Taxation of convertibles and other hybrids

Mohammed Amin of PricewaterhouseCoopers explains why the tax system has always found hybrids a problem.

TABLE 1

Attractiveness of debt with an individual shareholder

	Equity financing	Debt financing
Company		
Operating profits	100	100
Interest paid	–	(100)
Profit before tax	100	–
Corporation tax	(30)	–
Profit before tax	70	–
Dividend	(70)	–
Retained profit	–	–
Individual investor		
Dividend/interest income	70.00	100.00
Tax credit (1/9)	7.78	–
Taxable income	77.78	100.00
Tax at 32.5%/40%	25.28	40.00
Tax credit	(7.78)	–
Income tax payable	17.50	40.00
Income retained post tax	52.50	60.00

The UK tax system makes a clear distinction between debt and equity. Payments on debt, (interest) are a deductible expense. Conversely, payments on equity (dividends) are an appropriation of profit, and therefore not tax deductible. Accordingly, debt financing has almost always been more tax efficient than equity financing. The precise attractions of debt change as the tax system varies. (See 'Debt and taxes revisited – how the sums have changed' by the same author in *The Treasurer* November 1997.)

Table 1 illustrates that a higher rate taxpayer's net income increases from £52.50 to £60 if equity is replaced by debt. For a tax-exempt shareholder, the increase is even more dramatic, from £70 to £100.

The drawback with debt is the risk of financial distress. This limits the extent of debt financing. Accordingly, financial engineers have long sought to create instruments that reduce or avoid the financial risks of debt, while obtaining the favourable tax treatment. The tax authorities have been equally vigilant at blocking perceived 'loopholes'. Where do things stand today?

After looking at a couple of old provisions, I will review two provisions from the Finance Act 1996 and then look briefly at tax-deductible capital.

Participating interest

One way of reducing financial risk is to pay interest that varies with the borrower's results. If profits fall, less interest is paid. UK tax law counters by treating such interest as a 'distribution' (essentially, a dividend) and it is therefore not deductible.

At one time, 'tax exhausted' companies (ones with large tax losses) used this for tax planning, since distributions are generally tax free to corporate recipients, such as banks. The bank therefore agreed to accept a lower return in a tax-free form.

To counter this, UK tax law disapplies the above provision where the recipient is a company within the charge to corporation tax. This provision has recently caused difficulties with 'ratchet loans' where the interest rate rises if the borrower's results are below expectations. Arguably, such interest if paid to non-UK lenders was a distribution. But this year's Finance Act eliminates the problem. Interest that increases as the results worsen (the opposite of participating in profits) is no longer treated as a distribution.

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Interest on convertible debt

Interest on convertible securities is also treated as a distribution, except where paid to a company taxable in the UK. This would make convertible securities unattractive. But it does not apply where the convertible securities are listed on a recognised stock exchange, or are issued on terms that are reasonably comparable with the terms of listed convertible securities. Accordingly, when issuing non-listed convertible securities (for example, intra-group), it is essential to ensure they meet this test.

Finance Act 1996 (FA 1996) contains two important provisions for hybrids.

Asset-linked debt

Some securities pay interest equal to the dividend yield on an equity index (such as the UK All-Share index), while the capital amount repayable varies with movements in the equity index. Typical issuers are investment trusts. FA 1996 specifically caters for debt that is linked to the value of chargeable assets.

Briefly, the interest is deductible and taxable as normal. Otherwise, for the investor the debt is treated as a capital gains tax asset. Meanwhile, the issuer gets no tax relief if the amount ultimately repayable is more than the amount borrowed.

The specific requirements to qualify for this tax treatment are lengthy. Some key points are:

- the asset value linkage must be precise and applied to increases and decreases;
- a floor repayable amount of 10% of the original loan is permitted. Anything higher disqualifies the debt; and
- the linkage can be to a specific chargeable asset or to an index of chargeable assets, such as a share index. The retail prices index and similar foreign indices are explicitly disqualified.

Asset-linked debt can be a cost-effective way to give investors economic exposure to the reference asset. The main drawback for a UK issuer is the absence of tax relief for any uplift paid on redemption. This is less important for investment trust issuers. The non-deductibility of the premium on repayment is mirrored by the non-taxability of capital gains on the trust's equity investments. Such debt allows the investment trust to gear up, while avoiding repayment risk arising from a general stock market decline.

Convertible securities

The FA 1996 rules regarding convertible securities are asymmetric. They address the tax treatment of the investor, but not the issuer. Under the general tax rules, the issuer receives relief for interest and any premium on redemption. Meanwhile, under FA 1996, the investor is taxable on interest income. Otherwise, the holding is treated as a capital gains tax asset.

Where the convertible debt is denominated in foreign currency, the issuer recognises taxable exchange differences on translation as with any other foreign currency liability.

For the investor, if the convertible security is denominated in foreign currency, it stays outside the tax rules governing foreign exchange. Accordingly, the investor does not recognise taxable exchange differences on translation. Instead, any foreign exchange differences are subsumed within the overall capital gain or loss, since one compares the sterling acquisition cost with the sterling disposal value.

There are six requirements that convertibles must meet:

- the convertible must be an asset, since the rules do not apply to issuers;
- there are attached rights to acquire any shares in any company, not just the issuer;
- the extent to which shares may be acquired is not determined using a 'cash value'. The convertible must give exposure to the shares. For example, a right to convert into shares worth £x would be disqualified;
- the convertible must not be a 'relevant discounted security'. Briefly, these are securities with a redemption gain exceeding 0.5% pa (or 15% for securities with a life of over 30 years). Otherwise, the borrower could issue convertible securities at a tax-deductible discount, while the investor would only have a capital gain on redemption;
- on the issue date, there is more than a negligible likelihood that the conversion rights will in due course be exercised to a significant extent. This does not require the conversion rights to be 'in the money' on issue. However, if they are so far out of the money that their option value is negligible, I would expect this test to be failed; and
- the security must not be held as a trading asset by the investor.

For a company contemplating a rights issue, convertible bonds perhaps offer an alternative. The advantages are:

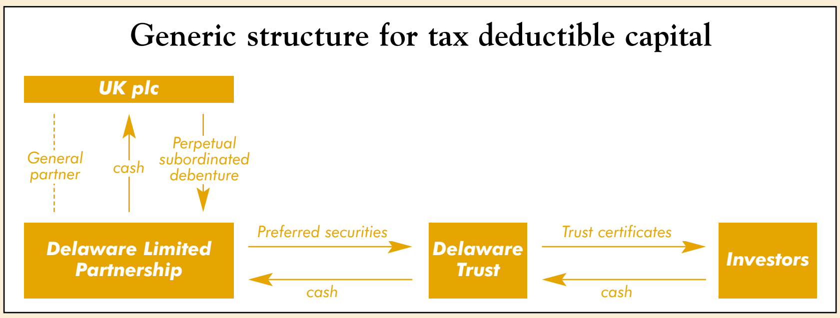
- finance at a lower interest rate than debt, due to the conversion option; and
- tax efficiency (see Table 1).

The main drawback here is the financial risk. If the share price fails to perform, repayment may fall due when the company has difficulty raising finance. One possible solution is to make the security mandatorily convertible, for example, by allowing the borrower to repay in shares.

However, the drawback of a mandatorily convertible bond is that there is a risk that it would not qualify as a 'loan relationship' – on the basis that it would not be a money debt.

As a result some commentators have expressed the view that the interest expense would not be deductible. This is not generally regarded as the better view, but nevertheless it remains a risk.

FIGURE 1



Exchangeable bonds

Over the last year, some German firms have issued bonds exchangeable into the shares of subsidiaries or trade investments. This monetises the shareholding, typically at a price higher than on the issue date, while deferring the disposal of the shareholding until the exchange option is exercised. This is particularly important in Germany, since an immediate disposal would be taxable, whereas a future disposal should fall after the implementation of the new German tax law making such big disposals tax free.

Exchangeable securities cause some difficulties under UK tax law. There is a view that an exchangeable will always be a 'relevant discounted security' because on exchange the investor may receive shares producing a gain exceeding the permissible 0.5% pa mentioned above. This concern does not arise with convertibles, as conversion is not treated as redemption of the security.

However the legislation in FA 1996 expressly permits securities exchangeable into the shares of another company. Therefore I believe that the Parliamentary Draftsman did not intend the potential problem mentioned above.

Tax deductible capital

Several proprietary structures have been used to raise capital while obtaining tax relief on the financing costs. The generic structure in *Figure 1* illustrates the concept. This structure allows UK Plc to pay tax-deductible interest on its perpetual subordinated debenture. UK Plc can suspend interest payments, but dividends on its shares can only be paid if interest is paid on the debenture. Accordingly, at an entity level, the debenture provides permanent capital to UK Plc, subordinated to all creditor claims, and with the ability to suspend interest payments.

The remaining elements of the structure are designed to simplify reporting requirements.

The Preferred Securities and the Trust Certificates have the characteristics of preferred stock, being perpetual, non-cumulative, non-voting with payments mirroring the terms of the perpetual subordinated note.

The Limited Partnership will be a 'look through' entity for tax purposes, while the Delaware Trust isolates the investors from US partnership reporting requirements.

The Inland Revenue has accepted that banks and other companies may make use of such structures.

However, it is vigilant against the exploitation of international asymmetries (for example, if the structure meant that under foreign law the investors were favourably taxed) and also wants to stop companies replacing existing normal capital with tax deductible capital.

Conclusion

The changes to the UK corporate tax system over the last few years have increased the attractions of tax deductible debt.

I expect to see more companies exploring hybrid structures as a way of obtaining tax relief without taking on all of the financial risks associated with simple debt. ■

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