UK stock lending and tax planning – two recent judicial decisions

Two recent decisions of the UK Courts have provided a valuable insight into how the complex legislation which governs the taxation of stock lending transactions may be interpreted judicially.

Although the decision of the UK Supreme Court (formerly the House of Lords) in DCC Holdings 1 considered the taxation of a repo transaction, the UK taxation legislation dealing with stock lending is very similar to that dealing with repos in the way it contains a number of “deeming” provisions and “statutory fictions”. The Supreme Court decided that the complex and closely articulated legislation in question could not be interpreted in such a way as to entitle the taxpayer company to a tax loss resulting from a transaction in which that company made a commercial profit. Lord Walker analysed the relevant legislation relating to manufactured payments, and ruled that the purpose of the legislation was to apply a tax treatment to the transactions that corresponded to their economic substance. Lord Walker commented at length about the “overwhelming need for a symmetrical solution” when applying the legislation, and said that to allow the taxpayer company to claim a large tax loss despite their having made a profit from the transaction, would amount to a “commercial nonsense”. Owing to the similarities between the UK taxation legislation dealing with stock lending and that which is applicable to repos, the decision in DCC Holdings signals a practical approach to addressing complex tax legislation in which the Court may reject interpretations which produce arbitrary or absurd tax results.

The decision in DCC Holdings has been accompanied by the decision of a lower Court, the First Tier Tax Tribunal, in Barnes. 2 The transaction considered in Barnes sought to exploit a perceived mismatch (now addressed through later legislation) between the stock lending manufactured interest rules and the legislation governing the accrued income scheme (AIS). The appellant, Mr. Barnes, had entered into by an institution operating in the UK may well face particular scrutiny at the present time for a number of reasons connected with the drive of the UK Government to discourage tax avoidance in the financial institution and banking sectors.

Any institution, fund or company looking to include tax mitigation attributes in a transaction needs to be aware of this environment, and transactions involving stock lending are no different. In particular, any transaction which HM Revenue perceives as being motivated by “tax avoidance” and which is entered into by an institution operating in the UK may well face particular scrutiny at the present time for a number of reasons connected with the drive of the UK Government to discourage tax avoidance in the financial institution and banking sectors.

At a time when revenue bodies across the world are concerned with the risk to national tax systems posed by the extent that banks and financial institutions use, as well as facilitate, tax planning schemes, the practical approaches of the Supreme Court in DCC Holdings and the First Tier Tax Tribunal in Barnes demonstrates the care and caution which is needed in contemplating transactions where the taxation attributes may be viewed as overshadowing or asymmetrical to the commercial and economic features of those transactions.