THE TAX ATTRACTIONS OF A DEEPLY DISCOUNTED SECURITY

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The issue of a deeply discounted security to raise money instead of the taking of a loan can be very attractive, because the discount which is paid on the redemption of the security is not interest for tax purposes and can thus be paid "gross" by a UK resident person to the non- UK resident person who provided the monies.

Furthermore, under general principles, the discount in the hands of a non-resident person is generally tax free under the disregarded income provisions (in ITA 2007 s.813), even though the discount has a UK source.

In addition, the discount is tax deductible in any UK tax computations if the monies were raised for the purposes of a trade, for example, or a UK letting business (within ITTOIA 2005 s272).

Thus if the discount is tax deductible in the UK, tax free under general principles in the hands of the recipient and can be paid gross, it is no wonder that this instrument (called a DDS) has been found by many to be attractive.

TYPICAL SITUATION WHERE AN INDIVIDUAL ISSUES A DDS

An individual resident in the United Kingdom wants to borrow monies – £1m, paying rolled-up interest in say 7 years' time of £0.5m when the loan is repaid – from a non-resident person, perhaps from an overseas structure where the income can be assessed on him under ITA 2007 s.730. He wants to pay a full rate of interest.

The interest will almost certainly be annual interest, and tax must be deducted at source under ITA 2007 s.874, if the lender's usual place of abode is outside the United Kingdom.

On the other hand, if the UK resident individual issues a deeply discounted security to the overseas provider of the monies which has a face value of £1.5m, but a present market value of £1m – because the security is to be redeemed in (say) 7 years' time for £1.5m, the £.5m difference (the discount) is not interest. It is paid gross in 7 years' time. It is deductible for tax purposes from any trading or property letting profits (for example) of the UK taxpayer, if he or she took the monies out for the purposes of the trade or property letting business. Moreover, under general principles, the discount is tax free in the hands of the overseas subscriber.

YOU'VE CAUGHT MY INTEREST: SO WHAT IS A DDS?

ITTOIA 2005 s.430(1) states that a security is a deeply discounted security if at the time it is issued the amount payable on maturity or any other possible occasion of redemption (A) exceeds or may exceed the issue price by more than A x 0.5% x Y, where Y is the number of years in the redemption period or 30 whichever is the lower. "Redemption" period means the period between the date of issue and the date of the redemption in question. If the discount is not a deep discount it is taxed as interest: see ITTOIA 2005 s.381.

Thus, in a typical situation, Mr X in the UK would *issue* (terminology is important here) the deeply discounted security, and the amount payable on maturity would be £1.5m – taking the above example. The overseas individual, company or settlement would *subscribe* for the security. In – say – 7 years time the security would be *redeemed*. Mr X would pay £1.5m.

There could be no doubt that the courts have struggled with the question of what is the difference between a deeply discounted security and a loan with a rate of interest being charged.

The courts have held that a discounted security is a security under which X agrees to pay monies on a particular date to the holder of the security and he sells that security. X sells a promise to pay monies. The buyer (subscriber) is not making an advance of monies: he is buying a bill or security.

In *Torrens v IRC* 18 TC 262, the issue was whether a bank which purchased a promissory note was in effect making an advance to the vendor of the promissory note. Best, LJ, at 267 stated:-

> "It appears to me that the purpose of the transaction being to put the Appellant in possession of funds, the method used was, as the certificate to the bank says, by the negotiation of bills and promissory notes and not by making advances on which the Appellant is chargeable with interest. The bank, instead of making an advance or allowing an overdraft in the ordinary way and charging interest from day to day on the amount of such overdraft, discounted the notes and dealt with them in the way described; and when a banker discounts a bill for a customer, giving him credit for the amount of the bill and debiting him with the discount, there is a complete purchase of the bill by the banker, in which the whole property and interest in it vest, as much as in any chattels he possesses... There is no difference in principle, in this connection, between the discounting of bills and the discounting of promissory notes and, in my opinion, it follows that the bank in this case did not make an advance to the Appellant, that he did not pay interest to the bank on such advance..."

In *Willingale v International Commercial Bank Ltd* 52 TC 242, Lord Salmon, dealing with a discounted security, stated at page 270:-

> "Although there may be some superficial similarity between (a) lending £10,000 for five years at a rate of interest of £X per cent on the terms that none of the interest amounting in all to £5,000 shall be payable until the principal becomes repayable and (b) buying a foreign bill of exchange with

> a face value equivalent to £15,000 for a price equivalent to £10,000, the two transactions are, in my view, essentially different from each other in character. The vendor is entitled to be paid £15,000 at the end of 15 years; no more and no less. The purchaser of the bill is entitled to sell the bill when he likes or keep it until maturity".

The distinction can be a fine one and both of the above decisions were split decisions although the taxpayer won in both the cases.

In the recent case of *Pike v R&CC* [2011] SF TD 830 a company issued loan (the term "loan" is an anathema in the DDS world) stock repayable after 13 years, and the redemption proceeds were to be the aggregate of the principal loan and the amount calculated as a percentage of the principal (the additional payment). It was held the additional payment was interest properly so called. The loan stock did not amount to a relevant discounted security.

It is felt that a deeply discounted security is a document under which the issuer declares in – say – 7 years time, he or she will pay the holder of the security £1.5m; he or she then asks how much will the proposed subscriber pay now for the same. The subscriber will look at interest rates and risks and other matters and will purchase the promise.

HOW DOES THE PAYER GET TAX RELIEF FOR THE DISCOUNT?

If the monies are raised by the taxpayer for the purposes of his trade or for example the letting of properties on a commercial basis the discount is tax deductible. It may be subject to transfer pricing constraints.

WHY CAN THE DISCOUNT BE PAID GROSS?

The discount can be paid gross because it is not interest. There are no provisions requiring tax to be deducted at source from a discount.

WHY IS THE DISCOUNT TAX FREE IN THE HANDS OF THE RECIPIENT?

Under general principles, the discount may well have a UK source, because the payer is in the UK but the disregarded income provisions in ITA 2007 s.813(1)(a) and s.825(2)(c) restrict the UK tax payable to the amount deducted at source, and of course no tax is deducted at source.

Thus in the hands of a foreign company under general principles the discount is tax free.

Note that if the subscriber to the discount is a foreign settlement, and there are UK beneficiaries amongst the class of beneficiaries or people who can benefit, then the discount is not tax free in the hands of the trustees: see ITA 2007 s.812(2) and s.815. Thus in an appropriate case where there is an overseas settlement with an underlying company, it will be prudent for the underlying company (subject to any shadow directorship concerns: ITEPA 2003 s.173 and s.67) to subscribe for the deeply discounted security rather than the settlement.

Although the discount may be tax free under general principles in the hands of the overseas company or trust, in an appropriate case, one must nevertheless consider the anti-avoidance provisions to see whether HMRC can pick up charges under, for example, the Income Tax Settlement Code in ITTOIA 2005 s.626 or under ITA 2007 s.720.

A UK COMPANY ISSUING A DDS

There are similar provisions dealing with the case where a UK company issues a DDS (CTA 2009 s.406 et seq).

The general rule with regards to debits is that one brings in only those debits which are recognised for the purposes of determining the company's profits or losses under generally accepted accounting principles (CTA 2009 s.307(2)).

On the other hand, if there is a connection between the subscriber and the issuer of the deeply discounted security, the generally accepted accountancy practice rules do not apply and a debit "is brought into account for the accounting period in which the security is redeemed" (s.407(2)(b)).

As to whether there is a connection between the parties is determined under s.408.

Under that section there is a connection between the companies if condition A or B is met (see CTA 2009 s.408(1)).

Condition A is there is a time in the period when one of the companies has control of the other or a major interest in the other.

Condition B is there is a time in the period when both companies are under the control of the same person.

For these purposes control in relation to a company means the power of a person to secure that the affairs of the company are conducted in accordance with the person's wishes, by means of the holding of shares or the possession of voting powers in relation to company or as a result of any powers conferred by the Articles of Association or other document regulating the company (s.472(2)).

For the purpose of determining whether A has a major interest in B, CTA 2009 s.473 states that A has such a major interest if-

a) A and one other person (C) taken together, have control of B and
b) A and C each have interests, rights and powers representing at least 40% of the holdings, rights and powers as a result of which A and C are taken to have control of B.

If relief is restricted to periods of redemption one can issue a number of securities and redeem at different times (and get tax relief) and refinance if needs be (*MacNiven v Westmoreland Investments* [2001] STC 237).

Transfer pricing would have to be taken into account and there is an Unallowable Purpose anti-avoidance provisions but this should not be applicable in the normal case (CTA 2009 s.442(5)).

Thus it may be advantageous for a UK trading company or for example a property letting company to issue a DDS to an overseas financier to raise monies rather than taking a loan and paying interest and deducting tax at source.

CHANGES IN THE PIPELINE

The Government is proposing to make changes with regards to the rules on interest. The latest paper is "Possible Changes to Income Tax Rules on Interest, Summary of Responses, October 2012".

One of the rules they propose to introduce with regards to income tax is a general anti-avoidance provision to catch "disguised interest". The point is whether HMRC may decide to treat a discount as disguised interest. There is nothing to indicate that that approach is to be adopted by HMRC, and they state that the proposed new disguised interest provisions are to be modelled on the corporation tax provisions in Chapter 2A of Part 6 of CTA 2009 and those rules do not seek to treat a discount properly so called as interest.

CONCLUSION

Deeply discounted securities properly drafted and with appropriate background correspondence showing the true nature of the transaction are attractive financial vehicles.