BOARD OF INLAND REVENUE RESOLUTION 50

FINANCE BILL 2003 COMMITTEE SCHEDULE 38

Amendment	Page	Line
*SC 300	419	42

Paul Boateng (Brent South - Lab)

Amendment 300

Schedule **38**, page **419**, line **42** at end insert—

' *Option premium to be reflected in sale price unless brought into account under derivative contracts provisions*

9A In section 730A of the Taxes Act 1988 (treatment of price differential on sale and repurchase of securities), after subsection (8) insert—

"(8A) In this section references to the sale price are to be construed—

(a) in a case where the securities are bought back by the transferor or a person connected with him in compliance with a requirement imposed in consequence of the exercise of an option acquired under the agreement to sell the securities or any related agreement, as references to what would otherwise be the sale price plus the amount of any consideration given for the option, and

(b) in a case where the securities are so bought back in the exercise of an option so acquired, as references to what would otherwise be the sale price less the amount of any consideration so given,

unless the consideration is brought into account under Schedule 26 to the Finance Act 2002 (derivative contracts)."'.

EXPLANATORY NOTE

SUMMARY

1. This amendment clarifies the tax treatment of option premiums in a sale and repurchase agreement (repo) where the repurchase element of the repo involves an option. Options are normally

taxed under the specific rules for derivative contracts, but where there is a repo the accounting practice for companies could take the option premiums outside the derivative contract rules. Those rules do not apply at all to individuals, which means that an individual must work through a complex chain of tax rules in order to determine the tax treatment of the option premium. This change now ensures that the option premium is clearly taken into the calculation of the repo price differential by way of the original sale price, unless it is already taken into account under the derivative contract rules for companies.

DETAILS

2. The amendment inserts Paragraph 9A into Schedule 38 to the Finance Bill.

3. Paragraph 9A Schedule 38 inserts a new subsection (8A) into section 730A ICTA 1988.

   a. New section 730A(8A)(a) deals with the case where the interim holder exercises an option to sell the securities back to the original owner (or a party connected with the original owner). In such a case the interim holder will normally pay an amount for the option to the original holder at the same time that he acquires the securities. This provision makes it clear that the amount paid for the option is to be added to the sale price for all purposes of the repo tax rules, unless that amount has already been taken into account under Schedule 26 FA 2002.

   b. New section 730A(8A)(b) deals with the case where the original owner exercises an option to repurchase the securities from the interim holder. In such a case the original owner will normally pay an amount for the option to the interim holder at the same time that he sells the securities. This provision makes it clear that the amount paid for the option is to be deducted from the sale price for all purposes of the repo tax rules, unless that amount has already been taken into account under Schedule 26 FA 2002.

BACKGROUND NOTE

4. A sale and repurchase agreement (repo) involves the sale of securities with an agreement for the seller to buy back those securities at a later date at an agreed price. As such, repos can be equivalent to a secured loan, with the transferred securities as collateral and the difference between the sale and repurchase prices equivalent to loan interest. Tax rules recognise this economic substance by taxing and relieving repos as secured loans, even if the underlying securities are company shares.

5. Finance Act 2002 substantially revised the corporate tax regime for derivative contracts, which includes options. It treats the vast majority of option premiums as income, with certain exceptions depending on the underlying subject matter.

6. One such exclusion concerns an option over company shares, where the option is not entered into as part of a company's trade.

7. The derivative contract rules only apply to companies - they do not apply at all to individuals.

8. For individuals, or for companies where Schedule 26 FA 2002 does not apply, the option premium is normally taxed or relieved under the chargeable gains rules under section 144 TCGA 1992. However, where there is a repo the chargeable gains rules are usually disapplied by section 263A TCGA, the intention being that the sale and repurchase are disregarded, and the difference between the sale and repurchase prices is treated as interest on a loan for tax purposes. This effectively switches off section 144 TCGA 1992, potentially leaving the option premium stranded.

9. In agreeing the terms of a repo involving an option, the parties would usually regard any option premium as part of the overall cost of or return from the repo as a whole. Companies would therefore expect to account for option premiums in a repo as part of the overall repo pricing, and this should normally bring the premium into the price differential, treated as interest for tax purposes. However, this treatment is not necessarily universal, leaving some potential gaps in coverage.

10. In order to put the matter beyond doubt and ensure complete coverage, this amendment brings the option premium in a repo into the calculation of the sale price, but only where the premium is not

already dealt with under Schedule 26 Finance Act 1992 - the derivative contracts regime. This continues the practice of following the accounting treatment.

11. The adjustment is made to the sale price because any option premium would be agreed and paid at the time of the sale that forms the first leg of the repo. However, the impact of the option premium will be to augment or reduce the overall price differential computed under section 730A(2) ICTA 1988. A company will therefore account for the premium for tax purposes on an accruals basis in accordance with section 730A(6) ICTA 1988 as an integral part of the price differential.

12. For example, a company sells securities for £10,000 and acquires an option to buy them back six months later for £10,200. It pays a premium of £20 for the option, and so the sale price will be reduced for the purposes of section 730A ICTA 1988 (and section 730BB ICTA 1988 where applicable) to £9,980. After six months the company exercises the option and buys the securities back for £10,200. The price differential will therefore be £220, and the company will bring in this amount on an accruals basis, both in its accounts and in its tax computations.

13. If a company accounts for the option premium as a derivative contract then it will continue to fall within Schedule 26 FA 2002; but if a company does not account for the premium in this way, or if the premium is clearly excluded from Schedule 26 FA 2002, then it will come within the repo rules.

14. For non-corporates the change ensures that the option premium in a repo is taken into account as part of the sale price - Schedule 26 FA 2002 does not apply to non-corporates. In such a case the impact of the option premium will still be on the price differential, but for a non-corporate the full amount of the deemed interest is deemed to be paid or received on the repurchase date.