# INTM551280: Hybrids: Financial instruments (Chapter 3): Example: Convertible note – valuation of discount

This example looks at situations where a company issues a zero-coupon convertible note to a related company. The option to convert has both a finance and an equity element and the two countries give a different valuation to the discount.

The example considers whether the valuation of the discount to modify the loan is within the hybrid and other mismatches from financial instruments rules and how it should be treated.

Co. 1 is resident in Country X and owns all the shares in Co. 2
Co. 2 is resident in Country Y. 
Co. 1 subscribes for a five year zero-coupon convertible note (the ‘Note’) with a principal amount of 100. 
The Note can be converted into shares of Co. 2 at the option of Co. 1. 
Under the laws of both Country X and Country Y, the Note is bifurcated for tax purposes, treating it as being issued at a discount. This discount is deductible by Co. 2 and is included in ordinary income by Co. 1. 
Country Y treats Co. 1 as having paid 80 for the Note and 20 for the share option, which may be accrued as a deduction for tax purposes over the term of the Note. 
Country X adopts the same tax treatment but treats Co. 1 as having paid 90 for the Note and 10 for the share option, which it brings in as ordinary income spread over the term of the Note.


## Background

* Co. 1 is resident in Country X and owns all the shares in Co. 2
* Co. 2 is resident in Country Y
* Co. 1 subscribes for a five year zero-coupon convertible note (the ‘Note’) with a principal amount of 100
* The Note can be converted into shares of Co. 2 at the option of Co. 1.
* Under the laws of both Country X and Country Y, the Note is bifurcated for tax purposes, treating it as being issued at a discount. This discount is deductible by Co. 2 and is included in ordinary income by Co. 1.
* Country Y treats Co. 1 as having paid 80 for the Note and 20 for the share option, which may be accrued as a deduction for tax purposes over the term of the Note.
* Country X adopts the same tax treatment but treats Co. 1 as having paid 90 for the Note and 10 for the share option, which it brings in as ordinary income spread over the term of the Note.
* The payee is not a relevant investment fund as defined in s259NA.
* The Note is not a regulatory capital security for the purposes of the Taxation of Regulatory Capital Securities Regulations 2013 (SI 2013/3209).

## Analysis - Applying the tests in s259CA TIOPA 2010

Do the interest accruals satisfy the relevant conditions to fall within the scope of the hybrid and other mismatches from financial instruments rules?

### Condition A: Are there payments or quasi-payments made under, or in connection with, a financial instrument?

The Note is defined as a financial instrument for the purposes of UK GAAP and therefore falls within the definitions provided in s259N.

There is no actual payment of interest in the intervening years until maturity, and no payment within the definition at s259BB(1). Therefore, we must consider whether the interest is a quasi-payment under s259BB(2).

Although there are no actual payments of interest in the intervening years until maturity, Co. 2 may claim a deduction in respect of accrued interest in calculating its taxable profits. It would be reasonable to expect that an amount of ordinary income would have arisen to Co. 1 had it adopted the same accounting approach (which in this case it actually has).

While the deduction is deemed to arise to Co. 2 for tax purposes, the accrued interest arises from the existence of economic rights between Co. 1 and Co. 2. S259BB(3) does not apply in these circumstances.

The accrued expense satisfies the definition of a quasi-payment within s259BB(2).

Condition A is satisfied.

### Condition B: Is either Co. 2 or Co. 1 within the charge to corporation tax for a relevant payment period?

The charge to corporation tax is the charge to the corporation tax in the UK.

If the UK is Country X, Country Y or both (i.e. a wholly domestic transaction), Condition B is satisfied, as either Co. 1, Co. 2 or both are within the charge to corporation tax.

If the UK is neither Country X nor Country Y, then Condition B is not satisfied, as neither Co. 1 nor Co. 2 are within the charge to corporation tax. You will need to consider the remaining conditions only if the imported mismatch rules in Chapter 11 apply.

### Condition C: Is it reasonable to suppose that there would be a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ in relation to this payment?

The background suggests it is reasonable to suppose that Country Y will allow Co.2 a deduction (the relevant deduction) of 20 for the accrued obligation under the Note against its ordinary income. It is also reasonable to suppose that Country X will not require Co.1 to bring more than 10 into tax as ordinary income. The deductions of 20 therefore exceed the 10 included as a receipt, and there is a mismatch.

The different valuation applied to the share option by Country X and Country Y determines the characterisation of the difference between 10 and 20 (or 90 and 80). This difference is debt from the perspective of Country Y, but equity from the perspective of Country X.

In this example, where the option to convert does create both a finance and an equity element, the split between them is being measured differently by each jurisdiction. This directly determines the character of 10 of the quasi-payment made by Co. 2.

There is a hybrid or otherwise impermissible deduction/ non-inclusion mismatch in that the relevant deduction exceeds the sum of the amounts of ordinary income that arises to each payee in the permitted taxable period by reason of the quasi-payment, and all or part of that excess arises by reason of the terms of the financial instrument. Therefore, Case 1 in s259CB(2)) applies.

Condition C is satisfied.

### Condition D: Are the two companies related, or is the Note or any arrangement connected with it, a structured arrangement?

Co. 1 owns all the shares in Co. 2, so the companies are related as defined at s259NC.

Condition D is satisfied.

There is no need to consider whether the arrangement is also a structured arrangement.

### Conclusion

As all the relevant conditions are satisfied to characterise the arrangement as a ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’, the relevant counteractions need to be considered.

## Counteractions

The counteraction applicable will depend on whether the UK is in the position of Country X and Country Y (or both).

**Counteraction where the UK is in the position of Country Y (the payer jurisdiction)**

#### Primary response

Where the UK is Country Y (the payer jurisdiction), s259CD applies to counteract the mismatch to the extent of the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ allocated to each period. This will be the case for each of the 5 years of the Note, provided it is not converted.

Co. 2’s deductions will be restricted by an amount equal to the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ in each accounting period until maturity if

Co. 2 accrues the discount over the 5 years,

the payment period coincides with their accounting period, and the Note is not converted.

**Counteraction where the UK is in the position of Country X (the payee jurisdiction)**

#### Secondary response

Where the mismatch has been fully counteracted in Country Y under s259CD or an equivalent provision, no further action will be taken by the UK.

If the ‘hybrid or otherwise impermissible deduction/ non-inclusion mismatch’ has not been fully counteracted in Country Y, s259CE applies to counteract the remaining mismatch by including that amount as income arising to Co. 1 for the counteraction period.

This will be computed in a similar manner to that outlined in the counteraction at s259CD above if Co. 1 also recognises the discount on a straight line basis over the 5 years, that the payment period coincides with their accounting period and that the Note is not converted

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