INCOME TAX TREATMENT OF DISCOUNTED SECURITIES

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The loan relationship provisions introduced by Part IV, Chapter II of FA 1996 have, rightly, attracted attention. The regime for corporate debt has changed fundamentally; planning opportunities and potential (and disastrous) pitfalls have arisen in what appears to be equal measure. What has attracted less attention is the income tax treatment of discounted securities, enacted in FA 1996 Schedule 13. The regime contained in Schedule 13 results in significant changes for persons outside the corporation tax regime who hold discounted securities.

In this article, I shall examine the position of individuals and companies who are subject to income tax, who hold discounted securities. In a subsequent article, I shall examine the position of trustees and also the provisions which apply specifically to gilt strips.

Schedule 13 applies where a person subject to income tax:

(i) holds a relevant discounted securities;

(ii) either (a) transfers or (b) redeems that security; and

(iii) thereby realises a profit or a loss.

Relevant Discounted Security

ICTA 1988 Schedule 4 (deep discount securities) and FA 1989 Schedule 11 (deep gain securities) have been repealed. In their place there is a single definition of relevant discounted security which is defined as follows: the security must give rise to an amount payable on redemption which gives rise to a deep gain *or may do so* (paragraph 3(1)). A gain is "deep" if, taking the term of the security and dividing

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it by two, the amount payable on redemption is greater than the resulting figure, expressed as a percentage ("the relevant percentage"). So for a five year bond, the "relevant percentage" is term of the bond (5) x ½ equals 2.5. So if the bond issues at £100, the gain is "deep" if the bond redeems at anything more than £102.50 (paragraph 3(3),(4)). A bond with a life of less than one year may still be a relevant discounted security; in this case each month, or part of the month, is treated as being 1/12 of a year (paragraph 3(4)).

This rule holds true for bonds with a life of less than thirty years. It does not apply to bonds with a life of thirty years or more. However, this is of no advantage to a taxpayer who wishes to escape the application of Schedule 13 which, as I explain below, may not be advisable) since the maximum "relevant percentage" is 15% (paragraph 3 (4)(b)). So if the return on any bond is 15% or more the gain is "deep" for paragraph 3(3) purposes. Interest is excluded from these calculations (paragraph 3(6)).

The test as to whether a security is a relevant discounted security and whether the gain is deep is applied at the date of issue of the security, assuming redemption in accordance with its terms (paragraph 3(1)). Furthermore, if the holder has an option to redeem early, the test is applied assuming that redemption has taken place on the earliest date at which the holder can redeem (paragraph 3(5)B)). An option to redeem on the part of the issuer (or some other third party) is ignored altogether.

It follows that a bond which issues at, say, £90 which redeems, at the option of the holder at the end of year one at £90 (perhaps together with some supplemental interest) but, if the holder does not exercise this option, redeems at £150 in year five is not a relevant discounted security. Applying the paragraph 3(3) test at the time of issue, one takes the earliest redemption date (at the end of year one) at which time the gain is not "deep" (since at that time the security redeems at par, that is, £90). Interest, as I observe above, is excluded from these calculations altogether (paragraph 3(6)). As such, the discount will be subject a Schedule D iii charge under ICTA 1988 section 18(3)(b). Any capital gain is subject to the terms of TCGA 1992 section 251 (and section 115 if it is a QCB) assuming that the security is not held as trading stock. The Inland Revenue cannot revisit the security after year one and say that it is a relevant discounted security because the gain is "deep", looking at the security after year one if the holder has not exercised his option. Paragraph 3(1) makes it quite clear that the test is applied only at the time of issue. This is in contrast to FA 1989 Schedule 11 paragraph 1(2) which applied the deep gains test on each redemption date where the security had multiple redemption dates. Equally, since the test is applied at the time of the issue alone, it is not possible to manipulate the terms of a security so that it alters status from being a relevant discounted security to being a non-relevant discounted security or vice-versa.

Furthermore, as I outline below, although the legislation is widely drafted so as to tax any profit realised by the holder on transfer or redemption of the security, the test as to whether a gain is "deep" and the security is therefore a relevant discounted security is calculated only by reference to the amount payable on redemption. Apart from paragraph 5 (redemption includes conversion) there is nothing in Schedule 13 which defines or extends the notion of "redemption", which must therefore take its normal meaning, that being extinction of the loan in consideration of the payment of monies payable under its terms. So if the relevant discounted security is issued at £90, which redeems at par (the holder being entitled to a commercial rate of interest) but which also carries with it a "put option" enabling the holder to "put" the security to some other person (other than the issuer) at, say, £120, that security is not a relevant discounted security and is outside the scope of Schedule 13.

Importantly, whereas the deep gains legislation in FA 1989 Schedule 11 paragraphs 2 and 3 excluded qualifying indexed securities and qualifying convertible securities, such securities are not excluded from the relevant discounted securities provisions. It follows that such securities are now likely to be relevant discounted securities if they are capable of realising a deep gain (independent of conversion rights). There are no "grand-fathering" provisions which preserve the capital status of such securities in the hands of the holders. Thus the holders of such instruments have lost capital gains tax treatment on transfer or redemption and will be subject to the provisions of Schedule 13 (although this may not be disadvantageous), if the bond is standing at a loss for the reasons given below.

There are certain specific exclusions from the definition of relevant discounted securities, in paragraph 3(2)(a)-(f) which are as follows:

(a) shares in a company;

(b) gilt edged securities that are not strips;

(c) excluded indexed securities;

These are further defined in paragraph 13, which, broadly, mirrors section 93 of FA 1996 which applies for the purposes of the loan relationship provisions. The aim of paragraph 13 is clear: if the return on a security is linked to a "chargeable asset", the security is excluded from Schedule 13. However, the drafting is cumbersome. A security is an excluded indexed security (and therefore not a relevant discounted security) if the "amount payable on redemption is linked to the value of chargeable assets" (paragraph 13(1)). An amount is linked to the value of chargeable assets if "in pursuance of any provision having effect for the purposes of the security, it is equal to an amount determined by applying a relevant percentage change in the value chargeable assets to the amount for which the security was issued" (paragraph 13 (2)). The "relevant percentage change" is the percentage change in the value of chargeable assets over the "relevant period" (being the period between the time of issue of the security and its redemption or any other period which is almost identical to it) (paragraph 13(4)). A "floor" of 10% is permitted (paragraph 13(5)). Paragraph 13(1) encompasses the application of the relevant percentage to any index of the value of such assets (paragraph 13(3)) but the retail prices index or "any similar general index of prices published by the government of any territory (or government agent)" is, in turn, excluded from the definition of such an index (paragraph 13(8)); thus, securities linked to the FT-SE 100 Index, Dow Jones etc will not qualify).

"Chargeable asset" is defined in paragraph 13(6) as simply an asset which would give rise to a chargeable gain made under the assumption that the asset belongs to the person to whom the gain accrues (if this is not in fact the case) (paragraph 13(7)). Units in a unit trust are encompassed and chargeable by TCGA 1992 section 100 as chargeable assets for this purpose (paragraph 13(7)(a)). There are two further assumptions with regard to this hypothetical disposal contained in paragraph 13(6). Firstly, it is assumed that the asset is not held as trading stock (paragraph 13(7)(b)). It follows that even if the asset is, in fact, held as trading stock, it is deemed not to be so for the purposes of Schedule 13.

Secondly, chargeable gains which may accrue under TCGA 1992 section 116 (10) (held over gains arising on the exchange of a QCB for a non-QCB, arising on disposal of the QCB) are disregarded (paragraph 13(7)(c)). So, QCBs are never chargeable assets for paragraph 13 purposes, even if they have had a gain rolled into them.

We recall that a security is only an excluded indexed security if the amount payable on redemption is equal to an amount determined by applying the relevant percentage specified in paragraph 13(2). This appears to be a drafting error. What the draftsman intended was that a security would be an excluded indexed security if the *return* was equal to an amount determined by applying the relevant percentage. On the words of paragraph 13(2), a security will only be an excluded index security if the amount payable on redemption (namely the principal and the return) is equal to an amount determined by applying the relevant percentage. Say a bond is issued at £100, the return on which is linked to the value of certain shares owned by the issuer. Say these shares increase in value by 10% between the date of issue and redemption. The return to the holder would be £110. However, on a literal reading of paragraph 13(2), the security will only be an excluded index security if the amount payable on redemption equals the amount determined by applying the relevant percentage to the value of the shares, i.e., the 10% increase in the value. So if the shares went up in value from £200 to £220 (an increase of 10%), the security will only be an excluded indexed security if the amount payable on redemption (principal and the return) is £10 (i.e., 10%) not £110. The provision can be made to work by reading the words "excluding the principal" after the word "redemption" in paragraph 13(1) and after the word "amount" in paragraph 13(2). It is unsatisfactory that the words of a provision which could have been quite easily drafted so as to be clear and plain should have to be stretched so as to be made to work. This is particulary the case given that this drafting oddity was drawn to the attention of the Revenue in the context of section 93, which is drafted in broadly similar terms in the context of the loan relationship provision, during the consultation process prior to its enactment (about which nothing seems to have been done). I assume that the provision will simply be applied with the words that I have suggested being read in. There is certainly authority for the proposition that words may be read in to a fiscal provision to ensure that they can work where a literal construction will lead to patent absurdity provided that the express words are not distorted (*O'Rourke v Binks* [1992] STC 703).

(d) life assurance policies;

(e) capital redemption policies;

(f) securities issued under the same prospectus as other securities which have been issued previously which are not themselves relevant discounted securities. So, if under the same prospectus, shares and loan notes are issued, the loan notes will not be treated as relevant discounted securities even if they realise a "deep gain". However, this is subject to a significant qualification in Schedule 13 paragraph 10. This provides that if the aggregate nominal value of securities which would be relevant discounted securities but for Schedule 13 paragraph 3(2)(f) are issued in a subsequent transfer to the original issue of securities under a prospectus (which originally issued securities are clothed with the protection of that provision), and the aggregate value of the securities which would be relevant discounted securities but for the protection of paragraph 3(2)(f) (i.e., all of the securities including those issued in the original issue), exceed the nominal value of securities which are not relevant discounted securities on any test, the protection of paragraph 3(2)(f) is withdrawn and all securities which give rise (or may give rise) to a deep gain will be treated as relevant discounted securities, irrespective of the time of issue. Thus the securities issued in the first issue will be retrospectively recast as relevant discounted securities while the subsequent tranche will always be so treated.

Tax Treatment of Profit Arising in Respect of a Relevant Discounted Security.

Where a person realises a profit from the discount on a relevant discounted security, he is charged to tax under Schedule D Case III (or if the security is a non-UK security, Schedule D Case IV (paragraph 1(1)). Tax is charged when the profit is realised on transfer or redemption. The profit is defined as the amount payable on the transfer or redemption, less the cost of the acquisition of the security (this is the only sensible meaning which can be given to the term "excess" which appears in Schedule 13 paragraph 1(3)). "Relevant costs" are added to the acquisition cost, these being the costs incurred in connection with the acquisition of the security (not being the acquisition cost of the security itself) and such costs incurred in connection with the transfer or redemption of the security (paragraph 1(4)). If the calculation produces a loss, the holder is entitled to "relief from income tax" on his income for the year in which the loss is sustained (paragraph 2(1)). Paragraph 2 does not specifically define the loss as a Schedule D Case III or Case IV loss. It follows that this loss would be redeemable against total income, which is vastly preferable to a capital loss. This accords with the loan relationship provisions which simply treat a negative balance of non-trading debits over non-trading credits as a non-trading deficit (see section 84(4)), subject to section 85 (and Schedule 8) which provide detailed rules as to utilisation of non-trading deficits for persons within the charge to corporation tax. Schedule 13 paragraph 2 makes no provision as to the form of the "relief" to which the individual is entitled on a loss arising from a relevant discounted security, from which follows the conclusion that the loss is relievable against total income.

Transfer

Any transfer of the security is a "transfer" for Schedule 13 purposes whether it is a sale or exchange or otherwise (paragraph 4(1)). Where an individual who is entitled to a relevant discounted security dies, then he is treated as making a transfer of security immediately before his death at market value to his personal representative (paragraph 4(2)). Transfers between persons connected under ICTA 1988 section 839 are treated as being made at market value (paragraph 8). Furthermore, if the relevant discounted security is transferred for consideration which is (or includes) consideration not in money or money's worth or is transferred otherwise then by a bargain made at arm's length, the transfer is also deemed to take place market value (paragraph 9).

Redemption

As observed above, the only extension to the term "redemption" is in paragraph 5, which provides that where a relevant discounted security is extinguished by being converted, under the rights conferred by the security, into shares of a company or into any other securities, the conversion constitutes redemption at an amount equal to the market value of the shares or other securities into which the security is converted. Gilt strips are excluded from this provision (paragraph 5(3)). So if a two year bond issues at £90 and redeems at £150 but confers an option on the holder to convert into shares in any company (whether the issuer or not) and the option is exercised whereby the holder obtains shares worth £160, the holder will be taxed to Schedule D Case III on £70.

The question arises as to whether *every* convertible is a relevant discounted security since the "amount payable on redemption" (if one accounted for the potential value of the shares) may involve a deep gain within paragraph 3(3)). The short answer is "no". In other words, the security is only a relevant discounted security if it is such, independent of conversion rights. This can be gleaned from the terms of paragraph 3(1)) which refers to "amount payable on redemption", which connotes a monetary sum, not a settlement in kind (whether by way of conversion or otherwise). Thus a security which issues at £90 but which redeems only on conversion with no monetary sum payable at all is not a relevant discounted security. However, the same security which redeems at £100 in two years' time, to be satisfied in shares or cash, is a relevant discounted security. In other words, the test of whether or not a security is a relevant discounted security is applied by reference to a monetary debt alone. A return which is not expressed in monetary terms is ignored. This becomes even clearer when one realises that the paragraph 3(3) definition of relevant discounted security and Schedule 13 is applied for the purposes of the loan relationship provisions in the corporate tax context by FA 1996 section 92(1)(d). A security which permits conversion into shares is encompassed by the loan relationship provisions only on the debtor side but not the creditor side under section 92. However, convertibles will only obtain such treatment if they are not relevant discounted securities (section 92(1)(d)). If all convertibles were relevant discounted securities because conversions rights may realise a deep gain, the legislation could not operate unless such convertibles were capped at an amount which was less than a deep gain. This would produce an absurdly restrictive view of section 92.