

LEGISLATION

Section 737A (sale and repurchase of securities: deemed manufactured payments) is amended as follows.

(2) In subsection (5) (application of Schedule 23A and dividend manufacturing regulations), after “apply” insert “, subject to subsection (5A) below,”.

(3) After that subsection insert—

“(5A) If the relevant person is not the person to whom the transferor agreed to sell the securities, the relevant person is not entitled, by virtue of anything in Schedule 23A or any provision of dividend manufacturing regulations, or otherwise—

(a) to any deduction in computing profits or gains for the purposes of income tax or corporation tax, or

(b) to any deduction against total income or total profits, by virtue of subsection (5) above.

Where the relevant person is a company, an amount may not be surrendered by way of group relief if a deduction in respect of it is prohibited by this subsection.”.

(4) In subsection (6) (interpretation), for—

(a) “subsection (5) above”, and

(b) “that subsection”,

substitute “this section”.

(5) The amendments made by this paragraph have effect in relation to securities if—

(a) the agreement to sell them was made on or after 27th June 2006, or

(b) a person other than the person to whom the transferor agreed to sell them became the relevant person in consequence of any other agreement made on or after that date.’.

‘Loan relationships: repo and stock-lending arrangements

13A(1) In Schedule 9 to FA 1996 (loan relationships: special computational provisions), paragraph 15 (disposal or acquisition made in

pursuance of repo and stocklending arrangements not to be related transaction) is amended as follows.

(2) In sub-paragraph (2)(b) (transfer to original transferor (“A”) giving effect to entitlement or requirement to rights on re-transfer etc.), after “to A” insert “by B”.

(3) The amendment made by this paragraph has effect in relation to any transfer to A (within the meaning of paragraph (a) of sub-paragraph (3) of paragraph 15) under arrangements—

(a) consisting in or involving an agreement made on or after 27th June 2006 for the transfer of rights by A to B (within the meaning of that paragraph), or

(b) involving an agreement made on or after that date providing for a transfer giving effect to the entitlement or requirement described in paragraph (b) of that sub-paragraph otherwise than by B.’.

SUMMARY

1. The two amendments reverse the effect of a recent decision of the Special Commissioners, the first instance tax tribunal. Their purpose is to prevent the legislation about sale and repurchase arrangements for securities (“repos”) being used to create artificial tax deductions or to escape tax on the income arising from repo agreements.
2. The first amendment prevents the holder of securities acquired under a repo agreement from obtaining a tax deduction for a deemed payment representing interest or dividends unless that person is also the person to whom the securities were first transferred.
3. The second amendment makes a minor change to the legislation applying to loan relationships (debt securities) to ensure that the transfer of securities under a repo can be ignored for tax purposes only if the seller and buyer and reseller and repurchaser are the same two people.
4. The amendments apply in relation to agreements made on or after 27 June 2006.

DETAILS

5. The amendments insert two new paragraphs into Schedule 6 to the Bill (financial avoidance).
6. Amendment 1# inserts a new paragraph 3A into Schedule 6.
7. Paragraph 3A(1) is introductory, and paragraph 3A(2) amends section 737A(5) so that becomes subject to the new section 737(5A).
8. Paragraph 3A(3) inserts this new section 737(5A) into the Income and Corporation Taxes Act 1988 (“ICTA”).
9. Section 737A operates in tandem with section 737C ICTA. Where during the term of a repo, a dividend or interest date occurs in respect of the securities which have been transferred, the actual payment of the dividend or interest will be made to the current holder, called the “interim holder” in the legislation.
10. The normal arrangement in repos is for the current holder to make a “manufactured” payment, representative of the dividend or interest, to the original owner so that the original owner retains the economic benefits of ownership. This is consistent with the economic substance of a repo which is that is a form of secured lending. However, some repo agreements do not provide for a manufactured payment. Instead the parties agree that the original holder pays a reduced repurchase price in lieu.
11. In such cases, section 737A deems a manufactured payment to be made, and section 737C then makes an adjustment for tax purposes to the repurchase price, the assumption being that the deemed manufactured payment and the real dividend or interest should be in the same amount and arise to the same person. However, in the avoidance scheme considered by the Special Commissioners, the deemed payment and the receipt of the real dividend or interest are claimed to arise for tax purposes to different persons with the result that there is a mismatch between the amounts charged to tax and the amounts claimed as a deduction against tax. This mismatch is removed by the amendment.
12. New subsection (5A), inserted into section 737A by paragraph 3A(3) of Schedule 6, provides that that a person cannot obtain a tax deduction for any payment section 737A deems it to make, and cannot surrender the deemed payment as group relief, unless that person is also the person to whom the securities were first transferred. The wording follows that of section 736B(2A) ICTA (no relief for deemed payments in stock lending transactions), but in this case relief will be denied for deemed payments

only if the person who is to sell the securities back is not the person to whom they are first sold.

13. Paragraph 3A(4) makes minor changes to the interpretation provisions in section 737A(6).
14. Paragraph 3A(5) is the commencement rule. The paragraph applies to deemed payments where the agreement to sell the securities was made on or after 27 June 2006, or to cases where the agreement under which the relevant person acquired the securities was made on or after that date.
15. The second amendment inserts a new Paragraph 13A into Schedule 6.
16. Paragraph 13A(1) is introductory, providing for the amendment of paragraph 15(2)(b) of Schedule 9 Finance Act (“FA”) 1996. Paragraph 15 deals with tax consequences for companies of repos where the securities concerned are assets representing loan relationships.
17. Paragraph 13A(2) gives the operative rule and limits paragraph 15 to ensure that the transfer and reacquisition under a repo or stock-lending transaction is only treated as not being a related transaction (and thus not an occasion where a profits or loss arises for tax purposes) where the transfer back of securities under a repo or stock loan is by the person who bought or borrowed them in the initial transaction. This brings it fully into line with section 263A Taxation of Chargeable Gains Act 1992 which covers repos of shares. .
18. Paragraph 13A(3) is the commencement rule. Paragraph 13A applies to cases where transfers back to the original owner are made under agreements made on or after 27 June 2006, or to cases where the agreement under which a person other than the original transferee is to transfer them back to the original owner is made on or after that date.

BACKGROUND NOTE

19. Repos involve the sale of securities with an agreement for the seller to buy back those securities from the buyer at a later date at an agreed price. Repos are commonly used as a form of secured lending so the repurchase price is generally increased to give the temporary holder of the securities a lender’s return.
20. Where repos occur under normal market terms using standard market documentation, the agreements usually provide that if securities on repo pay a dividend or interest, then the holder has to compensate the person who sold the securities by making equivalent payments –known as

manufactured payments- to that person. This ensures that the economic benefits and risks of owning the securities stay with the original holder.

21. However, some repos do not provide for manufactured payments to be made in respect of the dividends or interest paid to the temporary holder, but for a corresponding reduction in the repurchase price. In such cases, section 737A(5) ICTA deems a manufactured payment to be made to the original holder by the person from whom the securities are to be repurchased. In many circumstances, this deemed payment qualifies for corporation tax purposes as a deduction either in computing income or against total profits. Section 737C ICTA then deems there to be an equal increase in the price paid by the original owner to repurchase the securities.
22. In normal, two-party repos, this gives the right answer because the tax deduction for the deemed manufactured payment arises to the same person who received the real interest or dividends.
23. But in the case considered by the Special Commissioners there were three parties to the repo. The first buyer under the repo was a non-UK resident who received real coupon payments. The second buyer under the repo was its UK resident subsidiary (UK reseller) which held the securities only briefly before selling back to the original owner. The tax deduction for the deemed payment arose to the UK reseller so the claimed result is to give UK person a tax deduction in circumstances where it has made no economic loss. See *Bank of Ireland Britain Holdings Ltd v HMRC* (SpC 544).
24. The changes to section 737A will ensure that there can be no deduction for deemed manufactured payments unless the repo is a standard two party one.