

INCOME TAX AVOIDANCE USING STRIPPED BONDS

Overview

1. The Government proposes to introduce legislation in the 2005 Finance Bill, taking effect from 2 December 2004, to prevent tax avoidance by individuals and trustees liable to income tax using bonds issued by companies which have been stripped of some or all of their rights to interest.
2. The legislation will put it beyond doubt that where individuals or trustees acquire, on or after 2 December 2004, any rights derived from a company bond (whether rights to interest, principal repayment or a mixture of both), those rights are treated as relevant discounted securities.

Details

3. A discounted bond is one that is issued at a lower price than that at which it will be redeemed (repaid). Discounted bonds normally pay no interest or a very low rate of interest.
4. For income tax purposes, the relevant discounted securities (RDS) rules ensure that any profit a person makes from holding a discounted bond is charged to tax as income at the date the discount is realised (normally when the bond is sold or it matures). There are special rules for strips of Government bonds (gilts).
5. If a bond of nominal amount 100 is issued for 95 and pays no interest, a person who acquires the bond on issue and holds it to maturity will make a profit of 5. That 5 will be taxed for the year in which the bond is redeemed. If instead, the person sold the bond part way through its life for, say, 98, then the profit of 3 would be taxed for the year in which the sale takes place.
6. For tax purposes, discounted bonds are defined by reference to the difference between the issue price and the redemption price. Broadly the difference has to be more than a set percentage of the redemption amount, being $\frac{1}{2}\%$ for each year of the life of the bond.
7. The avoidance seeks to exploit this definition by mimicking the effect of discount but using bonds which were not issued at a discount so that it is claimed they do not fall within the definition of relevant discounted securities. The promoter takes an interest bearing bond which was issued at par, and separates away (strips) the rights to some or all future interest coupons. Because the right to the future principal repayment no longer carries with it all the interim interest payments, its value falls below par thus creating the effect of a discounted bond. This right is then sold to a person who holds it to maturity, or sells it before it matures, and realises a profit.
8. An simple example might be a bond of nominal amount 100 which pays 5% interest per annum. The bond is issued at par and will be repaid after 12 months

at par, so there was no discount on issue. The rights to the annual interest of 5 are separated out and the right to just the redemption amount of 100 is sold for, say, 95. An investor seeking a tax free profit purchases this right and holds it to maturity, thus realising a profit of 5.

9. It is claimed that because the original bond was not issued at a discount, the right to the principal repayment acquired by the investor does not fall within the definition of a relevant discounted security and so the profit is not chargeable to income tax. It is also claimed that the right to principal repayment is a qualifying corporate bond such that the gain of 5 on its disposal is not a chargeable gain liable to capital gains tax.

Anti-avoidance measures

10. The changes announced today will ensure that this scheme does not succeed by putting it beyond doubt that where some or all of the rights to interest on a company bond are separated from the right to the principal repayment, all of the resulting rights derived from the bond (whether rights to interest, principal repayment or a mixture of both) will be treated as relevant discounted securities for income tax purposes so that profits made on them are taxed as income at the date they are realised.
11. The change will apply to rights acquired on or after today.

Further information

12. Anyone wishing further information on the proposed legislation should contact either:

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