

FINANCIAL AVOIDANCE BY COMPANIES USING SALE AND REPURCHASE (REPO) OR STOCK LENDING AGREEMENTS

Overview

1. The Government proposes to introduce legislation in the 2005 Finance Bill, taking effect from 2 December 2004, to prevent tax avoidance by companies who purchase loan relationships under repo, or borrow them under stock lending agreements, and seek realise profits on that loan relationship in a non-taxable form.
2. The legislation will ensure that all profits made by a company in respect of loan relationships acquired under repo or stock lending agreements on or after 2 December 2004 are charged to tax.

Details

3. A repo agreement involves a company (the interim holder) purchasing a security with an agreement to sell it back to the original owner at some point in the future at a price agreed at the outset. Where the security pays a coupon during the term of the repo, the interim holder will receive that coupon but will be obliged to pay an equivalent amount to the original owner (a manufactured payment).
4. A stock lending agreement involves a company (the borrower) acquiring a security in return for an undertaking to return equivalent securities. As with repo, if the security pays interest during the term of the loan, the borrower will receive that coupon but will be obliged to pay an equivalent amount to the lender
5. Where the security is a loan relationship, the tax rules provide that only interest in respect of that loan relationship can be taxed on the interim holder or borrower.
6. The following example shows how the current rules result in tax following the economic result in most cases. Company A acquires a bond for 2000 under repo, and during the term of the agreement, the bond pays interest of 100. Company A pays manufactured interest of 100 to the original owner and at the end of the repo term sells the bond back for 2010. The cash profit is 10.

Company A is taxed on the interest of 100 plus the price differential of 10 but gets relief for the manufactured interest of 100, resulting in a net tax charge on profits of 10, matching the cash profit.

7. If instead of receiving the interest on the bond, company A sells the right to receive the interest for 100, that receipt is not itself interest and the company claims it is not taxable. The result is that although the cash profit remains at 10, company A claims net tax relief of 90 (price differential 10 less manufactured interest paid of 100), which can be set against other profits.

Anti-avoidance measures

8. The changes announced today will close this scheme down by providing that all profits a company makes from a loan relationship acquired under a repo or stock lending agreement will be taxable.
9. The change will apply to loan relationships acquired under repo (and buy/sell agreements which are similar) or stock lending agreements on or after today.

Further Information

10. Anyone wishing further information on the proposed legislation should contact either:

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