Analysis

Derivatives, repos and stock loans: an overview

Speed read

It will be relatively rare for tax practitioners to encounter derivatives, repos and stock loans as part of the structures they advise upon. Such transactions nevertheless play a key role in financial markets and can give rise to complex tax treatments. Accounting treatments will often drive those tax treatments for UK companies but not always. Withholding taxes, stamp taxes and esoterica such as the UK's anti-hybrid rules may also be relevant. A particular challenge is knowing the location of the tax rules in question, which will rarely limit itself to one convenient place on the UK tax statute book.

Matthew Mortimer
Mayer Brown
Matthew Mortimer is a Partner in Mayer Brown's tax practice. He concentrates predominantly on the tax aspects of acquisition and structured finance, M&A transactions, intragroup reorganisations and debt restructurings. He also advises in relation to international tax planning, private equity investments and fund formation. Email: mmortimer@mayerbrown.com; tel: 020 3130 3384.

Tamar Ruiz
Mayer Brown
Tamar Ruiz is an Australian-qualified Associate in Mayer Brown's tax practice in London. She advises on direct and indirect tax issues arising, in particular, in relation to public and private M&A, group reorganisations and restructures, finance transactions and real estate. Tamar also has experience advising on cross-border arrangements and has advised clients in a broad range of industries. Email: truiz@mayerbrown.com; tel: 020 3130 3280.

Tax practitioners will sometimes encounter derivatives and even repos and stock loans in relation to the transactions they advise upon. Such derivatives, repos or stock loans may be central to the transactions in question or play a more ancillary role such as the conversion of floating rate interest payments under a borrowing into fixed rate ones by means of an interest rate swap (see also below). Two key questions usually arise in relation to this type of transaction: how and where are they taxed, and what tax-related provision needs to be made for them in relevant contracts?

Thankfully, some of the heavy lifting in relation to the second question will be achieved under market standard documentation in the relevant areas, such as the ISDA Master Agreement as regards derivatives and the Global Master Repurchase Agreement (GMRA) as regards repo transactions. However, those provisions will not necessarily elucidate relevant tax treatments and may in any case need to be tailored to cater for those treatments.

Given this, the following paragraphs identify ten key features of the UK taxation treatment of derivatives, repos and stock loans and, in certain cases, how that treatment is reflected in transaction documentation. All references below to 'UK companies' are to UK and non-UK-tax resident companies that are within the charge to UK corporation tax in respect of the transactions in question, which might include an overseas tax resident company carrying on a UK property business, for example (CTA 2009 s 5).

Derivative contracts

CTA 2009 Part 7

In determining the UK corporation tax treatment of derivative contracts, the first port of call will usually be Part 7 of CTA 2009 ('Part 7') where most of the relevant rules are contained.

However, applicable tax treatments may also derive from the Disregard Regulations (SI 2004/3256), which are commented upon below, and TCGA 1992, which may govern the UK corporation tax treatment of certain options over shares, for example, that fall outside Part 7.

Crucially, for a derivative contract to fall within Part 7, it must be a 'relevant contract', namely, an option, future or contract for differences, satisfy 'accounting conditions' and not be excluded from Part 7 under CTA 2009 s 576.

In this regard, most forms of derivative contract as one would routinely understand that term will satisfy the first condition.

> The UK tax treatment of derivatives, repos and stock loans when entered into by UK companies can be complicated, often depending upon the accounting treatment of the relevant transactions but also whether the UK company is nevertheless required to diverge from that treatment for tax purposes

A wide range of derivative contracts, again, as one would usually understand that term, will also usually satisfy the second 'accounting conditions' requirement, including because a subset of derivative contracts, such as contracts for differences over land, creditworthiness and intangible fixed assets, will generally satisfy that condition even if they do not actually qualify as derivative contracts under applicable accounting standards (CTA 2009 s 579(2)).

In contrast, however, it can sometimes be difficult to determine whether the third exclusionary condition is satisfied, which is now considered.

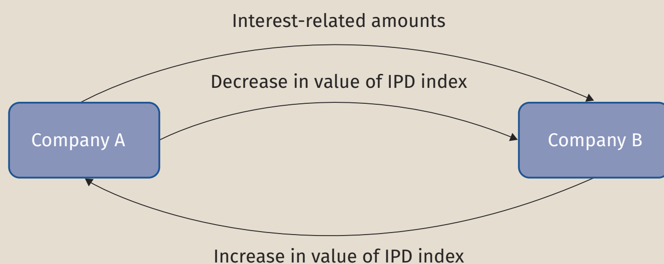
Exclusion from Part 7

It is often beneficial if a derivative contract falls within Part 7, including because of the tax relief that its provisions potentially permit in respect of payments and losses that a UK company makes or realises under the contract (see also below).

On occasion, however, it can be crucial to the tax efficient treatment of a derivative contract entered into by a UK company that it is excluded from Part 7 under the third gateway condition mentioned above, which a standard example in this area should illustrate, as follows.

Assume a company acquires shares as an investment and wants to protect itself against their value falling. It duly

Figure 1 : Property-based total return swap



Company A makes periodic payments to Company B, calculated by applying a benchmark interest rate (e.g. SONIA) to a notional amount. B is also required to make to A, or entitled to receive from A, payments calculated by applying to the same notional principal amount annual percentage changes in the value of the Investment Property Databank UK All Property Annual Index ('IPD Index'). In other words, A receives payments from B, or makes payments to B, if the index's value increases or decreases, respectively.

enters into a put option over the shares under which it can require its counterparty to purchase the shares from it at an agreed price of, say, 100. It pays a premium of 10 to the counterparty in return for this entitlement, which it does not have to exercise if it does not want but which will be cash settled if it does (i.e. by offsetting the above fixed 100 sale price against the value of the shares on exercise).

If the shares decrease in value, say, from 100 to 70, then, assuming the company is not eligible for the substantial shareholding exemption in respect of them, it will realise an allowable loss of, broadly, 30 on disposing of the shares. In contrast, if the put option over the shares falls within Part 7, the company will realise an income profit upon cash settling the contract of 20 (100 less 70 less premium of 10) against which it will not be eligible to offset the allowable loss it realises under the shares. In other words, if the put option falls within Part 7, the company will suffer UK corporation tax on an amount that does not represent its economic loss from the transaction, which will be its gain under the put option less its loss under the shares.

It should be advantageous therefore, that the put option in this scenario would usually be excluded from Part 7 under CTA 2009 s 591(3), in which case, the company would generally realise a chargeable gain under it pursuant to TCGA 1992 and be eligible to offset the above allowable loss against that gain.

Nevertheless, determining whether an exclusion of this nature will apply to the type of equity and intangible fixed asset based derivative contracts at which those exclusions are generally targeted can be complicated. It may even require bespoke transaction structuring.

For example, assume that a UK company issues warrants over shares to investors and accounts for the warrants as derivatives rather than as equity instruments, i.e. on the basis that the holders of the warrants can require the company to cash settle the warrants, which, it is understood, would usually preclude that equity instrument accounting treatment.

In such circumstances, the company may realise fair value profits and losses in its accounts under the warrants on an annual basis, which, if the warrant falls within Part 7, would ordinarily translate into taxable profits and relievable losses for it despite the company not realising those profits and losses (if at all) until the warrants were exercised.

Accordingly, to avoid this potentially unwelcome tax treatment, the company might try to ensure that the warrants did not fall within Part 7 in the first place, which would generally follow, for example, if it listed them on a recognised stock exchange (s 591(4)).

Income taxation

Part 7 applies two general rules to derivative contracts that falls within its provisions. The first is that those derivative contracts are taxed as income (CTA 2009 ss 571–574). The second is that they are taxed in accordance with the relevant company's accounting treatment of the contracts provided such treatment complies with UK GAAP or IFRS ('GAAP') (CTA 2009 ss 595 and 597).

In both cases, however, those rules are general only, as this and the following section will now explain.

As regards the first general rule of income taxation, a potentially important subset of derivative contracts that fall within Part 7 will be taxed as capital, generating chargeable gains and allowable losses, potentially, under TCGA 1992.

The derivative contracts in question are governed by prescriptive rules but break down, broadly, into certain types of property and embedded derivative.

The government indicated during its consultation to reform the rules governing the UK corporation tax treatment of loan relationships and derivative contracts in 2013 that, as far as it was aware, companies had only ever entered into the first type of property derivative for tax avoidance purposes. Accordingly, the practical significance of chargeable gains taxation for contracts of that nature may be limited.

It is worth noting, however, that the general intention behind the provisions in question (CTA 2009 ss 643 and 650) is to preserve chargeable gains taxation in circumstances where, had the company in question physically acquired the real estate to which it obtains a synthetic exposure under the relevant derivative contract, it would have been eligible for the same treatment under the TCGA 1992 (HMRC's *Corporate Finance Manual* at CFM55080).

Indeed, the provisions dealing with certain types of property-based total return swaps in CTA 2009 s 650 seem particularly sophisticated in this regard, generally permitting the company chargeable gains treatment in respect of changes in the value of eligible property indices from which it benefits or suffers under the swap but income taxation as regards the interest like payments it will usually make or receive under that contract (see also Figure 1 and CFM55110 in this regard).

In contrast, it is likely that the second set of derivatives that receive chargeable gains treatment under Part 7 – under CTA 2009 ss 645, 648, 652 and 656, in particular – have had more day-to-day significance since they relate to certain types of options and other derivatives over shares that are embedded within convertible and exchangeable notes.

In this regard, the accounting and related UK corporation tax treatment of such notes is complex and will depend, in part, upon whether the company in question is debtor or creditor under the note and whether it accounts for it under IFRS or UK GAAP (see also IFRS 9 at 4.3 in this regard). By way of illustration, however, if, under applicable GAAP, an issuer company is required to disaggregate, say, a call option over shares from the convertible bond in which it has been embedded and account for the two separately, the provisions in question may be relevant. Moreover, if they do apply, the issuer company will generally realise chargeable gains and allowable losses under the embedded derivative – for example, on the cash settlement, if any, of that derivative – which it must then bring into account

under the TCGA 1992 (see also CTA 2009 s 654 and CFM55450 in this regard).

GAAP

The second general rule under Part 7, as mentioned, is that a company's UK corporation tax treatment of a derivative contract which falls within that part is governed by the company's GAAP-compliant accounting treatment of those contracts. Consequently, the company will generally be required to bring fair value profits and losses into account on an annual basis under the contract since that is how it will usually account for the contract under applicable GAAP.

However, like the first general rule but to a far greater extent, there are exceptions to this rule under which affected companies may be required to diverge from that accounting treatment for relevant taxation purposes. The Disregard Regulations, which are considered in the next section, are an example of this when they apply. Other departures from accounting treatments may also be relevant, for example, where, in specified circumstances, a company enters into an interest rate swap in relation to a fixed capital asset or project (CTA 2009 s 604), is released from a payment obligation under a derivative contract as part of a 'statutory insolvency arrangement' (CTA 2009 s 611) or novates a derivative contract to a fellow group company that is also within charge to UK corporation tax in respect of that contract (Part 7 Chapter 5).

Part 7 and statutory provisions relating to it also provide for these divergences from accounting treatments in the context of tax avoidance. For example, if a company has an 'unallowable purpose' for being party to a derivative contract that falls within Part 7, it may be denied tax relief for payments it makes under the contract even if recognises them in its accounts (CTA 2009 ss 690–692). Similarly, to prevent unwarranted tax advantages, a company may also be required to diverge from its accounting treatment of a derivative contract for tax purposes if the regime TAAR or derecognition rules in CTA 2009 ss 599A–599B and ss 698B–698D, respectively, apply to that contract.

Absent the above type of provision, however, a company will generally bring profits and losses into account under its derivative contract in accordance with its GAAP compliant accounting treatment of the contract, as mentioned, which, in conjunction with a relatively recent law change in this area, may have beneficial consequences for it in relation to hedging transactions, for example.

Hedging transactions are more generally discussed in the following section. For current purposes, however, it can be noted that a company may account for an interest rate swap which it uses to turn a floating rate borrowing into a fixed one as a cash flow hedge (see also Figure 2). Moreover, if this is the case, then, the company will recognise some or all of the fair value profits and losses that arise to it under the interest rate swap as items of other comprehensive income for accounting purposes (see also the cashflow hedge example in CFM57330).

The point here is that, since the above law change in 2015, the company will not usually have to bring those fair value profits and losses into account for tax purposes until it recycles them to its income statement or profit and loss account (CTA 2009 s 597(1A)), which may avoid tax-related mismatches for it under the hedge.

In particular, whilst in economic terms those fair value profits and losses will generally be matched by corresponding fair value profits and losses under the hedged borrowing – for example, fair value profits and losses that result from changes in the floating rate of interest

Figure 2 : Interest rate swap

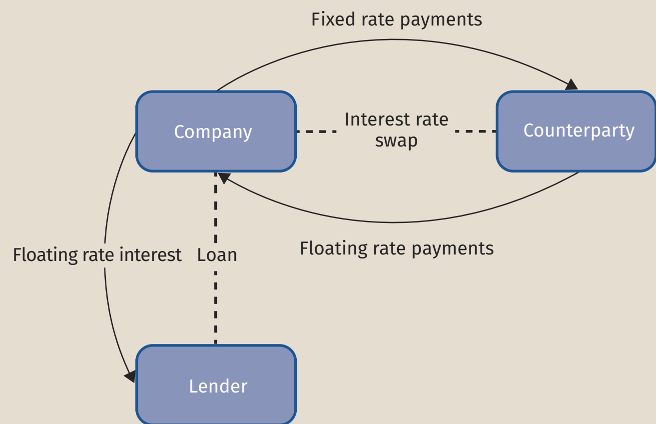
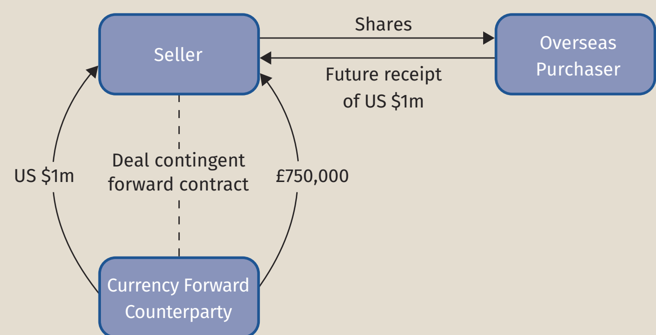


Figure 3 : Potential application of reg 5ZA



to which both the swap and borrowing are subject – the company will not usually recognise those profits and losses under the borrowing either in its accounts or for related UK corporation tax purposes.

Accordingly, by being able to disregard fair value profits and losses under the interest rate swap for tax purposes under the modified accounting approach described above, the company should generally avoid or mitigate a tax mismatch, i.e. having to bring such profits and losses into account for tax purposes but not the corresponding profits and losses under the borrowing.

Hedging

This is only one example, however, of when tax-related mismatches of that nature might otherwise arise in a hedging context.

For example, a company intending to sell shares in a particular currency may hedge against future fluctuations in relevant exchange rates which may make that disposal more expensive or valuable in sterling terms than it would otherwise be. The company might, for example, enter a 'deal contingent forward contract' under which on a contingent basis it forward sells an amount of the relevant foreign currency for an amount of sterling so that, in broad terms, it can fix the sterling denominated amount it expects to derive from the sale (see also Figure 3).

Absent the application of a relieving provision such as the new reg 5ZA in the Disregard Regulations, however, the company might suffer tax-related mismatches under such an arrangement for the following reasons:

- Depending upon fluctuations in the relevant exchange rate, the company might recognise forex gains or losses

Figure 4 : Standard ISDA master protection against s 696

Additional Tax Representation

Party A [i.e. counterparty to UK CT Payer] makes the representation specified below (the 'Additional Tax Representation'):

a. it is a party to each Transaction solely for the purposes of a trade (or part of a trade) carried on by it in the United Kingdom through a branch or agency; or

b. it is resident in the United Kingdom or in a jurisdiction with which the United Kingdom has a double tax treaty, which makes provision, whether for relief or otherwise; in relation to interest,

which shall be deemed to be repeated at all times until the Termination Date but which shall not be a representation for the purposes of Section 5(a) (iv) (Misrepresentation)...

An Additional Termination Event will occur if the Additional Tax Representation proves to have been incorrect or misleading in any material respect in relation to one or more Transactions (each an 'Affected Transaction' for the purposes of this Additional Termination Event) when made or repeated or deemed to have been made or repeated. The Affected Party shall be Party B only.

under the forward contract in its accounts which it would generally have to bring into account for tax purposes.

- In contrast, it would not be eligible to bring corresponding forex gains or losses under the shares into account for those purposes until, if at all, its disposal of the shares.

In other words, it may be crucial that provisions within the Disregard Regulations, such as the above-mentioned reg 5ZA, apply in such a case so that affected companies do not suffer tax-related mismatches.

For these purposes, the Disregard Regulations, where they apply, will often enable affected companies to disregard fair value and other profits and losses under derivative contracts that might otherwise create a tax related mismatch of the above nature.

For example, in relation to the hedging scenario mentioned above, reg 5ZA, if it applied, would enable the company to disregard profits and losses under the above deal contingent forward contract that it recognised in its accounts. Moreover, the company would also not have to bring the disregarded profits and losses back into account on its disposal of the shares since that would only ensue under the otherwise relevant EGLBAGL regulations (SI 2002/1970) if the disposal were taxable for it, which, assuming the substantial shareholding exemption applied, would not be the case (see also CFM62905 in this regard).

Crucially, however, the application of the Disregard Regulations will not always be mandatory where their conditions are otherwise satisfied. In particular, in the case of regs 7, 8 and 9, which relate to currency, commodity, debt and interest rate hedging contracts, respectively, the relevant company must validly elect for this to be the case, subject to exceptions, which it may decide against (regs 6 and 6A).

The point here is that, whilst the Disregard Regulations may protect affected companies from usually unwelcome tax-related mismatches, in doing so, they require those companies to depart from their accounting treatment of relevant hedging arrangements, which may be administratively burdensome for them. Certain companies may, therefore, prefer to follow that accounting treatment, either content to risk the prospect of tax-related mismatches or to rely upon the type of hedge accounting treatment described in the preceding section as a means of protecting themselves against those mismatches.

That said, the Disregard Regulations remain crucial to assimilate in this area, whether their application is mandatory, such as in relation to regs 4, 5ZA and 7A, for example, or optional, as, subject to the above-mentioned exceptions, in the case of regs 7, 8 and 9.

Section 696

One final point to note about derivative contracts is that payments under derivative contracts which fall within CTA 2009 Part 7 will not be subject to UK withholding tax even if this might otherwise follow under the UK's tax rules (ITA 2007 s 980).

However, whilst this is obviously beneficial, the exemption in question can easily mask a provision in Part 7 that may still prejudice the expected tax treatment of derivative contracts that fall within it.

In particular, whilst CTA 2009 s 696, the provision in question, will not impose withholding tax, it may nevertheless deny a company tax relief in respect of 'notional interest payments' that it makes under derivative contracts within Part 7, for example, under an interest rate swap.

In this regard, s 696 will not usually apply to 'notional interest payments' of this nature that are made as part of the trade they carry on in the UK by banks, building societies, financial traders, recognised clearing houses, recognised CSD and third county central counterparties, as defined (CTA 2009 s 697(1)). However, the section will apply to UK corporation tax paying companies that fall outside these definitions, if, broadly, they make such payments to counterparties that are based in overseas jurisdictions which have not entered into double tax treaties with the UK that contain an interest article (s 697(3)).

Given this, it is not uncommon to see the schedule to an ISDA Master Agreement containing the type of representation and related Additional Termination Event that is set out in Figure 4, which is intended to protect a UK-based corporate counterparty if s 696 did apply to deny it tax relief in respect of notional interest payments.

Repos and stock loans

Accounting treatment

A key feature underpinning the UK corporation tax treatment of repos and stock loans is that, as with derivative contracts, a UK company's GAAP compliant accounting treatment of those transactions will often determine that tax treatment.

For example, a UK company might enter into a fixed price repo transaction under which, acting as repo seller, it substantively borrows money from the repo buyer by selling debt securities to it for a particular purchase price and agreeing to repurchase them for an amount equal to that repurchase price plus a finance amount. In such a case, it is understood that the company would usually account for that transaction as a loan, which, in turn, would generally determine the UK corporation tax treatment of the transaction for the UK company under the repo rules in CTA 2009 Part 6 Chapter 10. In particular, under those rules, the UK company would generally be treated for applicable UK corporation tax purposes as remaining owner of the securities, despite selling them to the repo buyer, and as having paid a deductible finance cost under the UK's loan relationship rules to the repo buyer broadly equal to the difference between the repurchase and purchase prices (CTA 2009 ss 548, 550 and 551).

Similarly, if a stock lender acting on trading account disposes of shares to a stock borrower so that the stock borrower can satisfy a short sale of those shares it has undertaken in the market, it would be usual for the stock lender to retain the shares on balance sheet and not

recognise the disposal and subsequent reacquisition of the shares it makes under the stock loan in its accounts, in which case, the stock lender should not have to bring any profits and losses into account for UK corporation tax purposes as a result of that disposal and re-acquisition (CTA 2009 s 46).

However, a UK company's accounting treatment of repos and stock loans will not always be determinative in this regard. For example, if a repo seller or stock lender undertakes a repo or stock loan transaction over shares on capital account, it would generally have to rely upon specific relieving provisions to avoid having to bring into account any chargeable gains or allowable losses that result from its disposal and reacquisition of shares under those transactions (FA 2007 Sch 13 paras 6 and 11 and TCGA 1992 s 263B).

In addition, although financial market participants will often enter into the paradigm repo and stock loan transactions that are mentioned above, this will not always be the case and the accounting treatment of those transactions may, therefore, differ.

For example, transaction counterparties might enter into a 'special collateral' repo under which the repo buyer has a particular need for the debt securities or shares that are repoed to it. Moreover, in return for acquiring those debt securities or shares, the repo buyer may require less of a difference between the purchase and repurchase prices that it pays to and subsequently receives from the repo seller. It might even make a net payment to the repo seller for the privilege of acquiring the shares or securities under a so-called 'negative interest' repo, in which case, one would not generally expect the parties to account for the transaction as a financing with the tax consequences under the UK's repo rules mentioned above.

Withholding tax

Another defining feature of the UK tax treatment of repos and stock loans has traditionally been the prospect of UK withholding tax applying to payments that are made or deemed to be made under such transactions.

Thankfully, this prospect has significantly diminished in recent years owing to the abolition in FA 2013 of UK withholding tax on manufactured overseas dividends. Moreover, whilst UK withholding tax can still apply to manufactured dividends that are paid by a repo buyer or stock borrower in respect of dividends on UK shares, that will only be the case – under ITA 2007 s 918 and Authorised Investment Funds (Tax) Regulations, SI 2006/964, regs 69Z24A–69Z24C, respectively – if the shares are in UK REITs or Property Authorised Investment Funds, which should be relatively rare.

However, there are potential beartraps to mention in this context, as follows. UK withholding tax can still apply to manufactured interest payments that a UK-based stock borrower or repo buyer actually makes or, for repos that fall within the UK repo rules mentioned above, it is generally deemed to make under ITA 2007 s 925A if interest becomes payable under the repoed securities during the term of the repo (actual manufactured interest payments being ignored in those circumstances under s 925C).

In particular, UK withholding tax will usually be payable in such circumstances if the repo seller or stock lender are not within the charge to UK corporation tax, the debt securities are issued by a UK issuer and the securities are neither UK gilts nor debt securities that attract the UK's quoted Eurobond exemption (ITA 2007 ss 919 and 921).

In addition, the difference between the purchase and repurchase prices under the type of fixed price repo transaction mentioned above will also usually be treated as interest for UK withholding tax purposes. Consequently, absent an exemption and assuming the interest is 'yearly interest', which may not be the case, a UK-based repo seller would be required to withhold tax from that amount (CTA 2009 s 551(4) and CFM46410).

Stamp duty

UK stamp taxes have also been a perennial concern as regards repos and stock loans, potentially applying to one or more of the transfers of shares and debt securities that are made under them.

Thankfully, the type of debt securities that are transferred under repo and stock loan transactions will usually attract an exemption from UK stamp duty and SDRT, where otherwise relevant, either because they constitute exempt loan capital under FA 1986 s 79(4) or are transferred in uncertificated form through clearing systems, which would not usually trigger those taxes (FA 1986 ss 90(5) and 97A). Bespoke exemptions from UK stamp taxes, as contained in FA 1986 ss 80C and 89AA, may also apply in respect of both debt securities and shares that are transferred under repo and stock loans.

Anti-hybrid rules

One final point to note in relation to stock loans and repo transactions is that, depending upon the context, the UK's anti-hybrid rules may apply, potentially denying transaction participants tax relief for payments they make under the transaction or imposing tax on their receipts.

This is a complicated area, but an example of when the rules might apply relates to the potentially different treatments of a repo transaction under which a UK repo seller sells shares to an overseas repo buyer.

In particular, the jurisdiction of the overseas repo buyer may treat that repo for relevant tax purposes as the outright transfer of the repoed shares to the repo buyer, in which case, the repo buyer may be eligible for a participation exemption on any dividends it receives under the repoed shares. In the UK, in contrast, the repo buyer's receipt of those dividends would often be seen as part of the repo buyer's finance return from the transaction for which the repo seller would generally be eligible for tax relief (see also HMRC's *International Tax Manual* in this regard at INTM552510).

As a result, but only if all the relevant conditions in TIOPA 2010 s 259DA are satisfied, the UK repo seller in this transaction may be denied tax relief for that finance amount on the basis that it generates a 'hybrid transfer deduction/non-inclusion mismatch', which, alongside other potential applications of the UK's anti-hybrid rules in this area (see also INTM552010–INTM552550), is worth noting.

Summary

As will be seen from the above, the UK tax treatment of derivatives, repos and stock loans when entered into by UK companies can be complicated, often depending upon the accounting treatment of the relevant transactions but also whether the UK company is nevertheless required to diverge from that treatment for tax purposes. Consequently, specialist input will usually be required at an early stage in these transactions, both as regards their tax treatment more generally but also, as previously mentioned, in relation to how that treatment is dealt with in the market standard documentation which one usually sees in the relevant areas. ■