THESIS NUMBER T648

A DETAILED REVIEW OF THE NEW UK TAX RULES ON CORPORATE DEBT

Presently 40983 words

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1. Synopsis 6
2. Economic Overview 7
2.1. Purpose 7
2.2. Debt free business enterprise 7
2.3. Incurrence of trade debt 7
2.4. Finance from third parties 7
2.5. The spectrum of risk and reward 9
2.6. The challenge for the tax system 16
3. Taxation History 17
3.1. Purpose 17
3.2. The origins of the income tax system 17
3.3. Specific difficulties and legislative or judicial “remedies” 18
3.3.1. Premiums on debt repayment 18
3.3.1.1. Review of CIR v Thomas Nelson & Sons Ltd 18
3.3.1.2. Review of Lomax v Peter Dixon & Son Ltd 18
3.3.2. Losses on bonds 21
3.3.3. Capital gains 22
3.3.4. Bond washing 22
3.3.4.1. Review of Wigmore v Thomas Summerson and Sons Limited 23
3.3.4.2. The opportunity for tax avoidance 24
3.3.4.3. Initial legislative counteraction against bond washing 25
3.3.4.4. Fresh case law: Schaffer v Cattermole 25
3.3.4.5. Additional legislation against bond washing 26
3.3.5. Bonds without an interest coupon (zero coupon bonds) 26
3.3.5.1. Review of Lord Howard de Walden v Beck 26
3.3.5.2. Review of Ditchfield v Sharp 29
3.3.5.3. Increase in issuance of zero coupon bonds 31
3.3.5.4. A legislative regime for zero coupon bonds 31
3.3.6. Legislation to counter synthetic stripping 32
3.3.7. Puttable bonds 33
3.3.8. Accounting for discounts 33
3.3.9. Deferral of interest receipts 34
3.3.10. Zero coupon bonds held by associates of banks 35
3.3.11. Equity linked loan stock as a qualifying corporate bond 36
3.4. The position by 25 May 1995 36
3.5. Defects in the tax system 36
3.5.1. From Inland Revenue perspective 36
3.5.2. From taxpayer perspective 37
4. Stripping Government Bonds 38
4.1. Purpose 38
4.2. Fundamental concepts of debt instruments 38
4.2.1. The Yield Curve 38
4.2.2. Conversions between six monthly and annual interest rates 41
4.2.3. Bond Yields 41
4.2.3.1. The Running Yield 42
4.2.3.2. The Yield to Maturity 42
4.2.4. Re-investment Risk 43
4.2.5. Zero coupon bonds 45
4.2.5.1. Attractions for a long term holder 46
4.2.5.2. Attractions for short term speculative holders 46
4.2.5.3. Attractions for an issuing company 48
4.2.5.4. Attractiveness or otherwise for issuing governments 49
4.3. What is stripping? 49
4.4. Alternative methods 50
4.4.1. “Synthetic” stripping 50

4.4.2. "Direct" stripping 53
4.5. Why facilitate stripping? 54
5. How the New System Operates 56
5.1. Introduction 56
5.2. Fundamental principle 56
5.3. Key words and phrases 56
5.4. Who is within the new system? 57
5.4.1. In full 57
5.4.2. In part 57
5.5. What assets/liabilities are within the system? 57
5.5.1. Basic definition of a loan relationship 57
5.5.2. Money debts which are not loan relationships 58
5.5.3. Implications of the issue of an instrument 58
5.5.4. Convertible assets 59
5.5.4.1. Detailed requirements to qualify as a convertible seurity 59
5.5.4.2. Implications of being a convertible security 63
5.5.4.3. Opportunity for tax avoidance 63
5.5.5. Loans linked to chargeable assets 64
5.5.5.1. The charging and relieving provision 64
5.5.5.2. Applicable definition 64
5.5.5.3. Exclusion of trading assets 65
5.5.6. Index linked securities 66
5.6. How are the calculations made? 67
5.6.1. Mark to market 67
5.6.2. Accruals basis of accounting 68
5.6.2.1. Dealing with uncertainty 70
5.6.3. Selection of accounting method 74
5.6.3.1. Methods equating to an authorised accruals basis 74
5.6.3.2. Methods equating to mark to market 74
5.6.4. Mandatory use of authorised accruals in certain cases 75
5.6.5. Changing accounting methods 75
5.6.5.1. Inconsistent application of accounting methods 75
5.6.5.2. Changes of accounting method 76
5.6.6. Accounting for stripping or reconstituting a gilt 79
5.6.6.1. Company using mark to market accounting 79
5.6.6.2. Company using accruals accounting 80
5.7. Charging tax on credits 83
5.7.1. Trading credits 83
5.7.2. Non-trading credits 83
5.8. Giving relief for debits 84
5.8.1. Trading debits 84
5.8.2. Non-trading debits 84
5.8.3. Utilisation of net non-trading debits 84
5.8.3.1. Set off against any other current period profits 85
5.8.3.2. Surrender the deficit as group relief. 85
5.8.3.3. Carry back against profits of earlier accounting periods. 86
5.8.3.4. Carry forward against non-trading profits of next accounting period. 87
5.8.3.5. Default option 87
5.8.4. Meaning of loan relationships for trading purposes 88
5.8.5. "Hybrid" companies. 89
5.8.6. Pre-trading expenditure 89
5.9. Grandfathered gilts 90
5.10. Manufactured interest 90
5.10.1. Stock lending 90
5.10.2. Repo 92

5.11. Preserving the tax charge on other interest income 94
5.12. Amounts taken to reserves 95
5.13. Capitalised interest 96
5.14. Expenses 96
5.15. Withholding of income tax from interest payments 97
5.15.1. Government Securities 97
5.15.2. Interest payments by companies 97
5.15.3. Relief for income tax withheld 97
5.15.3.1. Opportunity for tax avoidance 98
5.16. Commencement Date 99
5.17. Double Taxation Relief 99
5.18. Overseas sovereign debt 100
5.19. Anti-avoidance 100
5.19.1. Interest deductions without a cash payment 100
5.19.1.1. Interest paid late 100
5.19.1.2. Discounted securities held by connected companies 101
5.19.1.3. Discounted securites of close companies 102
5.20. Connected persons 105
5.20.1. Accounting method where parties are connected 105
5.20.2. Connectedness test of section 87(3) 106
5.20.2.1. Limited exemption from section 87 106
5.20.2.2. Bad debts 107
5.20.2.2.1. Basic bad debt rules 107
5.20.2.2.2. Bad debts between connected persons 108
5.20.2.3. Debt for equity swaps 110
5.20.2.4. Groups of companies 110
5.21. Imported losses 112
5.22. Related transactions not at arms length 114
5.23. Unallowable purposes 114
5.23.1. Basic outline of the rules 114
5.23.2. Comparison with closely related provisions 116
5.23.2.1. Foreign exchange 116
5.23.2.2. Financial instruments 116
5.23.2.3. FA 1988 s.787 117
5.23.3. Application to accounting periods 117
5.23.4. Business or other commercial purposes 119
5.24. Changes to the income tax rules 119
5.24.1. Relevant discounted securities 119
5.24.1.1. Exclusions from relevant discounted securities 121
5.24.1.1.1. Shares in a company 121
5.24.1.1.2. Gilt edged securities that are not strips 121
5.24.1.1.3. Excluded indexed securities 121
5.24.1.1.4. Securities issued under the same prospectus 121
5.24.2. Charge on realised discounts and related losses 123
5.24.3. When are gains realised? 124
5.24.4. Application to gilt strips 124
5.24.5. Tax computation 125
5.25. Minor and consequential amendments 126
6. Interaction with Foreign Exchange rules 127
6.1. No double charge 127
6.2. Non-trading exchange gains and losses 129
6.3. Changes in classification 129
7. Interaction with financial instruments rules 131
7.1. No double charge 131
7.2. Debt contracts and options 131

8. Company Law and Accounting Aspects 134
8.1. Accounting methods commonly used historically 134
8.1.1. Lower of cost or net realisable value 134
8.1.2. Asset at cost unless value impaired 134
8.1.3. Accruals accounting for liabilities 135
8.1.4. Marking to Market 135
8.2. Applicable company law and accounting standards 135
8.3. Likely future accounting standards 135
9. Conclusions 137
9.1. Is it fair? 137
9.2. Does it meet the original objectives? 137
9.3. What areas need changing or clarifying? 137
9.3.1. UK to UK connected bad debts 138
9.3.2. UK to overseas connected bad debts 138

1. Synopsis

My goal is to review in detail the tax rules on Loan Relationships enacted in Chapter II of FA 1996 including the related Schedules, excluding Schedule 10 (Collective Investment Schemes) and Schedule 11 (Special Provisions for Insurers).

I propose to cover briefly the historical reasons why change was considered necessary by the Inland Revenue, and also disadvantages to taxpayers from the "old system." I will then consider in detail how the "new system" works, with particular emphasis on:

- Boundaries (e.g. what is a loan relationship)
- Internal coherence and consistency
- Interaction with the foreign exchange rules
- How the system fits with Company Law and UK accounting standards
- Anti-avoidance
- Tax planning possibilities
- Computational aspects, illustrating how "mark to market" and "authorised accruals" would be applied both to straightforward and to more complex situations.

Coverage of the transitional provisions will be restricted to matters having continuing effect, so that planning points requiring action prior to 31 March 1996 will not be covered.

The taxes covered will be income tax, capital gains tax, and corporation tax including corporation tax on chargeable gains. There will be no coverage of VAT or stamp duties, and I believe that inheritance tax and social security contributions are not in point.

2. Economic Overview

2.1. Purpose

This section illustrates how the carrying on of a business enterprise gives rise to increasingly sophisticated ways of dividing up the business returns. This arises for reasons unconnected with taxation.

2.2. Debt free business enterprise

Consider an enterprise conducted in corporate form, with a single owner, and which never incurs any form of borrowing.

All of the economic return clearly accrues to the owner, in an economic sense, even though company law treats the company and shareholder as separate persons. The owner may choose to re-invest the return within the company or to extract it for consumption or investment elsewhere. Again, company law distinguishes between "salary" paid to the owner and dividends, but in an economic sense with a sole owner there is no practical distinction.

2.3. Incurrence of trade debt

The first type of borrowing to consider is trade credit, where the company acquires goods or services but pays the supplier later, normally within weeks or months. Typically, there is no explicit return to the supplier for providing the credit. However, unless the supplier grants credit he may lose the sale.

Providing the credit gives the supplier no right to share in the profits of the enterprise. There is however a risk of non-payment if the enterprise becomes insolvent, in which case company law gives creditors priority of payment over shareholders. (This priority is often diluted if shareholders finance the company with loans).

2.4. Finance from third parties

The distinction from trade credit is that here one is considering finance from third parties who may have no other connection with the enterprise. Their only role is to provide finance in return for some form of return. (A return is necessary, as otherwise these providers have no reason to incur the risk of loss or to defer their own consumption).

The first question is whether the financier's return depends on participation in the profits of the enterprise? If the answer is negative (no business participation) then supplemental questions arise, e.g. is the return fixed or variable by reference to outside factors such as the daily yield on Treasury Bills? Is the financier to have priority of repayment over trade creditors?

The examples below show how increasingly complicated divisions of the economic return of the enterprise can arise:

Sole owner
Receives all economic returns from the enterprise Sole provider of finance

The first divide is the introduction of debt.

Debt	**Equity**
Fixed returns No participation in profits	Receives all the economic return after costs and fixed payments on debt
Repayment priority over equity	Receives the residual capital after repaying debt

The debt can be divided into two categories. For example, with a new category of convertible debt the financier may agree to a lower fixed return in exchange for the right (but not duty) to convert into shares. This would now give three categories.

Regular Debt	**Convertible Debt**	**Equity**
Fixed coupon	Lower fixed coupon	All residual economic returns
No participation	Participation via conversion option	All residual economic returns

Regular Debt	**Convertible Debt**	**Equity**
Priority repayment over equity	Priority repayment the same as regular debt	All residual capital

The company can divide up the share capital by issuing, for example, non-participating, non-cumulative preference shares. These are shares whose dividend is fixed (and higher than the fixed coupon on the regular debt) but which is paid only if there are profits, and whose capital repayment priority is before equity and after all debt. (In modern accounting terminology, such preference shares would be referred to as non-equity shares).

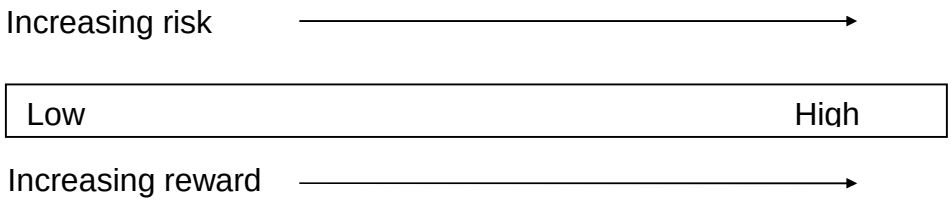
By now, we have four categories:

Regular Debt	Convertible Debt	Preference Shares	Equity

However, there is clearly endless scope for further sub-division.

2.5. The spectrum of risk and reward

Overall, economic theory indicates that there is a spectrum of risk and reward:



The instruments that comprise this spectrum are continuously increasing in variety as financial advisors devise new ways of partitioning the economic return of the enterprise to meet the risk/return profile desired by different potential investors. The reason for the continuing inventiveness is that the more closely the instrument matches the investor's risk/reward requirements, the less "waste" there is in providing the investor with excessive economic returns. *For example the financier may be willing to subscribe for 10 year bonds at a coupon of 10%, but if the enterprise insists on issuing 15 year bonds, if it will have to offer an interest rate higher than 10% to persuade the financier to invest.*

Need a better illustration bringing out the point.

The following list is intended only to illustrate some of the instruments devised, with the riskiest (and potentially most rewarding) listed first. However, in any actual situation the level of risk and reward will depend upon the precise legal terms of the instrument, the business of the enterprise and the other instruments also issued by it.

Name of instrument	**Brief Description**	**Issuer's Perspective**	**Investor's Perspective**
Warrants	Enable the holder to subscribe for new ordinary shares at a fixed price.	Can be used to raise cash without having to pay dividends. Frequently issued with debt instruments as a way of reducing the interest coupon on the debt.	Highly geared participation in future share price increases. Downside is absence of dividends.
Ordinary Shares	Shares that carry the voting power in normal circumstances, and are entitled to the residual profits and capital of the enterprise after paying prior claims.	Ordinary shareholders expect increasing dividends and collectively have voting control over the enterprise.	Ordinary shares correspond most closely to direct ownership of a part of the enterprise's business.

Name of instrument	Brief Description	Issuer's Perspective	Investor's Perspective
Participating Preference Shares	Preference shares which typically carry a fixed dividend plus a further participating dividend calculated by reference to ordinary dividends, and which have some conversion rights.	They add to the share capital and thereby increase the ability to take on debt. Unlike debt, the preference dividend payment is deferred if there are insufficient profits.	Often issued to venture capitalists, who require some annual returns, especially if sale of the participation maybe many years away.
Convertible Debt	Debt that carried a regular coupon and which also entitles the owner to convert into ordinary shares at a fixed price.	The rate of annual interest will be lower than regular debt due to the conversion option.	Participation in share price growth. The cost is lower annual interest income than with regular debt.
Callable Debt	Bonds issued, usually with a fixed rate of annual interest and a fixed redemption date. However the issuing company can redeem earlier if it wishes.	The fixed rate of interest enables the company to plan its finances, as does the knowledge that the bonds do not have to be redeemed until the fixed date. If interest rates fall, the company has the option to redeem the bonds ("call" them) and	A certain rate of return and certainty of repayment on or before the final date, unless the enterprise becomes insolvent. The call option held by the company is compensated for by a slightly higher rate of interest than

Name of instrument	Brief Description	Issuer's Perspective	Investor's Perspective
		borrow new debt at a lower interest rate.	regular debt.
(Regular) Debt	Bonds issued at a fixed rate of interest and with a fixed redemption date.	The company can plan its finances knowing the precise cash flows it is committed to throughout the life of the bonds.	The investor has a fixed rate of return and a certain date for repayment in the absence of insolvency.
Puttable Debt	Bonds issued at a fixed rate of interest and with a fixed redemption date, where the holders can require early redemption, often at a premium, on specified dates or in specified circumstances.	Similar to regular debt, but the company is exposed to the need to find cash for early redemption in certain cases. Without such "put" options, the company would have needed to pay a higher ate of interest.	Typically required where investors are concerned that the company may be a worse credit risk in the future in certain circumstances, e.g. if it is taken over by a company which has a worse credit rating or which incurs significant extra debt to make the acquisition.

Name of instrument	**Brief Description**	**Issuer's Perspective**	**Investor's Perspective**
Zero Coupon Bonds	The bonds are issued at a fixed price (e.g. £10) and are redeemable on a fixed date for a fixed amount (e.g. £100) but pay no interest during their life.	Enable the company to borrow without having to find cash for annual interest expense. These are often appropriate for growing companies whose business absorbs cash rather than generating cash, but which expect to be cash generating in future.	If the investor intends to hold until maturity, the zero coupon bond eliminates "re-investment risk". (See page 43). For short-term holders, such bonds provide an instrument suitable for speculation on interest rates as the value is very sensitive to changes in market interest rates.
Equity Index Linked Loan Stock	Bonds where the annual interest coupon and the final redemption amount change in accordance with movements in an equity market index such as the FT All Share index.	Typically issued by investment trusts to create gearing, since the trust's managers hope to create investment returns greater than the index. They avoid the risk with regular debt that share prices might collapse just when the debt is due to	They provide a return which matches the index without incurring investment management costs, at the cost of some "exposure" to the skills of the investment trust managers. This exposure is cushioned by the fact that the loan stock has

Name of instrument	Brief Description	Issuer's Perspective	Investor's Perspective
		be redeemed. Avoiding this risk enables higher levels of gearing.	priority to the share capital of the investment trust.
Property Linked Debt Certificates	Bonds where the annual interest is linked to the rental yields measured by an index of investment properties and whose redemption value is linked to capital movements in the property index.	During the recession, certain banks became involuntary owners of large amounts of investment property as their loan customers became insolvent. By issuing bonds linked to the investment property index, they were able to reduce their exposure to future property price movements.	Holding such bonds is a convenient way of gaining exposure to investment property without the management expense of having actual property, and with lower risk than buying property company shares, since the bonds are debt obligations of a major bank.

2.6. The challenge for the tax system

All of the instruments listed, and others, were devised to enable issuers and investors to satisfy their commercial objectives, and not necessarily with any tax considerations in mind. (In certain cases, the tax treatment available may have influenced which companies became issuers and which persons became investors).

The tax system is required to deal with such instruments, from the perspective of issuers and investors, while meeting the standard goals of:

- Fairness
- Certainty of treatment
- Avoidance of excessive tax collection costs
- Protection of the exchequer
- Avoidance of distortion in economic activity.

[MA to check against standard criteria later].

3. Taxation History

3.1. Purpose

This section reviews the history of the taxation system. The goal is to illustrate how it developed piecemeal as a result of judicial and legislative reactions to financial innovation.

3.2. The origins of the income tax system

Income tax was first introduced as a temporary measure during the Napoleonic wars, and then enacted permanently in **[1842]**. Given the dominance of agriculture in society, the tax system drew a fundamental distinction between "capital" and "revenue", deriving from the clear agricultural distinction between land and the produce derived from land. In simple cases, this distinction could be carried over to other areas of activity:

Activity	**Capital**	**Revenue**
Agriculture	Land	The annual wheat harvest
Manufacturing	Factory buildings and machinery	The goods produced for sale
Lending of money	The loan made	The annual interest received

Apart from agriculture (where land generally exists permanently) this simplistic distinction between capital and revenue has always given rise to difficulties. Even in the case of manufacturing, an important activity in the nineteenth century, the tax system prima facie gave no relief for the wearing out of machinery or factories, and specific reliefs had to be introduced in the form of capital allowances.

The lending of money gave rise to far more difficulties.

3.3. Specific difficulties and legislative or judicial "remedies"

This section considers a number of specific problems.

3.3.1. Premiums on debt repayment

If Lender loans £100 to Borrower, for five years at 10% interest payable annually in arrears interest, the whole of the return of £10pa is taxable income. At the end of the five years, Borrower repays the £100.

From the Lender's perspective, his overall return still 10% if the borrower undertakes to pay interest at, say 7%pa and to repay the £100 loan at a premium of £18.32 at the end of year five, i.e. to repay £118.32 in place of the £100 borrowed. However, can the Lender argue that only £7pa is revenue (the "fruit of the tree") while the premium of £18.32 is an accretion to capital and therefore tax free?

3.3.1.1.Review of CIR v Thomas Nelson & Sons Ltd

This straightforward issue appears not to have featured in tax litigation until 1938, in the case of CIR v Thomas Nelson & Sons Ltd, 22 TC 175. The taxpayer had lent money unsecured to its Indian subsidiary (which was not credit worthy enough to borrow from third parties) for a term of 10 years at an interest rate of 3%. On repayment a premium was also payable, calculated at varying rates over the life of the loan. The overall effective return to the lender varied between 5% and over 5½%.

The Scottish Court of Session held that the premium was taxable under Schedule D Case V (the debtor was in India) as interest. Lord President Normand said, "*The premiums are part of the consideration given by the borrowers for the use of the capital lent to them, and part of the creditor's share of the profit which the borrower ... is presumed to make from the use of the money.*" Lees' Trustee v Inland Revenue 1916 SC 188", also reported as Schulze v Bensted 7 TC 30. Lee's Trustee is the only case cited in Thomas Nelson and related to different facts. It is notable primarily because of the citation of Bell's dictionary for a definition of interest *"Otherwise stated, it is just recompense to the creditor for being deprived of the use of his money.*"

3.3.1.2.Review of Lomax v Peter Dixon & Son Ltd

The issue of premiums on bonds was considered again a few years later in Lomax v Peter Dixon & Son Ltd 25 TC 353, a decision of the Court of Appeal. This case merits detailed review as it sharply highlights a number of tax problems that were only fully addressed in legislation enacted over 50 years later.

The key facts are as follows:

- Peter Dixon & Son Ltd (PDSL) was a UK resident newsprint manufacturer.
- In 1930 it established a wholly owned Finnish resident subsidiary O Y Toppilla (OYT) to manufacture wood pulp in a Finnish factory for shipment to PDSL.
- By 1933, PDSL had advanced £319,600 to OYT. While the case report is silent, these amounts were presumably required for the initial fixed assets and working capital of OYT and any start-up losses.
- On 11 November 1933 under an agreement between OYT and PDSL:
  - OYT issued 680 consecutively numbered notes of £500 each to PDSL. The total face value of the notes was 680 x £500 = £340,000. As the existing debt was £319,600 the notes were issued at an aggregate discount of £20,000, i.e. 6% of the face value.
  - Interest on the face value of the notes was payable at 1% above the lowest discount rate of the Bank of Finland each year, subject to a maximum interest rate of 10%pa. The interest ran from 1 January 1933 with the first interest payment being due on 6 April 1934 and thereafter annually on 6 April. PDSL could require OYT to leave the interest outstanding (without interest being charged on the unpaid interest).
  - 100 notes were redeemable on 15 November 1933 and 29 notes on each subsequent 6 April.
  - Each note was redeemable at £600 (a 20% premium) provided that the net profit of OYT for the preceding year was sufficient to cover the premium.
  - PDSL was entitled to demand that OYT execute a mortgage over its real property and movables to secure the notes.
- On 15 November 1933 (i.e. 4 days after the agreement) 100 notes were redeemed. There was no premium paid. (The aggregate discount on these 100 notes was 100 x £500 x 6% = £3,000).
- 29 notes were redeemed on 6 April 1934, 1935, 1936, 1937 and 1938, in each case at £600 per note.
- The legal mortgage was never demanded.

- The interest due was not paid. Instead PDSL gave notices to OYT and the interest was merely credited to OYT's books.

The Inland Revenue sought to assess PDSL on the interest accruing each year, on the 6% discount and on the 20% premium. The Special Commissioners found for the company on all counts. Prior to the High Court, the Inland Revenue abandoned the attempt to assess the interest accruals, and the High Court found for the Revenue on the taxability of the discount and premium. The Court of Appeal reversed this and held that the discount and premium were non taxable. The leading judgement of Lord Greene MR contains a number of noteworthy points.

The Inland Revenue appears not to have challenged the bona fide commercial nature of the transactions, and Lord Greene certainly accepted this (Page 360).

It is hard to believe that present day Inland Revenue opinion would accept the arrangements as bona fide. Although the writer has not sought additional facts, some of the indicators that cast doubt upon the arrangements are:

- The interest rate "appears" commercial but may not adequately reflect the limited credit worthiness of OYT or the risk of war. (Lord Greene accepted the rate as commercial because these other risks were taken account of in the discount and premium arrangements).

- Interest being payable on 6 April, a date presumably chosen to defer taxability.

- The interest not being paid, with cash being used instead to make redemptions of notes.

Lord Greene (Page 360) also did not regard the repayment of 100 notes after 4 days as anomalous.

With respect to the 100 notes redeemed after 4 days, the decision shows how dominant "form" was over "substance" in judicial thinking at that time. Under the arrangements relating to these 100 notes, £47,000 owned by OYT on 11 November was repaid as £50,000 on 15 November, with the £3,000 difference held to be a capital transaction and non-taxable.

Turning to the key issue, Lord Green (Page 362) considered A lending £100 to B on the stipulation that £110 was repayable after two years. He considered that the £10 must be interest, as the contract does not otherwise provide interest at a reasonable commercial rate. He proceeded to consider moneylenders, where the amounts repayable were high in relation to the amounts borrowed but were entirely interest, in particular due to the information requirements of the moneylenders Act 1927. In these circumstances the risk of default was compensated for by a higher rate of interest.

Lord Greene then considered A lending £100 to B for an extended period such as 10 years, at a normal commercial rate of interest, with a £20 premium on repayment. He considered that such a premium, compensating for the risk of loss on the loan, would be capital. He proceeded to consider debenture issues by companies, where a normal company of "good" credit rating could borrow by issuing debentures at par with "normal reasonable" rates of interest. If the credit rating were "exceptionally good" the debenture could be issued at a premium, so that the effective return to the investor on the money invested would be a lower percentage than for the merely "good" company. Lord Greene pointed out that the investor would be taxable on all the interest received, with effectively no relief for the premium outlay on the investment. Conversely, the "extremely good" company could issue its debentures at par but pay a lower rate of interest.

Lord Greene (Page 364) recognised that actuarially the two scenarios were identical, but that if the "extremely good" company issued its debentures at par and paid a lower rate of interest, its investors would pay less tax as they received less interest.

Lord Greene then proceeded to consider a company of below normal credit rating. Such a company could either pay a higher rate of interest (taxable in full even though part of it was compensating for capital risk). Conversely it could issue its debentures with normal interest rates but issued at a discount or it could issue at par and pay a premium on redemption. In this case the discount or premium would compensate for the capital risk, in a non-taxable way.

Lord Greene's analysis shows that he fully recognised the economic equivalence of interest, discount and premium in transactions involving the lending of money. However, the tax system required him to dissect PDSL's transactions with OYT into separate components for interest and discount/premium. On the facts the interest rate was considered reasonable, so the discount/premium retained their capital nature and were not to be regarded as "disguised interest". Half a century would pass before such distinctions were swept aside by legislation.

3.3.2. Losses on bonds

With the strong distinction between income and capital, the tax system did not charge gains from bonds to tax, except where the gain could be shown to be disguised interest. However, a consequence of this approach was that there was no mechanism in tax law for investors (apart from financial traders such as banks) to receive any form of relief for losses on bonds, whether losses from market value fluctuations or losses from debtor insolvency.

Similarly, there was no mechanism to give borrowers tax relief for premiums paid on the redemption of debt or discounts suffered on the issue of debt. Such items were not interest, and were therefore treated as being of a capital nature.

3.3.3. Capital gains

Prior to the introduction of capital gains in 1965, economic gains were either taxable as income or they were tax free as being capital. Capital gains tax reduced the importance of the distinction, although a big difference remained between the rate of capital gains tax and the combined rate of income tax and surtax.

Debts have always presented a problem for capital gains tax. In the case of a debt repayable at its issue price, the lender is unlikely to make a capital gain from selling the debt. (In general, he can only make a gain if the debt is at a fixed interest rate and market interest rates fall, enabling him to sell the debt at a premium). However, a loss is always possible as the debtor may become insolvent. Accordingly, capital gains tax has always sought to exclude certain types of debt (typically referred to as “simple debts”) while including within its scope other debts (typically “debts on a security”).

The boundary between excluded/included debts has been a source of much litigation since 1965 and has also been the subject of almost continuous legislative change, especially in the 1980’s with the concept of “qualifying corporate bonds” and the repeated amendments to that definition.

Overall, the result has been ever increasing complexity.

3.3.4. Bond washing

Historically, tax law treated the receipt of interest from a bond very differently from the receipt of bond sales proceeds. This gave rise to potential difficulties and opportunities for tax avoidance exploiting the different treatment.

3.3.4.1.Review of Wigmore v Thomas Summerson and Sons Limited

The tax treatment of a seller of bonds part way through an interest period appears not to have been considered by the courts until 1925 in the case Wigmore v Thomas Summerson and Sons Limited 9 TC 577. (To a modern reader, the speed with which the case was litigated is remarkable, since the underlying transaction took place in only 1923).

On 9 May 1922, the taxpayer company made a purchase of 5% War Stock 1929-1947. A nominal amount of £25,411.48 (the monetary amounts have been decimalised for convenience) was purchased for a price of £25,285.64. On this stock, interest was payable on 1 June and 1 December each year, without deduction of income tax.

No dispute arose regarding the interest due on 1 June 1922 or 1 December 1922. (The interest due on 1 June 1922 would have been passed to the vendor, since the stock was quoted "ex interest" on 1 May and 1 November each year.)

On 10 April 1923, the company sold its holding of stock for £25,967.55, making a profit of £681.91 compared with the purchase price. The Inland Revenue accepted that £229.91 was a tax free "capital accretion." However, it sought to assess the balance of £452 as interest under Schedule D Case III, this amount being equivalent to interest on the stock from the last payment date of 1 December 1922 to the date of sale, 10 April 1923. (5% x £25,411.48 x 130/365 = £452.53).

The General Commissioners found for the taxpayer and discharged the Schedule D Case III assessment. Justice Rowlatt upheld their decision in the High Court. There were several noteworthy points in the judgement.

The Inland Revenue made it clear that it was only arguing for an apportionment in those cases where interest on the stock was payable gross. For the majority of stocks where interest was payable net of income tax, it would not seek apportionment. Rowlatt J considered this dichotomy to seriously weaken the Inland Revenue's arguments.

The Inland Revenue was willing to grant symmetrical treatment in respect of the apportionment to a purchaser of the stock i.e. on the next interest receipt on 1 June 1923, the purchaser would only be taxed on the element accruing from 23

April 1923 to 1 June 1923.

The Inland Revenue was also only seeking to apply this apportionment doctrine to sales, but not to other transfers such as gifts, inheritance or the change in the taxpayer's identity when a woman married so that the taxpayer became her husband. Also no attempt would be made to apportion to 5 April tax years in the case of a continuing holder. Again, Rowlatt J considered that all of these Inland Revenue concessions from universal apportionment weakened their case.

Rowlatt J was perceptive in analysing the financial economics of the transaction. He pointed out that dissecting the sale price by simple arithmetic into capital and interest (as proposed by the Inland Revenue) in fact gave an answer that had to be incorrect. He illustrated this by considering £400,000 nominal value of War Loan being sold on 1 March, exactly 3 months before the next interest payment date of 1 June. Arithmetically, 3 months interest, £5,000, had accrued. (5% x £400,000 x 3/12 = £5,000). However, it would not be accurate to say that, of the total price paid, £5,000 must relate to the accrued interest up to 1 March. "*To my mind it is absurd to say that a person is paying £5,000 in March for £5,000 to be paid in June. He does not do it*". Accordingly it would be necessary to value the right to receive the interest, i.e. compute "*the expectancy of the interest*". While such calculations could be done, Rowlatt J clearly did not accept them as a proper foundation for taxation.

3.3.4.2.The opportunity for tax avoidance

The decision in the Thomas Summerson case would appear to create an opportunity for tax avoidance, illustrated as follows. Consider a holder of £100 nominal of 5% War Loan, and assume that the market price of the stock, excluding the value of the accrued interest, is par. On 30 April, just before the stock became ex interest, the market price would be £102.08 (i.e. £100 + 5% x £100 x 5/12 = £102.08). By selling the stock in the market, the owner would receive the full £102.08 and have no tax liability. Otherwise, if the stock continued to be held and the interest was received, at say a 40% tax rate the tax cost would be £0.83 (£2.08 x 40% = £0.83).

If the only participants in the market were individuals paying tax at 40%, the apparent opportunity for tax saving would be illusory. In this scenario market prices would react to neutralise the tax effect i.e. on 30 April no individual would be willing to pay £100 + accrued interest to buy War Loan, since he would be facing an instant loss of £0.83 representing his tax liability. Instead of a theoretical price of £102.08, an individual purchaser would only offer £101.25 (i.e. £102.08 - £0.83) or in practice slightly more since the payment of the £0.83 income tax would be deferred for many months.

However, the markets also contain other participants (e.g. pension funds and

charities) who can ignore tax effects relating to interest, or who can ignore the capital / interest distinction (e.g. securities dealers). As a result, market prices do not in general change to counter the tax effects for individuals and accordingly the opportunity for tax avoidance would exist.

3.3.4.3. Initial legislative counteraction against bond washing

Parliament acted to eliminate, or more strictly, reduce this tax avoidance opportunity. FA 1927 s.33 applied in certain cases to prevent the avoidance of super tax (but not income tax) by the sale of securities cum interest, while FA 1927 s.35 gave corresponding super tax relief to purchasers of securities cum interest. When FA 1971 combined surtax (which had replaced super tax) and income tax, these provisions that by then were consolidated in ICTA 1970 were amended. The charging provision in ICTA 1970 s.30 applied:

- Only upon a notice served by the Board of Inland Revenue.
- If there was an avoidance of act least 10% of the higher rate tax liability that would have arisen in the absence of the cum interest sale or sales.
- The taxpayer had a defence if he could show that the higher rate tax saving was exceptional and not systematic, and that it had not happened in any of the three next preceding years.

As can be seen from the details above, ICTA 1970 s.30 was calculated to prevent only the most blatant avoidance of higher rate tax. For reasons that have not been investigated by the writer, at the same time ICTA 1970 s.32 which gave corresponding relief to the cum interest purchaser was repealed.

3.3.4.4.Fresh case law: Schaffer v Cattermole

In the 1980 case of Schaffer v Cattermole, 53 TC 499 the taxpayer who had purchased Government Stocks on the National Savings Stock Register (where the interest was paid gross) sought relief against being taxed on the purchased accrued interest. He lost comprehensively before the General Commissioners, the High Court and the Court of Appeal. The judges, rightly in the writer's opinion, expressed some sympathy with the taxpayer's analysis but considered that there were no grounds for deviating from the Thomas Summerson decision.

It would appear that, possibly due to the confirmation of the law by Schaffer v Cattermole, there was a growth in the avoidance of tax by the sale of securities cum interest. Although the writer has no statistical evidence, he recalls the

technique being regularly mentioned in the financial planning columns of the quality newspapers of the early 1980's as well as in journals aimed at tax professionals. Meanwhile ICTA 1970 s.30 was an obscure piece of legislation rarely mentioned even in the taxation press and presumably rarely invoked by the Inland Revenue.

3.3.4.5.Additional legislation against bond washing

In FA 1985, to take effect from 28 February 1986, the law was changed fundamentally. Apart from very small cases (nominal amount of holding under £5,000) the type of apportionment argued for by the Inland Revenue in Thomas Summerson and by the taxpayer in Schaffer was introduced. While such apportionment is not perfect (as pointed out by Rowlatt J in Thomas Summerson) it did have the effect of making the taxable income match the financial income much more closely.

3.3.5. Bonds without an interest coupon (zero coupon bonds)

It was not until 1940 that the courts first gave consideration to "zero coupon bonds", although the phrase did not enter common usage until the late 1970's.

3.3.5.1.Review of Lord Howard de Walden v Beck

The facts of this case, reference 23 TC 384, are as follows. On 11 December 1933 the taxpayer entered into simultaneous transactions with four Canadian companies. The analysis of the Special Commissioners and the High Court concentrated on the transaction that was clearest and simplest; the others were very similar. In this transaction, on 11 December 1993 the taxpayer paid £259,380 to St Francis Securities Ltd. In return, the company issued to him 120 promissory notes, each with a face value of £3,750. The first note was payable on 31 March 1934 and the remaining 119 at quarterly intervals. In total over 30 years the taxpayer would receive 120 x £3,750 = £450,000.

The 120 promissory notes could be regarded in several different ways:

- As giving rise entirely to payments of capital, so that there was no taxable income. This was argued by the taxpayer unsuccessfully before both the Commissioners and the Court.

- As representing 120 instalments of an annuity, so that they were entirely taxable income. The Inland Revenue never argued for this and Justice Wrottesley in the High Court made it clear that in general courts were reluctant to accept such arguments.

- As being partly income and partly capital.

If the promissory notes were partly income and partly capital, then the secondary question was how they should be dissected. Three alternatives are discussed in the case:

Alternative 1

Each note could be treated as a separate zero coupon bond.

After the Commissioners' initial hearing had decided the notes must be dissected, at a second hearing the taxpayer demonstrated that, using modern phraseology, the notes had an internal rate of return of $4^{1}/_{16}$% pa compounded quarterly. Using this, it was possible to calculate the net present value of each note on 11 December 1993. The balance of each note would be interest, taxable when the note was repaid. This gives rise to the following outcomes (calculations by the writer):

Note	Face Value	Net Present Value on Issue	Interest Element
1	£3,750	£3,712	£38
120	£3,750	£1,115	£2,635

The Commissioners decided that this was the appropriate method of dissection. It is also the method that would be preferred by anyone in commercial life who has to deal with such promissory notes, and recognises the individual transferable nature of each note. E.g. if the taxpayer had sold note number 120 in the open market on its issue, he would have received £1,115 as a price, if one assumes that the note had been issued by St Francis on arms length terms. (The arms length nature or otherwise of the transactions is not commented on in the judgement, but it would appear that the taxpayer had other relationships with the companies, since three of the four had pre-existing liabilities to the taxpayer).

A consequence of this analysis is that the amount of taxable income is low at the beginning and rises over the 30 years, since the notes only give rise to taxable income as each note is redeemed. (The tax system did not tax the appreciation in value of the notes until redemption).

Alternative 2

The Crown argued for an alternative dissection. This was based upon regarding all 120 promissory notes together and treating them as partial repayments of a loan, with annual rests. The Crown showed that 4% pa was the annual interest rate needed for this calculation.

This method of calculation had been approved in Scobies Case 4 TC 478 and 618 to dissect an apparent annuity. The High Court ruled that this method should be applied. The writer would illustrate this as follows:

Quarter 1	Capital owed £259,380	
	Interest at $4^{1}/_{16}$% for 1 quarter	£2,634
	Capital element (balancing figure)	£1,116
	Total payment	£3,750
Quarter 120	Notional capital owed £3,712	
	Interest at $4^{1}/_{16}$% for 1 quarter	£ 38
	Capital element	£3,712
	Total payment	£3,750

The Crown accepted that such a calculation would cause difficulty if, say, one note out of the sequence was sold to a third party company and held by the third party until maturity. However this difficulty was insufficient to assist the taxpayer before the High Court. By then the taxpayer was arguing (in the writer's view correctly) for the method in Alternative 1 if the notes were not accepted as all capital.

Alternative 3

Although Justice Wrottesley ruled in favour of Alternative 2, page 401 of the report makes it clear that he personally preferred an entirely different method, where each note comprised the same amount of interest and of capital. The writer would explain this as follows. In total there is £259,380 capital and £190,620 interest,

i.e. £450,000 - £259,380. As there are 120 notes, each would comprise £2,161 capital and £1,589 interest.

While Justice Wrottesley considered this method "the reasonable one", his comments show his insulation from commercial life as this method would use simple interest (as opposed to compound interest) for a series of notes whose life ran over 30 years.

3.3.5.2.Review of Ditchfield v Sharp

It was another 40 years before zero coupon bonds appeared before the courts again in the case of Ditchfield v Sharp 1982 STC 124 (High Court) and 1983 STC 590 (Court of Appeal).

The facts are relatively simple. On 23 May 1969, a UK company Berger Jenson & Nicholson Ltd ("Bergers") purchased the British Paints group of companies from a US vendor, Celanese Corp. The consideration given by Bergers comprised Bergers' ordinary stock units, Bergers loan stock and the issue by Bergers to Cel Euro NV (a Dutch subsidiary of Celanese Corp) of a promissory note. The promissory note was for an amount of £2,399,000 and was payable on 1 February 1973 without interest.

Part of the share capital of Bergers was held by a settlement established in 1934, "The Orwell Share Settlement". In 1970 Hoechst UK Ltd took over Bergers, and the trustees received a significant amount of cash and decided to invest the cash as follows. A UK merchant bank, NM Rothschild & Sons Ltd purchased the Bergers note from Cel Euro BV on 26 February 1970 and sold it to the trustees and other joint investors; Rothschilds also gave their own guarantee for payment of 75% of the promissory note on maturity.

The trustees provided £1,321,904 of the purchase amount and the other investors £457,727 making a total price on 26 February 1970 of £1,779,631. On 1 February 1973 Bergers redeemed the promissory note for £2,339,000 of which the trustees share was £1,781,969 and the other investors share was £617,031.

The Inland Revenue raised a 1972/73 assessment on the trustees for £460,065 being their "profit". The assessment was made under Schedule D Case III on the premise that the £460,065 was a "discount" taxable under ICTA 1970 s.109 (2)(b). An alternative 1972/73 assessment was also made on the trustees for capital gains tax; this was for only £247,233 as some of the beneficiaries were chargeable to capital gains tax in their own right, being absolutely entitled against the trustees.

The Special Commissioners held that the gain was capital. The Crown appealed and Walton J in the High Court held that the "profit" was a discount, taxable under Schedule D Case III. The Court of Appeal confirmed this. Several significant points were made in the judgements:

No evidence was offered regarding how the amount of the promissory note was arrived at in the original transaction with Celanese. However, Walton J had no problems concluding (rightly in the author's view) that in an arms length transaction the three years delay in payment under the promissory note must have reflected some compensation for delay. I.e. Celanese would have accepted a lower amount than £2,399,000 if Bergers had paid cash on 23 May 1969. Accordingly the issue of the promissory note was a discounting transaction.

One of the taxpayer's arguments was based on the time duration of the discounting transaction. The taxpayer accepted that interest was always taxable, whether paid in respect of a short or long time interval. However it was argued that discounts were different. Discounts for periods of up to a year were taxable (this was inescapable due to the House of Lords decision in Brown v National Provident Institution 8 TC 57) but discounts in respect of longer periods were not taxable. An example was given of long dated Treasury Stock, often issued at a discount, where the discount was never taxed even before FA 1973 put such "non taxation" on a statutory footing. The judges found no logical basis for such a 12-month cut off.

Walton recognised that taxing the whole of a discount could produce some injustice, even though tax law required it. He gave the example of a discounted promissory note bought at a low price by a secondary purchaser at a time when market interest rates were high. If market interest rates then fell and the note was resold, a significant part of the holder's profit would have nothing to do with the amortisation of the original discount. Nevertheless the entire profit would be taxed under Schedule D Case III. (This anomaly was addressed by the 1984 legislation discussed below).

The judges laid great stress on the approach in the Lomax case. I.e. in the absence of other facts if commercial interest was paid then a premium or discount was most probably capital, but in the absence of commercial interest a premium or discount was most probably taxable as income.

Counsel for the taxpayer raised before the Court of Appeal the ingenious argument that if there was an income element in the amount received by the trustees, it must be interest, not discount. (Interest would be taxable under ICTA 1970 s.109 (2)(a) unlike the assessment made on discounting under s.109 (2)(b) and the Inland Revenue was out of time to make a new assessment under s.109 (2)(a)). Fox LJ who held that having an interest element in the transaction did not

prevent it being a discounting transaction summarily dismissed this point.

Walton J recognised that the effect of the law was to tax the trustees on the discount "as if it were a lump sum paid by way of interest" but without giving any relief to the paying company. (This question of relief to the paying company was also addressed in the 1984 legislation).

3.3.5.3.Increase in issuance of zero coupon bonds

In the years prior to Ditchfield v Sharp coming to court, developments in commercial life changed zero coupon bonds from being oddities of obscure tax cases into integral parts of commercial life. A number of major foreign companies issued zero coupon bonds on the commercial debt markets to raise finance. It was not open to UK companies to raise finance in the same way, since UK tax law clearly gave no corporate deduction for the discount either year by year or on redemption of the bond. The tax position of investors was also unclear, and some tax advisers were promoting investment in the available foreign zero coupon bonds as a way of achieving returns economically equivalent to interest in the form of a capital gain.

3.3.5.4.A legislative regime for zero coupon bonds

On 25 June 1982 it was announced that the law would be changed. An Inland Revenue consultative document was issued in January 1983 and legislation followed as FA 1984 s.36 and Schedule 9. The key points of the legislation are as follows:

- The legislation applied not only to zero coupon bonds but also to all bonds issued at a discount of 15% or if less ½% for each year between issue date and redemption date.

- Holders were taxed on the actuarial amount of discount arising during their holding period, but a taxable event only occurred when the bond was transferred or redeemed. (To simplify the calculations, the issuing company was required to compute the actuarial income for each whole year between issue and redemption, and straight-line apportionment was used for dates not falling on anniversaries of the issue date.)

- Issuers received a corporate tax deduction on an accruals basis, except for cases obviously likely to lead to a loss of tax such as bonds held by associated companies or participators in close companies. However, the government was clearly willing to accept the loss of tax arising from the fact that corporate issuers received an accruals basis deduction while investors were only taxed

on a realisation basis. Presumably the loss of tax was expected to be small, and this was borne out in practice by the relatively small issuance of such bonds after 1984.

Gains other than those arising from the accruing discount remained within the capital gains regime. Conversely, it was possible for the investor to be subject to income tax while making an overall loss, as illustrated by the following transactions:

- Zero coupon bond purchased 1 January 1985 for £200 when interest rates are low.

- Zero coupon bond sold on 1 January 1986 for £150 because interest rates have risen.

- The accruing discount over the 12 months is, say £10.

The investor would be taxed on the £10 despite making an overall loss of £50; he would have £10 subject to income tax while the statute would give a compensating increase in his capital loss to £60.

Overall, the 1984 legislation provided a reasonably satisfactory and workable basis for giving tax relief to companies issuing zero coupon bonds and for taxing investors in such bonds. However, it did not prevent difficulties or perceived abuses arising in the future.

3.3.6. Legislation to counter synthetic stripping

Having enacted the deep discount bonds legislation, the following year Parliament found anti-avoidance legislation necessary to counter synthetic gilt stripping. FA 1985 Schedule 11 para 1 & 2 introduced what is now ICTA 1988 Sch 4 para 2 & 3.

The mechanics of synthetic stripping are discussed in section 4.4.1. The legislation had the effect of introducing an annual tax charge on the investor by deeming income to arise at the end of each income period equal to the linked income element, in cases where deep discount bonds were issued by a company and at least 75% of the assets of the company “were relevant securities” as defined.

The Government's concern was that otherwise such investors would have no tax liability until they disposed of the deep discount bonds. Meanwhile, the issuing company would be entitled to an accruals basis tax deduction in respect of the discount and could set that against the interest income arising on its portfolio of securities. The overall effect would be a reduction in aggregate tax revenue.

The legislation was effective in preventing the development of synthetic gilt stripping in the UK.

3.3.7. Puttable bonds

The deep discount bonds legislation only applied where there was an identifiable discount on the issue of the securities (sec ICTA 1988 Sch 4 para 1(1)(c)) by comparing issue price and redemption value. There was no mechanism for it to apply where the holder realised an economic gain from redemption of the bonds outside the mechanism in ICTA 1988 Schedule 4.

A simple example would be a bond with £100 face value, annual interest coupons of say £7pa, issued at £100, where the holder had a unilateral option (a "put option") to require the company to redeem the bonds at £105 after 3 years.

Such put options are often given to investors for bona fide commercial reasons, e.g. so that they can require the bonds to be redeemed if there is a charge in control of the issuing company. Equally one can envisage a tax avoidance opportunity if investors were in general not taxable on the redemption gain.

Accordingly, FA 1989 Schedule 11 introduced charging provisions to tax such "deep gains", along with complex exemptions for securities such as "qualifying indexed securities".

3.3.8. Accounting for discounts

The case of Willingale v International Commercial Bank Ltd, 52 TC 242 represents a high watermark for the tax system's ignoring both commercial reality and accounting.

Very briefly, the taxpayer bank's business comprised providing international trade finance for periods of between one and ten years, by discounting trade bills and

promissory notes. The bank also purchased such instruments in the secondary market. Once acquired, the bills and promissory notes were usually held until maturity.

In its financial accounts, the bank recorded its investments in bills at cost plus accrued discount. The discount between cost and maturity value was included in the bank's profit and loss account on an apportioned straight line basis over the life of the bill. In preparing its corporation tax returns, the bank excluded accrued discount from its taxable income. The tax returns recognised no income from a bill until the bill was sold or matured.

The House of Lords accepted that the tax returns were properly prepared. They gave the following reasons:

Accounting evidence was provided by the bank's auditors that, if the bank's statutory accounts had been prepared on the same basis as used in the tax returns, the auditors would have accepted them as giving a true and fair view. Accordingly, both the "accrual of discount" and the "non-accrual of discount" represented acceptable implementations of the normal principles of commercial accounting.

Lord Fraser (on page 273) did not accept (in the words of Stamp L.J.) "that there is no distinction in principle between earning interest and earning discount". His view was that, although interest accrues from day to day, discount does not.

In the writer's opinion, although modern courts and legislative practice increasingly expect a company to prepare its tax returns on the same basis as its statutory accounts, the House of Lords was right in not regarding the statutory accounts as determinative of the tax treatment. However, the House was wrong in not recognising the equivalence of discount and interest. Lord Fraser stressed that the discount was not realised until the bill was sold or matured. However, it is tolerably clear from the judgements that if the bills had been drafted so that they were for a face value of £100, and bore explicit interest at 7% pa with all of the interest being compounded and payable only on the maturity of the bill, then the bank would have been taxed on the accruing interest income year by year. The judgement was determined solely by the form of the transactions as discount rather than interest.

3.3.9. Deferral of interest receipts

Another "mischief" which the Inland Revenue increasingly encountered was the making of loans by UK companies to foreign affiliates, where the interest income was accrued by the UK company, but not currently received in cash. This could arise because no steps were taken to enforce payment or because the terms of the loan were so drafted that the debtor did not need to pay until some extended specified time. The simplest approach was for the foreign affiliate to issue a zero coupon bond, provided local tax law, as in Germany, gave it an accruals basis tax deduction. More elaborate arrangements relied upon the foreign affiliate issuing securities exempted from the deep gains charge in FA 1989 Sch 11.

Initially, the Inland Revenue contended that such Schedule D case IV/V income was taxable as it accrued, but had to concede in correspondence on many occasions that such an interpretation of the "arising basis" was not supported by the tax law.

Accordingly, FA 1993 s 61-66 was enacted. This creates an annual UK tax charge on the accruing income by deeming the security in question to be transferred at each year end of the UK company, and by overriding the exemptions in FA 1989 Sch 11.

3.3.10.Zero coupon bonds held by associates of banks

Eleven years after the original 1984 deep discount securities rules were enacted, the government legislated against deep discount (and various other) securities held by companies associated with banks. (Banks themselves as financial traders had always recognised deep discount income currently under Schedule D case I trading principles. However, they had simply arranged for any deep discount bond investments to be held by investment company subsidiaries).

FA 1995 s88 made some minor drafting changes to FA1993 s63-66. This enabled FA 1995 s89 to extend the application of the rules to debts of that kind held by companies associated with banks, using the association test of ICTA 1988 s416. The effect was to create a current period tax charge on income that otherwise would not be taxed until the debt was redeemed or transferred.

The legislation was necessary (from the Government's perspective) as banks were using such investment company subsidiaries to channel long term loans in deep discount form. Typically, a combination of a set of deep discount bonds with a series of redemption dates plus a "fixed to floating" interest rate swap together gave the borrower the equivalent of a long term amortising loan at floating interest rates, while the bank's subsidiary was not taxed on the related loan income until each tranche of deep disount bond matured.

3.3.11. Equity linked loan stock as a qualifying corporate bond

The deep gains legislation in FA 1989 schedule 11 para 2 (2) (c) contained an exemption for securities linked to a stock market index. Accordingly, it was possible to structure a loan that fell outside FA 1989 schedule 11 and which was also structured to be a qualifying corporate bond and therefore exempt from capital gains tax.

The first public use of this "anomaly" came in November 1994. A new investment trust, Fidelity Special Values plc issued loan stock that was linked to the value of the All Share Index. The promotional materials for this investment trust made clear that the loan stock had been carefully designed to be a qualifying corporate bond and therefore exempt from capital gains tax.

Legislative counteraction was immediate in the Budget on 29th November, which announced what is now FA 1995 section 50. That provision amended the definition of a qualifying corporate bond in TCGA 1992 section 117 to ensure that for all disposals after Budget day a quoted indexed security falling within paragraph 2 (2) (c) would not be treated as a qualifying corporate bond.

3.4. The position by 25 May 1995

By 25 May 1999, the date of the first announcement of the new rules, the relevant law was a complete mess. Lots of complex legislation had been passed piecemeal to deal with new commercial practices and to close perceived avoidance opportunities.

3.5. Defects in the tax system

Tax law relating to debts and interest had major defects, both from the perspective of the Inland Revenue and from the perspective of taxpayers. These defects were additional to its inability to deal with new concepts such as gilt stripping.

3.5.1. From Inland Revenue perspective

The law failed altogether to tax certain types of economic gains, while other gains were taxed on a "realisation basis". Some of the many anomalies (from the Inland Revenue perspective) are listed below:

There was no taxation of the discount on low coupon gilts, even though this was economically equivalent to interest.

Similarly, corporate bonds purchased in the secondary market below face value and held until maturity or sold at a profit gave rise to no taxable income (apart from the interest coupon).

A mismatch arose because the discount on a zero coupon bond was taxable only on disposal of the bond by the investor, while the issuing company received an accruals basis tax deduction.

There was no taxation of economic gains arising from changes in the market value of a zero coupon bond; the only item taxed on disposal was the accruing discount.

3.5.2. From taxpayer perspective

The tax system was also unfair to taxpayers, with some examples given below. While the Inland Revenue had equivalent concerns illustrated above, the tax system could not sensibly be defended by the argument that there were perverse treatments affecting both taxgatherer and taxpayer.

Some of the areas where taxpayers were not given relief for economic costs and losses are listed below:

- Investors in bonds received no tax relief for losses (even when realised) arising from either market fluctuations or declines in the borrowers creditworthiness.

- The issuing company received no tax relief for "deep gains" even though investors were taxed.

- Although tax relief was given for the incidental costs of obtaining loan finance, no tax relief was given for the costs of obtaining release from onerous loans. Many companies paid penalties to their bank lenders or premiums to their loan holders of tens of millions of pounds and obtained no tax relief eg when the privatised utilities redeemed at a premium high interest bonds held by the government.

4. Stripping Government Bonds

4.1. Purpose

The primary rationale for the new corporate debt rules was to enable the introduction of a gilt strips market. Accordingly, this chapter discusses the financial reforms that were desired, and the reasons why changes to the tax legislation were required.

To facilitate discussion of the financial and tax issues, a fundamental conceptual framework is first outlined.

4.2. Fundamental concepts of debt instruments

There are a number of underlying concepts which are familiar to participants (issuers, investors and dealers) in the bond markets. These will be explained using an illustration based upon a hypothetical government bond and a set of market circumstances on 1 January 1997. (The fact that 1 January is a bank holiday when UK financial markets are closed is ignored).

4.2.1. The Yield Curve

The Financial Times contains extensive details each day on market interest rates. Looking at the newspaper for 12 September 1997 one finds the following interest rates quoted from the inter-bank sterling market of the day before:

Time period	**% rate required on loans "LIBOR"**		**% rate offered on deposits "LIBID"**	
Overnight	$7\frac{1}{32}$	7.03125	$6\frac{1}{2}$	6.50000
7 days notice	$7\frac{1}{16}$	7.06250	$6\frac{7}{8}$	6.87500
One month	$7\frac{1}{8}$	7.12500	7	7.00000
Three months	$7\frac{9}{32}$	7.28125	$7\frac{5}{32}$	7.15625

Time period	% rate required on loans "LIBOR"		% rate offered on deposits "LIBID"	
Six months	$7\frac{13}{32}$	7.40625	$7\frac{9}{32}$	7.28125
One year	$7\frac{9}{16}$	7.56250	$7\frac{7}{16}$	7.43750

The actual quotations in the "Financial Times" were the fractions given above. The quotations have been converted into decimals for ease of comparison.

It should not be surprising that investors require different interest rates for different periods of time. A one-day deposit will be realised the following day, and can then be re-invested or deployed elsewhere. Conversely, a deposit that will not be repaid for, say, five years is not recoverable in the interim period. Even if the deposit is represented by a marketable instrument, and can therefore be sold to other investors, the owner is exposed to fluctuations in value as market conditions change. Accordingly, one would generally expect interest rates on five-year deposits to be higher than daily interest rates.

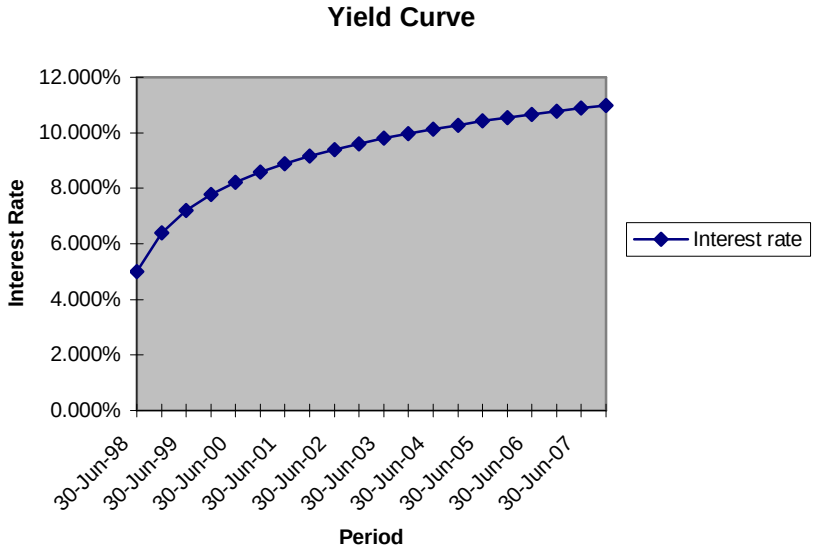
A graph showing the market interest rate for deposits of a particular length is referred to as a "yield curve".

The table and graph following illustrate a yield curve on 1 January 1998. The interest rates shown are hypothetical, and do not reflect actual market conditions on 1 January 1998.

Table 1

Period from 1.1.98 to:	Interest rate
30-Jun-98	5.000%
31-Dec-98	6.390%
30-Jun-99	7.200%
31-Dec-99	7.770%
30-Jun-00	8.220%
31-Dec-00	8.580%
30-Jun-01	8.890%
31-Dec-01	9.160%
30-Jun-02	9.390%
31-Dec-02	9.610%
30-Jun-03	9.800%
31-Dec-03	9.970%
30-Jun-04	10.130%
31-Dec-04	10.280%
30-Jun-05	10.420%
31-Dec-05	10.550%
30-Jun-06	10.670%
31-Dec-06	10.780%
30-Jun-07	10.890%
31-Dec-07	10.990%

Figure 1



The yield curve slopes upwards, sharply at first and then more smoothly. Looking at the two extremes, a six month deposit repayable on 30 June 1998 can be made at an interest rate of 5%, whereas a 10 year deposit not repayable until 31 December 2007 will yield an interest rate of 10.99%. (This yield curve shown is one for deposits repayable with all accumulated interest in one single payment e.g. after 10 years on 31 December 2007. Such interest rates are referred to by practitioners as "zero coupon spot rates", and it is necessary to quote rates in this precise formulation for later computational use).

4.2.2. Conversions between six monthly and annual interest rates

The convention used in this document is that all interest rates are based upon six monthly periods and then doubled to quote an annual rate. This is for convenience e.g. the interest rate for six months to 30 June 1998 is 2.5%, and this is referred to as 5% pa. [Strictly 2.5% every six months would compound to 5.0625%]. Similarly, the quoted rate of 6.39% for the 12 months to 31 December 1998 is taken to mean 3.195% (i.e. half of 6.39%) every six months. Using strict conversions from six monthly to annual rates would make the calculations harder to follow without changing any of the principles.

4.2.3. Bond Yields

Consider a hypothetical 10-year government bond issued on 1 January 1998. For each £100 bond certificate, the investor will receive £3.50 interest (assumed to be paid gross) every six months commencing 30 June 1998, with the last interest payment due on 31 December 2007. On 31 December 2007 the bond will be redeemed at its face value of £100. As £3.50 interest is paid every six months on £100 of face value, this would be referred to as a 7% bond.

As demonstrated by the table below, given the hypothetical yield curve prevailing on 1 January 1998, the bond would be issued at a price of £78.33 for £100 of face value. This price reflects investors' evaluation of each of the cash payments due from the bond at the interest rate applicable from the yield curve to that cash payment.

For convenience of reading, the table below and those that follow only show monetary values to two decimal places, although the underlying detailed calculations are done with a higher level of accuracy.

Table 2

Period from 1.1.98 to:	Interest rate	Periodic rate	Number of periods	Cash payment	NPV
30-Jun-98	5.000%	2.500%	1	£3.50	£3.41
31-Dec-98	6.390%	3.195%	2	£3.50	£3.29
30-Jun-99	7.200%	3.600%	3	£3.50	£3.15
31-Dec-99	7.770%	3.885%	4	£3.50	£3.01
30-Jun-00	8.220%	4.110%	5	£3.50	£2.86
31-Dec-00	8.580%	4.290%	6	£3.50	£2.72
30-Jun-01	8.890%	4.445%	7	£3.50	£2.58
31-Dec-01	9.160%	4.580%	8	£3.50	£2.45
30-Jun-02	9.390%	4.695%	9	£3.50	£2.32
31-Dec-02	9.610%	4.805%	10	£3.50	£2.19
30-Jun-03	9.800%	4.900%	11	£3.50	£2.07
31-Dec-03	9.970%	4.985%	12	£3.50	£1.95
30-Jun-04	10.130%	5.065%	13	£3.50	£1.84
31-Dec-04	10.280%	5.140%	14	£3.50	£1.74
30-Jun-05	10.420%	5.210%	15	£3.50	£1.63
31-Dec-05	10.550%	5.275%	16	£3.50	£1.54
30-Jun-06	10.670%	5.335%	17	£3.50	£1.45
31-Dec-06	10.780%	5.390%	18	£3.50	£1.36
30-Jun-07	10.890%	5.445%	19	£3.50	£1.28
31-Dec-07	10.990%	5.495%	20	£103.50	£35.51
					£78.33

If such a bond was quoted in the Financial Times, two particular items of information would be given as well as the price of £78.33.

4.2.3.1. The Running Yield

The running yield is the nominal interest rate (7%) divided by the price (£78.33), i.e. 8.94%. This figure shows the cash interest yield on the bond (7%) as a function of its price, but does not give the full return from the bond, since it ignores the gain from receiving repayment of £100 for a purchase price of £78.33.

4.2.3.2. The Yield to Maturity

The yield to maturity is the interest rate which, when used to discount the future receipts from the bond, computes a net present value equal to the current market price. More concisely, it is the internal rate of return when one considers the initial purchase price and future cash flows.

Internal rate of return of bond cash flows	**5.28%**
Date of event	**Bond cash flows**
1-Jan-98	(£78.33)
30-Jun-98	£3.50
31-Dec-98	£3.50
30-Jun-99	£3.50
31-Dec-99	£3.50
30-Jun-00	£3.50
31-Dec-00	£3.50
30-Jun-01	£3.50
31-Dec-01	£3.50
30-Jun-02	£3.50
31-Dec-02	£3.50
30-Jun-03	£3.50
31-Dec-03	£3.50
30-Jun-04	£3.50
31-Dec-04	£3.50
30-Jun-05	£3.50
31-Dec-05	£3.50
30-Jun-06	£3.50
31-Dec-06	£3.50
30-Jun-07	£3.50
31-Dec-07	£103.50

The yield to maturity is a convenient way of representing by one number the total return from the bond; both the £3.50 interest paid every six months and the redemption payment of £100, as compared with the purchase price of £78.33. Based upon these figures, the yield to maturity is 5.281% every six months, i.e. 10.561%pa. (Using the simple doubling convention of this paper).

In passing, looking at the sloping yield curve, this yield to maturity of 10.561% pa is similar to yields in the eight-year range. This is consistent with the fact that the "duration" of the bond is just over 8 years **[MA to check].** Duration is a measure of the length of the life of the bond taking into account the timing and size of the cash flows.

4.2.4. Re-investment Risk

Consider an investor who will require £100 on 31 December 2007. For example, the investor may be an insurance company which has sold annuities, and can

calculate that it will require £100 on 31 December 2007 to enable it to make the annuity payment it is committed to on that day. It wishes to ensure that it will have the cash available by immediately investing in a bond.

Purchasing £100 face value of bond for £78.33 would guarantee the receipt of £100 on 31 December 2007. However, it also generates interest receipts of £3.50 every six months, which are superfluous to the insurance company's requirements, and means that it would have laid out too much money up front.

If the yield to maturity of the bond remains constant at 10.561% pa over its 10-year life (not a realistic assumption in practice) then the table below gives its future market price.

Date	Bond price
1-Jan-98	£78.33
30-Jun-98	£78.96
31-Dec-98	£79.63
30-Jun-99	£80.34
31-Dec-99	£81.08
30-Jun-00	£81.86
31-Dec-00	£82.69
30-Jun-01	£83.55
31-Dec-01	£84.46
30-Jun-02	£85.42
31-Dec-02	£86.44
30-Jun-03	£87.50
31-Dec-03	£88.62
30-Jun-04	£89.80
31-Dec-04	£91.04
30-Jun-05	£92.35
31-Dec-05	£93.73
30-Jun-06	£95.18
31-Dec-06	£96.70
30-Jun-07	£98.31
31-Dec-07	£100.00

As one nears redemption day of 31 December 2007, the price nears £100 as the redemption proceeds become more imminent. At these bond prices, the yield to maturity at all the dates given is 10.561%.

The table below illustrates this. The investor spends £35.73 on bonds on 1 January 1998 at the market price of £78.33 per £100 face value. He then reinvests all future interest receipts into the bond at its then market price and will have approximately £100 on 31 December 2007 after the bond is repaid at face value and the final interest payment of £3.50 per £100 face value is received.

Period Start	Period End	Bond price	Investment of principal and interest	Face value acquired	Cumulative face value owned	Interest receipt at period end
1-Jan-98	30-Jun-98	£78.33	£35.73	£45.62	£45.62	£1.60
30-Jun-98	31-Dec-98	£78.96	£1.60	£2.02	£47.64	£1.67
31-Dec-98	30-Jun-99	£79.63	£1.67	£2.09	£49.73	£1.74
30-Jun-99	31-Dec-99	£80.34	£1.74	£2.17	£51.90	£1.82
31-Dec-99	30-Jun-00	£81.08	£1.82	£2.24	£54.14	£1.89
30-Jun-00	31-Dec-00	£81.86	£1.89	£2.31	£56.45	£1.98
31-Dec-00	30-Jun-01	£82.69	£1.98	£2.39	£58.84	£2.06
30-Jun-01	31-Dec-01	£83.55	£2.06	£2.46	£61.31	£2.15
31-Dec-01	30-Jun-02	£84.46	£2.15	£2.54	£63.85	£2.23
30-Jun-02	31-Dec-02	£85.42	£2.23	£2.62	£66.46	£2.33
31-Dec-02	30-Jun-03	£86.44	£2.33	£2.69	£69.16	£2.42
30-Jun-03	31-Dec-03	£87.50	£2.42	£2.77	£71.92	£2.52
31-Dec-03	30-Jun-04	£88.62	£2.52	£2.84	£74.76	£2.62
30-Jun-04	31-Dec-04	£89.80	£2.62	£2.91	£77.68	£2.72
31-Dec-04	30-Jun-05	£91.04	£2.72	£2.99	£80.66	£2.82
30-Jun-05	31-Dec-05	£92.35	£2.82	£3.06	£83.72	£2.93
31-Dec-05	30-Jun-06	£93.73	£2.93	£3.13	£86.85	£3.04
30-Jun-06	31-Dec-06	£95.18	£3.04	£3.19	£90.04	£3.15
31-Dec-06	30-Jun-07	£96.70	£3.15	£3.26	£93.30	£3.27
30-Jun-07	31-Dec-07	£98.31	£3.27	£3.32	£96.62	£3.38

Total cash received on redemption day

Redemption of bond holding at face value	£96.62
Final interest payment	£3.38
	£100.00

However, this strategy is critically dependent upon the assumption that the yield to maturity of the bond never changes over this 10-year period. In practice, interest rates change all the time, with corresponding fluctuations in bond prices and yields. Accordingly the bond investor cannot be sure that starting with £35.73 he will be able to accumulate £100 by 31 December 2007. The risk arises because he cannot be sure that he will be able to re-invest his future interest receipts at the yield originally hoped for. This risk is referred to as “reinvestment risk”.

4.2.5. Zero coupon bonds

A zero coupon bond is, quite simply, a bond that pays no interest. Instead, the only cash transactions between the issuer and the investor are:

- At inception, the investor transfers cash to the issuer and acquires a bond.

- At maturity, the issuer redeems the bond in accordance with its terms. This redemption payment by the issuer comprises both the return of the investor's original investment and an economic return to the investor covering the life of the bond.

There is a convention for bonds to have a redemption value that is fixed at a round amount such as £1,000 or £100. Considering the life of the bond and the appropriate interest rate then sets the issue price. For example, if the bond were to be issued for 10 years and with an implicit interest rate of 10.99 % pa then the issue price of the bond would be £34.30 for each £100 of face value. (As indicated by the yield curve detail on page 40 10.99% would be the appropriate interest rate for a 10 year zero coupon bond issued on 1 January 1998 in these hypothetical market conditions.)

Taking into account the writers convention regarding interest rates stated on page 41 the market value of the bond is calculated as follows:

$$\text{Market Value} = £34.30 = \frac{£100}{(1 + 0.1099/2)^{20}}$$

4.2.5.1.Attractions for a long term holder

A zero coupon bond is a particularly attractive investment for an investor who requires a known amount of cash on a known future date. E.g. if the current date is 1 January 1998 and the investor needs £100 on 31 December 2007, he knows that by investing £34.30 in a zero coupon bond, exactly £100 will be received on 31 December 2007. There is no longer any reinvestment risk arising from future fluctuations in interest rates. Many investors such as pension funds and insurance companies are in this situation, of having future liabilities whose timing and amount are known with reasonable precision, and for such circumstances a portfolio of zero coupon bonds with maturity at the desired dates can be very attractive in eliminating reinvestment risk.

4.2.5.2.Attractions for short term speculative holders

Bond prices fluctuate in response to changes in interest rates represented by changes in the yield curve. The greater the time delays before the bond’s cash flows are received, the greater the fluctuation in market values. Consider for example two alternative bonds:

Regular bond

Coupon payments of £3.50 every six months, first payment on 30 June 1998, last payment on 31 December 2007 along with a bond redemption payment of £100 on 31 December 2007. This is the hypothetical bond discussed on page 41.

Zero coupon bond

This has only a single redemption payment of £100 on 31 December 2007.

The market value of each bond on 1 January 1998 depends on the yield curve; i.e. the structure of interest rates for different time periods. As shown on page 42, with the yield curve assumed, the market value of the regular bond will be £78.33. If the entire yield curve is shifted upwards in parallel by one per cent, the value of the regular bond will fall from £78.33 to £73.46 as calculated below:

1.000% Rate uplift

Period from 1.1.98 to:	Uplifted rate	Periodic rate	Number of periods	Cash payment	NPV
30-Jun-98	6.000%	3.000%	1	£3.50	£3.40
31-Dec-98	7.390%	3.695%	2	£3.50	£3.26
30-Jun-99	8.200%	4.100%	3	£3.50	£3.10
31-Dec-99	8.770%	4.385%	4	£3.50	£2.95
30-Jun-00	9.220%	4.610%	5	£3.50	£2.79
31-Dec-00	9.580%	4.790%	6	£3.50	£2.64
30-Jun-01	9.890%	4.945%	7	£3.50	£2.50
31-Dec-01	10.160%	5.080%	8	£3.50	£2.35
30-Jun-02	10.390%	5.195%	9	£3.50	£2.22
31-Dec-02	10.610%	5.305%	10	£3.50	£2.09
30-Jun-03	10.800%	5.400%	11	£3.50	£1.96
31-Dec-03	10.970%	5.485%	12	£3.50	£1.84
30-Jun-04	11.130%	5.565%	13	£3.50	£1.73
31-Dec-04	11.280%	5.640%	14	£3.50	£1.62
30-Jun-05	11.420%	5.710%	15	£3.50	£1.52
31-Dec-05	11.550%	5.775%	16	£3.50	£1.43
30-Jun-06	11.670%	5.835%	17	£3.50	£1.33
31-Dec-06	11.780%	5.890%	18	£3.50	£1.25
30-Jun-07	11.890%	5.945%	19	£3.50	£1.17
31-Dec-07	11.990%	5.995%	20	£103.50	£32.30
					£73.46

I.e. the coupon bond will fall in value by 6.21% of its value.

The market value of the zero coupon bond on 1 January 1998 will be £34.30 as calculated on page 46 since the applicable interest rate for a repayment due on 31 December 2007 is 10.99% pa in the yield curve shown on page 40. When the entire yield curve is shifted upwards by 1% due to the assumed increase in interest rates, the applicable interest rate becomes 11.99% and the value of the zero coupon bond will fall from £34.30 to £31.21, a loss of 9.02% of its value. This is much greater decline in value than occurs with the regular bond.

Similarly, if interest rates fell, then the zero coupon bond's market value would rise by a higher percentage than the corresponding price increase in a regular coupon bond.

Accordingly, zero coupon bonds are an attractive speculative medium for anyone who wishes to speculate in the movement of long-term interest rates. Although the majority of the demand for a zero coupon bonds will come from long term investors seeking to avoid reinvestment risk, the demand from speculators is helpful in insuring the functioning of a liquid bond market.

4.2.5.3.Attractions for an issuing company

From the issuer's perspective, zero coupon bonds can be attractive if the money raised is to be used to fund a capital project which may not generate cash returns for some time, as they avoid the burden of intervening cash interest payments.

Companies are particularly attracted when the tax system, as in the USA and the UK, gives annual tax relief for the interest amortisation on zero coupon bonds even though no cash interest is paid out by the company until the bond is redeemed.

Accordingly, over the last 20 so years, there has been an increase in zero coupon bond issuance by corporate borrowers, so that they are no longer regarded as outlandish. For example, the writer was once an investor in zero coupon bonds issued by British Telecommunications plc.

4.2.5.4.Attractiveness or otherwise for issuing governments

Unlike companies financing long-term projects, governments find few if any attractions in zero coupon bond issuance. The evaluation of zero coupon bond issuance from a government's perspective would be quite different and take into account the fact that:

- Unlike companies, governments are not constrained by the availability of cash.
- The bond interest has the same impact in the public expenditure accounts regardless of whether it is paid out or not.
- Governments by definition are not seeking tax relief on the interest amortisation.

Accordingly, there has been relatively little zero coupon bond issuance by governments, compared with their vast issuance of regular coupon bonds.

4.3. What is stripping?

Historically, the potential demand from investors for zero coupon bonds has exceeded supply. In particular, with occasional exceptions (e.g. deutschmark denominated zero coupon bonds issued by the state government of Lower Saxony in Germany) governments have tended not to issue zero coupon bonds. This created the opportunity for intermediaries to effectively convert actual coupon bonds into zero coupon bonds.

Consider the bond illustrated on page 41. An investment bank could purchase this bond in the market for £78.33 for each £100 of face value. Each £100 bond then gives rise to 20 specific future cash flows. I.e. £3.50 payable each 30 June and 31 December, culminating in a final £103.50 payable on 31 December 2007.

Each of these 20 future cash payments could be sold, separately, to different investors. For example, the £3.50 payment due on 31 December 2005 would sell on 1 January 1998 for approximately £1.54.

After taking into account market demand, it is quite possible that the investment bank could pay £78.33 to buy a £100 face value bond and sell the 20 separate receipts to up to 20 different investors for an aggregate sales price in excess of £78.33, this excess representing its profit. The profit arises from the demand for zero coupon bonds exceeding the readily available supply. **Give a numerical example of someone selling annuities who does not want the final principal**

payment and therefore needs to get rid of it, at a loss. This investor would pay more for just the interest coupons.

This exercise is known as stripping because each individual cash flow is peeled away or "stripped" from the bond and sold separately. It corresponds to the exercise of physically detaching interest coupons from a bearer bond certificate and selling those coupons. In the USA, as the market developed, the term "STRIPS" was employed to stand for Separate Trading of Registered Interest and Principal Securities.[1]

4.4. Alternative methods

There are two fundamentally different ways in which a bond can be stripped.

4.4.1. "Synthetic" stripping

Under this route, an intermediary such as an investment bank purchases a bond. The investment bank then sells new, original, zero coupon obligations of its own, with a liability profile matching that of the regular bond owned by the bank.

For example, having purchased the £100 face value hypothetical bond mentioned on page 41, the investment bank could issue, inter alia, a £3.50 face value zero coupon bond repayable on 31 December, 2005, achieving an approximate issue price of £1.54. The Bank knows that it can meet the £3.50 obligation when due on 31 December 2005 since it owns a regular bond, which will supply the required cash.

From the investor's perspective, a zero coupon bond issued by an investment bank may carry a significantly higher credit risk (i.e. a risk of loss of value arising from the issuer's insolvency) than the underlying regular bond. For example, if the UK government issues the underlying regular bond, it is traditionally regarded as risk free since the UK government has never defaulted on its debts and could, if necessary, print more sterling currency to meet its sterling bond obligations. However, while this means that the investment bank holds a risk free asset, its matching zero coupon bond is not a risk free asset to the investor. If the investment bank becomes insolvent, the zero coupon bond investor will have to

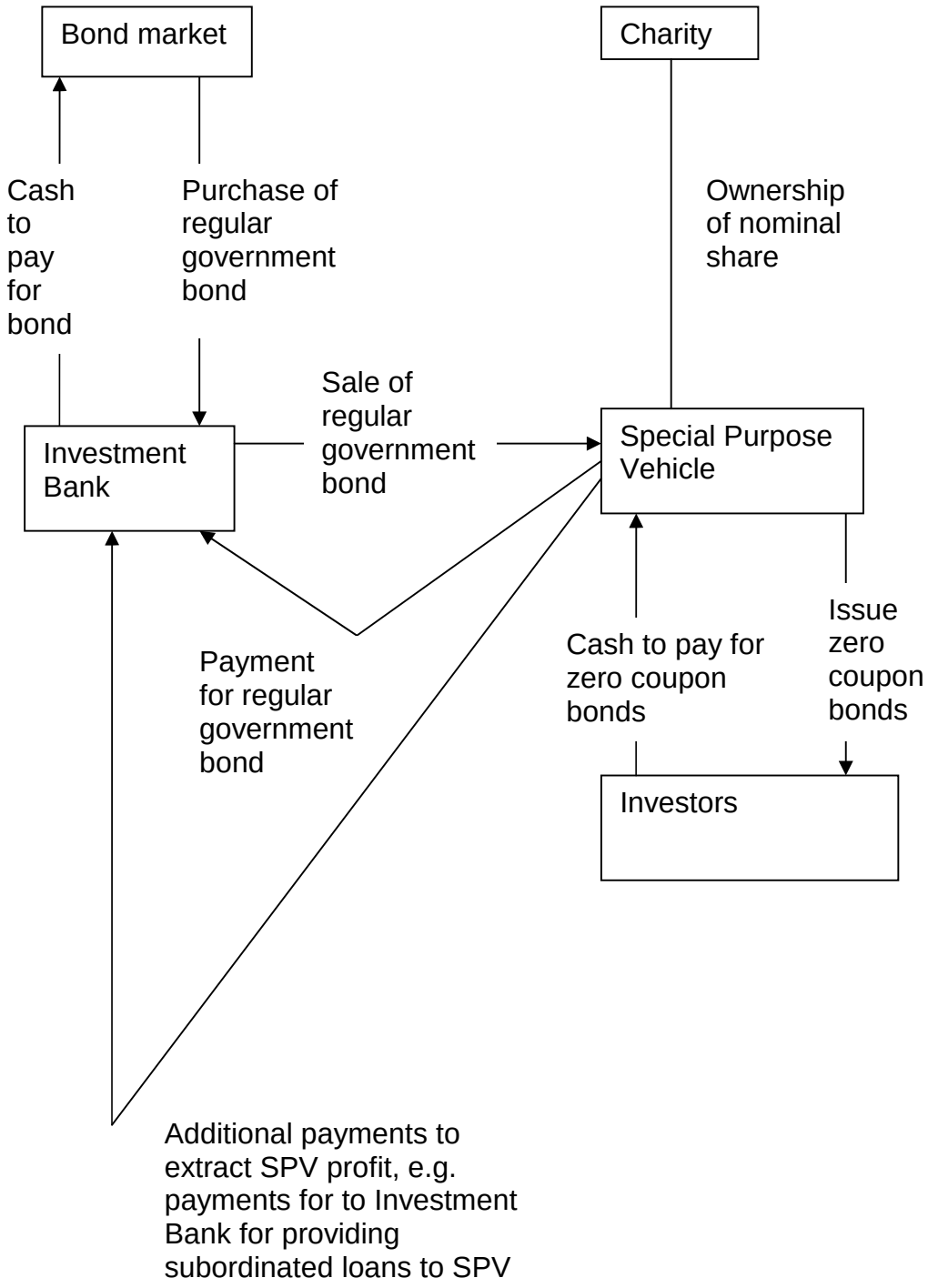
[1] "Strips and new instruments in the Gilt Edged Market" A consultative paper by the Bank of England May 1995

accept receiving only a rateable share (alongside other creditors) of the insolvent investment bank's assets.

To make the investor more secure, the investment bank could make its zero coupon bonds secured obligations, secured by a legal mortgage over the regular (government) bond held by the investment bank. While this reduces the riskiness of the investment bank’s zero coupon bonds, it does not make them risk free. There are many circumstances in which such a legal mortgage might prove insufficient. E.g. in a UK corporate insolvency certain obligations of the bank will rank ahead of a "fixed charge" or legal mortgage.

To make the secondary zero coupon bonds more secure, they could (and typically would) be issued by a "special purpose vehicle" (SPV). An SPV is typically a company that carries on no other activities, and has no other assets or liabilities. This is intended to ensure that the assets of the SPV (being the regular government bond) are fully available to meet its liabilities (being the zero coupon bonds issued by it.) The investment bank would not own the SPV, thereby isolating it from the investment bank's creditors. A typical structure for the transaction would be as illustrated on the next page:

An illustrative structure for indirect stripping using a Special Purpose Vehicle (SPV)



The principal drawbacks of synthetic stripping are:

- Even with all of the credit enhancement measures described using the SPV, the credit rating of the secondary zero coupon bonds issued will still be lower than that of government debt, as the zero coupon bonds will not be free from all default risk.

- The credit enhancement measures illustrated all involve additional complexity, initial legal and other fees for setting up the structure and annual costs for continuing to operate it.

However, synthetic stripping is all that is available unless a government introduces special measures to facilitate "direct" stripping. For example, until the recent changes to the UK government bond market, UK government bonds could only be stripped "synthetically." Furthermore, the tax system actively sought to discourage stripping. **(Cross refer)**

4.4.2. "Direct" stripping

In the case of direct stripping, the issuing government facilitates the separation of the interest coupons (i.e. the £3.50 payable every six months) and the principal repayment (i.e. the final £100 redemption) into separate registered government securities. The critical point is that each separate payment, i.e. each strip, remains a direct obligation of the government.

Accordingly, stripping the takes a risk free government coupon bond and converts it into a collection of zero coupon bonds which are as free from default risk as the original bond. The separation process requires nothing more than book entries in the government stocks Register, which in England is maintained by the Central Gilts Office (CGO).

To maintain market efficiency, it is desirable for the stripping process to be reversible. I.e. by separately purchasing the 20 interest coupons and the principal payment due under our hypothetical gilt (assuming it had been stripped) the investor would have acquired all the rights of the original coupon bond. Accordingly, he could ask the CGO to reconstitute this into a coupon bond capable of sale as a coupon bond. Such a reversibility would prevent the prices of regular unstripped gilts and gilt strips getting "out of line" with each other since market participants would eliminate the price anomalies by either stripping more gilts or by reversing some of the existing strips.

To summarise, direct stripping is preferable to synthetic stripping for the following reasons:

- It maintains the risk free nature of the government bond, rather than introducing new credit risk.
- The administrative costs should be much lower, as special purpose vehicles are not required.
- The process can be made the readily reversible, unlike synthetic stripping, where reversal would be as complex as the original stripping exercise.

Accordingly, if the government considers stripping as something to be encouraged, then it should facilitate direct stripping to enable the practice to develop.

4.5. Why facilitate stripping?

From the UK Government's perspective, there was a clear commercial rationale for changes to facilitate direct stripping, and incidentally eliminating the tax penalties on indirect stripping discussed on page **(to be written)**.

Most of the UK Government's borrowing takes place in sterling and therefore appeals to investors who wish to acquire risk free sterling fixed-interest assets. The rate of interest that the government must pay on new borrowings is determined by the price that investors will pay to acquire new government bonds offering particular future cash flows. Consider the hypothetical bond illustrated on page 41. Our calculations show that in the deemed market conditions of 1 January 1998, investors would pay £78.33 for each £100 of face value to acquire such a bond. This would give the government a computed funding cost over the life of this bond of 10.561% pa as computed on page 43.

Our discussion of stripping on page 49 explains why investors might be willing to pay slightly more to purchase zero coupon bonds whose payment profile exactly matches their requirements. In that example, the investment bank conducting the synthetic stripping captured the profit (i.e. the excess value of the future payments sold individually over the price of the coupon bond.) If however government bonds can be stripped directly (and reversibly) then it is impossible for such a pricing anomaly to exist due to the operations of arbitrage. The price of coupon gilts must rise slightly until it equals the price that investors are willing to pay in aggregate for the future cash flows they require. This higher price at which bonds can be issued implies a reduction in funding costs for the government.

It was estimated in the press at the time of the Bank of England's May 1995 paper that improvements in the operations of the gilts market could reduce aggregate government borrowing costs by up to 0.5%. Taking into account the outstanding stock of government debt, this saving would eventually represent an annual benefit to the Exchequer of **£X million pa** once the savings were fully reflected in government borrowing costs.

5. How the New System Operates

5.1. Introduction

The new system brought in by FA 1996 operates as a largely self-contained regime. It replaces the complex system that had grown up over a century or more as a result of case law, avoidance schemes and anti-avoidance legislation.

5.2. Fundamental principle

One fundamental principle can be discerned as underlying all of the new legislation, obscured though it is by all the inevitable complexity of new tax law. The principle is that:

- Companies should be taxed on their commercial gains from their debt positions, whether assets or liabilities, with the computations being made in a manner consistent with the company's own commercial approach.

- Relief for commercial losses should be given in the same way.

5.3. Key words and phrases

As the new system seeks to build afresh after doing away with the old rules, it tries wherever possible to avoid using phraseology that is encumbered with past interpretations. This new terminology drew some criticism when the law was first published, but in the opinion of the writer it was correct not to rely on using old phraseology.

Some of the key new terms are:

Loan relationship - section 81

Credits and debits - section 82

5.4. Who is within the new system?

5.4.1. In full

Section 80 (1) makes it clear that the new legislation applies to companies.

Section 80 (5) means that the charge under the loan relationship rules is exclusive for corporation tax purposes. As part of achieving that goal, section 79 abolishes the charge under schedule C in respect of public revenue interest, and replaces that with a charge to schedule D. A number of detailed, albeit straightforward consequential amendments are included in schedule 7 but not discussed further in this thesis.

Overall, it appears relatively clear that the loan relationship rules apply only for corporation tax purposes. Where companies are chargeable to income tax (eg companies deriving rental income from the UK or trading in the UK without a branch or agency and unprotected by a tax treaty) then old law, as amended by section 102, must be applied since the old law as amended continues for income tax purposes.

5.4.2. In part

Individuals and other persons who are liable to income tax are affected by the new rules to a limited extent, as specified by section 102 and schedule 13. The income tax provisions are discussed in section 5.24 of this thesis.

5.5. What assets/liabilities are within the system?

The new regime applies to assets and liabilities that are “loan relationships.” This section introduces this new concept and then discusses the boundaries of the definition.

5.5.1. Basic definition of a loan relationship

Section 81 (1) explains that a company has a loan relationship when it is in a debtor/creditor relationship in respect of a money debt and that debt arises from the lending of money. As one would expect, under section 81 (2) a money debt is

a debt that is payable in money or more indirectly by the transfer of the rights to a money debt.

An example of a debt that is not a money debt is the liability that arises when a company becomes obliged to deliver some form of asset. For example, if a company receives cash in exchange for a promise to deliver steel the following week, the company does not have a liability that falls to be settled in money and therefore does not have a money debt. Since it does not have a money debt, it also does not have a loan relationship.

5.5.2. Money debts which are not loan relationships

An example of a money debt that is not a loan relationship is unpaid purchase consideration. A company may purchase land in exchange for the promise to pay money the following week. The company's liability is a money debt, but it did not arise from the lending of money and accordingly it is not a loan relationship.

Section 81 (4) makes it clear that a debt arising from rights conferred by company shares is not a money debt. A simple example is an unpaid dividend. After the dividend has been declared, the shareholder has an enforceable money debt owed by the company.

A small number of shareholders typically fail to collect their dividends, for example because they have moved house and not left the company a new address or simply because they fail to bank small dividend cheques. After the statute of limitations expires, companies usually credit such unpaid dividends to their profit and loss account. In the absence of section 81 (4) the company would have a taxable loan relationship credit at that time which would be asymmetrical treatment, as the company received no form of relief when it incurred the liability.

5.5.3. Implications of the issue of an instrument

Section 81 (3) means that a money debt that is not a loan relationship (because the debt does not arise from the lending of money) can be transformed into one by the issue of an instrument. The instrument in question is one which represents security for the money debt or represents the right of a creditor in respect of the money debt. A simple example would be where a company owing unpaid purchase consideration for land (which by itself is not a loan relationship as discussed above) issues a promissory note, whether interest bearing on not, in respect of its liability. The legislation then deems the debt to have arisen from the lending of money, and since one then has a money debt arising (by hypothesis) from the lending of money, one has a loan relationship.

"Instrument" is not defined in the legislation.

5.5.4. Convertible assets

A special treatment is applied to convertible securities which are held as assets by a company. This is set out in section 92 and section 92 (1) (a) makes it clear that the section applies only to creditor relationships. Provided that the various tests of the section are met, the only amounts brought into account for taxation purposes under the loan relationship rules for the company that has the asset are "amounts relating to interest."

The section enumerates six requirements for the asset to qualify for the treatment set out in section 92 for convertible securities. As this section was the base for a widely used tax avoidance scheme, it merits detailed consideration.

5.5.4.1.Detailed requirements to qualify as a convertible seurity

(a) The asset must represent a creditor relationship of the company.

As explained above, the section applied only to the company which owns the asset and the tax treatment is therefore asymmetrical between the company which has the asset and the company which has the liability.

(b) Under the rights attached to the asset, the company is or may become entitled to acquire (whether by conversion or exchange or otherwise) any shares in a company.

This provision is much wider than the straightforward case of the issue of bonds which are convertible into shares of the issuing company. The shares that can be acquired maybe he in any company and it is not necessary for the bond to be explicitly converted. The kinds of scenario possible are illustrated below:

- A company holds a £1,000 face value bond which can be converted at any time into 100 shares of the company which owes the liability.

- A company owns a £1,000 face value bond issued by company A. At any time after 1 January 2001 the holder may surrender the bond back to company A in exchange for 100 shares of company B. Typically company A would have a partial shareholding in company B which it desires to convert into money without making an outright immediate sale of the shares of company B and accordingly it issues "exchangeable bonds"

- The company owns a £1000 face value bond issued by company A. The bond has a warrant attached which allows the owner of a warrant to subscribe at any time for 100 new shares of company A at a fixed price of £10 per share. Often such warrants are capable of being detached from the bond and traded separately. Section 92 would appear to apply to the bond only while the warrants are attached. The tax treatment appears relatively straightforward provided that the warrants are attached throughout the accounting period (so that section 92 applies for that accounting period) or conversely if the warrants have been detached before the accounting period started so that the security is treated as a "normal" security throughout the accounting period. In the author's opinion, section 92 should apply to an accounting period if the security was held at the start of the accounting period and at that time met the relevant tests, even if it fails to meet them at the end of the period. The alternative approach would appear to deviate excessively from the economics of the position.

(c) The extent to which shares may be acquired is not determined using a "cash value."

Cash value for the purposes of section 92 (1) (c) is not further defined in the legislation. Interpreting the provision requires consideration of the economics underlying a convertible security. The value of the security is intended to depend to some extent on the value of the underlying share. This is achieved by fixing the conversion ratio between the security and the underlying share at the outset, for example in the cases listed above under (b).

This provision counters an attempt to dress up a security as a convertible while avoiding any economic linkage with the underlying share. For example, if a £1,000 bond was convertible into whatever number of shares at the conversion date had a market value of £1,000 then prior to conversion the holder would have no economic interest in the market value of the underlying shares; he would have a pure debt instrument no different from any other bond issued by that company on similar terms regarding interest payments, redemption rights etc. In this case, the conversion privilege would be both worthless and have no equity characteristics.

A conversion privilege could fail to meet this test even if inherently valuable. For example if a £1,000 bond was convertible into whatever number of shares at the conversion date had a market value of £1,100 then the conversion right would clearly have a market value of £100 once the earliest date at which it could be exercised had arrived. However, the market value of the bond would still have no linkage to the market value of the underlying shares. The conversion privilege would have the same economic effect as a simple right to redemption of the bond, after the earliest conversion date, at a premium of £100.

(b) the asset is not a relevant discounted security as defined by schedule 13

The definition of "relevant discounted security" is given by a schedule 13 paragraph 3 and is discussed in detail on page X. Under that definition, until the change announced by the press release of ?? 19th February 99 and included in

Clause 59 Finance Bill 1999, it was relatively simple to create a discounted bond that avoided classification as a relevant discounted security.

A simple example is given by the following bond terms:

- The bond is issued on 1st January, 1999 an issue price of £68.

- The issuer is required to redeem the bond on 31 December 2003 at its face value of £100. This means that the implied yield over the 5 years is approximately 8% pa.

- The holder of the bond in general has no right to require repayment prior to 31st December, 2003. However, during the seven days commencing 1 July 1999, the holder may require the issuer to redeem the bond at the original issue price of £68.

Under these terms, the bond is not a relevant discounted security since, at the earliest date that the holder can require repayment, no deep gain arises as defined by schedule 13 paragraph 3. While the holder is unlikely to require the bond to be redeemed on 1 July 1999 at £68, thereby giving the issuer an effective interest free loan for six months, this carefully drafted early redemption right cannot be completely ignored as it gives the holder some small additional economic rights over and above a bond repayable only on 31st December, 2003.

There were also other variants, which are slightly more complex to describe, which also avoided classification as a relevant discounted security.

(e) On issue there is more than negligible likelihood of conversion being exercised

Section 92 (1) (e) is intended to avoid normal securities is being dressed up as convertible securities by adding on a conversion right that is never likely to be exercised "to a significant extent." This criterion has been criticised in publications as being subjective. However, while words like "negligible" are inherently subjective, there is a very practical test which focuses on the question of whether the conversion rights are something that can be ignored.

All it is required is to value:

- The bond as it is actually issued.

- The bond assuming that all of its other terms were unchanged but excising all conversion rights.

If those values effect are almost the same, then the conversion rights are not likely to be exercised and would appear to fail the test of section 92 (1) (b). A valuation exercise of this kind is not inherently difficult for an organisation such as an investment bank that regularly deals in shares, options, convertible bonds and non-convertible bonds. There is much comparable price data for such other instruments that can be applied to this comparison exercise.

While the evaluation test above is an expression of opinion by the writer, it appears to accord with the economics of convertible securities since if a conversion right has value on the issue date, then the likelihood of it being exercised cannot be regarded as negligible. Conversely, if the conversion right is valued as being almost worthless, then at that time there are no grounds for believing that it would be the due course be exercised to a significant extent.

It must be stressed that a conversion right need not be "in the money" for it to have value. For example, a £1,000 bond is issued and is convertible into four shares of the company at any time between the issue date and 2020, with the bond itself not being redeemable by the company any earlier than 2020. On the day of issue, the price of the shares is £100 per share. Before conversion became attractive, the share price would need to increase from £100 to £250 but there is a 20 year time horizon for this to happen. Such a conversion right would have a material value on the date of issue and could not be regarded as failing the test of section 92 (1) (e).

(f) The asset is not a trading asset of the holder

Where a company owns securities as part of its trading stock (eg a bank or a securities trader) then the treatment in section 92 is not applied so that the normal treatment of the disposal of those assets as giving rise to trading receipts is not disturbed.

5.5.4.2.Implications of being a convertible security

Section 92 (2) limits any income taxation of the holder under the loan relationship rules to amounts relating to interest. These amounts relating to interest are required under section 92 (3) to be computed using an authorised accruals method.

Section 92 (4) preserves the corporation tax treatment of chargeable gains by applying TCGA 1992 to assets which are convertible securities in the same way as it is applied to assets that are not loan relationships. This is a slightly convoluted way of stating that such convertible securities continued to fall within the definition of chargeable assets. Under section 92 (5) accrued interest is excluded from the capital gains computations, because of course it is already taxed under the loan relationship rules.

5.5.4.3.Opportunity for tax avoidance

The special tax treatment of convertible securities, with the holder being taxed only on interest income, created the opportunity for a widely used tax avoidance scheme. The heart of the scheme was a zero coupon convertible bond issued by a one member of a UK group of companies to another, with the bond being carefully designed to fall within the The definition of a convertible security set out in section 92. The company holding the security was not subject to any taxation year by year as the increase in value from the accrual of the discount did not constitute "interest". Instead, a charge to corporation tax on chargeable gains would arise when the bond was repaid on maturity, with this liability being reduced by indexation allowance. Furthermore, the security was convertible into shares with the intention that the owning company could avoid a chargeable

disposal by converting the security instead of allowing it to be redeemed.

Meanwhile, the issuing company was able to deduct the annual expense accrued from amortising the discount over the life of the bond using an authorised accruals method. S92 contains no special provisions affecting the company which owes the liability.

In February 1999 the expected counteraction came with an Inland Revenue press release that announced that the definition of relevant discounted security would be amended to eliminate this scheme.

5.5.5. Loans linked to chargeable assets

FA 1996 section 93 contains special rules which apply when a loan relationship is linked to the value of chargeable assets.

However, to avoid disturbing the treatment of trading activities, section 93 does not apply if the loan relationship is one "the disposal of which by the company would be treated as a disposal in the course of activities forming an integral part of a trade carried on by the company." It is not clear what this form of words adds to the usual exclusory wording in tax legislation, eg in ICTA 1988 s.402(4) " if a profit on sale of [the asset which is not being accorded capital treatment] would be treated as a trading receipt of that [company]"

5.5.5.1.The charging and relieving provision

The credits and debits brought into account under the loan relationship rules are restricted to amounts relating to interest, and only an authorised accruals basis of accounting may be applied in a ascertaining the interest debits and credits.

Where a company holds such a loan relationship as an asset, it remains within the charge to capital gains tax in the same manner as assets which are not loan relationships. Section 93 (5) excludes accruals of interest from the the capital gain calculations.

5.5.5.2.Applicable definition

The key definition is in section 93 (6). This requires that the amount payable to discharge the money debt must be determined by applying a relevant percentage change in the value of chargeable assets to the original amount of the loan.

Section 93 (7) makes it clear that an index of the value of chargeable assets can be used as an alternative to linking the loan to one or more specific chargeable assets. The change in value must be computed over the same time period as the incurrence and discharge of the money debt or an almost identical time period which differs only for ease of valuation.

Section 93 (9) contains a limited permissible deviation from the strict application of changes in market value of the chargeable asset. It is permissible to provide that "the amount so payable [on discharge of the money debt] must not be less than a specified percentage of the amount falling for the purposes of this chapter to be regarded as the amount of the original loan." The specified percentage cannot be more than 10%.

In the author's view, the protection permitted by section 93 (9) against downward fluctuations in the value of the chargeable asset is very limited since the highest permitted floor for the loan value is 10% of the amount of the original loan. Ie 90% of the loan value could be lost in downward asset price fluctuations. This may not have been the intention of the legislation and, for example, the CIOT annotated copy of the Finance Act 1996 interprets section 93 (9) as meaning that "the amount payable cannot be less than the original loan by up to and including 10%." However, in the author's view the wording of section 93 (9) is relatively clear and inconsistent with the CIOT commentary.

[check what HMIT manual says on this point]

For the avoidance of doubt, section 93 (13) makes it clear that the retail prices index and similar foreign indices cannot be regarded as of the value of chargeable assets.

5.5.5.3.Exclusion of trading assets

As one might expect, trading assets are excluded. This exclusion is set out in section 93 (11) (b) " the asset is not one the disposal of which by the company would fall to be treated for the purposes of corporation tax as a disposal in the course of a trade carried on by the company." The use of this more common form of words here again contrasts with the wording in S.93(1) mentioned above.

In the author's view, it is possible for a loan relationship to be within section 93 for one party but not for the other party. Consider the situation where the value of loan relationship is linked to the value of a specific building. Assume that the

debtor is a property trading company while the creditor has no trade and is an investment company.

The loan relationship liability of the debtor is outside section 93 and accordingly the debtor should obtain a tax deduction, for any uplift in the loan liability if the property increases in value. (The debtor will need to use mark to market accounting for the liability to achieve a year by year tax deduction, since there is no obvious way to apply an authorised accruals method for such a liability.)

As far as the creditor is concerned, the loan relationship is within section 93 since, if the creditor were deemed to own the property, any gain on disposal would be a chargeable gain. Accordingly, as far as the creditor is concerned any uplift in the value of the loan due to an increase in the property's value will only give rise to a chargeable gain, and the chargeable gain will only a rise when the loan relationship is disposed of.

The author is not aware of any marketed tax avoidance schemes based upon this opportunity for asymmetry. However, there is plenty of opportunity for tax avoidance when the debtor above can obtain full tax relief for the increase in the liability of the loan relationship while the creditor would be taxed only on disposal and with the benefit of indexation allowance.

5.5.6. Index linked securities

Special provisions are included in a section 94 to maintain the previous treatment of index linked gilt-edged securities. They apply only for the purpose of computing non-trading debits or credits, and are therefore of no relevance to the securities traders holding index linked gilts as trading stock.

Very briefly, under section 94 (3) the opening value of the gilt is increased or reduced by the movement in the retail prices index between the opening date and the closing date as defined in section 94 (2). The indexation adjustment is applied only to the capital value; there is no adjustment for inflation to the amount of the taxable interest income. This is a consistent with the the previous treatment of gilt-edged securities where the interest was a fully taxable but the changes in a capital value were not taxed. (New As changes in the capital value of gilts generally a are now taxable, it is consistent to tax changes in the capital value of index linked gilts. Preserving exemption for the inflation uplift is consistent with the terms under which index linked gilts are issued whereby the interest coupon is lower than that for conventional gilts in exchange for inflation protection.)

Under section 94 (4) regulations can be made by the Treasury which disapply the application of this section, but such regulations can only apply prospectively to gilts issued after the regulations.

It should be noted that it is only index linked gilts that allow the

inflation uplift to be tax free since the application of the section 94 is explicitly limited in section 94 (7). Accordingly, investors in index linked securities issued by companies the or by a foreign governments are taxed on the entire change in money value (as computed in sterling) without any relief for UK or foreign inflation.

5.6. How are the calculations made?

Section 82 (1) requires the company to compute the debits and credits from its loan relationships for the accounting period in question. Section 84 (1) requires the use of an authorised accounting method. The outcome of the calculations should fairly represent all of the company's profits gains and losses from its loan relationships. Section 84 (1) (a) makes it clear that the distinction between revenue and capital has been completely abolished in this context.

5.6.1. Mark to market

Section 85 (1) (b) authorises the use of mark to market accounting. Under this it is necessary to calculate the "fair value" of the loan relationship at each accounting period end. Fair value is defined in section 85 (6) and it is noteworthy that this phrase is used instead of "market value". At a trivial level, market value would not be appropriate when discussing a liability since all the existing statutory definitions of market value refer to the hypothetical sale of an asset.

More importantly there is a clear distinction between the fair value (as defined) of a liability and the market value of that liability. Suppose that a company's credit worthiness has been impaired because it has an excessive level of debt due to its equity base having been eroded by operating losses. If so, the market value of its liabilities (which are tradeable assets of its lenders) as measured in either the market for bonds or secondary trading of bank debt may be very low. However, if the company needed to pay a third party to take over those liabilities (as required by the fair value computation) then the amount payable would be greater than the market value. The reason is that the third party would be expected to meet the liabilities in full whereas the market value of the liabilities reflects the company's impaired credit rating.

This approach is the same as that of the accounting standard setting bodies which are considering possible changes to accounting standards which might have the effect of enabling companies to include their liabilities on the company balance sheet at market value rather than at face value. An accounting exposure draft has been issued **(give reference.)** This makes it clear that changes in market value from factors such as interest rates should be taken into account, but conversely any reduction in the market value of the company's liability arising from the impairment its credit rating should not be reflected in its statutory accounts.

Section 85 (4) requires payments to be allocated to the periods in which they become due and payable. Under this method, payments should not be apportioned between periods because at each period end the accrued payment obligation should be reflected in the fair value of the loan relationship.

5.6.2. Accruals basis of accounting

Section 85 (3) gives details of how calculations are to be made under an accruals basis of accounting. Very briefly, payments under a loan relationship are allocated to the accounting period to which they relate, irrespective of when they are paid or when they become due and payable. Where payments relate to more than one period, but they are to be apportioned between different periods on a just and reasonable basis. Apart from the specific rules on bad debts discussed on page 107 no accounting recognition is given to fluctuations in the market value of a loan relationship.

Section 85(2) (c) prohibits an accruals basis from calculating debits by reference to the value of a loan relationship asset. It contains no express prohibition of calculating credits by reference to valuation although it would not be normal practice for an accruals basis to calculate credits in such a manner.

Allocating the payments due under a loan relationship to appropriate accounting periods is conceptually relatively straightforward when all of the payments are fixed. The most complex pattern of fixed payments can be transformed into a calculation of annual debits by making the (usually reasonably accurate) assumption that the loan relationship is one with a constant implicit annual interest rate.

For example, consider the following loan terms for a borrowing by a company:

- £100 borrowed on 1 January 1998
- £50 repayable on 30 June 1998
- £30 repayable on 30 June 1999

- £40 repayable on 31 Deember 1999

This loan can be shown to have an implied interest rate of 7.78% per six months, equivalent to 16.2% compounded annually. If the borrower prepares accounts each year to 31 December, then the debits computed for 1998 and 1999 would be as shown in the table below.

Date	Cash flow		IRR, per six months	7.78%
1-Jan-98	100			
			Annual rate	16.2%
30-Jun-98	-50			
31-Dec-98	0			
30-Jun-99	-30			
31-Dec-99	-40			

Six months commencing	Opening loan balance	Interest for six months	Cash repaid	Closing loan balance
1-Jan-98	100.00	7.78	50.00	57.78
30-Jun-98	57.78	4.49	0.00	62.27
31-Dec-98	62.27	4.84	30.00	37.11
30-Jun-99	37.11	2.89	40.00	0.00

Calendar year	Opening loan balance	Interest debit in accounts	Cash repaid	Closing loan balance
1998	100.00	12.27	50	62.27
1999	62.27	7.73	70.00	0.00

The above calculation is straightforward, and needs no external data; only the assumption of a constant implied interest rate.

A slightly more theoretically correct calculation would look at the shape of the yield curve on 1st January, 1998, as set out on page, where the relevant risk free interest rates are:

Period	Annually stated rate	Six monthly rate
1 January 1998 – 30 June 1998	5.000%	2.500%
1 January 1998 – 30 June 1999	7.200%	3.600%
1 January 1998 – 31 December 1999	7.770%	3.885%

The calculations in the table above show that the interest rate on the corporate borrowing exceeds the above interest rates which relate to risk free government debt. If one assumes that a constant risk premium applies over the life of the loan (a reasonable assumption unless the borrowing company's credit worthiness is expected to change) then the risk premium required is 8.507% pa.

The debits for 1998 are then given by the following table:

Date	Cash flow	Risk free annual rate	Premium for risk, annual	Total annual rate	Six monthly rate	NPV of cash flows	Outflow, or year end balance	Interest for 1998
1-Jan-98	100.00					100.00		
30-Jun-98	(50.00)	5.000%	8.507%	13.507%	6.753%	(46.84)	50.00	3.16
31-Dec-98	0.00							0.00
30-Jun-99	(30.00)	7.200%	8.507%	15.707%	7.853%	(23.91)	27.81	3.90
31-Dec-99	(40.00)	7.770%	8.507%	16.277%	8.138%	(29.25)	34.20	4.95
Interest	(20.00)					-		12.01

The interest debit for 1999 will be £7.99, ie £20 total interest less £12.01 allocated to 1998.

Both methods of calculation should, in the writer's opinion, be equally acceptable to the Inland Revenue as applications of an authorised accruals method. While at the second is more theoretically correct, the first method is clearly much simpler to apply.

5.6.2.1.Dealing with uncertainty

The application of accruals accounting is more difficult when one or both parties to the loan relationship has a choice (ie an option) to determine what future payments will arise. Schedule 9 paragraph 3 addresses this. It introduces the statutory hypothesis at each period end that the party having an option will exercise it in the manner which (apart from taxation) appears, at that accounting period end, to be most advantageous to that party.

A simple illustration is given by a callable bond, ie a bond that the issuer has the right to redeem, if desired, earlier than its express repayment date. Assume the following terms:

Corporate bond, issued on 1st January, 1998, repayable at £100 on 31st December, 2007 with interest of £7.00 payable each 31 December.

The issuer has the right to call (ie repay) the bond on 31st December, 2002 at £105. If the call option is not exercised, it expires.

This bond has similar terms to our hypothetical gilt discussed on page 41. (Six monthly interest has been replaced by annual interest for arithmetic convenience.) However, the borrower has changed from the UK government to a company, and also the issuing company has been given a call option. Both factors would increase the rate of return desired by investors. Accordingly, assume that the bond is issued for £60, giving an implied yield to maturity of approximately 14.96% pa.

This gives rise to the following table of debits, under an authorised accruals method using the yield to maturity. (This is easier to compute than calculations using the yield curve as discussed above.)

IRR 14.96%

Date	Cash flow	Opening balance sheet liability	Interest debit	Cash payment	Closing balance sheet liability
01/01/98	60.00				
31/12/98	(7.00)	60.00	8.97	(7.00)	61.97
31/12/99	(7.00)	61.97	9.27	(7.00)	64.24
31/12/00	(7.00)	64.24	9.61	(7.00)	66.85
31/12/01	(7.00)	66.85	10.00	(7.00)	69.85
31/12/02	(7.00)	69.85	10.45	(7.00)	73.30
31/12/03	(7.00)	73.30	10.96	(7.00)	77.26
31/12/04	(7.00)	77.26	11.56	(7.00)	81.82
31/12/05	(7.00)	81.82	12.24	(7.00)	87.06
31/12/06	(7.00)	87.06	13.02	(7.00)	93.08
31/12/07	(107.00)	93.08	13.92	(107.00)	(0.00)

If there are no dramatic changes to the yield curve by 31st December, 1998, the appropriate assumption to make under schedule 9 paragraph 3 is that the issuer will not exercise its call option.

Now assume that by 31st December, 1999 market interest rates have fallen dramatically and according to the yield curve prevailing at 31st December, 1999,

the company will be able to borrow at a 5% yield to maturity on 31 December 2002. The simple calculation below demonstrates that calling the bond on 31st December, 2002 would be desirable.

	5%	Borrowing rate on 31.12.2002
	3.66	NPV of calling the bond
	Cash flow	
31/12/02	(105.00)	Early bond redemption
31/12/03	7.00	Payment saved
31/12/04	7.00	Payment saved
31/12/05	7.00	Payment saved
31/12/06	7.00	Payment saved
31/12/07	107.00	Payment saved

Accordingly, for 1999 the debits table must be re-computed on the assumption that that the bond will be called on 31st December, 2002. Of course one must not readjust the 1998 calculation since that year has elapsed and at 31st December, 1998 it was appropriate to assume that the bond would not be called. The new table below shows that the 1999 debit which of course is quite different from the amount originally expected of £9.27 shown in the table above.

IRR 23.58%

Date	Cash flow		Opening balance sheet liability	Interest debit	Cash payment	Closing balance sheet liability
31/12/98	61.97	Accrued amount				
31/12/99	(7.00)	Bond interest payment	61.97	14.62	(7.00)	69.59
31/12/00	(7.00)	Bond interest payment	69.59	16.41	(7.00)	79.00
31/12/01	(7.00)	Bond interest payment	79.00	18.63	(7.00)	90.63
31/12/02	(112.00)	Interest & call payment	90.63	21.37	(112.00)	(0.00)

Now assume that by 31st December, 2000 the yield curve has shifted again so that the company's borrowing cost at 31st December, 2002 is now expected to be in the region of 15%. The appropriate assumption at 31st December, 2000 is that the bond will not be called, and therefore the table of debits must be recomputed yet again as given below.

IRR 13.43%

Date	Cash flow		Opening balance sheet liability	Interest debit	Cash payment	Closing balance sheet liability
31/12/99	69.59	Accrued amount				
31/12/00	(7.00)	Bond interest payment	69.59	9.35	(7.00)	71.94
31/12/01	(7.00)	Bond interest payment	71.94	9.66	(7.00)	74.60
31/12/02	(7.00)	Bond interest payment	74.60	10.02	(7.00)	77.62
31/12/03	(7.00)	Bond interest payment	77.62	10.42	(7.00)	81.04
31/12/04	(7.00)	Bond interest payment	81.04	10.88	(7.00)	84.93
31/12/05	(7.00)	Bond interest payment	84.93	11.41	(7.00)	89.33
31/12/06	(7.00)	Bond interest payment	89.33	12.00	(7.00)	94.33
31/12/07	(107.00)	Interest & redemption payment	94.33	12.67	(107.00)	(0.00)

In passing, by using interest rate derivatives the company could, if it wished, "lock in" to its favourable borrowing capability as at 31st December, 1999. However, a detailed discussion is outside the scope of this thesis, and the purchase of a derivative would not impact upon the loan relationship calculations themselves.

The above calculations show that as a result of schedule 9 paragraph 3, changes in the market conditions can have a significant impact on the debits calculated under an accruals method even though under an accruals method one does not directly reflect changes in the market value of the loan relationship.

No equivalent to schedule 9 paragraph 3 is required for mark to market methods, since the value of any applicable options will be included within the overall assessment of the market value of the loan relationship.

No guidance is given regarding the meaning of "(apart from taxation)" in schedule 9 paragraph 3. The natural reading is that one makes the calculations assuming that the the party with the option is exempt from tax in respect of all debits and credits arising under the loan relationship. The words presumably arise from the parliamentary draftsman's perpetual concern about tax avoidance.

In the writer's opinion, this "apart from taxation" hypothesis achieves no revenue protection for the Exchequer and makes the assumptions about the exercise of options slightly less realistic. In the commercial world parties do in general consider the benefits of exercising options net of their tax consequences. However, the "apart from taxation" hypothesis does make schedule 9 paragraph 3 easier to apply in practice, since one can ignore the relevant parties actual tax position. That tax position might not even be known if the bond has been issued in bearer form and the option is held by the bond investor as in the case of a

puttable bond, ie a bond where the investor can require early redemption in certain cases.

5.6.3. Selection of accounting method

Section 86 (3) (a) stipulates that if the company has used an authorised accounting method in respect of a loan relationship when preparing its statutory accounts, it is required to use that same method for tax purposes. This represents a statutory reversal of one of the foundations of the decision in Willingale v International Commercial Bank Ltd.

Section 86 (3) (b) means that if a company has used in its statutory accounts an accounting method which equates to an authorised accounting method, then it is required for tax purposes to use the authorised accounting method which has been equated. In this case, it will be necessary to adjust the figures in the statutory accounts in order to produce the corporate tax return. However, it is a mandatory to adjust the accounts figures to bring them into line with the authorised method to which the accounts method equates; it is not permissible to prepare the corporate tax return using the opposite method.

5.6.3.1.Methods equating to an authorised accruals basis

Under section 86 (5) (a) if an accounting method "purports" to allocate payments to accounting periods according to when they are taken to accrue, then such an accounting method equates to an authorised accruals basis of accounting.

5.6.3.2.Methods equating to mark to market

Under section 86 (5) (b) if the basis of accounting produces credits and debits computed by reference to the value at different times of "a fair value" of the loan relationship and produces debits and credits relating to payments according to when they become due and payable, then it equates to an authorised mark to market basis.

More interestingly, under section 86 (6) if the company uses an accounting method which allocates payments to accounting periods according to when they are taken to accrue but:

- values the loan relationship at each accounting period end at a fair value assuming that accrued interest is to be ignored, i.e. a "clean mark to market" valuation and

- for reach accounting period the debits and credits produced by applying this method are practically equivalent to the results that would be obtained by using an authorised mark to market basis

then the method used is taken to equate to mark to market.

Give some examples of methods used in practice that only equate.

5.6.4. Mandatory use of authorised accruals in certain cases

As discussed in section 5.20.1 where the parties to a loan relationship are connected, the use of accruals accounting is mandatory.

5.6.5. Changing accounting methods

The legislation distinguishes between the inconsistent application of an accounting method and an actual change in accounting method.

5.6.5.1.Inconsistent application of accounting methods

Section 89 governs the situation where there is an inconsistency or material difference in the way that an authorised accounting method is applied in successive periods.

For example, consider a security purchased for a £50 which will be redeemed at £100 in five years time. The company applies an authorised accruals method to its investment by uplifting the value of the security by £10 each year, thereby including £10 in each year's taxable income. While this straight line approach would be condemned by a purist, it would practice probably be regarded as an

acceptable application of an authorised accruals method. After three years, the company decides that it would be more accurate to calculate the uplift in security value on an actuarial method. This still represents the application of an authorised accruals method, but now the calculations are prepared in an inconsistent manner and therefore section 89 must be applied.

The table below sets out the relevant figures:

	Straight Line Uplift	Straight Line Taxable Income From Uplift	Actuarial uplift	Actuarial Basis Taxable Income From Uplift	Cumulative difference in taxable income
Purchase of security	50		50.00		
Value at end of year 1	60	10.00	57.43	7.43	2.57
Value at end of year 2	70	10.00	65.97	8.54	4.03
Value at end of year 3	80	10.00	75.78	9.81	4.22
Value at end of year 4	90	10.00	87.05	11.27	2.95
Value at end of year 5	100	10.00	100.00	12.95	-

Under section 89 (1) at the commencement of year four a balancing credit or debit must be brought into account. This is computed by assuming that that the accounting method had always been applied in the way that it is used in the later period. From the table above, it can be seen that after three years the straight line approach has resulted in £4.22 more taxable income than the actuarial method applied from year four onwards. Accordingly, £4.22 must be deducted from the income of year 4.

In the absence of section 89, the company would be disadvantaged since it would have applied an authorised accruals method in years 1, 2 and 3, and the same authorised accruals method (albeit with a computational difference) in years 4 and 5 yet overall have been taxed on more than its true economic gain. Clearly without section 89 there would be scope for inconsistencies which worked in favour of the taxpayer and against the Inland Revenue.

5.6.5.2.Changes of accounting method

Actual changes in authorised accounting method are covered by section 90. Again, the principal goal of the legislation is to ensure that no debits or credits fall out of taxation as a result of the change.

If the change of method occurs part way through an accounting period then under section 90(2) the rules explained below are applied as if the period of change were subdivided by the date of change into two separate accounting periods. The debits and credits thereby calculated are brought into account in the (true single) period of change.

Similarly, if the new accounting method is applied from the start of an accounting period, all of the computational adjustments discussed below are, under section 90 (3) applied in that accounting period. There is no restatement of the results of prior periods.

The operation of section 90 is best illustrated numerically.

	Fair Value of Security	Mark to Market Basis Taxable Income	Actuarial uplift	Actuarial Basis Taxable Income From Uplift
Purchase of security	50.00		50.00	
Value at end of year 1	45.00	(5.00)	57.43	7.43
Value at end of year 2	60.00	15.00	65.97	8.54
Value at end of year 3	73.00	13.00	75.78	9.81
Value at end of year 4	86.00	13.00	87.05	11.27
Value at end of year 5	100.00	14.00	100.00	12.95

Change from authorised accruals method to mark to market

Assume that the company applies an authorised accruals method, using the strict actuarial approach, until the end of year three. At the commencement of year four, it changes to a mark to market method.

Under section 90 (3) (a)(i) compute the aggregate credits and debits for years three and four making the assumption in subsection 90 (4) that the security was disposed of at the end of year three and reacquired at the commencement of year four. (Credits are treated as positive numbers and debits as negative numbers.) The credit for year three, applying the accruals method but with the assumption regarding disposal, becomes 7.03, since there is a deemed disposal for 73.00 while the opening value under the actuarial method was 65.97. The credit for year four becomes 13, since there is a deemed acquisition for 73 and a closing market value of 86. The total, 7.03+13 = 20.03.

Under section 90 (3) (a) (ii) compute the aggregate credits and debits for years three and four without making the disposal assumption in 90(4). These are 9.81 for year three under the actuarial method, and 13 for year four under the mark to market method, which would require both the closing and opening market value to be applied. 9.81+13= 22.81.

Under section 90(3)(a)(iii) the second aggregate, 22.81, is subtracted from the first 20.03 giving a result of –2.78. Section 90(3)(b) then requires this figure, a debit because it is negative, to be brought into account at the beginning of period four, so that the net taxable income for period four becomes 13 under the mark to market method less 2.78 = 10.22.

The provision is effective, since the total cumulative taxable amounts by the end of year four are as follows, giving the same result as if mark to market had been applied from commencement.

Year	**Taxable for year**	**Method**
1	7.43	Accruals
2	8.54	Accruals
3	9.81	Accruals
4	10.22	Mark to market less relief above
Cumulative amount	36	

Change from mark to market method to accruals method

Assume instead that the company has used mark to market for years 1, 2 & 3 and then changes to an accruals such as the actuarial method computed above. Section 90(5) specifically addresses a change in this direction.

Again, under section 90(3)(a)(i) make the assumptions in section 90(4). Then compute the credit for year three which is 13, and for year four which is 14.05 to give an aggregate of 27.05. The year four figure takes into account section 90(5), which requires the credit for year 4 to be the closing amount under the accruals method, stipulated in section 90(6)(b) 87.05, less the opening value under the assumption in section 90(4), ie 73. Then 87.05 less 73 gives 14.05.

In the writer's view, section 90(5) is otiose. The draftsman was clearly concerned that without section 90(5) the amount for year four calculated above under section

90(3)(a)(i) might be 11.27 (ie the closing year four actuarial amount of 87.05 less the opening year four actuarial amount of 75.78.) However, in the writer's view the assumption required by section 90(4) of a reacquistion at the beginning of year four at the value of 73 is sufficiently explicit. Section 90(5) puts the matter beyond doubt, but is perhaps "belt and braces."

To complete the calculations, under section 90(3)(a)(ii) aggregate the credits for year three of 13 and for year four of 11.27 to give 24.27. These are computed without the disposal and reacquisition assumption of section 90(4).

Under section 90(3)(a)(iii) deduct the second aggregate of 24.27 from the first aggregate of 27.05 to give a figure of 2.78 which being positive is a credit. This credit is added to the taxable income of year four to make that 11.27+2.78=14.05.

The taxable amounts can then be summarised as follows. The overall result is the same as if accruals had been applied since the asset was first acquired, thereby achieving the intended goal of ensuring that no debits or credits escape taxation.

Year	**Taxable for year**	**Method**
1	(5.00)	Mark to market
2	15.00	Mark to market
3	13.00	Mark to market
4	14.05	Accruals plus additional credit computed above
Cumulative amount	42.05	

5.6.6. Accounting for stripping or reconstituting a gilt

The legislation prescribes in detail how to perform the calculations when a gilt is stripped or reconstituted.

5.6.6.1.Company using mark to market accounting

If the company is accounting using a mark to market method, no special difficulties are presented. Eg if it is stripping a gilt, thenat the start of the period it may own a gilt. During the period, it breaks the gilt down into strips and may sell some of them, retaining the others at the period end. It's taxable income can be computed quite straightforwardly;

Value at period end of gilt strips retained.	+
Proceeds from gilt strips sold during the period	+
Less value at start of period of gilt then owned	-
Taxable income for the accounting period	Sum

Despite this simplicity, the legislation addresses the matter directly, with a new section ICTA 1988 Section 730C being introduced by FA 1996 section 202(8) and Schedule 40 paragraph 7. The act of stripping or reconstituting a gilt gives rise to a deemed disposal and reacquistion at market value, along the lines discussed below for accruals accounting.

In the writer's view, ICTA 1988 Section 730C has no practical effect due to the trader applying mark to market accounting for all its security positions at each period end. The final taxable income will be the same as the amount computed above, and accordingly the provison could be regarded as otiose.

5.6.6.2.Company using accruals accounting

It is more problematical if the company is using accruals accounting, as the nature of what is held changes during the period. This is addressed by section 95. Where a gilt is stripped, section 95 deems the gilt to have been disposed of at its market value, and the strips to have been acquired at an aggregate cost equal to that market value. That figure is then allocated over the individual strips pro-rata to their individual market values. The calculations below illustrate this.

Assume that on 1 January 1998 the investing company purchased £100 nominal of the gilt hypothesised on page 41 at its price of £78.33. The invetor receives £3.50 interest on 30 June 1998. On 30 September 1998 it strips the gilt, and sells all of the strips except the "principal strip" of £103.50 due 31 December 2007.

Assume that by 30 September 1998 the yield curve has changed significantly from 1 January 1998, (a reduction of 1% in interest rates for all periods) and that the market value of the gilt on that date is £80.00. Assume also that the curve implies the values used below for the individual strips. The figures in the table show the individual strip values aggregating to £85.66 as against the value of the unstripped gilt of £80.00.

In an efficient market, such a difference would be arbitraged away very quickly, but it is quite feasible that there would be a small difference in value between the aggregate of the strip values and the whole gilt (see discussion of the rationale fo stripping on page 49) and the legislation clearly allows for the possibility of a difference. The large difference used by the writer is purely to make the example easier to follow.

Payment due date	Cash payment due for this strip	Market Value of strips on 30 September 1998	Allocate market value of whole gilt before stripping	Sale proceeds of strips
31-Dec-98	3.5	3.45	3.22	3.45
30-Jun-99	3.5	3.34	3.12	3.34
31-Dec-99	3.5	3.22	3.01	3.22
30-Jun-00	3.5	3.09	2.89	3.09
31-Dec-00	3.5	2.96	2.76	2.96
30-Jun-01	3.5	2.83	2.64	2.83
31-Dec-01	3.5	2.70	2.52	2.70
30-Jun-02	3.5	2.57	2.40	2.57
31-Dec-02	3.5	2.45	2.29	2.45
30-Jun-03	3.5	2.32	2.17	2.32
31-Dec-03	3.5	2.21	2.06	2.21
30-Jun-04	3.5	2.09	1.95	2.09
31-Dec-04	3.5	1.99	1.86	1.99
30-Jun-05	3.5	1.88	1.76	1.88
31-Dec-05	3.5	1.78	1.66	1.78
30-Jun-06	3.5	1.68	1.57	1.68
31-Dec-06	3.5	1.59	1.48	1.59
30-Jun-07	3.5	1.50	1.40	1.50
Subtotal		43.65	40.76	43.65
31-Dec-07	103.5	42.01	39.24	
		85.66	**80.00**	**43.65**

The gilt strip retained will mature at £103.5 on 30 June 2007 and has an initial accounting value of £39.24 on 30 September 1998. Accordingly, compound interest calculations will uplift this to £40.28 at 31 December 1998.

The company's taxable income for 1998 will be computed as follows:

Interest received 30 June 1998		£3.50
Deemed disposal proceeds of gilt on 30 September	£80.00	

Original cost of gilt on 1 January	£78.33	£1.67
Proceeds of gilt strips sold	£43.65	
Deemed cost of strips sold	£40.76	£2.89

Accrued accounting value of retained strip 31 December	£40.28	
Deemed cost of retained strip	£39.24	£1.04
Total taxable income for 1998		**£9.10**

Section 95(3) contains similar provisions if a company accounting on an accruals method reassembles a collection of individual gilt strips onto a complete gilt. All of the gilt strips are deemed to have been disposed of at their individual market values, and that aggregate amount is deemed to have been given as consideration to acquire the reconstituted gilt.

5.7. Charging tax on credits

If the calculations give rise to credits, then these are taxable. However, Schedule 9 paragraph 1 makes it clear that credits (and the corresponding debits to the payer) do not include amounts which are treated for tax purposes as distributions.

5.7.1. Trading credits

Under section 82 (2) if the company has a loan relationship for the purposes of a trade which it carries on, then credits in respect of that loan relationship are treated as receipts of that trade and included in the computations of the profits of that trade.

5.7.2. Non-trading credits

In all other circumstances, under section 80 (3) credits in respect of a loan relationship are taxable under schedule D case III.

Under section 80 (5) these charging provisions are exclusive for corporation tax purposes "subject to any express provision to the contrary".

5.8. Giving relief for debits

The legislation give relief in distinctly different ways for the two types of debit.

5.8.1. Trading debits

Under section 82 (2) if a company has loan relationships for the purposes of its trade, then any debits are treated as expenses of that trade and are deductible in computing the trading profits.

Section 82 (7) makes it clear that the treatment of trading debits as expenses under section 82 (2) (b) overrides the rules regarding allowable reductions in ICTA 1988 section 74. Accordingly, all of the previous complications involving the treatment of certain types of annual interest incurred for the purchase of capital assets as a "charge" have been swept away.

5.8.2. Non-trading debits

In all other cases, the debits are referred to as "non-trading debits". If the company has any "non-trading credits" then the non-trading debits must be subtracted from the non-trading credits.

There are three possible outcomes from the subtraction:

1. A positive number, representing the excess of the non-trade credits over the non-trade debits. This net non-trade credit is taxable under schedule D case III as outlined above.

2. Zero, when the non-trade credits and the non-trade debits are equal. There is therefore nothing to tax or relieve.

3. A negative amount, representing the excess of the non-trade debits over the non-trade credits. There are express statutory rules to give relief to this net non-trade debit, or non-trading deficit as it is called in the legislation.

5.8.3. Utilisation of net non-trading debits

Section 83 (2) sets out the claims that a company can make when there is a net non-trade debit i.e. deficit. It enumerates four specific claims which can be made for the whole or any part of the non-trade deficit. These are discussed below. There is also a fifth "default" option which applies in the absence of a claim.

5.8.3.1.Set off against any other current period profits

Schedule 8 paragraph 1 (3) sets out the order of priority. The non-trade deficit is relieved:

- After giving relief for brought forward trade losses
- Before relief for current year trade losses offset against other profits under ICTA 1988 section 393 A (1)
- Before relief for subsequent period trade losses carried back under ICTA 1988 section 393 A (1)
- Before relief for subsequent period non-trade deficits carried back under section 83 (2) (c)

It is clear from TCGA 1992 section 8 (1) (b) that brought forward allowable losses are deducted from current period chargeable gains before including chargeable gains in profits. Accordingly, non-trade deficits will be relieved after brought forward allowable losses. As terminal loss relief is now given under ICTA 1988 section 393 A (1), current year non-trade deficits will be relieved before terminal loss relief.

5.8.3.2.Surrender the deficit as group relief.

Under schedule 8 paragraph 2 (2) the amount being surrendered is treated for group relief purposes as if it were a trade loss. However the denial of group relief under ICTA 1988 section 397 (losses from farming and market gardening) and 393 A (3) (losses of Case V trades and trades not conducted on a commercial basis with a view to gain) is not applicable.

The new relief is much more generous than the previous relief for group relief surrender of "non-trade charges on income" which first had to be offset against the company's profits. It has eliminated the problem of interest expense in a

company holding foreign shares since there is no longer an automatic offset of the interest expense against foreign dividend income eligible for double taxation relief.

5.8.3.3.Carry back against profits of earlier accounting periods.

A non-trade deficit carried back can only be offset against schedule D case III profits on loan relationships (i e non-trade credits) due to schedule 8 paragraph 3 (4). The relief is a relatively low in priority, schedule 8 paragraph 3(6), being given after each of the following:

- Relief for brought forward losses or deficits
- Relief for trade charges
- Relief for investment companies for capital allowances, management expenses and "business charges"
- Relief for trade losses of current or future periods
- Relief for earlier period non-trade deficits offset against other income
- Non-trade deficits of other companies received under a group relief claim

The list in schedule 8 paragraph 6 is silent about the priority of group relief claimed for other companies' trading losses, as opposed to group relief claimed for other companies' non-trade deficits. However ICTA 1988 section 407 (2) (c) makes it clear that group relief always takes priority to the carry back of a non-trade deficit.

Under FA 1996 schedule 8 paragraph 7 non-trade deficits could be carried back for the period of three years prior to the period of loss, subject to not being capable of carry back to any period prior to 1st April, 1996. However under F (No. 2) A 1997 section 40 this period of three years was a shortened to 12 months, in the same way that losses carried back under ICTA 1988 section 393 A (1) were limited to 12 months.

5.8.3.4.Carry forward against non-trading profits of next accounting period.

Schedule 8 paragraph 4 (3) directs one to ICTA 1988 section 393 A to determine what constitutes "non-trading profits." The precise citation should be section 393 A (9) (b) which makes it relatively clear that one looks at the facts of the actual trade or trades carried on by the company to determine what constitutes non-trading profits.

5.8.3.5.Default option

If the company does not choose to make any of the claims above, then under section 83 (3) the non-trade deficit is carried forward as a "non-trading debit" into the immediately following period. Section 83 (4) has the effect of preventing such a brought forward non-trading debit being used to make larger any claim under (a)–(c) above in a future accounting period. (This last restriction appears otiose since the company could have made the carry back claim in the earlier period, and similarly could have made a claim to offset against other profits of the current earlier period.) **Is it really otiose?**

There are certain situations where it is more attractive to rely on the default option of section 83 (3) rather than make any of the claims under section 82 (2). For example, consider a company that is not part of a group with the following results:

	Trading profit or loss	**Non-trade debits**	**Chargeable gains**
Year 1	10		
Year 2	(30)	(20)	20
Year 3	(30)		20
Year 4	10		20
	(40)	(20)	60

If in year 2 the company elects under section 83 (2) (a) to offset the non-trade deficit against chargeable gains, then under schedule 8 paragraph 3 (b) (i) the offset takes priority to the offset of the trading loss. The end result will be that in year 4 the company is taxed on the chargeable gains of 20 having 20 trading losses carried forward.

Similarly it would be undesirable in year 2 to elect under section 83 (2) (d) to offset the year 2 deficit against the year 3 chargeable gains.

To pay no tax, the company must make no election in year 2 in respect of its non-trade deficit, which is then carried forward into year 3 as a brought forward non-trade debit. In the year 3, the company can elect under section 83 (2) (d) to have the deficit offset against the year 4 chargeable gains.

5.8.4. Meaning of loan relationships for trading purposes

Under s. 82 (2) one needs to determine if "a loan relationship of a company is one to which it is a party for the purposes of a trade carried on by it". If so, the debits and credits arising are dealt with as in sections 5.8.1 and 5.7.1 above.

There is no elaboration of this general definition. Section 103 (1) clarifies the position only for creditor relationships. In Parliament the Government indicated that the allocations between trading / non-trading in the company's accounts would be followed. However, in many cases the accounts do not contain an explicit allocation.

In the writers view:

- If a trading company has no non-trade assets (such as shares in subsidiaries or loans assets) then all of its borrowings must be for the purposes of its trade. Liabilities, finance assets, and if there are no non-trade assets, then that should conclude the position. In passing, if such a company borrows and pays a dividend, the borrowing must be for trading purposes since after the dividend payment the company has only trading assets, i.e. one does not need to consider whether the payment of a dividend is made for trading purposes.

- Where a company has both trading assets and non trade assets, then the question becomes much more difficult. One approach, perhaps the most intellectually consistent, would be to allocate the debits arising in respect of liabilities pro rata between the trading assets and the non-trading assets. This approach would recognise that money is fungible. However, s. 82 (2) clearly requires a purposive analysis, which however is often difficult in practice.

Consider a company which owns only trading assets, and which has £1 million cash in its bank account. It wishes to acquire a new subsidiary for £1 million, and to ensure that after the transaction it has £1 million cash to meet any short term needs. Accordingly, it decides as part of its liquidity management to borrow £1 million on a long term loan. It could:

- Borrow £1m, so it holds £2m cash, and then spend £1m on buying the new subsidiary.

- Spend its existing £1 million cash to purchase the new subsidiary, and then borrow £1m.

There is no self-evident way of determining the company's purpose in borrowing the £1m. Asking management may not resolve the question, since management makes decisions regarding sources of funds on commercial grounds taking into account the total cash requirements of the company. In practice it often makes little difference whether a debit is trading or non-trading, and accordingly there is limited experience of the Inland Revenue challenging allocations made in corporation tax computations.

Classifying credits is normally straightforward, since it is very unusual for a trading company to have a loan relationship asset for trading purposes. Section 103(1) also assists in this classification decision.

5.8.5. "Hybrid" companies.

Although the name never occurred in tax law, a hybrid company was a trading company that also carried investing activities, but did not meet the definition of an investment company. Interest on a loan to purchase investments gave rise to a non trade charge. If there was an overall tax loss, there were no statutory provisions under which the non-trade interest could be carried forward; the deduction was simply lost. FA 1996 eliminates this problem, as there are clear provisions for trade debits and non-trade debits with appropriate carry forward provisions.

5.8.6. Pre-trading expenditure

Pre-trading loan relationship debits are now less of a problem since they can be relieved as non-trade debits if desired. Schedule 14 paragraph 20 (1) also gives taxpayers a new right of election, enabling such items instead to be carried forward and treated as trading debits deductible on the commencement of trade.

5.9. Grandfathered gilts

For many years a for, governments have issued low coupon gilts and promoted these as suitable investments for higher rate taxpayers. Because the gilts were low coupon, they were sold at a significant discount to their face value and over the life of the gilt this discount would be realised by the investor as a tax free gain. The pricing of the gilts both on issue and subsequently on the stock market reflected their terms and the fact that they were most attractive to individuals who were higher rate taxpayers.

Accordingly there was an outcry from individual investors when the "gilts and bonds" proposals were first published in May 19 95, and intended to apply to individuals as well as companies. In response to the outcry, the authorities announced that the low coupon gilts mostly held by private investors would be "grandfathered" under the new rules.

Apart from a few instances discussed elsewhere in this thesis (eg gilt strips and relevant discounted securities) individuals are now essentially outside the new rules. However, section 96 preserves special treatment for the gilts involved, being 3 1/2 % Funding Stock 1999-2004 and 5 1/2% Treasury Stock 2008-2012. For these gilts, the only amounts chargeable under the loan relationship rules are amounts relating to interest, and an authorised accruals basis of accounting must be used to determine the taxable interest.

5.10. Manufactured interest

Since the FA 1996 legislation is intended as a complete code for the treatment of interest for companies, it must deal with "manufactured interest" and this is covered in section 97.

As a term, manufactured interest sounds arcane. It arises in two basic circumstances, illustrated below using £100 face value of the hypothetical gilt from page 41.

5.10.1. Stock lending

Stock lending typically takes place when a dealer (eg a gilt edged market maker) has sold a gilt to a purchaser (eg £100 Hypothetical Treasury Stock 2007 sold on

15 June 1998 for say £78.00 including 5.5 months accrued interest) without the dealer having the gilt in his inventory. The dealer will need to deliver £100 face value of the gilt to the purchaser on completion of the sale contract, and has a two basic choices:

Purchase the gilt in the marketplace at its prevailing price. The purchase price to the dealer will be around £78.00.

Borrow the gilt from someone else who happens to own it, eg a long term investor. The dealer would do this if he expected the gilt to fall in price due to market movements.

Assume that the dealer chooses to borrow £100 face value of the gilt from an investor on 15th June, 1998 and agrees to return the gilt on 15th July, 1998. The original gilt borrowed will of course be delivered by the dealer to the purchaser; by 15th July 1998 the dealer expects to have acquired £100 face value of the gilt by purchase in the marketplace.

The investor lending the gilt to the dealer will expect to be paid a fee for the lending transaction (eg a fee of 50 p to lend the gilt for the month) and will also expect to retain the benefits of ownership. In this case, the investor will want receive £3.50 interest on 30th June, 1998. The real interest on the gilt will be paid to whoever is the registered owner on the record date for the payment, presumably the third party purchaser who received the gilt on delivery from the dealer after 15th June, 1998. Accordingly, on 30th June, 1998 the dealer must make a payment of £3.50 from his own cash resources to the investor to compensate the investor for not receiving the real interest payment. This £3.50 payment from the dealer is "manufactured interest."

The effects of section 97 (1)-(3) are to treat the manufactured interest payment as if it were actual interest. The recipient of the manufactured interest is taxed as if it were interest received under the actual loan relationship (in this case the gilt) that has been lent. For the payor, the manufactured interest will give rise to a trading or non-trading debit depending upon the extent to which it is paid for the purposes of a trade. In the case of the dealer discussed above, the payment would clearly be a trading debit.

From a commercial perspective, the investor lending the gilt to the dealer is subject to a credit risk. If the dealer becomes insolvent, the gilt worth approximately £78 will not be returned on 15th July, 1998. If the dealer is highly credit worthy, the investor may be willing to accept this credit risk. Alternatively, he may require the dealer to provide a bank guarantee or to provide security over a

cash deposit. However, unlike the repo discussed below, it should be recognised that the investor is not raising any money by lending the gilt; he is merely earning the loan fee (assumed here to be 50 p) while continuing to enjoy all of the benefits of ownership.

5.10.2.Repo

A repo is a contract under which the owner of securities agrees to sell them and agrees to buy them back at a specified price at a specified future date. In economic terms, it is equivalent to the owner borrowing money using the securities as collateral. However, a repo contract is much simpler to implement than a loan agreement, and the provider of money under a repo (ie the purchaser) is in a much more secure position in the event of the insolvency of the original owner.

Repos of government securities have been commonplace in continental and United States government debt markets for many years. However, the legal framework of the UK government bond market did not facilitate the repo of UK government securities until 1995 when the law was changed in order to increase the commercial attractiveness of UK government securities. (Prior to the change, there were arrangements for the lending of UK government securities as outlined above but these were limited to a small number of approved gilt edged market-makers.)

To illustrate a repo before considering the complications of interest paid on the security involved, consider the holder on 30 September 1998 of a zero coupon bond due on 31 December 2007. Using the gilt strip figures on page 81, a bond with a face value of £103.50 would have a market value of £39.24. Assume that the investor wishes to borrow money for three months, and has found a counterparty.

- On 30 September 1998 the investor will contract to sell the bond to the counterparty for a price of, say, £38.00. Under the same contract, the investor will agree to buy the bond back on 31 December 1998 at a price of, say, £38.51.
- On 30 September 1998 the investor receives £38 cash and parts with legal ownership of the bond.
- On 31 December 1998 the investor pays £38.51 cash and re-acquires legal title to the bond.

The selling price on 30 September 1998 will be fixed a little below the market value of the bond. The goal is equitable distribution of the credit risks involved if either party defaults. A sale at market value on 30 September 1998 would expose

the counterparty to the risk that by 31 December the bond value had fallen but the investor was insolvent and refused to honour his purchase commitment. Similarly an excessively low price on 30 September 1998 exposes the investor to risk if the counterparty becomes insolvent and cannot return the bond on 31 December 1998. In practice, as well as the process of fixing the initial price, a repo contract will contain provisions for depositing margin if the market value of the underlying bond fluctuates outside set boundaries during the course of the repo contract.

While the selling price is linked to the market value at 30 September 1998, the repurchase price in December 1998 is not linked to the expected value of the security at that date. Instead, it is simply the original 30 September price plus an element representing interest at short term rates for the three months, in this case 51p = £38 @ 5.4% (assumed short term rate) for ¼ year.

ICTA 1988 section 730 A sets out the basic tax rules for repo transactions. This legislation was introduced by FA 1995 as part of the reforms for gilt repo transactions mentioned above. Under section 730 A (2)(a) where the repurchase price is more than the sale price (as it is above) the price difference is treated as interest paid by the re-purchaser on a deemed loan from the interim holder of an amount equal to the original sale price. Accordingly, tax law seeks to follow the economics of the transaction.

Under old law, the deemed interest payment arising under a repo transaction was treated as "yearly interest." To harmonise with the new language of FA 1996, schedule 14 paragraph 37 amended section 730 A (6) and introduced a new (6 A) so that the deemed interest is regarded as arising under a loan relationship.

ICTA 1988 section 737 A is an anti-avoidance provisions. It applies where a repo transaction straddles an interest payment date of the security and the terms of the repo contract allow the interim holder to keep the interest receipt while reflecting its value in the repurchase price specified in the contract.

Such an approach could enable a person to avoid the effect of UK withholding tax on an interest payment. In a slightly more complex manner, repo arrangements could be used by an individual to finance speculative investment in a gilt; interest on money borrowed to finance such an investment position would not normally be tax deductible. By allowing the repo counter party to retain the interest payment under the gilt, the individual would be attempting to avoid being taxed on the interest income, and thereby using the interest forgone as a "gross" contribution towards his financing costs.

In such cases section 737A(5) deems the interim holder to make a payment of manufactured interest to the original transferor. This deemed payment can then be made subject to tax or to withholding tax as appropriate. Section 97(4) ensures that the provisions integrate with the new loan relationship rules.

While FA 1995 introduced the modern rules on repo in ICTA 1988 s.730A, it was important for the FA 1996 changes to avoid unnecessary changes to that regime. FA 1996 Sch 14 para 37 makes minor changes to the wording of ICTA 1988 s.730A to ensure that it harmonises with the language of "loan relationships" and "debits and credits".

More importantly, Sch 9 para 15 ensures that the legal sale and repurchase transactions constituting a repo transaction are not treated as "related transactions" under s.84. Instead they are disregarded. However Sch 9 para 15(5) preserves the status of any underlying transactions involving the issuer (eg the redemption of the debt) as "related transactions" even if they relate to a loan relationship which is the subject of a repro. The clear intention is that it is only the repo transaction itself which is ignored, because there is a separate code in ICTA 1988 s.730A to deal with repos.

Sch 9 para 15(3)(b) contains an important item of anti avoidance legislation within it. The sale and repurchase are treated as a repo (ie disregarded) when either the transferor is a party to the repurchase transaction or a person connected (within ICTA 1988 s.839) with the transferor is the repurchaser. Similarly repo treatment applies when the rights re-acquired are "equivalent" to the rights sold, ie the reacquisition does not have to be of the same asset.

Without such anti-avoidance provisions, it would be possible for companies accounting on the accruals basis to use sale and repurchase transactions straddling their period end to crystallise market value falls in their loan relationships, while not crystallising gains on those loan relationships whose market value had risen (simply by not engaging in sale/repurchase transactions with appreciated loan relationships.) This would have the wholly undesirable consequence, from the Government's perspective, of effectively allowing such companies to value their loan relationships at the lower of "cost + accruals" or "market value."

5.11. Preserving the tax charge on other interest income

The new rules are intended as a comprehensive code, and to be the only provisions dealing with the charge to tax for companies in respect of interest. Most of the detail in FA 1996 concerns interest (as well as other credits) arising on loan relationships. However it is also possible to have interest arising on other money debts, where those money debts are not loan relationships, such as the examples which 5.5.2 considers.

Section 100 (2) preserves a tax charge by deeming interest to be payable under a loan relationship. However, the charge arises only on interest and not on any other debits or credits.

For the avoidance of doubt, section 100 (3) is enacted to enable interest income to be deemed to arise and be taxed in respect of transfer pricing adjustments under ICTA 1988 section 770, even where there is no actual loan, only a deemed loan as a result of one company having a notional debt with the other in respect of the amount by which it has been overcharged or underpaid, as revealed by the transfer pricing adjustment.

With a similar goal, Sch 9 para 16 ensures an effective tax charge on deemed interest arising on an actual loan relationship due to the application of the transfer pricing rules. This would be applicable when a transfer pricing adjustment was made to increase the interest income on a loan owed to a UK company or vice versa.

5.12. Amounts taken to reserves

Section 84 (1) (a) makes it clear that one must bring into account the debits and credits representing all profits gains and losses of the company, arising from its loan relationships, including those of a capital nature. To dispel any doubt, section 84 (2) (b) explicitly includes any profits, gains or losses which are carried to any reserve maintained by the company other than its share premium account.

However, section 84 (2) (a) also explicitly excludes any debits or credits which are required to be transferred to the company's share premium account. The key word here is "required". Under company law, very few items are required to be transferred to the share premium account. These are:

Need to research for a list

5.13. Capitalised interest

Interest charged to capital has been a cause of difficulty in the tax system for some time. When companies paid income tax, they were effectively denied relief for such interest, as was confirmed in the case Chancery Lane Safe Deposit & Offices Co Ltd v IR Commissioners, 43 TC 83. The introduction of corporation tax continued the denial of relief, by statute, in what became ICTA 1970 s.248(5)(a**). [Check when ICTA 1988 s.383(5)(a) was amended to exclude interest].**

Schedule 9 para 14 ensures that under the loan relationship rules capitalised debits are deductible for the accounting period that they relate to in the same way as if they had been taken directly to the profit and loss account.

Sch 9 para 14 applies only to debits (and credits) which are used to determine "the value of a fixed capital asset or project". In the writer's opinion, this is to be read as "fixed capital asset or [fixed] project". Accordingly, interest debits which are capitalised into balance sheet current assets (eg included in the value of work in progress or finished goods, as might occur with traders developing buildings or constructing large machines for sale) are not deductible in the period which they relate to. Instead, the debit is carried forward as part of the cost of the trading stock, and only becomes an expense in the profit and loss account in the period in which the stock is sold. The Inland Revenue are known to take this point.

5.14. Expenses

Section 84 (1) (b) allows the company to bring into account all charges and expenses incurred under or for the purposes of its loan relationships and related transactions.

This eliminates a significant trap for companies under the previous law. While old law gave relief for the costs of procuring a loan **(give reference)** they did not give any relief for the penalty that might be payable for the early repayment of an onerous loan. For example, a company that took out a 10 year borrowing at a fixed rate of say 9% per cent might wish to repay the loan after 6 years when market interest rates had fallen to say 7%. Its lender would not normally allow the company to repay the loan without also requiring a penalty payment to compensate the lender for the fact that the money received on the loan repayment would have to be invested at 7% instead of the 9% payable under the loan. Old law gave no relief for such a normal commercial penalty payment.

Section 84 (4) makes clear that relief is given for abortive expenses incurred for the purposes of entering into a loan relationship.

5.15. Withholding of income tax from interest payments

Only limited changes have been made to the withholding rules.

5.15.1. Government Securities

Interest on gilts is now paid gross. [give reference] This is essential with gilt stripping since the purchaser of a single stripped interest coupon has, as discussed above, purchased a zero coupon bond. It would be quite iniquitous if the Treasury were to withhold basic rate income tax from the entire amount of the payment to him when the stripped interest coupon became a payable.

5.15.2. Interest payments by companies

There have been no fundamental changes to the rules governing the withholding of income tax by companies making interest payments. Accordingly, apart from specific statutory exemptions such as quoted Eurobonds [give reference] one needs to consider the traditional distinction between "short interest" which does not require the deduction of income tax at source and "annual interest" which does. A detailed discussion of this distinction is outside the scope of this thesis.

5.15.3. Relief for income tax withheld

The basic provision which gives a company relief for income tax withheld from interest income is ICTA 1988 section 7 (2). Under this provision, the income tax withheld is set off against corporation tax assessable for the accounting period in which the interest received falls to be taken into account for corporation tax purposes. The mechanism for the company to obtain relief is to include a claim in its corporation tax return, as stipulated in section 7 (6) or in an amended return.

Prior to the Finance Act 1996 it would be relatively rare for the period for which corporation tax was charged to be earlier than the period of receipt since most forms of interest suffering income tax withholding would, for most companies, be chargeable to tax when received.

With both the mark to market method and the accruals method, under the new legislation it will be much more common for interest income to be taken account of for corporation tax purposes in an accounting period earlier than the period in which the interest is received. If the interest payment has not been received by the time that the corporation tax return for the chargeable period is finalised, it would appear difficult for the company to claim credit against corporation tax for income tax withheld, since no actual withholding will have been suffered as the interest will not have been paid.

Section 91 provides a relatively ungenerous form of relief in such cases. Where an interest payment is received which has been included in the taxable income of an accounting period which ended more than two years prior to the date of receipt, then ICTA 1988 section 7 (2) has effect in relation to the income tax "as if the interest had fallen to be taken into account for the purposes of corporation tax in the accounting period in which the payment of that interest is received."

The effect of a successful claim under section 91 (2) is that the income tax withheld from the interest receipt can be offset against the company's general corporation tax liability in respect of the accounting period in which the interest is received. No adjustment is made to the corporation tax liability of the original accounting period in which the interest was brought into account. The writer considers the relief to be ungenerous since it is the least that any "fair" tax system could do; to give the recipient company relief for the income tax withheld.

Section 91 requires a claim. The time limit in section 91 (6) should not be onerous as the company has until two years after the end of the accounting period in which the interest is received or if later six years after the end of the accounting period in which the credit in respect of the interest income was brought into account. However, if the company is unfortunate enough to miss the claim time limit, section 91 (7) then prevents any attempt to offset the income tax withheld against income tax that the company itself deducts from its payments under ICTA 1988 schedule 16 paragraph 5.

5.15.3.1.Opportunity for tax avoidance

The law as it now stands contains an opportunity for tax avoidance. This is best illustrated by an example.

Consider two UK group companies, each with a calendar year end. There is an interest bearing debt of £1000 between them, with the interest at 6% for each calendar year being paid 11 months after the year to which it relates. Being annual interest it is subject to deduction of 20% **[check rate]** tax at source. The creditor

company files its 1997 corporation tax return in December 1998, after it has received in November 1998 the 1997 interest receipt and certificate of tax withheld. Each company has other income of £1000.

This gives rise to the following cash flows:

	Creditor	**Debtor**
Other income	1,000.00	1,000.00
Interest expense / income	(60.00)	60.00
Taxable income	940	1060
Corporation tax due 30.9.98	291.40	328.60
Offset income tax withheld		(12.00)
	291.4	316.6
Quarterly tax accounting 14.1.99		
Income tax withheld	12.00	

The result is that the group obtains relief for the income tax withheld on 30 September 1998 even though the income tax itself is not paid to the Inland Revenue until 14 January 1999. With the change to quarterly tax payments arising under CTSA, the timing benefit becomes even greater.

5.16. Commencement Date

The new rules apply in full to accounting periods commencing after 1 April 1996. There are detailed rules for the straddling accounting period, and for untaxed gains / losses on brought forward positions. These are not discussed further in this thesis.

5.17. Double Taxation Relief

Schedule 14 para 43 sets out the rules for calculating double taxation relief on non-trading credits. The new rules are fair to the taxpayer. Under the newly inserted ICTA 1988 s. 797 A:

- non-trade credits which have foreign tax associated with them are taken into account without the deduction of non-trade debits, for the purposes of computing the amount of UK corporation tax on the income. This maximises the available double taxation relief (DTR.)

- the non-trade debits are effectively reduced by any amounts of non-trade debits surrendered as group relief, or carried backwards or forwards.

- the remaining balance of the non-trade debits can be allocated by the company against sources of income as it wishes, enabling offset last against sources carrying DTR.

The overall effect is to minimise wastage of DTR. Schedule 14 para 44 recasts in new language the previous rules limiting double taxation relief when financial traders receive interest on overseas loans net of foreign tax deductions.

5.18. Overseas sovereign debt

ICTA 1988 s.88A – s.88C were enacted by FA 1990 and contained specific restrictions on the rate at which UK companies could claim bad debt relief for overseas sovereign debts arising from the making of loans (as opposed to debts for the provision of goods or services). They were introduced (rather late) to limit the tax relief to banks and other financial institutions from the 1980's third world debt crisis.

With the recasting of the law, ICTA 1988 s.88A – s.88C have been replaced by Sch 9 para 8 and 9. Apart from a change in the language to "loan relationships" and "debits and credits" the FA 1996 legislation recasts the old law and the writer cannot discern any changes of substance.

5.19. Anti-avoidance

Understandably, the new rules contain a number of anti-avoidance measures.

5.19.1.Interest deductions without a cash payment

Ever since the original zero coupon bonds legislation (FA 1984 schedule 9 paragraph 5) UK tax law has sought to restrict the ability of UK companies to receive a tax deduction for interest expense, where the interest has not yet been paid. The new legislation continues this approach with several specific measures.

5.19.1.1.Interest paid late

Schedule 9 paragraph 2 applies to interest expense when section 87 mandates the use of accruals accounting. If the interest expense for an accounting period

has not been paid by 12 months after the period end, then a deduction for the interest debit is postponed until the interest is paid.

To avoid needlessly disturbing UK to UK situations, where the deduction will be matched by an equal amount of taxable income, schedule 9 paragraph 2 (2) (b) protects the accruals basis deduction provided the creditor brings the full amount of the interest into account "for any accounting period." This predicates the creditor being a company, since individuals do not have accounting periods.

5.19.1.2.Discounted securities held by connected companies

Schedule 19 paragraph 17 (1) applies where relevant discounted securities are held by a connected company at any time during an accounting period of the issuer. Under paragraph 17 (2) a deduction for the interest debit for that period is postponed to the accounting period when the security is redeemed.

Again, for UK to UK situations, paragraph 17 (1) (d) serves to protect the accruals basis deduction provided that credits for the full amount of the discount referable to that accounting period are brought into account by the creditor.

Paragraph 17 (4) uses the definition of relevant discounted securities set out in schedule 13, discussed on page **x x**. However, paragraph 17 (5) contains a free-standing definition of "connected" rather than using section 87 by cross reference. This raises the question of whether the definitions actually match. The table below compares them.

Connected test in section 87	**Connected test in Schedule 9 paragraph 17**
87 (3) (a)	Matched by 17 (5) (a)
87 (3) (b)	Matched by 17 (5) (b)
87 (3) (c)	Not relevant as paragraph 17 applies only where the benefit of the security belongs to a company, and there is a separate regime in paragraph 18 for relevant discounted securities issued by close companies.
87 (4)	Matched by 17 (6)
87 (6)	Matched by 17 (9)

87 (8)	Nothing equivalent. See comment below.

The omission (presumably intentional) from paragraph 17 of any provision equivalent to section 87 (8) considerably widens the impact of the test of connectedness. It means that a substantial security investor and therefore loan creditor can easily be deemed to have control over a company. ICTA 1988 section 417 (1) (b) will make it a participator unless the banking exclusion of section 417 (9) applies, and due to section 416 (2) (c) it is quite possible for the loan creditor's stake to exceed that of the shareholders.

Paragraph 17 (7) is a good example of the care that has generally been taken over the drafting of the legislation. Its effect is to preserve the accruals basis deduction of the issuer where the required conditions are met. As with section 88 discussed on page x x, it is needed because one common mechanism for the issue of discounted securities is to issue them all to one investment bank which then resells them to third parties, and such a bank can sometimes be connected with the corporate issuer for quite innocent reasons. Eg many commercial groups may contain an investment banking company and there is no good policy reason for forcing such groups to use a third party investment bank when making a bona fide issue of discounted securities intended for third party investors.

5.19.1.3.Discounted securites of close companies

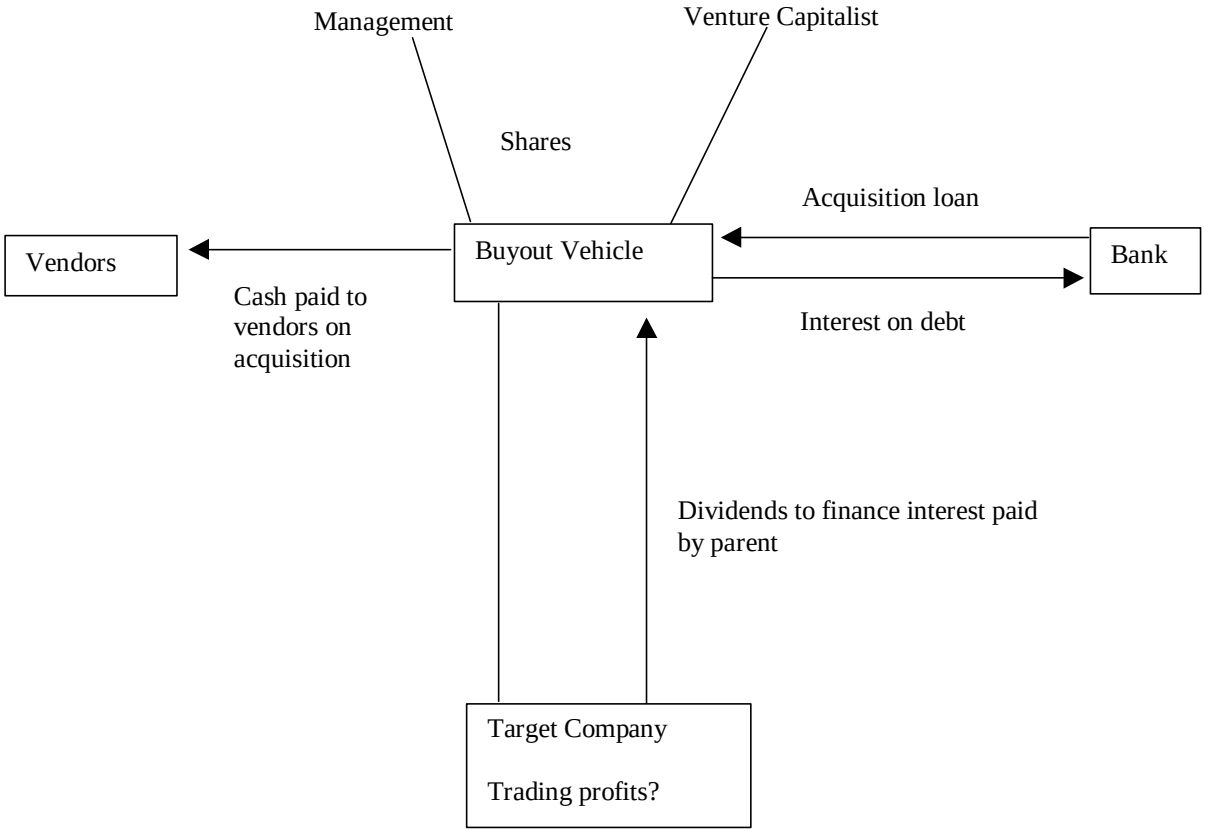
Paragraph 18 is a truly draconian provision. It applies if at any time in or before an accounting period the security is held by a participator, an associate of such a participator, or a company controlled by such a participator. (This brings out the unexpected point that under the definitions of ICTA 1988 section 417 (3)-(4) a company controlled by a participator is not his associate.) The consequence is that under paragraph 18 (2) no amount is deductible in respect of any of the discount until the accounting period of redemption.

The absence of any two year limit to the "look back" period (unlike section 87 or schedule 9 paragraph 17) and the structure of paragraph 18 (2) referring to the whole of the discount (unlike paragraph 17 (2) "amount of the discount that is referable to the relevant period") makes it clear that ownership at any time by a participator disqualifies an accruals basis deduction even if the security is owned by an unconnected third party for many years afterwards. It is hard to identify a rationale for taking this approach, unless the draughtsman was obsessed by the risk of tax avoidance involving close companies.

Paragraph 18 (4) and 18 (5) contain some useful relaxations intended to prevent certain holders of securities being treated as participators. Paragraph 18 (5) is an extension to paragraph 18 (4) as otherwise a bank that owned other security holdings might become a participator, even if one excluded the relevant discounted security in a question from the test, relying on paragraph 18 (4).

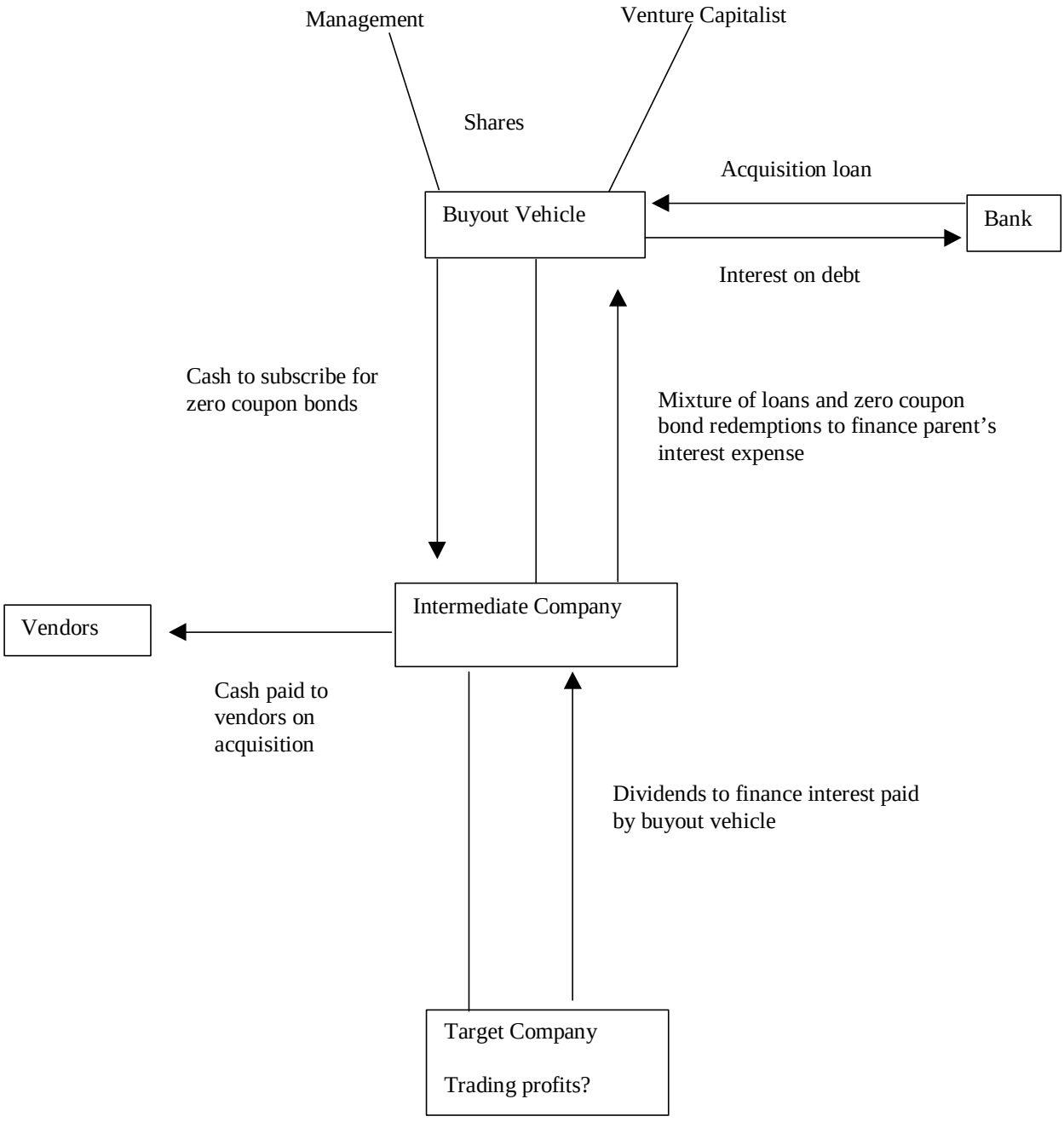
The provision applies with full force even if the holder is a UK company required to bring the corresponding credits into charge to tax year by year as they accrue.

Paradoxically, this provision has proved a useful aid to tax planners where it is desirable to effectively postpone a tax deduction. Consider the situation of a highly leveraged management buyout.



The buyout vehicle will have a significant amount of interest expense on its acquisition debt, and no taxable income. To obtain effective relief, it needs to surrender its interest expense as group relief against the trading company's taxable profits. However, the trading profits maybe depressed by restructuring costs, and it is quite common for excess interest expense to arise. Carried forward interest debits in the buyout vehicle are of limited value, as they cannot be group relieved in future periods. It is problematic whether the buyout vehicle will ever have non-trade credits with which to relieve the non-trade debits brought forward under section 83 (3).

One solution is to make the buyout vehicle a close company, even if it is not already close. There are many ways of doing this, but the details are not relevant for this thesis. The finance for the acquisition is then cascaded down as follows using an intermediate company.



With this structure, there is an overall acceleration of taxable income. The buyout vehicle has taxable income on an accruals basis arising on its holding of zero

coupon bonds. This taxable income offsets its deduction for interest expense arising from interest paid to the bank.

Typically, the amount of the zero coupon bonds will exceed the amount of the buyout vehicle's acquisition debt. The reason is that the buyout vehicle will have issued share capital as well as debt to finance the purchase, and the total purchase money raised can be cascaded down to the intermediate company as zero coupon bonds.

The intermediate company has no accruals basis deduction, due to the application of paragraph 18. The effect should be to ensure that the group has an overall taxable profit, before the zero coupon bond redemptions discussed below. Indeed, if the trading company has tax losses from restructuring costs, if desired these can be surrendered to the buyout vehicle to shelter its net taxable income.

The group's overall tax position can then be "fine tuned" to break even by redeeming just enough zero coupon bonds each year. (The redemptions will generate tax deductions for the intermediate company in respect of the bond discount.)

5.20. Connected persons

As one would expect, there are many cases in the legislation where special rules apply to connected persons. The rules in section 87 are discussed first and then the other provisions applicable to connected persons are discussed, paying particular attention to the test of connectedness.

5.20.1. Accounting method where parties are connected

Section 87 applies where the company has a loan relationship and for any accounting period is connected with its debtor or creditor respectively. Under section 87 (2) the only permissible accounting method usable by the company is an authorised accruals basis of accounting.

It is relatively clear from the structure of section 87 (3) that the mandating of accounting method applies accounting period by accounting period. Accordingly, the existence of a connection during the current period (thereby requiring accruals accounting) does not prevent the company changing to mark to market accounting

in a future accounting period if in that future period the company is not connected with its debtor/creditor under the tests of section 87 (3).

5.20.2.Connectedness test of section 87(3)

Under section 87 (3) a company is connected with another person for an accounting period if at any time during that accounting period or in the two years before the beginning of that period the control tests of section 87 (3) (a)-(c) are satisfied. There is the common exclusion that two companies are not connected solely because they are controlled by the Crown, a foreign sovereign power etc.

The test of control is that used in ICTA 1988 section 416 (2)-(6). Similarly, section 87 (7) imports the meaning of participator and associate in ICTA 1988 section 417 but with the modification in section 87 (8) that a person shall not be regarded as a participator in relation to a company "by reason only that he is a loan creditor of the company."

These provisions which look standard to a tax practitioner in fact give rise to some very difficult points. **Illustrate the problems by using the first Britannia Building Society securitisation analysis and the Inland Revenue press release issued recently which indirectly confirms that our analysis was correct.**

5.20.2.1.Limited exemption from section 87

Section 88 provides an exemption from the effects of section 88 in certain cases. It applies only to the company which has the creditor relationship; the debtor having the liability is still required to use the accruals method by virtue of section 88 (5).

Section 88 (2) contains the be specific tests that must be satisfied to qualify for this exemption. Provided the tests are satisfied, the company having the creditor relationship will be able to use mark to market accounting; indeed by virtue of section 88 (2) (b) the company will inevitably be using mark to market accounting.

The most obvious situation eligible for exemption under section 88 arises where a company wishes to borrow money by issuing quoted Eurobonds as in section 88 (2) (d) (i) or short term commercial paper having a life of less than one year as in section 88 (2) (d) (i i) and the initial issue of the Securities is handled by a an

investment banking company which is connected with the borrower. For example, those companies may be part of the same group of companies. The normal way of conducting such an issue of securities is for all the securities to be acquired by the investment bank and then resold to third-party investors. The investment bank would typically use mark to market accounting and would not find it convenient to to be required to use authorised accruals in respect of its short period of ownership of the securities. Provided that the investment bank sells at least 70 per cent of the securities to third parties within three months, it should be possible to meet all of the tests of section 88 (2).

5.20.2.2.Bad debts

Bad debts present no great problems under mark to market accounting, since at each period end any changes in the likelihood of the debt going bad will be reflected in its market value. However, with accruals accounting the basic rule, as set out in s.85(3)(c) is that for creditor relationships (ie assets) one must assume that every amount payable under the relationship will be paid in full as it falls due. Ie the debtor must be assumed to be totally creditworthy. The only exception is in the case of authorised arrangements for bad debt.

5.20.2.2.1.Basic bad debt rules

Schedule 9 para 5(1) sets out the basic rules for bad debt relief. The creditor is allowed to depart from the assumption that all amounts will be paid when they fall due in the case of:

- a bad debt
- a doubtful debt to the extent estimated to be bad
- if a debt is released.

While the first two items mirror the wording of ICTA 1988 s.74(1)(j) the last one is different. Strictly speaking, ICTA 1988 s.74(1)(j) only permits tax relief for the release of a debt if the release happens “as part of a relevant arrangement or compromise” as defined in ICTA 1988 s.74(2). (The point is never taken in practice by the Inland Revenue, for several reasons, eg any such release amongst third parties will have been preceded by the debt already qualifying as doubtful). Accordingly dropping the “relevant arrangement” in Sch 9 para 5 should make little difference in practice to creditors.

Sch 9 para 5(2) understandably requires the creditor to recognise a taxable credit if a bad debt is recovered.

Looking at the position of the debtor, where a debt is released a taxable credit will, in general, arise to the debtor since its liabilities will have reduced. This follows from s.85(3)(e). However, as a relieving provision, Sch 9 para 5(3) provides that no taxable credit needs to be recognised:

where the release is part of a "relevant arrangement" as defined, basically a voluntary arrangement under the insolvency act or an arrangement under CA 1985 s.425. This provision means that debtors have a strong reason for ensuring that any release is made under a relevant arrangement, even if creditors can be relatively indifferent as discussed above.

where the loan relationship is between connected persons as set out in s.87. This is equitable since the lack of taxation for the debtor on the release is mirrored by the lack of relief for the creditor (discussed below). This exemption applies irrespective of whether the connected creditor is within the charge to corporation tax.

In a similar manner, Sch 9 para 7 protects the debtor from having to recognise a taxable credit if a government investment (in the form of a loan relationship) is written off by a release of the obligation to repay the debt,

5.20.2.2.2.Bad debts between connected persons

Schedule 9 para 6 governs the treatment of bad debts where the parties are connected within the s.87 definition, ie when s.87 mandates the use of accruals accounting.

Apart from a limited exclusion for debt to equity swaps (discussed below) the creditor is denied any form of bad debt relief. This is achieved by para 6(3) which excludes the possibility of para 5 permitting bad debt relief, thereby re-instating the statutory hypothesis that the debtor will make all payments in full as they fall due. Para 6(6) prevents companies avoiding the prohibition of bad debt relief by making an outright disposal of the loan relationship to a third party at its (depressed or minimal) market value to realise a debit from the disposal. Para 6(6) achieves this by effectively assuming for computational purposes that the creditor has not disposed of the loan relationship at the period end. More precisely, the debits/credits for the period must not be higher/lower than they

would have been if no disposal had occurred. This effectively prevents any tax recognition of the economic loss on the bad debt. Para 6(7) clarifies the provision by preventing the creditor from being taxed on amounts (eg future interest receipts) that accrue after the date of the actual disposal of the loan relationship.

The basic rule that connected creditors do not get bad debt relief might be considered a reasonable balance for connected debtors not being taxed on the corresponding release. However, the connected provisions contain several potential traps. One of these, relating to the purchase of "distressed debt" is illustrated below.

Groups with poorly performing subsidiaries often end up with insolvent subsidiaries which are supported by group loans. An example balance sheet is illustrated below:

Insolvent subsidiary plc

Operating assets (at market value)	£10,000,000
Share capital	£1,000,000
Accumulated losses	(3,000,000)
Shareholders funds (deficit)	(2,000,000)
Parent company loan	12,000,000
	£10,000,000

Historically, if the vendor group was selling Insolvent Subsidiary plc to an acquiring group, one common approach would be for the vendor group to sell the share capital for a nominal £1 and to sell the parent company loan of £12,000,000 for its market value of £10,000,000. In the acquiring group's ownership the loan would become a "second hand debt" and therefore within the charge to capital gains tax under TCGA 1992 s.251(1). However, the acquiring group would simply be advised to ensure that Insolvent Subsidiary plc never triggered a capital gains tax disposal by repaying the debt.

Following FA 1996, the above purchase has materially adverse and somewhat unexpected tax consequences for the acquiring group. The subsidiary becomes connected with the acquiring group. Accordingly at the acquiring company's period end the debt is deemed to have a value of £12,000,000, ie to be payable in full. However, the initial value of the debt is the price paid, £10,000,000 and accordingly the purchasing company has £2,000,000 taxable credit, irrespective of the subsidiary company's performance since acquisition. The Inland Revenue are aware of the unfortunate consequences, but have confirmed that they will take the point **[cite source].**

5.20.2.3.Debt for equity swaps

Prior to the enactment of the final form of the rules in FA 1996, there was much discussion regarding the potentially adverse effect of earlier drafts of the rules on debt for equity swaps. The concern was that the new rules would deny lenders bad debt relief if they took part in such a swap, with the consequence that lenders would be more likely to put the debtor company into formal insolvency proceedings. The amount of equity that a lender acquires in the swap can often make it connected within s.87.

As a result of effective representations, Sch 9 para 6(4) and 6(5) contain a relatively generous form of relief. Provided that the creditor and debtor were not connected (as defined by s.87) prior to the debt for equity swap, then the lender is not prevented by para 6(3) from recognising bad debt relief. The quantum of the relief would clearly be computed by comparing the face value of the original loan with the market value of the equity obtained as a result of the swap. (In practice the equity is always worth significantly less than the original loan amount since lenders only engage in swaps when their loans are impaired in value).

The debtor does not have a taxable credit from the swap since it is protected by Sch 9 para 5(3) since s.87 applies to mandate accruals accounting, assuming that the creditor has acquired enough shares to become connected. If the lender has not become connected (because the lender's shareholding is too low) then the debtor company would be advised to ensure that the swap takes place as part of a "relevant arrangement" as defined in ICTA 1988 s.74(2) to avoid a taxable credit arising.

5.20.2.4.Groups of companies

Sch 9 para 12 could be described as the loan relationships equivalent to the way that TCGA 1992 s.171 applies to chargeable assets. It can be summarised very briefly by saying that transfers of a loan relationship between group companies

are ignored, except for the purposes of ascertaining which company is taxed/relieved in respect of the underlying debts/credits arising from the loan relationship.

Given the importance of the provision in practice, it is worth reviewing in greater detail.

The capital gains tax definition of a group is applied since para 12(8) applies para 11(5).

It applies where as a result of a "related transaction" (using the s.84 definition) either directly between two group companies or indirectly via a series of transactions (which can involve third parties) one group company directly or indirectly replaces another as party to a loan relationship. (Although insurance companies are outside the scope of this thesis, the provision also applies to loan relationship transfers arising as part of certain transfers of insurance businesses).

The transaction of transfer is disregarded (ie it gives rise to no debits and credits) and the transferor and transferee are deemed to be the same company, except for the purpose of deciding who shall recognise debits and credits arising from the loan relationship itself (as opposed to debits and credits from the transfer transaction which are disregarded).

Para 12(6) counters attempts to avoid continuity treatment by devising a new loan relationship with equivalent provisions.

As para 11 excludes group companies from the market value rule contained therein, one would expect para 12 to be aimed at tax avoidance rather than being a relieving provision. Because adverse consequences for the taxpayer from a group transfer could always be avoided by setting an arbitrary sale price to avoid the problem (since there is no market value rule due to para 11) one would expect group transfers to work against the Exchequer if the transaction were recognised for tax purposes. A simple example follows:

UK Parent has lent £100 to UK sub A for 10 years at 10% interest, that being the arms length rate. Both are of course required by s.87 to account for the loan relationship under an accruals method.

A year or so later, UK interest rates have fallen far below 10%. Accordingly subsidiary A's liability has become onerous, and the market value of the liability is not £100 but say £150. The group wishes subsidiary A to obtain tax relief for this £50 value charge without triggering an equivalent taxable receipt. Accordingly

having subsidiary A repay the debt at £150 (in the hypothetical absence of para 12) would be inadequate, since the £50 debit to subsidiary A would be matched by a taxable credit to the parent.

Suppose (in the absence of para 12) that subsidiary A pays another group company, subsidiary B, £150 in order to take over subsidiary A's onerous loan owed to the parent. Subsidiary A has ceased to be a party to the loan relationship, and should be able to deduct the £50 net debit in the period that it is paid. Proper accounting for subsidiary B would be to bank the £150 cash received, and recognise a liability on its balance sheet for £150. Year by year subsidiary B will pay £10 interest to the parent, and also write the £150 down towards £100 (the debt eventually repayable) with the write down each period being a (taxable)credit which reduces the interest expense. Overall the group receives an extra £50 deduction in the year of payment, and then "gives this back to the Inland Revenue" over the remaining life of the loan. This would be clearly unacceptable to the Exchequer and is prevented by para 12. Para 12 also applies if the group interposes a third party in between subsidiary A and subsidiary B.

In passing, it should be noted that there is no equivalent in the loan relationships legislation to TCGA 1992 s.18(2). Accordingly if subsidiary A and subsidiary B were not group companies (eg if both were held by an overseas parent so that there was no UK direct or indirect principal company of the group) then the transaction discussed above would be effective for tax purposes.

5.21. Imported losses

The Inland Revenue is always concerned, with some justification, that taxpayers will arrange their affairs so that tax deductions fall in the UK while gains arise in a tax free form overseas. FA 1996 Sch 9 para 10 is intended to avoid losses being imported into the UK by companies which account on an accruals method.

The potential tax avoidance can be illustrated as follows. Assume an overseas based group which is not concerned by the "controlled foreign companies" rules. On 1 January 1998 it incorporates two new subsidiaries in a tax haven.

Subsidiary A has issued share capital of £10,000,000. This is invested in a zero coupon bond due on 31 December 2007 issued by a third party company. Assume that the purchase price for the bond is £34.30 per £100 as illustrated on page 41 (x ref). (This ignores the credit risk difference between government debt and corporate debt for simplicity). Accordingly, the face value of the bond acquired will be £ 29,149,931.

Subsidiary B has share capital of £1 and borrows £10,000,000 by issuing a zero coupon bond due on 31 December 2007 to a third party at an issue price of £34.30 per £100. Accordingly, the face value of the bond issued will be £ 29,149,931.The bond is guaranteed by the parent company, since subsidiary B is itself not creditworthy with only £1 of share capital. The £10,000,000 cash received is loaned to the parent company (probably on interest bearing terms as subsidiary B is resident in a tax haven and is therefore not taxable on the interest income).

As mentioned on page 46, on 1 January 1998 the implied interest rate for zero coupon bonds repayable on 31 December 2007 is 10.99%. Subsidiary A and Subsidiary B both account on the accruals basis, so at 31 December 1998 the bond asset/bond liability will be shown in their respective balance sheets at £11,129,195, being the original £10,000,000 investment/borrowing and one year's accrued discount/interest. The balance sheet amount can be computed as $£10,000,000*(1+0.1099/2)^2$.

Market interest rates always fluctuate. By 31 December 1998 the implied yield on zero coupon bonds due 31 December 2007 will no longer be 10.99%. Assume that it has risen to, say, 11.99%. The group arranges for Subsidiary A to become UK resident on 1 January 1999 by transferring its central management and control to the UK, and for it to become part of the multinational's UK sub-group. Subsidiary B remains resident in the overseas tax haven.

On 2 January 1999 subsidiary A sells its zero coupon bond for its market value of £10,221,172, computed as £29,149,931/(1+0.1199/2)18, thereby realising a deductible loss of £908,023 compared with the accounts carrying value on 1 January 199 under the accruals basis of £11,129,195. This loss can be surrendered as group relief. Subsidiary B meanwhile repays or buys in its zero coupon bond at the same amount of £10,221,172, making an offshore tax free gain. Conversely, if interest rates had fallen below 10.99% by 31 December 1998, then the group would have arranged for Subsidiary B to have been the company that became UK resident.

The tax avoidance opportunity only arises where accruals accounting is used. With mark to mark accounting, since the date of becoming UK resident starts an accounting period, the loan relationship position would be marked to market on that date. Accordingly, UK tax effect would only be given to economic changes that arose after the acquisition of UK residence.

Accordingly, the counteraction in Sch 9 para 10 is limited to cases where accruals accounting is used. It applies where there is an accounting period during which a loss arises and that loss is wholly or partly referable to a time when the loan relationship was not subject to UK taxation. Under Sch 9 para 10(2) "no part of

the loss that is referable to a time when the relationship was not subject to UK taxation shall be treated…as arising in the loss period or any other accounting period of the chargeable company".

No guidance is given on how this disqualified loss is computed. Sch 9 para 10(3) merely defines how the relevant time period is identified, it does not tell us how to compute the loss referable to that time. In the writer's opinion the appropriate way to perform the computations is to determine the "fair value" of the loan relationship (as defined in _____) on the date that the loan relationship comes within the charge to UK tax, and only losses measured from this starting point should be UK tax deductible.

Finally, Sch 9 para 10(4) extends the scope of the provision to guard against transference of the loan relationship between different persons. Otherwise the transferee could argue that it had never been a party to the loan relationship while being outside the charge to UK tax. Any transference is potentially caught, not just that between connected persons.

5.22. Related transactions not at arms length

The creation of loan relationships between UK companies and non-resident affiliates is of course subject to the transfer pricing rules in ICTA 1988 s.770. However, there would still remain significant tax avoidance opportunities from subsequent non-arms length "related transactions" (as defined in s.84). An illustrative example is given below.

[NEED A REALISTIC EXAMPLE BEFORE I CAN EXPLAIN THIS PARAGRAPH]

5.23. Unallowable purposes

Sch 9 para 13 is the most prominent anti avoidance provision contained in the new legislation.

5.23.1. Basic outline of the rules

The operative provision is contained in para 13(1) and can be summarised as follows (separating out the key concepts):

- identify “in any accounting period” if a loan relationship has an “unallowable purpose”

- if the answer is yes, compute the debits (using an authorised accounting method in the normal way) and on a “just and reasonable basis” determine what part of the debits are “attributable” to the unallowable purpose.

- exclude from the debits “brought into account” (ie the tax deductible debits) the part attributable to the unallowable purpose.

Para 13(2) makes it clear that “loan relationship has an unallowable purpose” is a form of shorthand, and what one seeks is the purposes for which the company is a party to the loan relationship or the purposes for which the company enters into transactions which are related transactions. If those purposes include a purpose “which is not amongst the business or other commercial purposes of the company” then the loan has an unallowable purpose. Two items of guidance are given.

- Para 13(3) tells us that the business or other commercial purposes of the company do not include “the purposes of any part of its activities in respect of which it is not within the charge to corporation tax”. This guidance is of relatively limited application and clearly does not aim to be an exclusive definition. It would, for example, apply to deny relief for interest debits on money borrowed to expand the mutual trading activities of a company eg a bar in an incorporated working mens club.

- Para 13(4) is helpful to the taxpayer. Paraphrased, it states that a tax avoidance purpose is a business or commercial purpose provided that it is not the main purpose, or one of the main purposes, for which the company enters into the transaction. However, a tax avoidance purpose is not limited to tax avoidance by the company or by connected persons. It extends to any purpose that consists in securing a tax advantage for any other person. (To be disqualified it still needs to be a purpose of the company that this tax advantage be secured for the other person; no account needs to be taken of the purposes for which the other party has undertaken the transaction). The definition of tax advantage is that used in ICTA 1988 Part XVII Chapter I, ie s.703 – s.709 “transactions in securities”, and specifically set out in s.709(1). Tax is defined in s.832(3) and means income tax or corporation tax.

5.23.2. Comparison with closely related provisions

The corporate debt rules in FA 1996 were the third phase of a major modernisation of tax law, following the new rules on foreign exchange and the new rules on financial instruments. These predecessors had their own fundamental anti-avoidance rules.

5.23.2.1. Foreign exchange

Under FA 1993 an exchange loss is disregarded if "the nominal currency of the asset or liability is such that the main benefit or one of the main benefits that might be expected to arise from the company's holding the asset or owing the liability is the accrual of the loss".

5.23.2.2. Financial instruments

The anti-avoidance provisions are set out in FA 1994 s.165 – s.168. Upon close reading, most of these provisions are directed at the concern that UK taxpayers will transfer value to related persons, and do not contain a motive test.

The closest one that comes to a motive test is FA 1994 s.167(2)(a) where a financial instrument contract has been entered into, and if the parties had been dealing with each other on arms length terms the contract would not have been entered into at all (or would have been entered into on different terms).

This could be used to attack a tax motivated contract since it may be possible to show that, although the pricing of the contract is market pricing, arms length third parties would not have entered into the contract at all. A simple example would be:

- UK parent has UK subsidiaries A and B, each capitalised with £10,000,000.
- A and B enter into an interest rate swap with a notional principal amount of, say,
  £1 billion, whereby A pays fixed interest to B and receives floating interest.
  The companies have no commercial rationale for entering into the swap.

- the swap is priced at market terms so that there is no initial payment between A and B. By the end of one year, market interest rates will have fluctuated, and one of A/B will have an unrealised loss and the other an unrealised gain. Assume A has the loss for ease of discussion.

- the swap is closed out by A making termination payment to B, computed at arms length prices.

- for tax purposes, A's deductions are surrendered as group relief against B's income, so there is no overall group income or loss.

- A is then liquidated to crystallise an allowable capital gains tax loss, while B continues in existence, loaning its funds interest free to the parent.

FA 1994 s.167(2)(a) is effective to counter this, even though market pricing was used for all transactions, since if A and B had been dealing at arms length, they would not have entered into the transactions. (ICTA 1988 s.703 may also assist the Inland Revenue).

The overall conclusion is that no attempt has been made to use consistent anti-avoidance language in FA 1993, 1994 and 1996. While this could be argued to derive from the different subject matters, in the writer's opinion the difference is more likely to simply follow from different drafting styles. It is notable that under FA 1993 and FA 1994 the deduction is disqualified in full, whereas FA 1996 takes a more reasonable approach of ascertaining how much of the debit relates to the unallowable purpose, and disallowing only that.

5.23.2.3.FA 1988 s.787

The other relevant related anti avoidance provision is ICTA 1988 s.787. This was enacted specifically in 1976 to counter the "pre-paid interest scheme" then being marketed, and has been little used since. This applies a motive test which, if infringed, results in all of the interest deduction being disallowed. Logically it should have been repeated post Sch 9 para 13, but has been left presumably as a "belt and braces" deterrent against tax avoidance.

5.23.3.Application to accounting periods

Sch 9 para 13(2) looks at "the purposes for which at times during that period, the company is a party to the relationship". Arguably, in many cases a company will have no purposes at all during that period for being a party to the relationship.

Consider a company with calendar accounting periods which in 1998 issues a 10 year fixed interest non callable bond, to a third party, for an admitted tax avoidance purpose. In making its plans during 1998, the company fully expects tax advantages to arise throughout the 10 year life of the bond, but all the borrowing and tax avoidance transactions are implemented during 1998.

Throughout 1999, the company is a party to the loan relationship. However, that is because it was already a party to it at the start of 1999, and the company is contractually committed to the terms of the bond. It could only escape the bond by a breach of contract which would be litigable and which lawsuit the company would inevitably lose. Further, such conduct would damage the company's general commercial reputation.

Can the Inland Revenue argue that the company has a tax avoidance purpose during 1999? They will certainly wish to, and with current judicial hostility to tax avoidance the Inland Revenue would almost certainly prevail. However, in the writer's opinion the words of Sch 9 para 13 do not support such an interpretation; they require one to look at the actual purpose of the company in 1999 for being a party to the loan relationship. In 1999 the company either has no purpose at all for being a party (the loan being simply a legacy position) or its only purpose for being a party is to preserve its general commercial reputation.

The writer's interpretation could assist the Inland Revenue in certain cases. Consider a UK company which has issued a 10 year bond to a tax haven affiliate. The bond is at a fixed interest rate of 10%, and is callable (repayable) at £105 whenever the company wishes. All the pricing was arms length on the date of issue, and the money borrowed was used for genuine commercial purposes, so initially Sch 9 para 13 did not apply.

Several years later, market interest rates have fallen to 4%. Assume that it can clearly be demonstrated that the UK company could save money by calling the bonds at £105 financed by fresh borrowing from either the tax haven affiliate or from third parties, at 4%. However, it decides not to do so, since it is attractive from a group perspective to continue paying 10% tax deductible interest to the tax haven affiliate.

Arguably ICTA 1988 s.770 does not apply to the interest expense, since the bond was issued on arms length terms. It is by no means clear that s.770 can be used

to deem the UK company to have called the bond and refinanced. The writer has briefly reviewed the new transfer pricing legislation now in ICTA 1988 Sch 28 AA and it is not clear whether that would assist the Inland Revenue in this hypothetical case. However, in the writer's view Sch 9 para 13 would apply to each accounting period in which the company chose to remain a party to the loan relationship (by not calling the bond) because at that time in that period its purpose was a group tax advantage (either for that period or other periods).

5.23.4. Business or other commercial purposes

The question of what qualifies within "the business or other commercial purposes of the company" has been the subject of much speculation. The Inland Revenue have given some views of their own **[give details]**.

5.24. Changes to the income tax rules

As mentioned on **page (x ref)** the new loan relationship rules have no impact for income tax purposes except as specified in S.102 and Schedule 13. These provisions relate to discounted securities.

5.24.1. Relevant discounted securities

Consistent with the approach of using new language untainted by previous history, the draftsman relies upon a new concept, "relevant discounted securities" as defined in Sch 13 para 3. The definition can be summarised as follows:

- consider the terms of the security when issued (whether before or after FA 1996);
- assume redemption is in accordance with its term;
- ignore any possibility of redemption prior to maturity except when the holder has an option to require redemption prior to maturity. If so, apply the test of whether a deep gain will or might arise by looking at the earliest occasion when the holder may require redemption. (See decision on page 56 (x ref) for the tax avoidance opportunity this presented);

- check if the redemption amount on maturity will (or may) exceed the issue price. If not, the security is not a relevant discounted security;

- if the gain on redemption will or may exceed [$^{0.5}/_{12}$ x N x maturity value] where N is the number of whole or party months from issue date to redemption date, (or if N exceeds 360 then if the gain will or may exceed 15% of maturity value) then the security is a relevant discounted security, subject to the exceptions discussed below. Sch 3 para 3(4) avoids using a formula, but as always when the draftsman avoids algebra the textual definition is less clear than a formula would be.

The draftsman is anxious to catch potential gains as well as certain gains. Without the words “or might be an amount which would involve such a gain” in Sch 13 para 3(1) the definition would be inadequate, for the same reason that the “deep gains” legislation in FA 1989 Sch 11 was needed to catch contingent gains otherwise escaping the deep discount securities provisions of ICTA 1988 Sch 4.

Sch 13 para 14(1) makes every gilt strip a relevant discounted security, without requiring any arithmetical tests regarding the size of the discount. Such certainty is commendable. While it is presently unlikely, it is otherwise possible that at some future date UK gilt interest rates might fall below 0.5% pa (eg consider recent Yen denominated interest rates) which would have the effect of excluding gilt strips from the relevant discounted securities rules.

5.24.1.1.Exclusions from relevant discounted securities

Sch 13 para 3(2) lists a number of items that are excluded from being relevant discounted securities. Some of these are noteworthy.

5.24.1.1.1.Shares in a company

It has become very common for listed UK investment trusts to issue "zero dividend preference shares". As an investment these are like zero coupon bonds, but are legally preference shares. (If the investment trust has no other debt, then a zero dividend preference share is commercially virtually as secure as a zero coupon bond would be). Since they are excluded from being relevant discounted securities, they remain within the charge to capital gains tax, allowing individual investors to benefit from the annual capital gains tax exemption and from tapering of capital gains.

5.24.1.1.2.Gilt edged securities that are not strips

This represents a 100% retreat from the original plan in May 1995 to charge individuals income tax on all gilt gains. Accordingly for individuals and other income tax payers, all gains (and losses) apart from interest on gilts continue to be exempt from income tax or capital gains tax.

5.24.1.1.3.Excluded indexed securities

These are defined in Sch 13 para 13. This looks very similar to the definition of asset linked debt in s.93. It is worthwhile comparing the definitions to ascertain whether there is a real distinction between them additional to the draftsman's commendable desire to avoid using the phrase "loan relationship" in an income tax context. Upon a close reading of s.93(6) to s.93(13) and para 13(2) to para 13(8) there is no actual difference in the definitions. The only differences are in terminology.

5.24.1.1.4.Securities issued under the same prospectus

Where securities have already been issued under a prospectus, and those already issued securities are not relevant discounted securities (or more precisely were not relevant discounted securities since one applies the test by looking at the

security at the time of issue) then further issues of securities under the same prospectus are also not relevant discounted securities.

This is a very practical relieving measure. As an illustration, assume that on 1 January 1998 a company issues £100 million of 10% debentures redeemable 31 December 2007, with a coupon of 10% per annum payable semi-annually on 30 June and 31 December. The debentures are issued at par, (ie £100 issue price for each £100 nominal value) and are of course not relevant discounted securities. The prospectus provides that the company may at any time during the life of those debentures issue a further £50 million of debentures, having identical rights and being in every respect interchangeable with the debentures issued on 1 January 1998.

The remaining £50 million are issued on, say, 31 March 1998. The issue price would be expected to be £102.50 per £100 nominal, if market interest rates were unchanged, since the issue price on 31 March 1998 would reflect 3 months of accrued interest. However, assume that there has been an upwards movement in market interest rates, so that on

31 March 1998 the debentures can only be issued at £94 per £100 nominal. This means that mathematically the second tranche of debentures are being issued at a level of discount which ensures a deep gain on maturity.

It would be wholly impractical in commercial terms for the £100 million tranche issued on 1 January 1998 to not be relevant discounted securities while the £50 million tranche issued on 31 March 1998 were relevant discounted securities. It would mean that the two tranches were not fungible, since ownership by individuals has different tax consequences. While administrative procedures could be put in place to keep separate records of the two tranches, they would add to operating costs. Even more importantly, the trading liquidity of the two separate tranches would clearly be less than the liquidity of a £150 million outstanding amount of fungible debentures.

Sch 13 para 10 exists to protect the Exchequer from abuse of this exemption. It applies if the nominal value of the securities in issue that would otherwise (apart from para 3(2)(f)) be relevant discounted securities ever exceeds the nominal value of those securities issued under the prospectus which are inherently not relevant discounted securities. Eg in the example above, if the secondary issue on 31 March was not of £50 million but of any amount exceeding £100 million. Where para 10 applies, all of the securities issued under the prospectus are treated as relevant discounted securities for the purpose of any events (defined in para 10(3)) occurring after the time when the threshold was trangressed. Para 10 has the effect of changing the status of all the securities, including those issued originally which were not relevant discounted securities when issued and which were not issued at a deep gain. This can be very undesirable for existing holders.

This identifies a practical point for lawyers acting for the investors in an issue of securities, where the securities are not intended to be relevant discounted securities. If the prospectus permits further issues under the same prospectus that could exceed the nominal amount of the first issue, then the lawyers should insist upon a warranty from the issuing company that the further issues will not be made in a manner that causes paragraph 10 to apply.

5.24.2. Charge on realised discounts and related losses

Under Sch 13 para 1(1) a realised profit from the discount on a relevant discounted security is charged to income tax under schedule D case III, or case IV where the security is out of the United Kingdom. (One assumes that the existing law on the situs of debts continues to apply). Sch 13 para 6 integrates the charge with the other tax rules applicable to trusts and estates, while para 12 integrates with ICTA 1988 s.739 and s.740. Para 11 prevents double counting of the accrued interest under the accrued income scheme by excluding that scheme, while Sch 13 para 1(1) is used to tax the whole gain including accrued interest.

Despite the reference in para 1(1) to “profit from the discount” the actual computation specified in para 1(3) ignores the discount, and simply compares the proceeds on transfer or redemption (less relevant costs) with the acquisition cost. As one might expect, there is a market value rule for transfers between connected persons (using the ICTA 1988 s.839 test) in Sch 13 para 8. Para 9 covers the usual problem of consideration not in moneys worth or a bargain not at arms length.

While this gain might be related to the security having been issued at a discount, it can arise just as easily from fluctuations in the market value of the security caused by fluctuations in interest rates. Accordingly Schedule 13 takes the same approach as the deep gain rules in FA 1989 Sch 11, and is quite different from the deep discount security rules in ICTA 1988 Sch 4 which carefully computed and taxed only the discount accruing over the period of ownership while other gains on the security (arising from market price fluctuations) fell within the capital gains tax rules or were exempt if the deep discount security was a qualifying corporate bond.

The approach of making all profits from relevant discounted securities taxable in full, rather than trying to dissect them into taxable discount and non-taxable “other value fluctuations” has much to commend it, as it considerably simplifies the calculations. Any disadvantage to taxpayers compared with previous law is, in the

writer's view, fully compensated by Sch 13 para 2 which for the first time provides income loss relief for realised losses on relevant discounted securities.

Sch 13 para 7 ensures that relief is not given for losses if a gain would have been exempt from tax.

5.24.3. When are gains realised?

Under Sch 13 para 1(2)(a) the triggering event is either the redemption of the security or any earlier "transfer". "Transfer" as defined in Sch 13 para 4(1) includes any transfer by way of sale, exchange, or gift. Death also gives rise to a notional transfer at market value immediately prior to death (so it is the individual who is chargeable rather than the gain being income of his estate). Sch 13 para 4(4) prevents any avoidance being achieved by a sale of the beneficial interest without an immediate transfer of the security itself. The usual rules regarding options and conditional contracts apply.

Sch 13 para 5 extends the normal meaning of redemption to ensure that it covers conversion into shares or other securities. For the avoidance of doubt, it does not apply to exchanges covered by Sch 13 para 14 (stripping a gilt or reconstituting it).

5.24.4. Application to gilt strips

The government was clearly concerned that individuals would use gilt strips to defer their income tax liabilities on interest income. Accordingly Sch 13 para 14(4) introduces a tax charge by effectively marking to market all gilt strips held by an individual on 5 April each tax year and taxing the deemed gain or relieving the deemed loss.

The government's concern was well founded. This can be illustrated by comparing the position of two investors, assuming that Sch 13 para 4(4) had not been enacted.

Investor A

He invests £1,000 into coupon gilts yielding 7% gross, and maintains that investment for 20 years, reinvesting all income after paying 40% income tax.

Assume no fluctuations in interest rates, and for simplicity that income tax is paid immediately the interest arises rather than after a short delay.

The individual earns 7% gross, which after 40% income tax is 4.2%.

£1,000 compounded for 20 years at 4.2% becomes £2,276.96.

Investor B

Investor B invests £1,000 into a gilt strip priced with an implied yield of 7% and sells that 20 years later.

His outcome is as follows:

Proceeds from gilt strip (£1,000 @ 7% for 20 years) £3,869.68

5.24.5.Tax computation

Proceeds	£3,869.68
Cost	1,000.00
Gain	2,869.68
Tax @ 40%	1,147.87
Net proceeds after tax	£2,721.81

Investor B's return is equivalent to a post tax interest rate over the 20 years of 5.13% which significantly exceeds investor A's post tax return of 4.2%. Investor B's gain is of course at the expense of the Exchequer, which receives no tax on his accruing value for 20 years.

While Sch 13 para 14(4) has been enacted in the case of gilt strips, there are no equivalent provisions affecting individuals who invest in corporate zero coupon bonds. While one can argue that investors in corporate zero coupon bonds face credit risk, there is no equivalent rationale for excluding from the rules stripped bonds of foreign governments. At present the investors face exchange risk when making such investments, but this will disappear for the euro zone if the UK enters monetary union. At that stage, if not earlier, one would expect Sch 13 para 14(4)

to be extended at least to stripped overseas government bonds denominated in euros. Otherwise it will become vacuous.

Sch 14 para 14(2) and para 14(3) repeat for income tax purposes the rules which apply to companies on stripping and reconstituting gilts which are discussed in section 5.6.6.2. on page 80.

5.25. Minor and consequential amendments

Schedule 14 contains a large number of amendments to the existing tax legislation. These are necessary as a result of the introduction of the new language of “loan relationships” and “debits” and “credits.” The basic aim of the schedule as a whole is to keep the underlying effect of the old law while using new language, except where changes in effect are intended by the other parts of FA 1996. Accordingly, most of the amendments made by schedule 14 are not discussed in detail in this thesis.

6. Interaction with Foreign Exchange rules

FA1996 makes a number of changes to the FA 1993 rules. These are intended to simplify matters where both sets of rules are applicable. Eg they avoid the need to separately track carried forward non-trade forex losses and non-trade interest debits.

6.1. No double charge

Schedule 9 paragraph 4 (1) requires the debits and credits to be computed disregarding any debits or credits generated by the accounting method as a result of exchange fluctuations.

The application of this rule is straightforward when the amount of the loan relationship expressed in foreign currency is invariant between period ends. Eg assume:

- The company borrows $100 on 1 January 1998
- Interest of $3.50I s payable every 30 June and 31 December
- The loan is repayable at $100 on 31 December 2007

Each year the only debit to be recognised under the loan relationship rules is the $7 of interest expense. This amount will be converted into sterling for inclusion in the tax computations using an appropriate exchange rate eg year end closing spot rate, or average rate for the year.

The exchange fluctuations on the $100 face value of the loan continue to be taxable / deductible under the 1993 foreign exchange rules, whose effect is protected by schedule 9 paragraph 4 (2).

The same principles apply when the amount of the loan relationship is not invariant in foreign currency. However the calculations are more complex. FA 1993 section 127 was amended by FA 1996 schedule 14 paragraph 67. The application of the rules is illustrated by the following example of a dollar denominated zero coupon bond owed by a company with a calendar year end, which uses the average rate for the year when translating income and expense items.

Interaction with Foreign Exchange rules

Date	$ liability	Spot rate	Year	Average rate
1/1/1998	$30	1.60		
31/12/1998	$32	1.65	1998	Say 1.62
31/12/1999	$35	158	1999	Say 1.63

Loan relationship calculations

1998 – loan relationship debit $2 at average rate 1.62 = £1.23
1999 – loan relationship debit $3 at average rate 1.63 = £1.84

Foreign exchange calculations

		Foreign currency	Rate	Local currency ie £
1998	Opening liability FA 1993 S.127(2)(a)	$30	1.60	18.75
	FA 1993 S.127(2)(b) local currency equivalent at each time immediately after the debt increases	$2	? use 1.62	1.23
				19.98
	FA 1993 S.127(2)(e) at end of accounting period	$32	1.62	19.39
	Taxable exchange gain, as liability in £ has reduced			0.59

		Foreign currency	Rate	Local currency ie £
1999	Opening liability FA 1993 S.127(2)(a)	$32	1.62	19.39
	FA 1993 S.127(2)(b) local currency equivalent at each time immediately after the debt increases	$3	? use 1.63	1.84
				21.23
	FA 1993 S.127(2)(e) at end of accounting period	$35	1.58	22.15
	Deductible exchnage loss, as liability in £ has increased			(0.92)

Under FA 1993 section 127 (1 B) the accruing discount is treated as an increase in the nominal amount of the debt. This is entirely what one would expect. However the wording of section 127 (2) (b) was not amended by FA 1996, and that subsection assumes that there is a specific time when the increase in the debt amount arises. This time needs to be ascertained as one requires an exchange rate to be obtained and applied.

In reality the discount accrues over the entire accounting period. The most practical way to make section 127 (2) (b) apply consistently is to use the same exchange rate as applied in translating the interest expense debit. In our example, the average rate for 1998, 1.62, was used to translate the interest expense and

Interaction with Foreign Exchange rules

therefore this rate is used for section 127 (2) (b) I E one assumes that the $2 arises evenly over the year 1998.

If the $2 interest debit was translated using the closing rate of 1.65 (which is a valid method) then the corresponding assumption for 1998 for the purposes of section 127 (2) (b) should be that the amount of debt increases on the single date of 31st December, 1998 ie to translate the $2 increase at 1.65 to compute the exchange gain or loss.

Proceeding in this consistent manner ensures that the aggregate sterling amount taxable under the loan relationship and foreign exchange rules is equal to the sterling economic profit or loss. Eg for 1998 the interest debit of £1.23 and the exchange gain of £0.59 combine to give a net £0.64 deductible amount. The economic loss is $32 @1.65 less $30 @ 1.60 = £0.64.

6.2. Non-trading exchange gains and losses

Schedule 14, para 69 effectively subsumes non-trading foreign exchange differences into their FA 1996 equivalents:

a non-trading exchange gain is brought into account as if it were a non-trade credit in respect of a loan relationship.

a non-trading exchange loss is brought into account as a non-trade debit.

Similarly FA 1996 Sch 15 para 24 converts carried forward non-trading exchange gains and losses into brought forward non-trade debits governed by s. 83 (3). Sch 15 para 23 has the equivalent effect in the opposite direction, so that a non-trade loan relationship deficit can be carried back against exchange profits arising before 1 April 1996.

6.3. Changes in classification

Sch 14 para 70 makes changes to the definitions of qualifying assets and liabilities in FA 1993 s. 153.

Interaction with Foreign Exchange rules

Assets which fall under s. 92 (convertibles) or s. 93 (asset linked debt) are not qualifying assets for the foreign exchange rules.

The former exclusion for convertible liabilities in FA 1993 1.153(6) is repealed. Accordingly such liabilities now give rise to taxable exchange differences (Previously it was relatively straightforward to keep an intra group currency liability outside the foreign exchange rules by making it convertible)

Interaction with Foreign Exchange rules

7. Interaction with financial instruments rules

FA 1996 also amends the FA 1994 financial instruments rules. The main change is to block a loophole relating to options.

7.1. No double charge

Section 101(1) precludes a charge under the 1994 Financial Instruments rules on qualifying contracts if the debit or credit is brought into account under the 1996 loan relationship provisions. The 1996 rules are therefore the primary.

The provision is needed due to the new rules on debt contracts.

7.2. Debt contracts and options

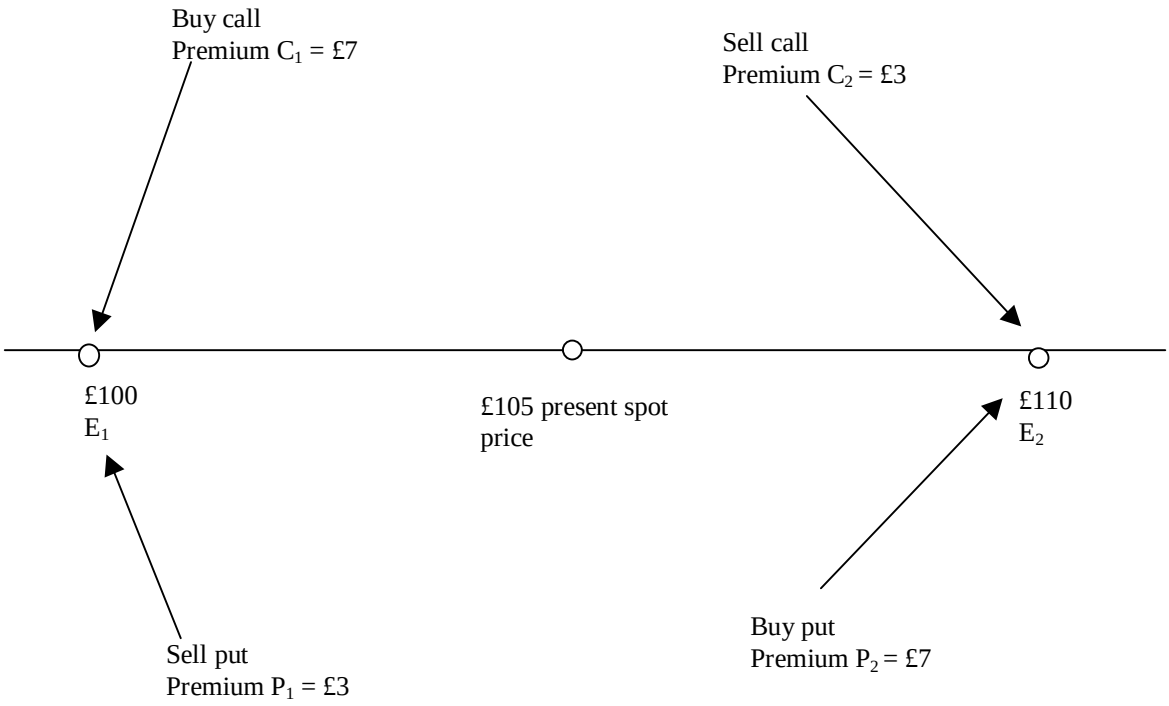
Finance Act 1994 part IV chapter II brought in a new tax regime for what legislation and the Inland Revenue call "Financial instruments". In commercial life, they are more commonly referred to as interest rate derivatives and currency derivatives.

A detailed discussion of the financial instruments rules is beyond the scope of this thesis. However, one important point is that in 1994 capital gains on government securities were still tax free and accordingly options over government securities were also tax free. **[give statutory reference]**

This provided an opportunity for tax avoidance. The scheme involved the taxpayer entering into four options with a trading counter party, the net effect being that the taxpayer received an economic return equivalent to interest but in a tax free form. **[Give an illustration.]**

Consider a gilt that is currently trading at £105. The company enters into the following transactions in European style options, ie options that can only be exercised on their expiry date as opposed to American style options which can be exercised at any time during their life. For simplicity, assume that the expiry date is 12 months away.

Interaction with financial instruments rules



Regardless of the closing price of the gilt on the one date that the options can be exercised, the company's proceeds from the options are always £10 ie E2-E1. This can be shown as follows.

Gilt closes below £100, say at £99

Both call options are "out of the money" and expire worthless. There is a receipt on the exercise of the put option purchased of £11 plus a payment on the put option sold of £1 ie net proceeds £10.

Gilt closes between £100 and £110, say at £103

The call option held produces a return of £3 and the put option held produces a return of £7, ie total proceeds of £10. Both of the options sold are out of the money and expire worthless.

Gilt closes above £110, say at £111

Both put options are out of the money and expire worthless. There is a return on the call option held of £11 and a payment on the call option sold of £1 ie net proceeds of £10.

Accordingly, on the expiry date the company will always receive £10 ie E2-E1.

The cost of the position when established, one year prior to the expiry date, was £7+£7 for the two options purchased less £3+£3 proceeds for the two options sold, a net cost of £8. Ie C1+P2-C2-P1

There is a net gain of £2 on the initial investment of £8. As demonstrated above, this is a risk free return since it is independent of the price of the gilt on the exercise date of the options. On the illustrative figures used, the return is 25% pa. In reality, since the options market works efficiently, the relationship between the option prices C 1, C 2, P 1, P2, and the exercise prices E1 and E2 will be such that the actual rate of return (ignoring transaction costs) should equate to a risk free interest rate eg the interest rate on Treasury bills. Transaction costs should be minimal when dealing in large amounts.

Until the change in the law, gains on options over gilts were tax free, just as gains from buying and selling gilts themselves were tax free. However, once the possibility of the "gilt box scheme" producing a tax free return equivalent to interest became widely known, legislative change was inevitable.

Section 101(2) makes debt contracts qualifying contracts by introducing a new FA1994 Section 147A. This has the effect of killing the scheme, since gains on qualifying contracts are taxable income. The detailed definitions are set out in schedule 12 which introduces a new section 150 A into FA 1994.

Interaction with financial instruments rules

8. Company Law and Accounting Aspects

When the new rules were first announced, some concerns were expressed by commentators that they might conflict with company law. However, the writer considers that such concerns were exaggerated.

8.1. Accounting methods commonly used historically

The main accounting methods used historically are briefly discussed below:

8.1.1. Lower of cost or net realisable value

This method has typically been used to value trading stock included in current assets on a company's balance sheet. In the context of debts, it would be used to value creditor relationships held by a financial trader.

Although a normal method of accounting, FA 1996 prohibits its use for tax purposes, since it is unduly prudent because declines in net realisable value are recognised in the accounts, but increases are not recognised.

Quite apart from tax law, this accounting method has been growing less popular in recent years, especially with the changes in practice in the securities market after "big bang" in 1986. R v Inland Revenue Commissioners, ex parte S G Warburg & Co Ltd, 1994 STC, concerned an application for judicial review following a change from "lower of cost or market" (effectively net realisable value) to "mark to market". The most notable point in the decision is that accountancy practice and revenue law in 1987 was that mark to market was not a valid method of stock valuation. Such a finding would be unlikely today given changes in commercial practice.

8.1.2. Asset at cost unless value impaired

This method would typically be used to value a fixed asset. In the context of debts held as fixed assets, it would not be appropriate for tax purposes unless any accruing interest/

discount on the debt was recognised. Otherwise, it would again be excessively prudent for tax purposes. Normal accounting practice would now be to recognise such income (Cross refer to FRS4).

8.1.3. Accruals accounting for liabilities

Such accounting is mandatory following FRS4. It would clearly be wrong to have a liability and not recognise any growth in that liability from the accrual of discount.

8.1.4. Marking to Market

This is now normal practice for securities dealers and other financial traders, when dealing with their trading assets and derivatives positions.

It is not yet normal practice to mark long term liabilities to market. For example, many investment trusts have previously taken out long term borrowings at high (eg 12%) fixed interest rates. In their balance sheets, such a liability would be recorded at face value, ie £100 per £100 originally borrowed, even though such debt could not be repaid at par prior to maturity. Due to the intervening decline in market interest rates, the company may need to pay, say, £120 per £100 of debt to retire the debt at the balance sheet date.

The economic significance of this is starting to be recognised, and one increasingly encounters in the financial press two alternative calculations of net asset value for such trusts, one calculation deducting the loan liability at par, and the other deducting the loan liability at its higher market value.

8.2. Applicable company law and accounting standards

In the writer's opinion, company law does not prevent companies preparing their accounts in accordance with accruals accounting. To the extent that a profit depends on the increase in carrying value of an asset due to accruing income, such income is not part of distributable reserves since it has not been realised.

Companies are allowed to use mark to market accounting in their statutory accounts when dealing with assets. However, it is not presently permissible to use mark to market accounting for loan liabilities.

8.3. Likely future accounting standards

There is significant controversy over accounting standards (specify). This would require companies to mark derivatives positions to market. The main intellectual argument against marking all derivatives positions to market is that often they hedge exposures on liabilities, and marking the derivative to market (possibly

recording a loss) is inappropriate unless the liability can also be marked to market (to record an opposite gain if the derivative is an effective hedge).

The likely resolution is permission to also mark liabilities to market, to reflect market interest rate changes but not changes in market value arising from changes in the credit worthiness of the company itself. (Otherwise, a company with large liabilities would be in the anomalous situation of recording income as a result of the market value of the company's liabilities falling if the company's credit worthiness was impaired!)

As a result, the valuation approach likely to be adopted for company law purposes mirrors the definition of "fair value" of liabilities discussed in sections (X ref).

9. Conclusions

With the sweeping changes brought in by FA 1996 and the complexity of the details of the legislation, it is easy to lose track of the overall principles. However, it is possible to draw some fundamental conclusions.

9.1. Is it fair?

The initial reaction of the writer to the 25 May 1995 Inland Revenue press release was that the Inland Revenue were using the need to change the law as an opportunity to write a "wish list" of tax law changes. In the writer's view, the original proposals were not fair.

As a result of the major changes between 25 May 1995 and the enactment of FA 1996, the writer believes that a fair balance has emerged.

The Inland Revenue have been able to block many loopholes in the existing tax law. Much more importantly, there is a coherent approach which is intended to ensure that economic gains on debt positions are taxed without excessive attention to the detailed form of the positions.

The taxpayer benefits from a much higher level of symmetry in the law – eg losses on bonds are now deductible. The calculations used are inherently more logical, and archaic concepts such as only obtaining relief for annual interest when paid have been swept away.

9.2. Does it meet the original objectives?

The most important objective was to allow gilt stripping, and of course this has been achieved.

The wider objective was to sweep away vast amounts of old, complex, piecemeal legislation and to replace it with a coherent modern code dealing with debt and interest. Despite the remaining complexity (much for anti-avoidance reasons), in the writer's opinion these objectives are achieved. The new code embodies far better recognition of modern commercial practice.

9.3. What areas need changing or clarifying?

The law continues to change, not least because tax advisors have been astute to exploit any loophole as in the case of convertible debt.

The area where the writer finds the new rules least satisfactory is connected party bad debt. The complex definitions of connectedness are accepted as necessary, since any simpler definitions are likely to be exploited. However, the more fundamental point is that there is no logic to the Inland Revenue's denial of bad debt relief for losses on loans to connected companies. Also, the present rules contain many traps as discussed in the text.

A more logical alternative approach might be:

9.3.1. UK to UK connected bad debts

To allow the bad debt relief only to the extent that the debtor recognises "debt forgiveness income". If the debtor avoids actual tax payable due to insolvency, the creditor's bad debt relief could be correspondingly restricted in a group situation.

9.3.2. UK to overseas connected bad debts

If necessary, widen the transfer pricing rules to protect against UK creditors granting excessive credit to overseas affiliates, by correspondingly restricting their bad debt relief. If this is regarded as insufficient, bad debt relief could be restricted to the amount of economic loss suffered by the group, eg a bad debt owed by a wholly owned foreign subsidiary would give rise to no relief, while a 75% owned subsidiary would give rise to 25% relief.