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UK Tax Reformed & STRIPS Announced

- **Inland Revenue has announced draft reform of UK fixed income taxation.**
- **Capital Gains will no longer be exempt from taxation, instead CG and income taxation to be unified.**
- **Simultaneously BoE publishes consultative document on STRIPS.**

Taxation Reform. The Inland Revenue consultative document says:

“ *the attempt in the present legislation to distinguish between income and capital gains would disappear for UK residents and UK branches. All returns to investors would be treated as income;”*
“ *correspondingly, losses made on redemption or disposal of a gilt or bond would be allowable as income losses;”*
“ *corporate holders of gilts and bonds would compute profits and losses year by year on an accruals or a ‘mark-to-market’ basis”*
“ *non-corporate holders would be taxed on a realisation basis, with a threshold below which only interest payments were taxable;”*
“ *companies issuing bonds would be given tax relief for interest payments and discounts on an accruals basis”;*
“ *Gains and losses made by non-resident holders of gilts and bonds would remain outside the UK tax system except to the extent that they come into the computation of profits of a UK branch or agency”.*

The unification of income and capital gains taxes into a total return tax will remove the relative tax advantage of low coupon gilts over high coupon gilts for UK taxable institutional investors (as the capital gain of low coupons will now be taxable, and the capital loss of high coupons will be offsettable against tax).

Further, the old capital gains exemption has been particularly beneficial to index-linked gilts. The new arrangements mean that the **real** capital gain on low coupon ILGs will become taxable. Hence, just as in conventionals, high coupon above par ILGs (the $4\frac{3}{8}$% 2004 and $4\frac{1}{8}$% 2030) should rally, and low coupons (the 2% and $2\frac{1}{2}$% issues) should fall. As the real yield curve is almost exactly flat relative value can be satisfactorily determined just from real yield.

Indeed, the announcement of the proposed tax measures has prompted both conventional and index-linked gilts high coupons to outperform, this being particularly pronounced in the ’99 and ’00 maturity area of the conventionals.

When will these tax changes take place? The Inland Revenue is consulting market participants until 30 June. After this the most likely course of action is that the IR will announce the outline of what is to happen, and the changes will be valid from the date of that announcement. This done, the Revenue will then consult on the details, the actual legislation being passed as part of the next Finance Bill along with the next Budget.

STRIPS announced. In parallel with the Inland Revenue’s announcement the BoE has published a long-expected consultative document on STRIPS (see *Anomalies IV: 8%00, 6%99 and STRIPS?* dated 19 Oct 94 and *Anomalies VI: 07Dec2015 ⇒ Gilt Strips Inevitable* dated 18 Jan for the implications). This document and the subsequent meeting between the BoE and the market participants contained one major surprise. **The Bank says that it has not decided whether or not the 07 Dec stocks should be made STRIPpable: there is a very real possibility that BoE will introduce a completely different series of STRIPpable issues with coupons on some entirely different date, and possibly with slightly different tax treatment.** The consultation process ends on 30 June — expect an announcement late in Q3.

What effect will these tax changes have on various market participants?

- Life Insurance Companies at present have income tax on gilt coupons, but no capital gains tax (or allowable loss) on gains or losses (or ‘pulls-to-par’). In future they will be taxed on gilt coupons and capital gains at same rate. Hence the current preference for discount bonds will change to neutrality.

- Pension funds are currently exempt from tax on both gilt coupons and capital gains, and will remain so. Previously pension funds have utilised the cheapness of higher coupon stocks. They are expected to continue to be willing to own gilts cheap to the curve.

- The Inland Revenue intends that private individuals, who hold only a small part of the market and are an even smaller part of the liquidity, will not be troubled by having to report gains and losses on small disposals. However, even if small investors were to make capital gains there is an annual CGT allowance, and those few taxed investors owning high coupon gilts would be able to offset the capital loss against gains elsewhere. High income tax individuals will continue to prefer index-linked because of the provision for indexation.

So, what to do? This depends on the type of investor (and of course, the asumption that the proposed changes will be implemented).

- Those geared (funded) investors who are synthetically short low coupon gilts against high coupon gilts will find that the cost of remaining short is no longer justified. Unwind the synthetic positions, taking profits.

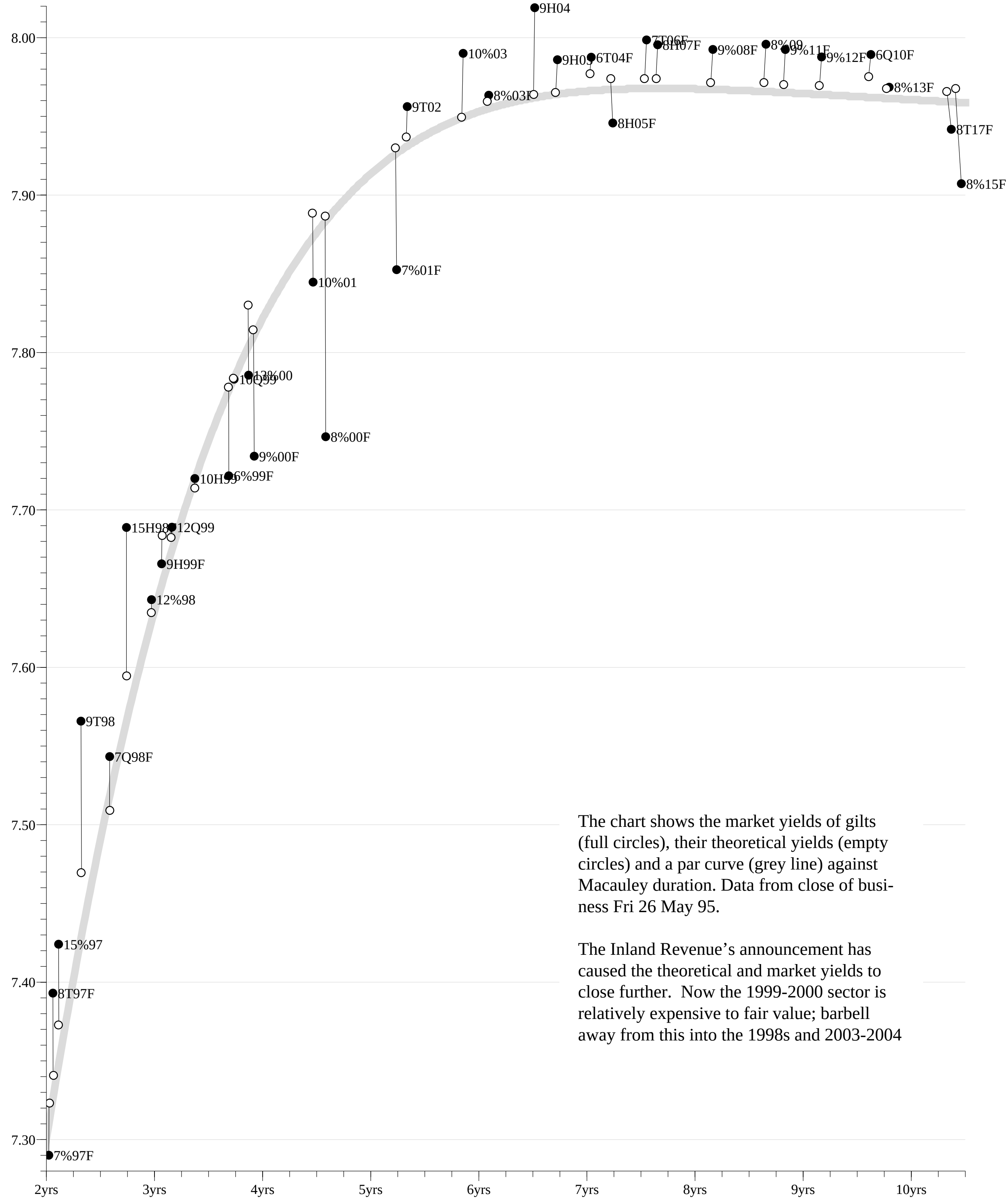
- Cash investors should note that the high coupon ’99 and ’00 stocks have been substantially marked up, more so than the longer and shorter high coupon stocks. Switch out of the ’99-’00 area into the anomalously cheap $9\frac{3}{4}$% Jan 98 and $9\frac{1}{2}$% Oct 04. (See chart on the next page.)

- The 7% Aug 97 is also cheap. £100 nominal of this is convertible (at the holder’s option) into £86 nominal of the 9% Aug 12 at the start of Feb ’96. The option is worth about $\frac{3}{4}$ point, but costs only ≈3/32. This is a great value speculative play on a continued rally.

- Holders of the 8% Dec 15 should be aware that they are vunerable to the BoE’s decision on which stocks to make STRIPpable. However, we believe that the slight premium on the 8%15 is a fair reflection of the probability that it will become the longest STRIPpable issue.

In general, the tax and STRIP proposals mark the final step in the UK authorities modernisation of the gilt market. As the market becomes increasingly efficient gilt issues will no longer reflect the domestic taxable investors’ preferences. So the BoE’s intention that the gilt market should trade on the basis of interest rate and inflation expectations rather than tax anomalies is rapidly approaching fulfilment.

PTO for chart



The chart shows the market yields of gilts (full circles), their theoretical yields (empty circles) and a par curve (grey line) against Macauley duration. Data from close of business Fri 26 May 95.

The Inland Revenue's announcement has caused the theoretical and market yields to close further. Now the 1999-2000 sector is relatively expensive to fair value; barbell away from this into the 1998s and 2003-2004