our refusing to give the relief which we would give to a company undertaking such a transaction. But our

current practice involves treating the swap payment as an annual payment and the 1988 Finance Act contains provisions (Section 36) which deny relief to individuals for annual payments, except in specified circumstances. This restriction is aimed at cutting down relief for deeds of covenant, but it seems to give an unjustifiable result in the case of individuals making swap payments. It would mean that an individual would make the payment gross, and get no relief against his income for amounts paid. (He might also not be chargeable to tax on amounts received.) This is clearly unfair and the most satisfactory way round it would be to treat the payments as interest. Our proposed solution should enable us to deal on similar terms with swap payment transactions involving both companies and individuals, but in the case of individuals relief would be given, as for interest, only where the underlying loan was for a qualifying purpose such as the purchase of property for letting.

23. We would add that we have to take a decision on this particular case now in advance of consultations on swaps generally. We would propose, if Ministers are content, to treat this case by concession by the interest route rather than the annual payment route we still apply to companies.

Revenue and administrative and compliance costs

24. Compared with the strict letter of the law there would be some cost in our recommended option because we would be giving relief for swap payments which at present is not strictly due. But compared with our present practice the cost would be minimal. In a few cases we would be giving up deduction of tax at source, but as we have said, we suspect we are getting little of the tax due anyway. There would be no significant administrative costs for us or compliance costs for the taxpayer.

Way forward

25. Legislation will be needed to implement our recommended option. But the matter is of importance to all players in what is a very large-scale swaps market. Prior consultation about our proposed option seems unavoidable and indeed desirable. This will need to take place with all the main representative bodies - in particular the BBA, CBI, Law Society, Association of Corporate Treasurers - who have written to us on the subject.

Timing of Legislation

26. A consultative document could not be produced before the autumn, and given the complex and wide-ranging nature of the subject representative bodies would need some time to digest the issues and we thereafter to assimilate their comments. This would give very little time for preparing legislation for the 1989 Finance Bill. And, as mentioned in paragraph 20, this topic is linked, as regards cross-frontier transactions, with the "thin capitalisation" exercise. If legislation is decided upon for both topics, the shape of the "thin capitalisation" provisions should, ideally, be known in framing that for swaps. We would suggest that we should have a full consultation process aiming at legislation in 1990. Until then our existing swaps practice would continue subject, to aligning swap payments with interest for individuals.

27. Meanwhile, when we next report extra statutory concessions to NAO, we would say that we had identified that part of our practice on swaps was extra statutory, that we were reviewing it, that it was not appropriate to publish it while it was being reviewed, and that after review we would publish it, withdraw it, or put forward replacement legislation.

Summing up

28. Swaps are a widespread and important part of the way in which companies raise finance internationally and tailor their exposure to currency and exchange rates. The present statutory provisions are not adequate to cope with transactions of this nature. We have an unpublished practice which seeks to meet this requirement: it now appears to be extra-statutory, is inadequate and does not reflect the realities of the market where it is unrealistic to expect payments to be made under deduction of tax.

29. Clarification of our practice is sought by the BBA, and non-banks are beginning to ask for a change. We also need to clear our lines with the NAO.

30. Our suggested solution would essentially treat swap payments as interest but would not require deduction of tax, subject to a possible exception in certain circumstances for payments to non-residents. It would require legislation and prior consultation with representative bodies concerned. We would aim to produce a document for circulation to them later this year with a view to legislation probably not before 1990.

31. We would be grateful for Ministers' views and whether they are content for us to go ahead with consultations on the basis of our preferred option.

A C GRAY

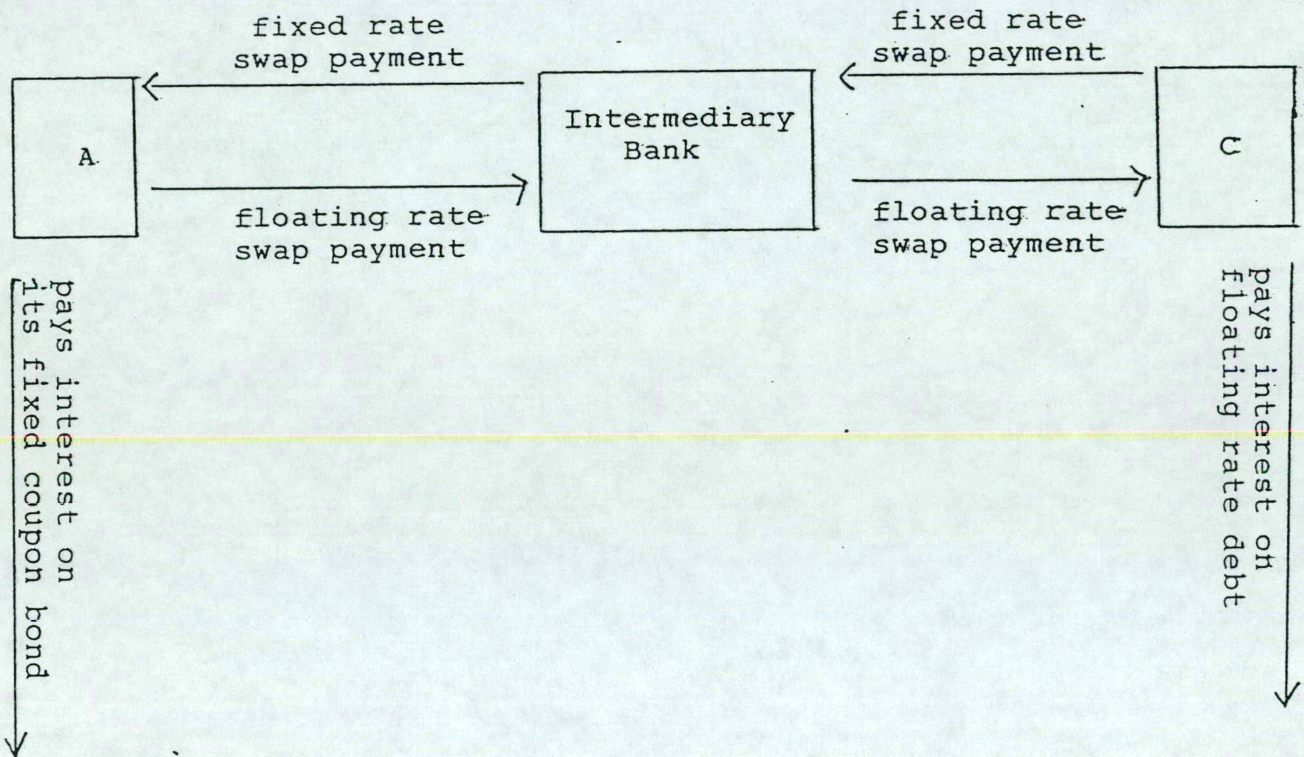
ANNEX A

Company A pays fixed rate interest on its bond issue, but wants floating rate finance.

Company B pays floating rate interest on its debt but seeks fixed rate financing.

Intermediary Bank (1) pays a fixed rate swap payment to A in exchange for receiving a floating rate payment, and

(2) pays a floating rate swap payment to B in exchange for a fixed rate payment.



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FROM: **R C M SATCHWELL**
DATE: **27 September 1988**

MR JOHNS - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Peretz
Mrs Lomax
Mr Ilett
Mr Gilhooly
Mr Cropper

Mr A Clark
(Bank of England)

Mr J W Calder - IR
PS/IR

INTEREST SWAPS

The Financial Secretary yesterday discussed with you and others your minute of 1 September covering Mr Gray's paper.

You explained that the current treatment of swaps was unsatisfactory; much of the tax law relating to interest dated back over 100 years, and was not well adapted to swaps. Since 1977 the Revenue had treated swaps as annual payments, which required tax to be deducted at source. However, the Eurobond market worked on a gross basis; so in 1979 it was agreed to allow gross payments if the swap counter party was a UK bank. But that in turn put non-banks (and particularly US and Japanese investment houses bound by the Glass-Steagal Act and its Japanese equivalent) at a disadvantage. The present treatment therefore needed to be reviewed; at the very least it would have to be put onto a statutory basis.

The British Bankers Association had recommended that the present treatment should be extended to include non-banks. But that created worries about chargeability on the recipient, where it was either an investment company, or a non-resident. The law on interest contained anti-avoidance provisions against these cases, but the law on annual payments did not. And tax could not be collected in these circumstances (nor of course in any other) through an extra-statutory concession.

You were therefore proposing a variant on the BBA scheme, whereby swap payments would be treated as interest, but there would be no deduction at source. The differences from the BBA proposal were that the scheme would be done under legislation, rather than through an ESC; and that because swaps would be treated as interest, the anti-avoidance provisions would automatically come into play. Mr Ilett said that this would have the benefit of making a unified market for swaps, since banks and non-banks would be treated alike.

The Financial Secretary asked about the relationship of this work to that on exchange rate gains and losses. You said that exchange rate gains and losses referred to capital sums; this was a much trickier and more sensitive area. A first draft of the consultative document on this subject would probably be ready by the end of October. Provided that resources were available, it should be possible to have a consultative document on swaps drafted by Christmas, and both documents published before the end of this financial year, if not earlier. The consultation periods for both would be long; legislation would not be before the 1990 Finance Bill. The Financial Secretary agreed to proceed on this timetable.

R.C.M.S.

R C M SATCHWELL
Private Secretary

Inland Revenue

PP3-P1.

Oil and Financial Division
Somerset House

FROM M A JOHNS
DATE 4 NOVEMBER 1988

1. MR BEIGHTON
2. FINANCIAL SECRETARY

As Mr Johns says, his purpose in putting this note forward today is to draw attention to another possible item for the Finance Bill ahead of the Chancellor's starters meeting on Tuesday at which a major issue may be relative priorities

JHB 4/11

INTEREST SWAPS

1. At your meeting on 27 September you agreed that we should produce a consultative document on this subject before Christmas but not aim at legislation before 1990. In fact we have made more rapid progress than we had expected and I hope to be submitting to you a draft document next week. At the same time we have come under greater pressure for early action than was the case when you discussed the issue with us. I am sending you this note in advance of the Chancellor's meeting on Budget starters so that you can consider the case for advancing legislation on swaps to 1989 against other priorities for next year's Finance Bill.

2. What has happened since our meeting is that representatives of four leading US and Japanese investment houses came in to complain about their exclusion from our existing practice. As

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cc		
	Chancellor of the Exchequer	Mr Isaac
	Chief Secretary	Mr Painter
	Paymaster General	Mr Beighton
	Economic Secretary	Mr Bush
	Mr Scholar	Mr Houghton
	Mr Peretz	Mr Johns
	Mr Culpin	Mr Hall
	Mr Ilett	Mr Skinner
	Mr Gilhooly	Mr Hunter
	Mr Cropper	Mr Bryce
	Mr A Clark (Bank of England)	Mr Nield
	Mr Jenkins (Parliamentary Counsel)	Mr J W Calder
		Mr Keith
		Mr Moule
		PS/IR

explained in paragraph 14 of Mr Gray's note of 1 September, investment houses which do not have a retail arm do not qualify as recognised banks under our legislation and therefore our practice requires tax to be deducted at source from swaps in which they are involved unless the counterparty is a recognised bank or gets trading (Case 1) treatment for the swap. The result is that they are unable to compete on equal terms with banks. We asked why this problem had only now become sufficiently important to lead to high level representations. They said that the entry of building societies to the swap market had given a new boost to business which they were shut out of. Financial concerns were also actively reviewing where they should locate in the lead-in to 1992 and there was a danger that swap business would move elsewhere, possibly to Frankfurt. We explained that with Ministers' authority, we were actively reviewing the position but I could not hold out much hope that there would be legislation in 1989. They expressed concern about this and pressed hard for concessionary treatment to be extended to them in the meantime.

3. There are three options:

a. to stick to the original strategy of no further change to the concessionary practice, a lengthy consultation period, and legislation in 1990. As always, it is difficult to weigh up threats to relocate in the lead-in to 1992, especially if a promise of redress is held out. But there clearly is some risk and, if firms relocate for other reasons, some risk that blame will be put on the Government's tax rules.

b. not to legislate before 1990 but to extend our concessionary practice to non-banking investment houses. One problem about this is how to define the qualifying swap traders without just creating demands for further extensions at the margin. We are urgently consulting the Bank of England about possibilities: we would hope we could find a workable

solution but could not promise that it would be very robust. We should be widening the area in which we are at risk from abuse, extending yet further a practice which we now believe has no statutory backing (as would be very apparent from the document). And from the tactical viewpoint, if we extend the beneficial parts of our practice to the main actors excluded from it at present, then the main effect of the eventual legislation would be to introduce safeguards. The Government might find little support for proposals to legislate against abuse if all the good news had already been conceded.

c. to change our timetable and legislate in 1989. We think, given the speedier than expected progress on drafting, this would be feasible in terms of timetable. We do not expect much criticism of our proposals so a fairly short consultative period could be offered (a month or six weeks at most finishing before Christmas). We could instruct during the consultative period in the hope that only changes at the margin would be needed in the light of consultation.

4. The main problem with this third option is the resources of Parliamentary Counsel and space in what is already looking like a very big bill. There would also be some strain on our own resources and a small risk that, for example, it could interfere at the margins with work on exchange differences or unit trusts on which you may put a higher priority. We have not consulted Parliamentary Counsel but we guess that the legislation might run to 3 or 4 pages. And even if he could cope (since we would be aiming to instruct him before Christmas) you may not want the Finance Bill to be increased this much.

5. There were two other, less important, reasons why we originally advised in terms of legislation in 1990. One was so that any changes could be aligned with any action on thin capitalisation. However, it would be possible to include any consequentials for swaps in specific thin capitalisation legislation even if we had done the main legislation on swaps in

1989. The second was to align the timetable with consultations on exchange differences. As Mr Gray explained in paragraph 6 of his note, there are problems about the treatment of exchanges of capital sums under currency swaps which will be addressed in the draft consultative document on exchange differences currently being prepared by our Business Taxation division. If we consult first on this area of swaps there may be some complaints that we are dealing with a less important problem on swaps while leaving the most serious difficulty (exchange differences) untouched. While we are pressing ahead with the draft document on exchange differences as work on Starters allows we could not wait to issue both documents together if we were to legislate on swap periodic payments in 1989. It would be necessary to say in the consultation that the government was aware of the exchange problem and looking at it separately.

6. This note is for information. We will anyway press ahead with putting a draft consultative document to you and a final decision can wait until you have seen that.

M.A. Johns

M A JOHNS

RS96FST.42

FROM: R C M SATCHWELL
DATE: 7 November 1988

MR JOHNS - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Peretz
Mr Gilhooly
Mr Ilett
Mrs Chaplin
Mr A Clark (Bank of England
Mr Jenkins (OPC)

Mr Beighton - IR
Mr McGivern - IR
PS/IR

INTEREST SWAPS

The Financial Secretary was most grateful for your minute of 4 November.

Of the three options outlined in your minute, the Financial Secretary would prefer the second; no legislation before 1990, but extending the current concessionary practice to non-banking investment houses. He hopes that your discussions with the Bank of England can produce a workable solution.

On priorities for work leading up to next year's Finance Bill, the Financial Secretary would put the areas mentioned in your minute in the following order:-

- the work on international comparisons of unit trust regimes
- exchange rate gains and losses
- interest swaps

R.C.M.S.

R C M SATCHWELL
Private Secretary

chex.ps/jmt/73 **CONFIDENTIAL**

FROM: J M G TAYLOR
DATE: 11 November 1988

PS/FINANCIAL SECRETARY

cc **PS/Chief Secretary**
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Peretz
Mr Gilhooly
Mr Ilett
Mrs Chaplin
Mr Jenkins (OPC)

Mr Beighton - IR
Mr McGivern - IR
Mr Johns - IR
PS/IR

INTEREST SWAPS

The Chancellor has seen your note of 7 November in response to Mr Johns' minute of 4 November.

2. He has noted the Financial Secretary's ordering of priorities for work leading up to next year's Finance Bill. Of the three areas mentioned, the Chancellor thinks that the work on international comparisons of unit trust regimes is far and away the most important, because of its life assurance read-across.

J M G TAYLOR

Inland Revenue

Oil and Financial Division
Somerset House

FROM M A JOHNS
DATE 30 NOVEMBER 1988

1. MR BEIGHTON
2. FINANCIAL SECRETARY

INTEREST SWAPS - BUDGET STARTER 157

1. As promised in my note of 4 November I attach a draft consultative document on interest swaps. (This has not entailed any significant diversion of resources from your higher priorities since most of the substantive work was done before Mr Gray's note of 1 September and most of the drafting before my note of 4 November. On unit trusts - your top priority - we have just received the UTA's detailed proposals and are urgently reviewing their implications.)

2. In my note of 4 November I set out three options for handling on swaps:

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cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Mr Scholar
Mr Peretz
Mr Culpin
Mr Ilett
Mr Gilhooly
Mr Tyrie
Mr Hewitt (Bank of England)
Mr Jenkins (Parliamentary Counsel)

Mr Isaac
Mr Painter
Mr Beighton
Mr Bush
Mr Houghton
Mr Johns
Mr Hall
Mr Skinner
Mr Hunter
Mr Bryce
Mr Nield
Mr J W Calder
Mr Keith
Mr Moule
PS/IR

At your meeting on 25 November you said that you were not attracted by course c, but I fear that it may be the only alternative to doing nothing in 1989.

30/11

a. no change to our present concessionary practice, lengthy consultation (a response date of, say, 31 May 1989) and legislation in 1990

b. consultation and legislation as in (a) but an extension of our present concessionary practice to cover the main non-banking investment houses

c. a faster track consultation process (a response date of, say 31 January) and legislation in 1989.

3. In Mr Satchwell's note of 7 November you favoured option (b) so we have been exploring the possibilities actively with the Bank of England. The investment houses we spoke to suggested two possible definitions for the additional bodies who ought to be added to recognised banks as beneficiaries of our present practice:

- institutions listed under Section 43 of the Financial Services Act (effectively players in the money markets)

- members of the International Swap Dealers Association. (ISDA)

We have discussed with the Bank a third possibility

- institutions authorised under the Financial Services Act to carry out investment business.

4. The Bank of England are opposed to the use of the first or third of these. Neither is particularly closely tied to capability to do swaps business. Under either definition some swaps dealers would not qualify; on the other hand, either definition would let in many financial firms who are not swaps traders but who might take part in swaps if there were tax advantages without the safeguards which our proposed eventual legislation would impose. The Bank are concerned about using lists prepared for their particular regulatory purposes for fairly unrelated tax purposes. They are worried, for example,

that firms will seek to get approval on the Bank's list for the tax benefits that follow rather than because they want to do the sort of business for which the relevant approval is actually designed. The Bank do not have any reason to approve swaps dealers as such and therefore have no ready made definition.

5. Membership of ISDA seems to us even less satisfactory. It is true that members will all be interested in swaps business. However, all it is is a trade association, based in New York and the government would be giving tax advantages to membership of a particular international body on which it had no leverage at all. While there is no reason to suppose ISDA would positively encourage membership by those wishing to exploit UK tax advantages, they might have neither the ability nor the inclination to turn them away.

6. It looks, therefore, as if the only way to extend our present practice would be to a specially tailor made list of our own. It would take some time to devise definitions and consider applications for approval under the definition. By the time we had done so legislation would very probably be almost as quick, even if deferred to 1990. There is, of course, also the general problems about this option referred to in my note of 4 November. We would be extending - at our own discretion - a practice which we now believe has no statutory backing. And the Government might find it harder to legislate later if the main change was to prevent abuse rather than to give additional relief. Legislation gets round the problem of definition not by having a tailor made list of parties entitled to pay swap fees gross but by letting swaps by <u>all</u> parties be paid gross provided they meet certain prescribed conditions. The extra players brought in by legislation if we had made an interim extension to investment houses would, however, be of relatively little importance. (Some corporate treasurers would like to get into this market but so far they have not been very vocal). So the main public reaction to legislation would relate to the restricting conditions not the extra people benefiting. The emphasis would be the other way round if there were no interim step.

7. I am sorry to have raised the prospects of a middle way in my last note, only to find in the light of the Bank of England's advice that it is not practicable. I think the choices on handling now effectively reduce to (a) or (c) of paragraph 2, except that on (c) you could possibly consider buying more time by actually introducing legislation at Committee Stage rather than the Bill as published. This is a fairly specialised area and would have been the subject of consultation so if we got the new clauses down well in advance of debate there ought not to be the normal complaints about Committee Stage legislation of bouncing the other side. As between (a) and (c) the choice seems to us finely balanced. Course (a) runs some risk of driving business out of London though it is hard to see that if business has been here so long under present rules the relatively subtle changes in the market this year referred to in para 2 of my 4 November note will tip the balance for many firms suddenly towards Frankfurt. But it will certainly give the appearance of the UK dragging its feet. Course (c) risks overloading a long Finance Bill. My personal recommendation would be in favour of legislation in Finance Bill 1989 but it is very marginal.

M. A. Johns

M A JOHNS

Draft consultative document on the taxation treatment of swap fees

1. Introduction

2. Swaps - a general description

3. Tax treatment of swap fees under strict law

4. Current Inland Revenue Practice

5. A possible new scheme of relief.

1. INTRODUCTION

1.1 This Consultative document is about the tax treatment of fees paid under swap agreements. It covers fees paid where only interest flows are exchanged (an "interest rate swap") and also where in addition to an exchange of interest flows there is an exchange of currency on termination of the swap (a "currency swap"). The paper does not however consider the tax consequences of the exchange of currency itself. There have been representations that these consequences can create difficulties but these are being considered separately.

1.2 Swaps did not exist when the present law on interest and annual payments was developed and Revenue practice has evolved over the last 10 years or so to fit them in as well as possible to laws devised for other purposes. In the light of this the Revenue practice has for several years been to treat recurrent swap fees as annual payments while applying rules on deduction of tax at source applying to interest. But in many cases it is doubtful whether this practice is consistent with the strict letter of the law. In some cases the current practice may give relief which would not otherwise be due. In others it imposes a requirement to deduct tax, which effectively prevents some companies from doing business in the swaps market. Representations have been made by a number of bodies connected with the market that the existing practice ought to be modified.

1.3 Ministers have therefore authorised the Revenue to consult interested parties with a view to developing new rules which could be incorporated in legislation. The aim would be to encourage the operation of the swaps market without putting up artificial barriers on entry, while protecting the Exchequer against loss of tax. This paper puts forward a possible scheme. In broad terms recurrent swap fees would be assimilated by legislation to interest but without the requirement to deduct tax, except possibly in limited circumstances where the absence of such a requirement might be exploited for avoidance purposes. This would not restrict the availability of relief for swap fees paid for genuine commercial purposes which already exists. On the contrary the object of the legislation would be to facilitate the use of swaps both by making the tax treatment clearer and by removing the requirement to deduct tax in most cases. But there would be safeguards to ensure that a more relaxed regime of this kind was not open to abuse.

1.4 As well as recurrent fees, swaps often involve an initial arrangement fee. Where recurrent fees would be deductible, this initial fee would also be deductible under the new scheme, as if it were an incidental cost of obtaining loan finance.

1.5 The document first considers briefly the nature of swaps, goes on to describe the treatment which would probably have to be applied under strict law and the Revenue's practice as it has evolved. It then sets out how the possible new scheme would operate.

1.6 Readers are invited to comment on any aspect of the document, in particular on the possible new scheme and the detail of the legislation which is suggested would be necessary if it were to be put into effect. Representations are sought by [31 January/May 1989] and should be forwarded to the Board of Inland Revenue, Swap Fees Consultation, Room 9, New Wing, Somerset House, London WC2R 1LB.

2. SWAPS - A GENERAL DESCRIPTION

2.1 Companies use swaps for a variety of purposes. Most commonly swaps will be associated with an underlying borrowing. The effect of the swap is to substitute a more suitable interest or currency liability for that on an existing debt. Interest rate swaps are now a widespread, even commonplace, device for corporate borrowers to borrow on finer terms. They make use of the varying ratings of companies in different market sectors, reflected in the borrowing terms they are offered - eg one company may be able to obtain fine fixed income terms, whereas another has a primary rating in the floating rate market. Currency swaps however may be primarily a device for reducing long term exchange risk rather than for borrowing more cheaply. In each case the effect is that there are annual payments of net amounts representing the difference between interest paid on two different bases and it is the tax treatment of these net payments which is the subject of this consultation.

2.2 Examples

i. Interest rate swaps

A borrower who has borrowed at fixed rates of interest may prefer to pay floating rates (or vice versa). He therefore agrees with a counter party (often a bank) that he will make a stream of payments, calculated by reference to floating rates, to the counterparty who will in turn make a stream of payments to the borrower equal (in timing as well as amount) to the fixed rate interest which the borrower must pay to the original lender. Thus for the borrower the interest payable is cancelled by the swap fees receivable, and he is left making payments equal to interest at floating rates.

ii. Currency swaps

Currency swaps involve an exchange of capital sums but usually include an exchange of interest payments as well, on which the same issues arise as for pure interest swaps. For example, a borrower who wants sterling but has borrowed dollars, enters into an agreement with a counter party under which he swaps the dollar proceeds of the loan for sterling (this may be on a notional basis) and undertakes to swap the sterling back for dollars at the original rate of exchange at the end of the agreement, to coincide with the date when the loan becomes repayable. During the period of the agreement he pays to the counterparty swap fees based on sterling interest rates and receives from the counterparty swap fees based on dollar interest rates. As with the interest rate swap, the exchanges of interest flows are normally set off against each other so that only the net balances change hands.

2.3 In addition to the widespread use of swaps to change the currency and/or the interest payable on borrowings, swaps have also developed to meet investors' needs. For example if there were insufficient floating rate loan stock on the market to meet demand, an investor might purchase a fixed rate bond from a financial dealer (often a bank) but swap the fixed rate interest payable with the bank in return for a floating rate receipt. Alternatively, as with currency exchange swaps for borrowers, the asset swap can be used to provide an investor with a floating rate investment in a currency which he would not be able to obtain so easily or cheaply himself.

2.4 In the above examples swaps are used to alter the currency or interest rate exposure arising from specific liabilities or assets. They may also however be used to tailor a net overall exposure to a particular currency or interest rate. And of course a company might also enter a swap without having any underlying exposure at all, in which case the swap will generate profits or losses in its own right.

2.5 In all these cases the swaps change the terms of finance but are not intended to transfer value from one party to another or (by and large) convert income into capital. While, after the event, it may prove that payments all go one way, with a standard commercial swap the parties will have negotiated terms at the outset under which the two streams which are netted off are seen as having equal value. Where one currency is expected to appreciate against the other there may be some expectation that one party to a currency swap will pay more by way of annual payments and the other more by way of capital repayment but the size of that effect is limited to expectations of the relative movement of the currencies. In other cases there is no conversion of revenue to capital.

2.6 It is, however, possible to construct arrangements in the form of swaps which do transfer value from one party to another. For example, a member of an international group wanting to increase profits in a foreign affiliate for tax reasons could arrange a swap where a low interest rate was used as the basis of payments into the UK and a high interest rate as the basis of payments out. Or a swap could be used to convert taxable income into tax free capital; for example a "zero coupon" swap where one party pays interest but the other party pays an enhanced capital sum at the end of the swap and no interest in the intervening period.

2.7 The Government's aim is to facilitate genuine commercial swaps where there is an even handed flow of income but if it were also to allow tax relief for payments of the sort described in the previous paragraph it could be exposed to serious erosion of its tax base.

3. TAX TREATMENT OF SWAP PAYMENTS UNDER STRICT LAW

3.1 The main aspects to be considered on the tax treatment of swap fees paid under any of the different types of swap described in the previous section are

a. whether these payments are deductible for the payer, and, if so, whether on an accruals basis, or only as and when paid;

b. whether tax is deductible at source on making payment.

i. Deductibility

3.2 Relief for expenditure incurred by a company is broadly available if it is either a trading expense (in the case of a trading company), a management expense (in the case of an investment company) or a charge (in the case of either). To be allowed as a trading expense a sum has to be incurred by a trading company for the purposes of its trade and on revenue as distinct from capital account (ie for current operating and not for investment purposes). To be deductible as a management expense a sum has to be incurred by an investment company for the purposes of managing its investments. If it is a trading or management expense, a sum is deductible in computing the paying company's profits as it accrues rather than only when paid.

3.3 Allowability as a charge depends on the expenditure being an "annual payment" which is "ultimately borne" by the company - and not for example offset by an equivalent counterpayment. To be an annual payment the sum paid must be regarded as "pure income profit" in the recipient's hands, that is, must not be a payment for goods or services nor simply a receipt item in an overall profit/loss computation. Charges are allowable against profits only as and when paid and tax has to be deducted upon payment.

3.4 Swap fees (whether in an interest or a currency swap) can therefore be allowable as trading expenses only if incurred by a trading company for trading purposes on revenue account. Particularly in the case of currency swaps where an exchange of capital sums take place, swap fees may fail to qualify as deductible trading expenses. Recurrent swap fees would not normally be regarded as expenses of management and therefore if paid by non trading companies or on capital account would generally be relievable (as charges) only if they could be regarded as annual payments. Here however the "pure income profit" criterion may not be met, since the swap fees will generally be no more than an item in the payee's overall receipts, from which his net profits are calculated. So no relief is strictly due.

3.5 Where initial swap fees are concerned, the rules in Section 77 ICTA 1988 relating to incidental costs of raising loan finance would not apply so as to allow a deduction and therefore no relief is available.

ii. <u>Tax deduction at source</u>

3.6 Deduction of tax at source does not apply to trading/management expenses. It would apply only if swap payments were annual payments. If they are not, deduction of tax cannot in strictness be required.

4. CURRENT INLAND REVENUE PRACTICE

4.1 In fact Revenue practice evolved in response to swaps in a way that has diverged from the probable strict legal basis as described in the previous chapter. The application of the strict law to these new instruments was far from clear and it did not accord with commercial reality. The Revenue therefore has up to now adopted an interpretation different from that spelt out above.

4.2 The Revenue stated in 1977 to participants in the market that it was prepared to treat recurrent swap fees as if they were annual payments and to allow relief as a charge from which tax should be deducted. In September 1979 it was also agreed that where such fees were paid to or by UK banks payment could be made without deduction of tax. (This broadly mirrors the special statutory gross treatment which applies to such banks as regards interest paid and received).

4.3 The current Revenue practice is as follows

i. Deductibility

Recurrent fees paid by banks (and other financial concerns actively engaged in the swaps business) as part of their normal business will normally be allowed as a trading expense on the accruals basis. (This reflects strict law.) For other companies recurrent interest rate swap fees are generally allowable as a charge (on a payments basis) - as are recurrent currency swap fees, except where paid gross to a UK bank by a trading company for trading purposes, when they can be allowed as a trading expense.

4.4 This practice may therefore give relief beyond that strictly allowable by statute. The beneficiaries here are investment companies (since only exceptionally might swap payments qualify as management expenses under existing law), and trading companies in those circumstances where the swap payments cannot be treated as trading expenses.

4.5 Deductibility is not extended to initial swap fees, where practice is in line with the interpretation set out in paragraph 3.5.

ii. Deduction of tax at source

4.6 Payment of recurrent fees gross is permitted

a. where made by or to a UK bank acting as principal in the ordinary course of its banking business;

b. where made by (other) financial concerns who would treat the payment as a trading expense.

Otherwise tax should be deducted at source.

5. A POSSIBLE NEW SCHEME OF RELIEF

5.1 A number of considerations arise in looking at what revised treatment should operate in this area. One is to take account of realities in the market. First, swaps would not take place if the payer could not obtain relief for his swap payments and in any case there is no reason in principle for denying relief for what are, usually, genuine business outgoings. Second, we understand from swaps practitioners that swaps, in particular interest swaps, would not be economic with the cash flow disadvantages caused by deduction of tax. Insofar as the existing Revenue practice, in providing relief for swap payments - where not available as trading expenses under existing law - as charges, requires deduction of tax, participants in the market who are not banks are put at a disadvantage. Companies will not do business with them because of the possible requirement that tax would have to be deducted for relief to be allowed.

5.2 There are a number of active participants in the market who, although they trade as dealers in finance, do not qualify as banks under tax law, in particular some investment banks which do not have retail accounts. In the swaps market generally, the involvement of these non-bank financial traders may be set to increase. We have received representations from such traders that our current practice is unfair to them.

5.3 In addition companies which are neither banks nor financial traders may wish to enter swaps directly with each other. We have received representations that our practice forces companies to use banks as intermediaries in these transactions and that this may be disadvantageous to the companies concerned.

5.4 Swap transactions have to date largely been confined to the corporate sector but cases involving individuals can arise. The current Revenue practice is ill adapted to such cases since Section 36 of Finance Act 1988 severely restricts the circumstances in which annual payments can be taken into account in computing the income of an individual.

5.5 All this points to a solution which allows the payer a deduction against his profits in most circumstances but does not require him to deduct tax from payments to the swap counter party. But, while ensuring a workable and flexible framework for swaps to operate, any solution must at the same time ensure that swap receipts are properly chargeable on recipients, incorporate adequate protection against abuse, and should also, if possible, avoid undue distortions compared with the tax treatment of ordinary borrowing costs.

Outline of possible new scheme

5.6 It would seem that these various and occasionally divergent considerations could best be met by a scheme which generally treated recurrent swap fees as if they were payments of interest but without the requirement for deduction of tax at source in most circumstances. Legislation would be required in order that this solution could be effectively implemented. This would apply - subject to specified exceptions - the normal interest charging and relieving sections, and also enable the established anti avoidance interest provisions to be invoked if necessary. It would also cater for swap payments made and received by individuals.

5.7 The detailed framework of the legislation that would be required is set out in paragraph 5.9-5.10. But first we set out broadly how the scheme would differ from current law and practice, and also how the treatment of recurrent swap fees would differ from that for interest:

i. Deductibility

The position in present law whereby recurrent swap fees, when payable on revenue account for trading purposes, are deductible as trading expenses on the accruals basis would effectively be preserved. Here swap fees would be treated rather more generously than interest, but more uniformly, in that there would be no distinction between "annual" and "short" swap payments where made for trading purposes. At present, interest lasting less than a year ("short" interest) is, if a trading expense, fully deductible on the accruals basis, whoever it is paid to. But "annual" interest (that is interest capable of lasting a year or more) is only deductible on the accruals basis as an expense if paid to a UK recognised bank. Otherwise it is deductible on the payments basis as a charge (and tax generally has to be deducted on payment). Since under the new scheme deduction of tax would not generally apply to swap fees, it would seem to make sense to treat all swap fees for trading purposes in the same way, no matter who they are paid to. As a safeguard here however the new scheme would make deductibility dependent on the fees being paid for bona fide commercial purposes and being no more than would be payable in an arm's length transaction between independent parties.

Where payable otherwise than as a trading expense recurrent swap fees would be, like annual interest, allowable as a charge as and when paid.

Where recurrent swap fees were payable to a non UK resident associated company, assimilation to interest would entail that, like interest, the payments may under Section 209(2)(e)(iv) and (v) ICTA 1988 be treated as a distribution and therefore disallowed in computing

profits unless that Section were overridden by the terms of the interest article of the relevant Double Taxation Agreement. Exemption from Section 209(2)(e)(iv) and (v) under Double Taxation Agreements is normally subject to various limitations, which would therefore apply to recurrent swap fees where these were within the interest article following assimilation to interest in domestic law.

ii. Deduction of Tax

Except when payable to a recognised UK bank, annual interest paid by companies normally has to be paid under deduction of tax. However, as indicated above, gross payment would be permitted generally for swap fees in order not to undermine the swaps market. Interest flows on any underlying borrowing would of course still be subject to deduction of tax in the normal way.

An exception to gross payment would however have to be considered for swap payments to non residents whose profits were not chargeable to tax in the UK (ie where the payment was not connected with a UK branch). Otherwise there would be a possibility - despite existing avoidance safeguards - of gross payment being exploited by international groups (in similar situations, interest as such would often be subject to deduction of tax). Deduction of tax would not however be required in the case of financial dealers paying swap fees to non-residents in the ordinary course of business.

iii. Chargeability

Where recurrent swap fees were receivable on revenue account under an agreement entered for trading purposes they would be taxable as a trading receipt on the accruals basis and not as a separate interest receipt, despite the assimilation of swap fees to interest generally. This would preserve the current position under strict law for such receipts. Swap payments not treated as trading receipts would be assessable, as if they were interest, when receiveable.

5.8 This scheme seeks to minimise the risk of arbitrage at the Exchequer's expense which might occur, notably if relief were given to a trader on an accruals basis but his swap receipts were chargeable only when received. As far as possible, to the extent a company obtained relief for payments on an accruals basis, its receipts would be chargeable on the same basis and similarly where the relief was on a payments basis chargeability would be on the normal basis applying to interest receivable. It is not possible to achieve complete

timing symmetry, but the scheme would at least ensure that the scope for such arbitrage would be no greater and indeed might be somewhat less than is the case with interest payments.

Detail of legislation

5.9 A definition of swap fees and rules setting out the treatment of such fees would be required for the purpose of any legislation. An interest rate swap would be defined as an agreement between two parties to exchange sums calculated as if they were interest arising over a specified period on a specified fixed or variable amount (or its equivalent at the date of the agreement in another currency), the amount payable by each party being calculated at a different specified fixed or floating rate and/or in a different currency; or to pay to each other any excess of the amount that would be payable over the amount that would be receivable under such an agreement.

5.10 Where swap fees were incurred under such an agreement the main rules would be:

i. recurrent fees would be deemed to be interest (annual interest where the period of payment could be a year or more)

ii. deductibility would be available only if

a. the interest rates on which the recurrent fees were based were commecial rates (taking account of the currency on which they were calculated) and the fees payable were no more than would be paid in an arm's length transaction, and

b. the charging and payment dates for each party to the swap agreement were simultaneous (to avoid relief/chargeability mismatches and scope for exploitation, eg deep discount securities, see paragraph 5.12 below)

c. swap fees under the agreement were payable at least annually.

iii. deduction of tax would not apply to swap fees within ii. except to payments other than in the course of a financial trade to non residents (This would not be relevant where the swap fee was chargeable to UK tax in computing profits of a UK branch).

iv. subject to the above rules recurrent swap fees paid to UK residents wholly and exclusively for trade purposes or paid to non residents in the course of a financial trade would always be deductible (on the accruals basis) in

computing trading profits; in such circumstances the corresponding swap fee

received would be a trading receipt (ie chargeable on the accruals basis). In other circumstances payments would be allowed as charges and payments received taxed as interest.

v. recurrent swap fees that did not meet the deductibility criteria would nevertheless remain chargeable on the recipient (as for interest).

vi. where recurrent swap fees were deductible under ii. an initial fee for arranging the swap would be treated as if it were an incidental cost of obtaining loan finance within Section 77 ICTA 1988.

International aspects

5.11 A major advantage of assimilating swap payments to interest would be that the various provisions applying to interest would also be applied to swaps, giving protection against avoidance and abuse, particularly through cross frontier payments. These include being able to treat interest as a distribution and so refuse deductibility (section 209 ICTA 1988), and denying relief where the essential purpose of the transaction is not commercial but to obtain relief (Section 787). Section 209 and 787 do not of course apply exclusively to cross-border transactions. In addition the terms of the UK's double taxation agreements with other countries would provide further protection. A further consideration is whether there is a need for further powers to counteract the tax free extraction of UK profits to overseas associates via payment of deductible interest. The safeguards here are currently being reviewed following a separate consultative exercise on "thin capitalisation" and it would be important that any additional or revised measures that emerged from that exercise should be applicable to swap payments as well, since otherwise swap payments might be used as a way round interest relief safeguards. Whether this would involve further legislative controls in addition to those mentioned earlier will depend on the outcome of the "thin capitalisation" review.

Deep Discounted Securities and Swaps

5.12 Swaps involving securities issued at a deep discount, notably zero coupon stocks where no interest is payable, (all the return being contained in the difference (discount) between issue price and redemption price), pose a potential problem. This would arise if a company issued a zero coupon bond and then entered into a swap with (typically) a bank whereby the company made floating rate payments to the bank each year, in return

for a lump sum payable by the bank on maturity of, and used to repay, the zero coupon bonds. It is arguable that the company would not be entitled to a deduction for the accruing discount under the 1984 deep discount legislation on the grounds that the discount was not (because of the swap) ultimately borne by the company (paragraph 5(3) Schedule 4, ICTA 1988). But if this argument were not correct and if the new scheme set out above allowed relief for swap payments in this situation the company would be able to claim relief each year for both the accruing discount (under the deep discount legislation) and for the floating rate payment to the bank (under the swaps legislation). It might be taxed at the end of the agreement on the lump sum received but it would in the meantime have been receiving a double deduction equivalent in the normal case to twice the true commercial cost of its borrowing. The bank would be taxable on its swap receipts but might be able to claim relief each year under established tax case law for the accruing portion of the lump sum to be paid at redemption. The Revenue have so far refused to extend their current practice to these swaps. The new scheme would also deny the possibility of excessive relief by restricting relief to swaps where both payment flows were made annually at the same time.

Swaps by Individuals

5.13 The new scheme would deal in similar terms with swap payment transactions involving both companies and individuals. However, individuals are only entitled to relief on interest for certain specified purposes (principally where the interest is a trading expense, or where it is for the purchase of the person's only or main residence or of property for letting, but there are a number of other qualifying purposes). By assimilating swap fees to interest for tax purposes, relief for swap payments would be available only where the swap was associated with an underlying loan for a qualifying purpose such as the purchase of property for letting.

fim2.cr/Neilson/M.61

CONFIDENTIAL

FROM: M J NEILSON
DATE: 6 DECEMBER 1988

FINANCIAL SECRETARY

cc PS/Chancellor
PS/Economic Secretary
Mr Scholar
Mr Peretz
Mrs Lomax
Mr Culpin
Mr Ilett
Mr Gilhooly
Mr Tyrie
Mr Beighton)
Mr Johns) Inland
Mr Neild) Revenue

Mr Collins Bank

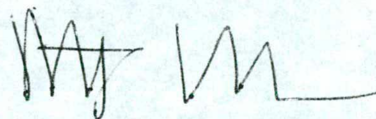
INTEREST RATE SWAPS - BUDGET STARTER 157

You asked if FIM saw any way of reviving the "middle way" on interest rate swaps, ie legislation in 1990 with an extension of the current concession to cover the main non-banking investment houses.

As Mr John's note explains, the problem is establishing suitable criteria, which can be defended, for deciding who should benefit from the concession. No existing lists or definitions quite fit the bill, and it would take too long for the Revenue to establish a tailor made list.

We have however identified another option which we think is worth exploring further. This would involve a two stage process. First, only firms authorised under the Financial Services Act or appearing on the Bank's section 43 list would be eligible to benefit from the concession. But authorisation or listing would not alone be sufficient. The second stage would be for each firm to apply to the Inland Revenue for the concession. The Inland Revenue would then contact the relevant supervisor - either the Bank or TSA - who would indicate whether these firms operated in the swap market (for example they could confirm that the firm's business plan indicated that they were involved in swaps). This would form the basis of a decision on whether to extend the concession.

It is to early to say whether this option would, in practice, provide sufficiently objective criteria for the Inland Revenue to defend. But we think it is worth pursuing further before abandoning the middle way altogether. If you agree, we shall get together quickly with the Inland Revenue and the Bank to see if this option is workable.



M J NEILSON

fst.jf/R.Satchwel/21.8.12.88

CONFIDENTIAL

FROM: R C M SATCHWELL
DATE: 7 December 1988

MR JOHNS - IR
MR NEILSON

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mrs Lomax
Mr Peretz
Mr Gilhooly
Mr Ilett
Mr Tyrie
Mr Jenkins (OPC)

Mr Beighton)
Mr Nield) IR

PS/IR
Mr Hewitt (Bank)

STARTER 157: INTEREST RATE SWAPS

The Financial Secretary was most grateful for your respective minutes on this starter.

As I said in my minute of 7 November, the Financial Secretary's preferred option is to extend the current concessionary practice to non-banking investment houses, and then legislate in 1990. He therefore agrees with Mr Neilson's suggestion of trying to work up (in conjunction with the Bank) a two stage scheme for deciding who could benefit from the concession. He very much hopes that this will produce a workable solution.

The Financial Secretary has commented that if this is not possible, then we shall have to legislate in 1990 following a

lengthy consultation period. Because of pressures on next year's Finance Bill, legislation in 1989 is not an option.

The Financial Secretary will hold a meeting to discuss the content of the draft consultative document when he has received your further advice.

R.C.M.S.

R C M SATCHWELL
Private Secretary

Inland Revenue

Oil and Financial Division
Somerset House

FROM M A JOHNS

26 JANUARY 1989

If the TSA agree we can now go ahead with consultation here. As Mr Johns says, since this is explicitly not for legislation in 1989, there seems no reason to hold back consultation until after the Budget. We shall now take this off the starters list. LHB 26/1

1. MR BEIGHTON
2. FINANCIAL SECRETARY

INTEREST RATE SWAPS - BUDGET STARTER 157

1. Following Mr Neilson's note of 6 December we have had further discussions with the Bank and with The Securities Association and we have now arrived at what appears to be a workable solution to the problem of finding a "middle way" which would extend the current Revenue concession to the main non banking investment houses pending legislation in 1990.

2. As I said in my earlier notes, any solution of this sort carries two risks:

   i. that the Government and Revenue could be criticised for extending a wide extra statutory practice which contains risk to the Exchequer because of lack of safeguards.

   ii. that ultimate legislation could become harder if most of the aspects favourable to the taxpayer had been given away by concession.

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cc Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Mr Scholar
Mr Peretz
Mr Culpin
Mr Ilett
Mr Gilhooly
Mr Tyrie
Mr Nielson
Mr Hewitt (Bank of England)
Mr Jenkins (Parliamentary Counsel)

Mr Isaac
Mr Painter
Mr Beighton
Mr Bush
Mr Houghton
Mr Johns
Mr Hall
Mr Skinner
Mr Hunter
Mr Bryce
Mr Nield
Mr J W Calder
Mr Keith
Mr Moule
PS/IR

But we think the route proposed which would restrict the extended concession to financial firms regularly entering into swaps (and not extend it - as the legislation would - to the generality of corporate treasurers) would limit both risks.

3. Under this scheme payment of swap fees gross would be allowed where made to or by a company trading as a swap dealer in the ordinary course of its trade and for this purpose any company would be regarded as dealing in swaps which was

- either authorised by TSA under the Financial Services Act or listed as exempt under Section 43 by the Bank, and

- confirmed by to the Bank or TSA, as the case may be, to be entering into swaps as part of its regular business activity.

4. The procedure for approving companies would not be based on the making of any existing list available to the Revenue but would involve individual companies requesting the Bank or TSA to certify to the Revenue that they met the above conditions. The Bank or TSA would then establish whether the company was entering swaps as part of its regular business activity either by reference to existing business plans or by enquiry of the company concerned. Any company which was found not to meet regulatory requirements for carrying on such business would be instructed not to do so and would not obtain the certificate required for the purposes of the Revenue concession. The Bank and TSA would be prepared to undertake this work as they would regard it as a useful check for regulatory purposes of the activities financial firms were carrying on. It would require no significant use of Revenue resources.

5. If you are content with this approach, I would need to put the proposal formally to TSA. At present we have their agreement at working level and they would need to clear it with their board although they expect no problems. It would then be important to publish both the interim extended ESC and the Consultative

Document on legislation at the same time so that people could see the full intentions of the Government. This could be done by means of an arranged Parliamentary Question and a Press Release early in February. When we discussed timing before, however, you felt that there might be difficulties in issuing a Consultative Document between Christmas and the Budget. Delay to the Budget would obviously add to the impatience of the prospective beneficiaries and if it was made clear that the consultation period extended to the Summer does not seem essential. But if you wanted to do so the Press Release could be deferred to Budget day. No Parliamentary Question would then be needed and the Consultative Document could be issued shortly afterwards.

6. I attach

- a draft Parliamentary Question and Answer

- a draft Press Release. In the event of a Budget Day announcement there would be no Parliamentary Question and the Press Release would need consequential amendment.

- a revised draft Consultative Document.

7. A 3-4 month period for consultation would seem ample, pointing to asking for comments by the end of June.

M. A. Johns

M A JOHNS

SWAPS - DRAFT PARLIAMENTARY QUESTION AND ANSWER

Question

To ask the Financial Secretary to the Treasury if he will comment on the deductibility for tax purposes of fees paid under the financial instruments known as swap agreements.

Answer

Recurrent fees which are paid under interest rate or currency swap agreements are not interest for tax purposes, but under a long standing practice the Inland Revenue allows companies to deduct such fees in computing their profits as if they were annual payments. In the normal case the law requires the payer to withhold tax from annual payments and account for it to the Inland Revenue before the payments can be deducted, but under the Inland Revenue's practice there is no such requirement where swap fees are paid or received by a UK bank in the ordinary course of its trade.

Representations have been made that this practice discriminates unfairly against UK operators in the swaps market who are not recognised as banks for tax purposes. It has in any case become clear that the practice is extra-statutory.

As a short term measure the Inland Revenue is continuing its practice as an extra-statutory concession but extending its coverage to meet the objections to it.

As from today the deductibility of swap fees under the Inland Revenue concession will not require tax to be withheld from fees paid or received by a UK company trading as swap dealer in the ordinary course of that trade. The tax treatment of swap fees paid by or to such a company will therefore be exactly the same as for swap fees paid by or to a recognised UK bank. For the purposes of applying this concession a company will be regarded as carrying on the trade of swap dealer only if a certificate is produced to the Inland Revenue from the Bank of England that it is listed as an exempted person under Section 43 Financial Services Act 1986 or from The Securities Association that it is authorised as a member to carry on investment business under the Financial Services Act 1986, along with confirmation that the company is known by the Bank or The Securities Association as the case may be, to be entering swaps as part of its regular business activity.

The Inland Revenue is today issuing a Press Release which sets out the detailed terms of the extra statutory concession and the procedures to be followed by any company wishing to benefit from this extension of the Inland Revenue concession.

For the longer term I have approved the issue by the Inland Revenue today of a consultative document setting out a possible new statutory scheme of relief for swap fees. Under this scheme, relief, with no requirement to deduct tax, would be allowed for all swap fees, by whomever

paid, subject to certain restrictions designed to protect the Exchequer from possible abuse. I have placed copies of the document in the Library.

DRAFT PRESS RELEASE

TAX TREATMENT OF SWAP FEES:

ISSUE OF CONSULTATIVE DOCUMENT
EXTRA STATUTORY CONCESSION

1. In response to a Parliamentary Question today, the Financial Secretary, the Rt Hon Norman Lamont announced today

- the publication of an Inland Revenue consultative document setting out a possible new statutory scheme of relief for swap fees

- an extra statutory concession by the Inland Revenue to be operative pending the introduction of new legislation.

2. The Financial Secretary said

"[As in Parliamentary Question and Answer]".

Consultative Document

3. Copies of the consultative document may be obtained by calling at or writing to the Inland Revenue Reference Room, Room 8, New Wing, Somerset House, Strand, London WC2R 1LB. The price is £ (including postage): payment should be made by cheque or postal order (payable to "Inland Revenue") or in cash. Postage stamps cannot be accepted in payment.

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4. Responses to the consultative Document are invited by [30 June] 1989. They should be sent to:

> The Board of Inland Revenue,
> Swap Fees Consultation,
> Room 69,
> New Wing,
> Somerset House,
> Strand,
> London,
> WC2R 1LB

Extra Statutory Concession

5. The text of the extra statutory concession is as follows:

> Where annual swap fees are not deductible in the computation of trading income under strict law the net fees paid will be treated as if they were annual payments for the purpose of computing Corporation Tax profits. Where such fees are paid by or to a recognised UK bank or swaps dealer in the ordinary course of its trade, deduction of the fees as a charge will not be conditional upon tax having been deducted and accounted for to the Inland Revenue. A recognised UK bank is a company which is recognised by the Inland Revenue as a bank for the purposes of Section 349 Income and Corporation Taxes Act 1988. A recognised UK swaps dealer is a company which is either listed by the Bank of England as an exempted person under Section 43 Financial Services Act 1986

or authorised as a member of The Securities Association to carry on investment business; and which is confirmed by the Bank of England or The Securities Association to be entering swaps as part of its regular business activity.

6. Companies wishing to be regarded as swap dealers for the purposes of the interim Inland Revenue concession should write to the Bank of England or to The Securities Association along the lines of the specimen letters below.

Companies lead regulated by the Bank of England

SWAP FEES - INLAND REVENUE CONCESSION

On behalf of XYZ Limited I hereby authorise you to certify to the Inland Revenue that XYZ Limited has been listed as an exempt person under Section 43 Financial Services Act 1986 and is known by you to be entering swap agreements as part of its regular business activities.

The letter should be addressed to

Mr [I Bond],
Wholesale Markets Supervision Division,
Bank of England,
Threadneedle Street,
London,
EC2R 8AH

Companies lead regulated by The Securities Association

SWAP FEES - INLAND REVENUE CONCESSION

On behalf of XYZ Limited I hereby authorise you to certify to the Inland Revenue that XYZ Limited is authorised as a member of The Securities Association to carry on investment business and is known by The Securities Association to be entering swap agreements as part of its regular business activities.

The letter should be addressed to

Mr [C Woodburn],
Head of Financial Regulation,
The Securities Association Limited,
The Stock Exchange Building,
London,
EC2N 1EQ

On receipt of the required certificate from the Bank of England or The Securities Association the Inland Revenue will write to the company concerned confirming that it is recognised as a swaps dealer for the purpose of this concession.

NOTES FOR EDITORS

1. Swaps are fixed term agreements designed to exploit the different ratings in different financial markets of two counterparties with complementary needs. For example party A may be able to raise

fixed rate finance at a lower rate than party B but may want floating rate finance where he enjoys no such advantage; while party B wants fixed rate finance. Party A will therefore raise a fixed rate loan and party B a floating rate loan but they enter a swap under which A pays to B sums based on floating rates and receives from B sums based on fixed rates. The sums are set so as to share the benefit of A's better credit rating in the fixed rate market and each party effectively ends up with the kind of finance it wants at a lower cost than would otherwise have been obtainable. Often a bank or financial dealer will intermediate in these swap transactions. Swaps are used in both the interest and currency markets and often perform a hedging function for companies. The volume of swaps has increased considerably over recent years and they represent a major activity in the financial markets.

2. Under existing law it is doubtful whether many swap payments are deductible for tax purposes at all. However, Inland Revenue practice, now formalised in this extra statutory concession, has been to accept that they are deductible as annual payments in computing the payer's tax liability but to require tax to be deducted before they are paid to the counter party unless one of the parties is a recognised bank for the purposes of paying interest without deduction of tax. This is now being extended to swaps where one or other party is a swap trader and is approved under financial services regulations by the Bank of England or The Securities Association.

Under the legislation proposed in the consultative document swap payments by all parties would be payable without deduction of tax subject to certain safeguards to protect the Exchequer.

3. An extra-statutory tax concession is a relaxation which gives the taxpayer a reduction in tax liability to which he is not entitled under the strict letter of the law. Most concessions are made to deal with what are, on the whole, minor or transitory anomalies under the legislation and to meet cases of hardship at the margins of the code where a statutory remedy would be difficult to devise or would run to a length out of proportion to the intrinsic importance of the matter.

4. Inland Revenue Extra-Statutory Concessions are of general application, but in a particular case there may be special circumstances which must be taken into account in considering the application of the concession. A concession will not be given in any case where an attempt is made to use it for tax avoidance.

5. Inland Revenue concessions are published in the booklet IR 1 which is available free from tax offices. The concession published today will be included in the next edition of the booklet (unless there is legislation before this is published).

Draft consultative document on the taxation treatment of swap fees

1. Introduction

2. Swaps - a general description

3. Tax treatment of swap fees under strict law

4. Current Inland Revenue Practice

5. A possible new scheme of relief.

1. INTRODUCTION

1.1 This Consultative document is about the tax treatment of fees paid under swap agreements. It covers fees paid where only interest flows are exchanged (an "interest rate swap") and also where in addition to an exchange of interest flows there is an exchange of currency on termination of the swap (a "currency swap"). The paper does not however consider the tax consequences of the exchange of currency itself. There have been representations that these consequences can create difficulties but these are being considered separately.

1.2 Swaps did not exist when the present law on interest and annual payments was developed and Revenue practice has evolved over the last 10 years or so to fit them in as well as possible to laws devised for other purposes. In the light of this the Revenue practice has for several years been to treat recurrent swap fees as annual payments while applying rules on deduction of tax at source applying to interest. But in many cases it is doubtful whether this practice is consistent with the strict letter of the law. In some cases the current practice may give relief which would not otherwise be due. In others it imposes a requirement to deduct tax, which effectively prevents some companies from doing business in the swaps market. Representations have been made by a number of bodies connected with the market that the existing practice ought to be modified.

1.3 Ministers have therefore authorised the Revenue to consult interested parties with a view to developing new rules which could be incorporated in legislation. The aim would be to encourage the operation of the swaps market without putting up artificial barriers on entry, while protecting the Exchequer against loss of tax. This paper puts forward a possible scheme. In broad terms recurrent swap fees would be assimilated by legislation to interest but without the requirement to deduct tax, except possibly in limited circumstances where the absence of such a requirement might be exploited for avoidance purposes. This would not restrict the availability of relief for swap fees paid for genuine commercial purposes which already exists. On the contrary the object of the legislation would be to facilitate the use of swaps both by making the tax treatment clearer and by removing the requirement to deduct tax in most cases. But there would be safeguards to ensure that a more relaxed regime of this kind was not open to abuse.

1.4 As well as recurrent fees, swaps often involve an initial arrangement fee. Where recurrent fees would be deductible, this initial fee would also be deductible under the new scheme, as if it were an incidental cost of obtaining loan finance.

1.5 The document first considers briefly the nature of swaps, goes on to describe the treatment which would probably have to be applied under strict law and the Revenue's practice as it has evolved. It then sets out how the possible new scheme would operate.

1.6 Readers are invited to comment on any aspect of the document, in particular on the possible new scheme and the detail of the legislation which is suggested would be necessary if it were to be put into effect. Representations are sought by [31 January/May 1989] and should be forwarded to the Board of Inland Revenue Swap Fees Consultation, Room 9, New Wing, Somerset House, London WC2R 1LB.

1.7 Ministers have as an interim measure authorised the Revenue to introduce an extension of its existing concessionary practice, which would allow relief for swap fees paid gross to or by UK companies carrying on the business of swap dealer as well as those carrying on the business of a bank. The details of this interim measure [are being announced in a Press Release of today's date/were announced in a Press Release issued on].

2. SWAPS - A GENERAL DESCRIPTION

2.1 Companies use swaps for a variety of purposes. Most commonly swaps will be associated with an underlying borrowing. The effect of the swap is to substitute a more suitable interest or currency liability for that on an existing debt. Interest rate swaps are now a widespread, even commonplace, device for corporate borrowers to borrow on finer terms. They make use of the varying ratings of companies in different market sectors, reflected in the borrowing terms they are offered - eg one company may be able to obtain fine fixed income terms, whereas another has a primary rating in the floating rate market. Currency swaps however may be primarily a device for reducing long term exchange risk rather than for borrowing more cheaply. In each case the effect is that there are annual payments of net amounts representing the difference between interest paid on two different bases and it is the tax treatment of these net payments which is the subject of this consultation.

2.2 Examples

i. Interest rate swaps

A borrower who has borrowed at fixed rates of interest may prefer to pay floating rates (or vice versa). He therefore agrees with a counter party (often a bank) that he will make a stream of payments, calculated by reference to floating rates, to the counterparty who will in turn make a stream of payments to the borrower equal (in timing as well as amount) to the fixed rate interest which the borrower must pay to the original lender. Thus for the borrower the interest payable is cancelled by the swap fees receivable, and he is left making payments equal to interest at floating rates.

ii. Currency swaps

Currency swaps involve an exchange of capital sums but usually include an exchange of interest payments as well, on which the same issues arise as for pure interest swaps. For example, a borrower who wants sterling but has borrowed dollars, enters into an agreement with a counter party under which he swaps the dollar proceeds of the loan for sterling (this may be on a notional basis) and undertakes to swap the sterling back for dollars at the original rate of exchange at the end of the agreement, to coincide with the date when the loan becomes repayable. During the period of the agreement he pays to the counterparty swap fees based on sterling interest rates and receives from the counterparty swap fees based on dollar interest rates. As with the interest rate swap, the exchanges of interest flows are normally set off against each other so that only the net balances change hands.

2.3 In addition to the widespread use of swaps to change the currency and/or the interest payable on borrowings, swaps have also developed to meet investors' needs. For example if there were insufficient floating rate loan stock on the market to meet demand, an investor might purchase a fixed rate bond from a financial dealer (often a bank) but swap the fixed rate interest payable with the bank in return for a floating rate receipt. Alternatively, as with currency exchange swaps for borrowers, the asset swap can be used to provide an investor with a floating rate investment in a currency which he would not be able to obtain so easily or cheaply himself.

2.4 In the above examples swaps are used to alter the currency or interest rate exposure arising from specific liabilities or assets. They may also however be used to tailor a net overall exposure to a particular currency or interest rate. And of course a company might also enter a swap without having any underlying exposure at all, in which case the swap will generate profits or losses in its own right.

2.5 In all these cases the swaps change the terms of finance but are not intended to transfer value from one party to another or (by and large) convert income into capital. While, after the event, it may prove that payments all go one way, with a standard commercial swap the parties will have negotiated terms at the outset under which the two streams which are netted off are seen as having equal value. Where one currency is expected to appreciate against the other there may be some expectation that one party to a currency swap will pay more by way of annual payments and the other more by way of capital repayment but the size of that effect is limited to expectations of the relative movement of the currencies. In other cases there is no conversion of revenue to capital.

2.6 It is, however, possible to construct arrangements in the form of swaps which do transfer value from one party to another. For example, a member of an international group wanting to increase profits in a foreign affiliate for tax reasons could arrange a swap where a low interest rate was used as the basis of payments into the UK and a high interest rate as the basis of payments out. Or a swap could be used to convert taxable income into tax free capital; for example a "zero coupon" swap where one party pays interest but the other party pays an enhanced capital sum at the end of the swap and no interest in the intervening period.

2.7 The Government's aim is to facilitate genuine commercial swaps where there is an even handed flow of income but if it were also to allow tax relief for payments of the sort described in the previous paragraph it could be exposed to serious erosion of its tax base.

3. TAX TREATMENT OF SWAP PAYMENTS UNDER STRICT LAW

3.1 The main aspects to be considered on the tax treatment of swap fees paid under any of the different types of swap described in the previous section are

a. whether these payments are deductible for the payer, and, if so, whether on an accruals basis, or only as and when paid;

b. whether tax is deductible at source on making payment.

i. Deductibility

3.2 Relief for expenditure incurred by a company is broadly available if it is either a trading expense (in the case of a trading company), a management expense (in the case of an investment company) or a charge (in the case of either). To be allowed as a trading expense a sum has to be incurred by a trading company for the purposes of its trade and on revenue as distinct from capital account (ie for current operating and not for investment purposes). To be deductible as a management expense a sum has to be incurred by an investment company for the purposes of managing its investments. If it is a trading or management expense, a sum is deductible in computing the paying company's profits as it accrues rather than only when paid.

3.3 Allowability as a charge depends on the expenditure being an "annual payment" which is "ultimately borne" by the company - and not for example offset by an equivalent counterpayment. To be an annual payment the sum paid must be regarded as "pure income profit" in the recipient's hands, that is, must not be a payment for goods or services nor simply a receipt item in an overall profit/loss computation. Charges are allowable against profits only as and when paid and tax has to be deducted upon payment.

3.4 Swap fees (whether in an interest or a currency swap) can therefore be allowable as trading expenses only if incurred by a trading company for trading purposes on revenue account. Particularly in the case of currency swaps where an exchange of capital sums take place, swap fees may fail to qualify as deductible trading expenses. Recurrent swap fees would not normally be regarded as expenses of management and therefore if paid by non trading companies or on capital account would generally be relievable (as charges) only if they could be regarded as annual payments. Here however the "pure income profit" criterion may not be met, since the swap fees will generally be no more than an item in the payee's overall receipts, from which his net profits are calculated. So no relief is strictly due.

3.5 Where initial swap fees are concerned, the rules in Section 77 ICTA 1988 relating to incidental costs of raising loan finance would not apply so as to allow a deduction and therefore no relief is available.

ii. <u>Tax deduction at source</u>

3.6 Deduction of tax at source does not apply to trading/management expenses. It would apply only if swap payments were annual payments. If they are not, deduction of tax cannot in strictness be required.

4. CURRENT INLAND REVENUE PRACTICE

4.1 In fact Revenue practice evolved in response to swaps in a way that has diverged from the probable strict legal basis as described in the previous chapter. The application of the strict law to these new instruments was far from clear and it did not accord with commercial reality. The Revenue therefore has up to now adopted an interpretation different from that spelt out above.

4.2 The Revenue stated in 1977 to participants in the market that it was prepared to treat recurrent swap fees as if they were annual payments and to allow relief as a charge from which tax should be deducted. In September 1979 it was also agreed that where such fees were paid to or by UK banks payment could be made without deduction of tax. (This broadly mirrors the special statutory gross treatment which applies to such banks as regards interest paid and received).

4.3 The current Revenue practice is as follows

i. Deductibility

Recurrent fees paid by banks (and other financial concerns actively engaged in the swaps business) as part of their normal business will normally be allowed as a trading expense on the accruals basis. (This reflects strict law.) For other companies recurrent interest rate swap fees are generally allowable as a charge (on a payments basis) - as are recurrent currency swap fees, except where paid gross to a UK bank by a trading company for trading purposes, when they can be allowed as a trading expense.

4.4 This practice may therefore give relief beyond that strictly allowable by statute. The beneficiaries here are investment companies (since only exceptionally might swap payments qualify as management expenses under existing law), and trading companies in those circumstances where the swap payments cannot be treated as trading expenses.

4.5 Deductibility is not extended to initial swap fees, where practice is in line with the interpretation set out in paragraph 3.5.

ii. Deduction of tax at source

4.6 When swaps are allowed as a charge, payment of recurrent fees gross is permitted

a. where made by or to a UK bank acting as principal in the ordinary course of its banking business;

b. where made by or to a UK swaps dealer acting as principal in the ordinary course of its swap dealing business (under the interim concession mentioned at paragraph 1.7);

Otherwise tax should be deducted at source.

5. A POSSIBLE NEW SCHEME OF RELIEF

5.1 A number of considerations arise in looking at what revised treatment should operate in this area. One is to take account of realities in the market. First, swaps would not take place if the payer could not obtain relief for his swap payments and in any case there is no reason in principle for denying relief for what are, usually, genuine business outgoings. Second, we understand from swaps practitioners that swaps, in particular interest swaps, would not be economic with the cash flow disadvantages caused by deduction of tax. Insofar as the existing Revenue practice, in providing relief for swap payments - where not available as trading expenses under existing law - as charges, requires deduction of tax, participants in the market who are not banks are put at a disadvantage. Companies will not do business with them because of the possible requirement that tax would have to be deducted for relief to be allowed.

5.2 There are a number of active participants in the market who, although they trade as dealers in finance, do not qualify as banks under tax law, in particular some investment banks which do not have retail accounts. In the swaps market generally, the involvement of these non-bank financial traders may be set to increase. We have received representations from such traders that our current practice is unfair to them.

5.3 In addition companies which are neither banks nor financial traders may wish to enter swaps directly with each other. We have received representations that our practice forces companies to use banks as intermediaries in these transactions and that this may be disadvantageous to the companies concerned.

5.4 Swap transactions have to date largely been confined to the corporate sector but cases involving individuals can arise. The current Revenue practice is ill adapted to such cases since Section 36 of Finance Act 1988 severely restricts the circumstances in which annual payments can be taken into account in computing the income of an individual.

5.5 All this points to a solution which allows the payer a deduction against his profits in most circumstances but does not require him to deduct tax from payments to the swap counter party. But, while ensuring a workable and flexible framework for swaps to operate, any solution must at the same time ensure that swap receipts are properly chargeable on recipients, incorporate adequate protection against abuse, and should also, if possible, avoid undue distortions compared with the tax treatment of ordinary borrowing costs.

Outline of possible new scheme

5.6 It would seem that these various and occasionally divergent considerations could best be met by a scheme which generally treated recurrent swap fees as if they were payments of interest but without the requirement for deduction of tax at source in most circumstances. Legislation would be required in order that this solution could be effectively implemented. This would apply - subject to specified exceptions - the normal interest charging and relieving sections, and also enable the established anti avoidance interest provisions to be invoked if necessary. It would also cater for swap payments made and received by individuals.

5.7 The detailed framework of the legislation that would be required is set out in paragraph 5.9-5.10. But first we set out broadly how the scheme would differ from current law and practice, and also how the treatment of recurrent swap fees would differ from that for interest:

i. Deductibility

The position in present law whereby recurrent swap fees, when payable on revenue account for trading purposes, are deductible as trading expenses on the accruals basis would effectively be preserved. Here swap fees would be treated rather more generously than interest, but more uniformly, in that there would be no distinction between "annual" and "short" swap payments where made for trading purposes. At present, interest lasting less than a year ("short" interest) is, if a trading expense, fully deductible on the accruals basis, whoever it is paid to. But "annual" interest (that is interest capable of lasting a year or more) is only deductible on the accruals basis as an expense if paid to a UK recognised bank. Otherwise it is deductible on the payments basis as a charge (and tax generally has to be deducted on payment). Since under the new scheme deduction of tax would not generally apply to swap fees, it would seem to make sense to treat all swap fees for trading purposes in the same way, no matter who they are paid to. As a safeguard here however the new scheme would make deductibility dependent on the fees being paid for bona fide commercial purposes and being no more than would be payable in an arm's length transaction between independent parties.

Where payable otherwise than as a trading expense recurrent swap fees would be, like annual interest, allowable as a charge as and when paid.

Where recurrent swap fees were payable to a non UK resident associated company, assimilation to interest would entail that, like interest, the payments may under Section 209(2)(e)(iv) and (v) ICTA 1988 be treated as a distribution and therefore disallowed in computing

profits unless that Section were overridden by the terms of the interest article of the relevant Double Taxation Agreement. Exemption from Section 209(2)(e)(iv) and (v) under Double Taxation Agreements is normally subject to various limitations, which would therefore apply to recurrent swap fees where these were within the interest article following assimilation to interest in domestic law.

ii. Deduction of Tax

Except when payable to a recognised UK bank, annual interest paid by companies normally has to be paid under deduction of tax. However, as indicated above, gross payment would be permitted generally for swap fees in order not to undermine the swaps market. Interest flows on any underlying borrowing would of course still be subject to deduction of tax in the normal way.

An exception to gross payment would however have to be considered for swap payments to non residents whose profits were not chargeable to tax in the UK (ie where the payment was not connected with a UK branch). Otherwise there would be a possibility - despite existing avoidance safeguards - of gross payment being exploited by international groups (in similar situations, interest as such would often be subject to deduction of tax). Deduction of tax would not however be required in the case of financial dealers paying swap fees to non-residents in the ordinary course of business.

iii. Chargeability

Where recurrent swap fees were receivable on revenue account under an agreement entered for trading purposes they would be taxable as a trading receipt on the accruals basis and not as a separate interest receipt, despite the assimilation of swap fees to interest generally. This would preserve the current position under strict law for such receipts. Swap payments not treated as trading receipts would be assessable, as if they were interest, when receiveable.

5.8 This scheme seeks to minimise the risk of arbitrage at the Exchequer's expense which might occur, notably if relief were given to a trader on an accruals basis but his swap receipts were chargeable only when received. As far as possible, to the extent a company obtained relief for payments on an accruals basis, its receipts would be chargeable on the same basis and similarly where the relief was on a payments basis chargeability would be on the normal basis applying to interest receivable. It is not possible to achieve complete

timing symmetry, but the scheme would at least ensure that the scope for such arbitrage would be no greater and indeed might be somewhat less than is the case with interest payments.

Detail of legislation

5.9 A definition of swap fees and rules setting out the treatment of such fees would be required for the purpose of any legislation. An interest rate swap would be defined as an agreement between two parties to exchange sums calculated as if they were interest arising over a specified period on a specified fixed or variable amount (or its equivalent at the date of the agreement in another currency), the amount payable by each party being calculated at a different specified fixed or floating rate and/or in a different currency; or to pay to each other any excess of the amount that would be payable over the amount that would be receivable under such an agreement.

5.10 Where swap fees were incurred under such an agreement the main rules would be:

i. recurrent fees would be deemed to be interest (annual interest where the period of payment could be a year or more)

ii. deductibility would be available only if

 a. the interest rates on which the recurrent fees were based were commecial rates (taking account of the currency on which they were calculated) and the fees payable were no more than would be paid in an arm's length transaction, and

 b. the charging and payment dates for each party to the swap agreement were simultaneous (to avoid relief/chargeability mismatches and scope for exploitation, eg deep discount securities, see paragraph 5.12 below)

 c. swap fees under the agreement were payable at least annually.

iii. deduction of tax would not apply to swap fees within ii. except to payments other than in the course of a financial trade to non residents (This would not be relevant where the swap fee was chargeable to UK tax in computing profits of a UK branch).

iv. subject to the above rules recurrent swap fees paid to UK residents wholly and exclusively for trade purposes or paid to non residents in the course of a financial trade would always be deductible (on the accruals basis) in

computing trading profits; in such circumstances the corresponding swap fee

received would be a trading receipt (ie chargeable on the accruals basis). In other circumstances payments would be allowed as charges and payments received taxed as interest.

v. recurrent swap fees that did not meet the deductibility criteria would nevertheless remain chargeable on the recipient (as for interest).

vi. where recurrent swap fees were deductible under ii. an initial fee for arranging the swap would be treated as if it were an incidental cost of obtaining loan finance within Section 77 ICTA 1988.

International aspects

5.11 A major advantage of assimilating swap payments to interest would be that the various provisions applying to interest would also be applied to swaps, giving protection against avoidance and abuse, particularly through cross frontier payments. These include being able to treat interest as a distribution and so refuse deductibility (section 209 ICTA 1988), and denying relief where the essential purpose of the transaction is not commercial but to obtain relief (Section 787). Section 209 and 787 do not of course apply exclusively to cross-border transactions. In addition the terms of the UK's double taxation agreements with other countries would provide further protection. A further consideration is whether there is a need for further powers to counteract the tax free extraction of UK profits to overseas associates via payment of deductible interest. The safeguards here are currently being reviewed following a separate consultative exercise on "thin capitalisation" and it would be important that any additional or revised measures that emerged from that exercise should be applicable to swap payments as well, since otherwise swap payments might be used as a way round interest relief safeguards. Whether this would involve further legislative controls in addition to those mentioned earlier will depend on the outcome of the "thin capitalisation" review.

Deep Discounted Securities and Swaps

5.12 Swaps involving securities issued at a deep discount, notably zero coupon stocks where no interest is payable, (all the return being contained in the difference (discount) between issue price and redemption price), pose a potential problem. This would arise if a company issued a zero coupon bond and then entered into a swap with (typically) a bank whereby the company made floating rate payments to the bank each year, in return

for a lump sum payable by the bank on maturity of, and used to repay, the zero coupon bonds. It is arguable that the company would not be entitled to a deduction for the accruing discount under the 1984 deep discount legislation on the grounds that the discount was not (because of the swap) ultimately borne by the company (paragraph 5(3) Schedule 4, ICTA 1988). But if this argument were not correct and if the new scheme set out above allowed relief for swap payments in this situation the company would be able to claim relief each year for both the accruing discount (under the deep discount legislation) and for the floating rate payment to the bank (under the swaps legislation). It might be taxed at the end of the agreement on the lump sum received but it would in the meantime have been receiving a double deduction equivalent in the normal case to twice the true commercial cost of its borrowing. The bank would be taxable on its swap receipts but might be able to claim relief each year under established tax case law for the accruing portion of the lump sum to be paid at redemption. The Revenue have so far refused to extend their current practice to these swaps. The new scheme would also deny the possibility of excessive relief by restricting relief to swaps where both payment flows were made annually at the same time.

Swaps by Individuals

5.13 The new scheme would deal in similar terms with swap payment transactions involving both companies and individuals. However, individuals are only entitled to relief on interest for certain specified purposes (principally where the interest is a trading expense, or where it is for the purchase of the person's only or main residence or of property for letting, but there are a number of other qualifying purposes). By assimilating swap fees to interest for tax purposes, relief for swap payments would be available only where the swap was associated with an underlying loan for a qualifying purpose such as the purchase of property for letting.

Robert 05.27.1.89

CONFIDENTIAL

FROM: R C M SATCHWELL
DATE: 27 January 1989

MR JOHNS - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Peretz
Mr Gilhooly
Mr Ilett
Mr Nielson
Mr Tyrie
Mr Hewitt - Bank
Mr Jenkins - OPC

Mr Beighton - IR
PS/IR

INTEREST RATE SWAPS

The Financial Secretary was most grateful for your minute of 26 January. He is pleased that you have managed to find a workable solution for extending the current concessionary practice to the main non-banking investment houses pending legislation in 1990. He is content for you to put the proposal formally to TSA.

On handling, the Financial Secretary would prefer a Budget Day announcement and publication, which would fit in neatly with the publication of the consultative document on exchange rate gains and losses. He will hold a meeting shortly to discuss your revised draft of the consultative document and Press Release.

R.C.M.S.

R C M SATCHWELL
Private Secretary

Robert 03.02.2.89

CONFIDENTIAL

FROM: R C M SATCHWELL

DATE: 2 February 1989

MR JOHNS - IR

cc PS/Chancellor
PS/Chief Secretary
PS/Paymaster General
PS/Economic Secretary
Mr Scholar
Mr Culpin
Mr Peretz
Mr Gilhooly
Mr Ilett
Mr Nielson
Mr Tyrie
Mr Hewitt - Bank
Mr Jenkins - OPC

Mr Beighton - IR
PS/IR

INTEREST RATE SWAPS

The Financial Secretary has read the draft consultative on interest rate swaps attached to your minute of 26 January. He is content with the draft as it stands.

The draft Press Release which was also attached to your minute will however need to be amended, and to come forward for approval alongside all the other Budget Day Press Releases.

R.C.M.S.

R C M SATCHWELL
Private Secretary

Inland Revenue

BUDGET CONFIDENTIAL

Oil and Financial Division
Somerset House

FROM: J W CALDER

DATE: 20 FEBRUARY 1989

1. Mr Beighton

2. Financial Secretary

INTEREST RATE SWAPS

I attach a copy of the Budget Day Press Release for your approval.

This is along the same lines as the draft press release attached to Mr Johns' note of 26 January but has been shortened and amended to take account of the fact that there is to be no Parliamentary Question.

J W CALDER

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cc. Chancellor of the Exchequer
Chief Secretary
Paymaster General
Economic Secretary
Mr Scholar
Mr Peretz
Mr Culpin
Mr Ilett
Mr Gilhooly
Mr Tyrie
Mr Nielson
Mr Gieve
Mr Beighton
Mr Johns
Mr Bush
Mr Houghton
Mr Skinner
Mr Hunter
Mr Bryce
Mr Nield
Mr Keith
Mr Moule
Ms McFarlane
PS/IR

[3x] 14 March 1989

INTEREST AND CURRENCY SWAPS

As part of the Chancellor's budget proposals, the Inland Revenue is publishing today:

- a consultative document setting out a possible new statutory scheme of relief for swap fees
- an extra statutory concession to apply pending the introduction of new legislation.

The aim is to make it easier for a wider range of firms to take part in the growing market for interest and currency swaps (financial instruments which enable firms to diversify their interest and currency exposures).

Under present practice relief for swap fees is allowed but in some cases relief is conditional upon tax being deducted at source. But there is no requirement to deduct tax where swap fees are paid to or by a recognised UK bank in the course of its trade. Representations have been made that this practice discriminates unfairly against non bank operators in the UK swaps market. It has in any case become clear that the practice is extra statutory.

As a short term measure the Chancellor has authorised the Inland Revenue to continue its existing practice modified so that relief for swap fees paid to or by a UK swaps dealer will be allowed in exactly the same way as for swap fees paid to or by a UK bank. For the longer term, the consultative document sets out a possible new statutory scheme of relief, on which comments from interested parties are invited by 30 June 1989.

/CONSULTATIVE DOCUMENT

CONSULTATIVE DOCUMENT

1. Under the scheme set out in the consultative document relief, with no requirement to deduct tax, would be allowed for all swap fees, by whomever paid, subject to certain restrictions designed to protect the Exchequer from possible abuse. This would not restrict the availability of relief for swap fees paid for genuine commercial purposes which already exists. On the contrary the object of the legislation would be to facilitate use of swaps both by making the tax treatment clearer and by removing the requirement to deduct tax in most cases.

2. As well as recurrent fees, swaps often involve an initial arrangement fee. Where recurrent fees would be deductible, this initial fee would also be deductible under the new scheme, as if it were an incidental cost of obtaining loan finance.

3. Copies of the consultative document may be obtained by calling at or writing to the Inland Revenue Reference Room, Room 8 New Wing, Somerset House, Strand, London WC2R 1LB. The cost of the document is £1.10 (including postage); payment should be made by cheque or postal order (payable to "Inland Revenue") or in cash. Postage stamps cannot be accepted in payment.

EXTRA-STATUTORY CONCESSION

4. The text of the extra-statutory concession is as follows:

"Where annual swap fees are not deductible in the computation of trading income under strict law the net fees paid will be treated as if they were annual payments for the purpose of computing Corporation Tax profits. Where such fees are paid by or to a recognised UK bank or swaps dealer in the ordinary course of its trade, deduction of the fees as a charge will not be conditional upon tax having been deducted and accounted for to the Inland Revenue. A recognised UK bank is a company which is recognised by the Inland Revenue as a bank for the purposes of Section 349 Income and Corporation Taxes Act 1988. A recognised UK swaps dealer is a company which is either listed by the Bank of England as an exempted person under Section 43 Financial Services Act 1986 or authorised as a member of The Securities Association to carry on investment business; and which is confirmed by the Bank of England or The Securities Association to be entering swaps as part of its regular business activity."

5. Companies wishing to be recognised as swap dealers for the purposes of the interim Inland Revenue concession should write to the Bank of England or to The Securities Association along the lines of the specimen letters below.

/Companies lead

Companies lead regulated by the Bank of England

Mr I Bond
Wholesale Markets Supervision Division
Bank of England
Threadneedle Street
London
EC2R 8AH

SWAP FEES - INLAND REVENUE CONCESSION

On behalf of XYZ Limited, I hereby authorise you to certify to the Inland Revenue that XYZ Limit has been listed as an exempt person under Section 43 Financial Services Act 1986 and is known by you to be entering swap agreements as part of its regular business activities.

Companies lead regulated by The Securities Association

Mr C Woodburn
Head of Financial Regulation
The Securities Association Limited
The Stock Exchange Building
London
EC2N 1EQ

SWAP FEES - INLAND REVENUE CONCESSION

On behalf of XYZ Limited, I hereby authorise you to certify to the Inland Revenue that XYZ Limited is authorised as a member of The Securities Association to carry on investment business and is known by The Securities Association to be entering swap agreements as part of its regular business activities.

6. On receipt of the required certificate from the Bank of England or The Securities Association the Inland Revenue will write to the company concerned confirming that it is recognised as a swaps dealer for the purpose of this concession.

/NOTES FOR EDITORS

NOTES FOR EDITORS

1. Swaps are fixed term agreements designed to exploit the different ratings in different financial markets of two counterparties with complementary needs. For example A may be able to raise fixed rate finance at a lower rate than B but may want floating rate finance where he enjoys no such advantage; while B wants fixed rate finance. A will therefore raise a fixed rate loan while B raises a floating rate loan, and the two parties will enter a swap under which A pays to B sums based on floating rates and receives from B sums based on fixed rates. The sums are set so as to share the benefit of A's better credit rating in the fixed rate market and each party effectively ends up with the kind of finance it wants at a lower cost than would otherwise have been obtainable. Swaps are used in both the interest and currency markets, often with a bank or financial dealer as intermediary, and they often perform a hedging function for companies. The volume of swaps has increased considerably over recent years and they represent a major activity in the financial markets.

2. Under existing law it is doubtful whether many swap payments are deductible for tax purposes at all. However, Inland Revenue practice, now formalised in this extra statutory concession, has been to accept that they are deductible as annual payments in computing the payer's tax liability but to require tax to be deducted before they are paid to the counter party unless one of the parties is a recognised bank for the purposes of paying interest without deduction of tax. This practice is now being extended to those swaps where one or other party is a swap trader and is approved under financial services regulations by the Bank of England or The Securities Association. Under the legislation proposed in the consultative document swap payments by all parties would be payable without deduction of tax subject to certain safeguards to protect the Exchequer.

3. An extra-statutory tax concession is a relaxation which gives the taxpayer a reduction in tax liability to which he is not entitled under the strict letter of the law. Most concessions are made to deal with what are, on the whole, minor or transitory anomalies under the legislation and to meet cases of hardship at the margins of the code where a statutory remedy would be difficult to devise or would run to a length out of proportion to the intrinsic importance of the matter.

4. Inland Revenue Extra-Statutory Concessions are of general application, but in a particular case there may be special circumstances which must be taken into account in considering the application of the concession. A concession will not be given in any case where an attempt is made to use it for tax avoidance.

5. Inland Revenue concessions are published in the booklet IR 1 which is available free from tax offices. The concession published today will be included in the next edition of the booklet (unless there is legislation before this is published).