

INTEREST RATE CONTRACTS AND THE SCHEDULAR SYSTEM

by Michael Thomas

In the present climate of economic uncertainty borrowers may be attracted to enter into various types of contract to hedge against fluctuations in interest rates. A standard interest rate swap agreement involves two parties, usually at least one being a bank, agreeing to make payments to one another calculated by reference to variations in interest rates; which party is liable to make payments and their amount will depend on whether rates are above or below a particular level. There are many varieties of interest rate contract but this article focuses on swaps.

Where the taxpayer is a company then the tax treatment is set out in Part IV Chapter II of the Finance Act 1994. But where the taxpayer is not a company the position becomes less clear. I recently had to consider the tax treatment of an interest rate swap entered into by a partnership between individuals carrying on a Schedule A rental business in order to hedge against interest payments on loans taken out to purchase its investment properties. The short answer is that the Inland Revenue treat payments made or received under the swap as Schedule A expenses or receipts. The Revenue's practice is set out in Tax Bulletin 25 (October 1996). This treatment is premised on the interest itself being deductible in accordance with s.74(1)(f) ICTA 1988.

As a matter of common sense the Revenue's approach is correct: payments received by the borrower under the swap are netted off against the interest payments it makes producing the same economic effect as if the borrower had taken out a new loan with different interest payments. But while the tax system should produce common sense results the legal basis on which it does so should also be clear. Here we have a receipt under an interest rate swap agreement being labelled as income arising from the exploitation of land. This is equivalent to labelling a giraffe as an elephant and demonstrates that the Schular system must rely on fictions and twisted logic in order to produce sensible results.

The Revenue's approach to swap contracts entered into by Schedule A businesses follows, in accordance with the rule that Schedule A profits are computed in the same way as those of Schedule D Case 1, their treatment of swaps entered into by traders, as set out in Statement of Practice 14/91. But the conclusion that receipts under swap contracts are trading income from the underlying activity which the swap was protecting is difficult to reconcile with Nuclear Electric v Bradley [1996] STC 405 where the House of Lords took a narrow view as to when investment income could amount to a trading receipt, albeit that their Lordships did recognise that it could. Nuclear Electric decided that investment receipts providing against future trading payments were not trading receipts but unfortunately their Lordships gave little further guidance on the question of when investment income will be a trading receipt. Perhaps the best reconciliation is to say that receipts under interest rate contracts are

receipts from the underlying activity when they are used to set off against deductible interest payments which are costs of that activity in the present year.

In Statement of Practice 14/91 the Revenue give guidance as to when a payment made or received under an interest rate contract will be treated as a trading outgoing or receipt, notwithstanding that the taxpayer has no trade in interest rate contracts. Essentially they say that payments made under interest rate contracts taken out to reduce the risk of trading transactions will be treated as trading profits or losses. This treatment is undoubtedly helpful in that it allows profits and losses under the swap to be set off against interest payments and trading profits respectively. But of course a Statement of Practice is not a statute and to rely on it a taxpayer must show a legitimate expectation of being allowed the treatment it affords. Where the interest payments hedged against service capital borrowings it could be argued that Statement of Practice 14/91 does not apply because there is no trading transaction, although the better view is that where the borrowings are related to a Schedule D Case 1 trade the Statement of Practice applies: that would make economic sense. More fundamentally the Statement of Practice does not deflect the central criticism that the Schedular system only arrives at sensible results by labelling payments received under swap contracts as trading profits or income arising from the exploitation of land.

If an individual, or for that matter an investment trust, takes out a swap purely as a speculative investment, rather than to hedge or as part of a trade in

swaps, the question arises as to which case of Schedule D the income falls into. The Revenue's original view, as expressed in Extra Statutory Concession C17, was apparently that such receipts were Schedule D Case III annual payments. This seems dubious as it is difficult to see how swap payments are pure income profits, especially where payments fall to be made by both parties during any year. The better view is that the net annual payments made and received under the swap should be within Schedule D Case VI. What is clear is that without legislation such as that which applies for corporation tax purposes the Schedular system cannot adequately cope with interest rate contracts.

The above analysis ought to be academic and sterile. Unfortunately, it has practical relevance because the general rule remains that profits and losses arising under the different Schedules and the different cases of Schedule D must be segregated notwithstanding the difficulties of classifying income in the first place. Our tax system is undeniably complex but complexity should be the cost of precision and not the result of distorting concepts and twisting logic. Taxpayers should be able to undertake transactions with knowledge of the law that will apply rather than have to rely on the Revenue to apply its Statements of Practice. The Schedular system is unnecessary historical baggage; it should be scrapped and replaced with a business profits tax.

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