

Tax Treatment of Stocklending/Sale and Repurchase (repo) Transactions

Introduction

In 1995 the Revenue Commissioners published details of the tax arrangements that would apply to stocklending (or securities lending) and repo transactions. The Revenue Commissioners have now decided to revise the existing arrangements in relation to stocklending and repo activities.

Nature of transactions

Stocklending and repo transactions are a common feature of well developed financial centres. These transactions involve the temporary transfer of stock or securities from one party to another with a simultaneous commitment to reverse the transaction at some point in the future. The difference between a stock loan and a repo transaction is that in a repo contract there is an agreed return date whereas in a stock loan contract there is no pre-agreed return date. There are two important aspects to stocklending and repo transactions from a tax viewpoint:-

Transfer of Title

A key feature of these transactions is that a transfer of legal title occurs which is subsequently reversed on completion. If the taxation of these transactions were to reflect the legal form of what has occurred, a charge to Capital Gains Tax or Income/Corporation tax might arise. Notwithstanding this legal form, the substance is essentially one of lending.

Income receipts/payments

Where stock is on loan the borrower is normally entitled to any dividend/interest payments made because, as noted above, a transfer of legal title takes place so that the stock is held in the borrower's name. However, the borrower will normally be required to reimburse the lender for any dividend payments. This compensating payment is termed a "manufactured payment".

The effect of this reimbursement transaction is that the lender is put in the same position as if he/she had not loaned the stock and had received the real dividend, and the borrower, as if he/she had not borrowed the stock and so received no dividend.

In stocklending transactions the profit earned by the lender will either be reflected in a small margin between the “selling” and “repurchase” price or in the form of a side fee paid by the borrower, depending on the particular circumstances.

Revenue Approach

Arrangements have been agreed by the Revenue Commissioners to recognise the substance of these transactions, to tax only the accounting profit earned and, in general, to leave both the borrower and the lender in the same position as if no stock loan had taken place. In particular these arrangements mean that:

(i) A stock loan or a repo will not be regarded as a disposal/acquisition for tax purposes. Similarly, the subsequent return of the stock by the borrower will not be regarded as an acquisition/disposal. If the loan and return take place at different prices then any profit earned will be treated as a fee received by the lender and taxable in full.

(ii) Manufactured payments will normally be taxable in the hands of the recipient.

However, manufactured payments will be treated as exempt from tax when received by a lender for whom the corresponding real dividend would have been an exempt receipt or would not have given rise to Irish tax if it had been received by the lender. Examples of this treatment include:

- the receipt of manufactured payments by tax exempt funds such as charities, pension funds or the pension fund business of a life assurance company;
- the receipt of manufactured dividends in respect of Irish equities by an Irish resident company for whom the real dividends would have ranked as franked investment income and,
- the receipt of manufactured payments in respect of overseas securities by Irish taxable lenders for whom the real dividends on such securities would

have attracted a nil Irish tax liability by virtue of an entitlement to a credit against Irish tax for foreign underlying tax. This situation will apply only where the combined rate of foreign underlying tax and withholding tax would have exceeded the Irish tax rate if the lender had received the real dividend. If the manufactured payment on such dividends exceeds the real dividend received (net of foreign withholding tax, but before Irish encashment tax) then the excess will be taxable in full.

(iii) Stocklending fees received by tax exempt funds will be regarded as exempt for tax purposes provided that the income from the stock loaned would also have been exempt from tax.

(iv) Manufactured payments will normally be deductible by borrowers against the real dividends or interest in computing the borrowers' liability to Irish tax. **In the computation, the amount of the manufactured payment must be deducted directly from the related real dividends or interest and should not be deducted from any other income.** No deduction will, however, be granted for the manufactured payment where the real dividend or interest:

- is exempt from tax either because the income is franked investment income or because the borrower is an exempt fund, or
- does not give rise to Irish tax in the hands of the borrower by virtue of an entitlement to credit relief for foreign underlying tax.

(v) By way of exception to (iv) above, where an Irish taxable borrower borrows overseas securities from an Irish taxable lender, the borrower may choose, in order to maximise the benefit of any available credit relief for foreign withholding tax on the real dividend or interest, to treat the manufactured payment as if it was a charge on income and so deduct it from total profits rather than directly from the real dividend or interest. This facility will not apply where credit relief is also available for underlying tax in respect of the real dividend or interest.

(vi) Rebates of interest on cash collateral will be deductible against the interest arising on such cash collateral.

(vii) Transfers of stock which take place under a stock loan or repo transaction to which these arrangements apply will be treated as exempt from Irish stamp duties.

Conditions and Restrictions

The arrangements outlined above will apply subject to the following conditions and restrictions:

(a) The arrangements will apply to lending and borrowing institutions whether trading or non trading which are within the scope of Irish tax and which are: companies, building societies, pension funds, charities or collective investment funds.

There is no requirement that both parties to the stocklending or repo transaction be within the scope of Irish tax. The arrangements will not apply to individuals or partnerships.

(b) Subject to the two exceptions outlined below, the arrangements will apply to

- All interest bearing, discounted and premium bearing securities
- Equities quoted on recognised stock exchanges.

The first exception to the above concerns Irish equities which are lent across dividend payment dates. In relation to stocklending/sale and repurchase transactions involving Irish equities, the arrangements will not apply unless the lender, if he/she had received the real dividend and had filed any required declarations or claims, would have been eligible for exemption from the dividend withholding tax provisions under domestic law or the terms of a Tax Treaty.

The second exception relates to Irish corporate bonds which are lent across coupon dates. The arrangements will not apply to stocklending/sale and repurchase transactions involving Irish corporate bonds, except in either of the following circumstances:-

- where the lender of the bonds is eligible for exemption from the interest withholding tax provisions under domestic law or the terms of a Tax Treaty
- or,

- where both parties to the transaction are subject to the interest withholding tax provisions.

(a) Stocks/Securities may be denominated in any currency.

(b) Statutory audited accounts of the relevant institutions, insofar as these transactions are concerned, must recognise the substance rather than the form of the activities. In this regard the accounts must be unqualified. The Revenue Commissioners will apply the tax treatment in line with the accounting treatment. Deviations from this will not be allowed.

(c) Any party to a stocklending/sale and repurchase transaction who avails of the terms of these arrangements is required to keep a record of any such transactions.

(d) It has been decided to limit these arrangements to transactions extending for periods of 6 months or less.

(e) These arrangements will be effective for stocklending/sale and repurchase transactions which take place on or after 6 April 1999.

These arrangements will be kept under review. The Revenue Commissioners reserve the right to withdraw any or all of these arrangements in the event of their being used for tax avoidance purposes. In particular, the Revenue Commissioners are aware that exempt vehicles, such as pension funds, could be utilised to secure tax benefits that would otherwise not be available. If this happens, these arrangements will be withdrawn and the strict technical position applied.

Any unusual situations not dealt with here will be examined on a case by case basis by the Revenue Commissioners.