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superseded**



**Manufactured Interest
on UK Securities**

Guidance Notes

June 1999

Financial Institutions Division

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1. About These Notes

1.1 These notes are provided to assist concerns which are party to transactions in UK securities to comply with their obligations as regards tax on manufactured interest. Further copies are available from the Inland Revenue website at www.inrev.gov.uk, or contact Ian Valentine at

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1.2 The April 1999 version of these notes differs from the January 1998 version largely in the removal of the appendices on quarterly accounting on gilt edged securities (which was abolished with effect from 1 April 1999) and CREST claims. The latter is now produced as a separate document, slightly updated to reflect changes in the Corporation Tax regime as it affects dividends on UK equities.

These notes are for guidance only and reflect the tax position at the time of writing. They do not affect any right of appeal.

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2. Important Changes to Legislation

2.1 The main text of these notes deals with the legislation which applies from 1 July 1997. Important changes to legislation affecting the manufactured interest regime since 1995 are summarised in paragraphs 2.2 to 2.7 below and are then dealt with in footnotes.

Loan relationships

2.2 The loan relationships legislation in Chapter II Part IV FA 1996 changed fundamentally the taxation of income and gains from loan relationships held by companies. A company has a loan relationship whenever it stands in the position of creditor or debtor as respects any money debt and that debt is one arising from a transaction for the lending of money¹. UK debt securities accordingly represent loan relationships and this will include, for example, convertible debt securities (which, along with other special cases, are given particular treatment in the loan relationship legislation).²

Stock Lending

2.3 The purpose test³ and the tax approval restrictions on the lending of UK securities other than gilt edged securities⁴ were removed with effect from 28 May 1996⁵.

¹ Where an instrument is issued for the purpose of representing security for, or the rights of a creditor in respect of, any money debt, that debt is taken to be a debt arising from the lending of money (Section 81(3) FA 1996).

² Section 92 FA 1996.

³ Section 129 (2B) ICTA 1988.

⁴ Taxation restrictions in respect of lending of gilt edged securities were removed with effect from 2 January 1996 - SI 1995 No. 3219.

⁵ SI 1996 No. 1228

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There are therefore after this date no taxation restrictions on the use to which UK securities (including gilt edged securities) in a stock lending arrangement may be put, or on the persons who may borrow or lend such securities. Section 129 ICTA 1988 was accordingly repealed and replaced by a new provision, Section 263B TCGA 1992. This ensures that acquisitions and disposals under stock loans are disregarded for Capital Gains Tax purposes.

2.4 In computing the profits of a trade for the purposes of Income Tax under Schedule D Case I the accounting treatment, which is to reflect the substance of the transaction in accordance with Financial Reporting Standard 5, will be followed.

2.5 A company's profits and gains from its loan relationships will be computed under an authorised accounting treatment in accordance with the loan relationship legislation in Chapter II Part IV FA 1996.

2.6 The need to distinguish between approved and unapproved manufactured interest disappeared with the removal of restrictions on stock lending, and the concept of unapproved manufactured interest has been dropped.⁶

Restructuring the Legislation

2.7 Prior to 1 July 1997 the manufactured interest legislation was found in both Schedule 23A ICTA 1988 (which dealt with liability in respect of manufactured interest paid by UK resident companies) and Section 737 ICTA 1988 (which dealt with liability in respect of payments by persons other than UK resident companies and with the reverse charge). Schedule 23A ICTA 1988 now covers all

⁶ SI 1996 No. 1227 - with effect from 28 May 1996

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manufactured interest. Section 737 ICTA 1988 has been repealed as a result.⁷

⁷ Also, The Income Tax (Manufactured Interest) Regulations 1992 (SI 1992 No. 2074), which supplemented Schedule 23A and Section 737, have been revoked with effect from 1 July 1997.

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3. The Statute - Schedule 23A ICTA 1988

3.1 Schedule 23A ICTA 1988 imposes a liability to identify, and account for tax on, manufactured interest. It also governs how relief is to be granted to the payer and how manufactured interest is to be treated in the hands of the recipient.

Meaning of "Manufactured Interest" and "UK Securities"

3.2 Manufactured interest is any payment, made under a contract or other arrangements for the transfer of UK securities, which is representative of interest on those UK securities. For example,

- where a loan of UK securities is outstanding over an interest payment date, and the lender does not receive the real interest to which he would have been entitled had the securities not been lent, any payment made by the borrower to the lender to compensate the lender for loss of the interest will be manufactured interest.
- Similarly, where a cum dividend short sale of UK securities is settled with ex dividend stock, any payment made by the vendor to the purchaser to compensate the purchaser for not receiving the real interest will be manufactured interest.
- And under a sale and repurchase transaction (repo), any payment made by the buyer of the securities under the first leg of the transaction, to the seller, which is representative of the interest not received by the seller will be manufactured interest (and see paragraph 4.2 below as regards deemed manufactured interest in certain repo transactions).

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But where a recipient is simply passing on real interest to which he is not beneficially entitled, for example,

- he has made a cum dividend sale out of a long position and receives the interest merely because the relevant register has not been updated to reflect the change of holder, or
- he has bought special ex dividend and receives the interest merely because he is the registered holder of the securities, or
- he is a nominee passing the interest to the beneficial owner,

this does not amount to interest manufacture (and see paragraph 4 below regarding the status of the payer).

3.3 "UK securities" means securities of the UK government, or of any public or local authority in the UK, or of any company or other body resident in the UK. But it does not include quoted Eurobonds (as defined in Section 124 ICTA 1988) held in a recognised clearing system,⁸ (which are in fact "overseas securities" for the purposes of Schedule 23A ICTA 1988) or UK equities.

The Main Charge to Tax

3.4 Under Paragraph 3(2) of Schedule 23A ICTA 1988 manufactured interest in the hands of the manufacturer is treated for the purpose of accounting for tax as an annual payment. The manufacturer has to deduct and account for Income Tax, at the lower rate⁹ from the gross amount of the deemed annual payment. The gross amount of the deemed annual payment is equal to the gross amount of the real

⁸ There are currently four Recognised Clearing Systems - Cedel, Euroclear, Depository Trust Co. of New York and First Chicago Clearing Centre.

⁹ The basic rate applied to payments made up to and including 5 April 1997.

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interest, that is, the amount of the real interest before any deduction for Income Tax that may be required.

3.5 But there is no obligation to account for tax, either under the main charge or under the reverse charge (see paragraph 3.7 below) where the manufactured interest is representative of interest payable on gilt-edged securities or otherwise where the real interest is payable without deduction of tax¹⁰.

3.6 The recipient of manufactured interest is treated as receiving a payment of real interest on the securities in question¹¹. He is deemed to receive an amount equal to the gross amount of the real interest for all tax purposes (except for the purposes of the loan relationships legislation, when the accounting treatment will be followed - see paragraph 6.3 below).

The Reverse Charge

3.7 Where the interest manufacturer is not resident in the UK, and the manufactured interest is not attributable to the carrying on of a trade in the UK by the manufacturer, tax is not (subject to paragraph 3.10 below) payable by the manufacturer. But where the manufactured interest is received by a "UK recipient" that recipient should account for the tax (the so-called "reverse charge").

"UK recipient" for this purpose means either

- i. a person resident in the UK, or
- ii. a person not resident in the UK but carrying on a trade in the UK through a branch or agency, provided the manufactured interest is attributable to the carrying on of the trade in the UK.

¹⁰ Paragraph 3A(2)(b) Schedule 23A ICTA 1988.

¹¹ See Section 97 FA 1996 as regards the loan relationship legislation and Paragraph 3(3) Schedule 23A ICTA 1988 for all other purposes

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3.8 The UK recipient is not, however, chargeable if he can show that the interest manufacturer was entitled to the real interest¹² either,

- as the holder of the UK securities concerned, or
- directly or indirectly from a person from whom he acquired the securities or to whom he transferred them, and who was entitled to the real interest as the holder of the securities;

and

- the amount of Income Tax falling to be deducted from the payment of the real interest was not reduced (under arrangements giving effect to a claim under a double taxation agreement).

3.9 Where paragraph 3.8 above does not apply only because the amount of tax falling to be deducted was reduced, the UK recipient remains liable. But his liability is limited to the difference between tax at the lower rate of Income Tax and the tax, if any, actually deducted.

3.10 Where paragraph 3.8 above applies the interest manufacturer (who will not be resident in the UK or trading in the UK) will not normally be liable for tax in respect of the manufactured interest he has paid. But there is an exception to this where, although tax was not deducted at a rate less than the lower rate of Income Tax from the real interest, the interest manufacturer is nevertheless entitled subsequently to claim relief (under the relevant double taxation agreement with the UK). In such a case he is liable for an amount of tax equal to the relief he is entitled to claim. But he is then treated as having made a claim under the double taxation agreement, so that the

¹² Regulation 4(1) SI 1997 No. 992 with effect from 1 July 1997. Prior to that date Paragraph 5 Schedule 23A ICTA 1988 provided relief in respect of registered securities only. The new relief covers both registered and bearer securities but does not extend (unlike Paragraph 5 Schedule 23A) to the case where the interest manufacturer repos or on-lends the securities so that he is not entitled to payment of the real interest.

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repayment due to him is set off against, and meets, his liability.

3.11 A UK recipient who is beneficially entitled to manufactured interest within paragraph 3.7 above is treated as receiving interest which has borne Income Tax by deduction whether or not he is liable to the reverse charge¹³.

3.12 The reason for the provisions explained in paragraphs 3.9 and 3.10 above is to prevent excess repayment of Income Tax when real interest effectively passes through a person who is not resident in the UK (and who does not carry on a trade in the UK), to a UK recipient. A UK beneficial recipient of the manufactured interest will be treated as receiving taxed interest, but in addition the non resident may be entitled to relief under a double taxation agreement with the UK. So, where the non resident receives relief at the time of receipt of the interest, that relief is retrieved from the UK recipient. Where the non resident does not receive relief at the time of payment of the interest any entitlement to relief at a later time under the double taxation agreement is matched by liability under Schedule 23A ICTA 1988.

¹³ Regulation 3(3) SI 1997 No. 992.

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4. Other relevant legislation

4.1 **Section 736B ICTA 1988** applies where, as a result of a stock lending arrangement, a dividend or interest on any securities is paid to a person other than the lender but no manufactured payment is made to the lender by way of compensation. In these circumstances¹⁴ Section 736B deems there to be a manufactured payment by the borrower to the lender on the same date as payment of the real interest or dividend.

4.2 **Section 737A ICTA 1988**¹⁵ has the effect of deeming manufactured interest to be paid where, in a sale and repurchase arrangement which crosses a coupon date, the first buyer does not make a separate manufactured payment to the seller in respect of the coupon, but the repurchase price is reduced to reflect the interest received by that buyer.

4.3 Where the section applies, Schedule 23A ICTA 1988 applies as if

- the relevant person (the first buyer in a simple repo) were required under the arrangements to pay an amount representative of the coupon;
- a payment were made by that person in discharge of that requirement; and
- the payment were made on the date the repurchase price of the securities becomes due.

4.4 Section 737A applies not only where the sale and repurchase are made under the same agreement, but also where they are made under related agreements. Agreements

¹⁴ Section 736B ICTA 1988 applies in relation to arrangements entered into on or after 1 July 1997.

¹⁵ Section 737A ICTA 1988 came into effect in relation to UK Securities with effect from 1 May 1995.

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are “related” if they are entered into in pursuance of the same arrangement regardless of the date on which either agreement is entered into. This wording is much wider than that previously used in Section 729 ICTA 1988¹⁶ (which referred to the same or any collateral agreement), and for instance prevents the parties avoiding the effects of the legislation by entering into the first agreement on day 1 and the second agreement on day 2.

4.5 Section 21 Taxes Management Act 1970. In order to supervise the tax treatment of manufactured interest the books and records of any person who carries on a business consisting in or involving any dealings in UK securities are subject to inspection by officers of the Inland Revenue under the powers granted by Section 21 TMA 1970¹⁷. The power is limited to those books and records which in the opinion of the Board contain or may contain information relating directly or indirectly to

- any transaction in securities,
- any transaction under which a manufactured payment has, will or may be made, or
- the making or receipt of a manufactured payment.

Inspection visits will be made periodically.

¹⁶ Section 729 ICTA 1988 was not regarded as applying to approved stock lending arrangements, or where a manufactured payment was within Schedule 23A ICTA 1988, and was repealed with effect from 6 November 1996 - SI 1996 No. 2646(C.75). Section 729 ICTA 1988 did not in any event apply to securities within the Accrued Income Scheme.

¹⁷ Section 21 TMA 1970 as amended by Paragraph 14 Schedule 10 FA 1997 applies to transactions entered into on or after 1 July 1997, and all manufactured payments made on or after that date.

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5. Status as principal

5.1 Liability arises under Schedule 23A ICTA 1988 when a person manufactures interest. To manufacture interest that person must be acting as a principal. This is because an agent is, in the main, transparent for tax purposes so that the actions of the agent are those of his client.

5.2 This Guidance Note is accordingly, with one exception, concerned with the taxation consequences and the accounting and reporting requirements where persons are acting as principal.

5.3 The one exception referred to in paragraph 5.2 is where liability arises as a result of the reverse charge (see paragraph 3.7 above) on the UK recipient of manufactured interest from outside the UK. The reverse charge applies to both principals and agents.

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6. Corporation Tax Treatment of manufactured interest paid or received under deduction of tax

6.1 Companies (whether resident in the UK or not so resident but carrying on a trade through a branch or agency in the UK) will be liable to Corporation Tax in accordance with the loan relationships legislation in Chapter II Part IV FA 1996, subject to set off of any Income Tax suffered on that interest.

6.2 A manufactured payment in respect of interest on a UK security which represents a loan relationship is treated for Corporation Tax purposes¹⁸

- i. as if it were interest under a loan relationship to which the company is a party; and
- ii. where that company is the company to which the manufactured interest is payable, as if that relationship were the one under which the real interest is payable

6.3 Such manufactured interest is accordingly treated as an interest debit or credit under a loan relationship to which the company is a party, and is brought into account on the same basis as if the company had received the real interest. Manufactured interest is not deemed to be in an amount equal to the gross real interest for the purposes of the loan relationship legislation.

6.4 Where the manufactured interest is paid by a company for the purposes of its trade it is treated as a trading debit. Any other payments are treated as non trading debits.

6.5 Manufactured interest received is treated as a trading credit if it is received in the course of activities

¹⁸ Section 97 FA 1996 - with effect from accounting periods ending on or after 1 April 1996.

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forming an integral part of its trade. Any other payments received are treated as non trading credits.

7. Income Tax Treatment of manufactured interest paid or received under deduction of tax

Recipients of Manufactured Interest

7.1 Concerns which are not companies are liable to Income Tax on the gross amount of manufactured interest received (equal to the gross amount of the real interest), subject to set off of any Income Tax suffered by deduction from that gross interest. Manufactured interest received under deduction of Income Tax should be excluded from any computation of trading profits under Case I of Schedule D.

Payers of Manufactured Interest

7.2 Manufactured interest paid in the normal course of a trade will be taken into account in computing the profits of that trade on normal Case I principles.

7.3 Where payment is not made in the normal course of a trade, and is not otherwise deductible, the gross amount of the manufactured interest is allowable as a deduction against total income¹⁹.

¹⁹ Paragraph 3(2)(c) Schedule 23A ICTA 1988 - with effect from 1 July 1997.

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8. Returns

The Main Charge to Tax

8.1 Forms CT61 should be used by UK resident companies and by companies not resident in the UK but trading through a branch or agency in the UK²⁰.

8.2 The form CT61 should show the total gross amounts (see paragraphs 3.4 and 3.6 above) of manufactured interest paid or received in the return period. Receipts from which tax has been deducted and amounts liable to the reverse charge (see paragraph 3.11 above) should be entered as income received under deduction of Income Tax. Amounts paid should be entered as annual payments.

8.3 For concerns who are not within paragraph 8.1 above the appropriate return form (SX1) can be obtained from their local Inspector of Taxes, or from Inland Revenue City F LBO, Ibex House, 42-46 Minories, London EC3N 1HL. Advice on completion of the return can be obtained from the City F Help Desk on 0171-265-5347. The return should be made within 30 days of the end of the period of account, or of the year of assessment if accounts are not drawn up, but tax should be accounted for quarterly, within 14 days of the relevant quarterly period, on payslips obtainable from the appropriate Inspector of Taxes or from City F LBO.

The Reverse Charge

8.4 Tax may be payable in certain circumstances by the UK recipient (see paragraphs 3.7 and 5.3 above).

²⁰ Schedule 16 ICTA 1988 is applied to non resident companies trading in the UK through a branch or agency by Paragraph 3(7) Schedule 23A ICTA 1988.

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8.5 Where the UK recipient is a company, whether resident in the UK or not resident in the UK but trading through a branch or agency in the UK, Schedule 16 ICTA 1988 is applied in relation to the tax due²¹. Form CT61 should be used to account for the tax. The manufactured interest received (in respect of which the reverse charge is due) will rank as income of the beneficial recipient received under deduction of tax. This income can be used to frank tax due under Schedule 16 ICTA 1988 on relevant payments (including manufactured interest) made by the beneficial recipient, but not to frank the reverse charge.

8.6 Where the UK recipient is not a company, tax should be accounted for quarterly along with the main charge (see paragraph 8.3 above). The manufactured interest received, in respect of which liability arises, should be returned using the annual SX1. The manufactured interest received will rank as income of the beneficial recipient received under deduction of tax.

8.7 An agent may be liable to the reverse charge in respect of manufactured interest received

- to which the agent himself is beneficially entitled, and
- to which a client is beneficially entitled.

The agent will therefore need to ensure that the manufactured interest received is treated as the income of the beneficial recipient only. In particular, an agent who is a company accounting for liability on form CT61 must exclude manufactured interest to which clients are beneficially entitled from any claim in the CT61 to frank tax due from the agent under Schedule 16 ICTA 1988. This should be kept in mind when following the guidance in the CT61 notes.

²¹ Regulation 3(1) SI 1997 No. 992

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9. Irregular manufactured payments

9.1 Paragraph 7 Schedule 23A contains an anti-avoidance provision which applies where the amount paid by way of manufactured interest plus the tax to be accounted for on that payment exceeds the gross amount of the equivalent real interest. The excess is for all purposes regarded not as manufactured interest but as a separate fee for entering into the arrangements. The normal tax rules for both payer and recipient will apply to the fee.

9.2 Conversely, where the amount of manufactured interest paid, plus the tax accountable in respect of that payment (if any), is less than the gross amount of the real interest, relief for the payer is limited to the amount of the payment plus the amount of the tax (if any).

9.3 Paragraph 7 does not, however, apply for the purposes of the loan relationships legislation (see paragraph 2.3 above).

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10. Vouchers

10.1 When a person makes a payment of manufactured interest under deduction of tax the normal rule²² is that he must provide the recipient with a voucher showing the gross amount of the payment, the amount of tax deducted, the amount actually paid, and the date of payment. Recipients of manufactured interest will need a voucher to substantiate a claim to relief in respect of tax suffered by deduction.

Crest Settlement

10.2 The normal rule that a voucher must be written by an interest manufacturer is modified where the payment is made by way of a market claim through the CREST settlement system. In order to ease any administrative burden on the UK financial markets the voucher may in certain instances be written by the recipient of the manufactured interest or his agent/custodian. The details are explained in the notes on CREST claims.

²² Paragraph 3(8) Schedule 23A ICTA 1988.