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THE ACCRUED INCOME SCHEME: THE CASE FOR REFORM

Text of a memorandum submitted in September 2002 by the Tax Faculty to the Inland Revenue setting out the case for reform of the accrued income scheme.

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THE ACCRUED INCOME SCHEME: THE CASE FOR REFORM

INTRODUCTION

This paper has been prepared by the Tax Faculty of the Institute of Chartered Accountants in England & Wales. It is prepared in response to continued concerns from members that the accrued income scheme (AIS) is overly burdensome as compared with the amounts of tax at stake. The paper looks at the problems caused by the scheme and the case for reform and considers possible alternatives.

The AIS was introduced in the FA 1985 and took effect from 28 February 1986. It was introduced to counteract 'bond-washing', namely the practice of converting accrued interest into a tax-free capital gain by selling fixed-interest securities at a time when the price reflected a significant element of accrued interest. In essence, the provisions are designed so that the accrued interest element at the date of sale is taxed as income in the hands of the seller, with a compensating allowance to the purchaser.

When the scheme was introduced more than sixteen years ago, the top rate of income tax was 60%. The top rate of income tax is now only 40%.

1 OBJECTIONS TO THE SCHEME

- 1.1 We have two major objections to the AIS. First, there is the complexity and length of the legislation. In the latest Butterworth's Tax Handbook, TA 1988 ss 710-728 consume 13 pages of dense and complex legislation to bring accrued income on purchases and sales of fixed-interest securities within the income tax regime. These provisions cater for just about every conceivable eventuality. As noted above, the provisions were designed to counteract 'bond-washing', but this practice was, we believe, largely aimed at the securities industry. However, many individuals are also affected. Once an individual comes to hold, on a single day, securities with a combined nominal value of more than £5,000, all his securities he holds are within the AIS, both in the year concerned and in the following one. The result is that many ordinary transactions are caught.
- 1.2 Secondly, complying with the regime carries substantial costs and exposures:
 - tax advisers and brokers (or other investment managers) have to learn the rules. (Few practitioners could say without checking whether the accrued interest on (a) a purchase cum-interest or (b) a sale ex-interest is (a) added to or (b) deducted from income, and vice versa.) Even when the basics are learnt, a practice office will frequently come across unusual transactions not affording easy answers, a point underlined by queries in the weekend press;

- it is easy, even for professionals, to overlook unrelieved allowances on purchase so they fail to be claimed on sale. The unadvised are likely to miss them altogether, even when correctly accounting for a sale;
- it is no surprise that the complexities make it difficult for the Tax Return Guide to give clear instructions. For instance, what is meant by ‘each kind of security’ and why, if reliefs exceed charges, should box 10.14 be changed (gross) but not Box 10.13 (tax), and what about Box 10.12 (net)?
- for overseas securities, the problem is even greater – is the accrued income converted at the purchase date or the interest date?
- brokers have to write and operate programs that separate the accrued interest on purchase and sale (which pre-AIS they only did on gilts with less than five years to run) and notify the client;
- unrepresented taxpayers have to fill in their returns correctly even though they may well not understand what they are doing;
- unwittingly, many will no doubt fill in incorrect returns, failing to recognise such a counter-intuitive system;
- we suspect our comments above regarding learning and compliance costs also apply to the Revenue;
- it is likely that the complications have the effect of steering investors and their advisers away from direct investment in fixed-interest securities rather than indirect investment through bond funds. ‘It will cost you’ is a typical adviser’s reaction to a client thinking of investing directly in bonds. This is a distortion to the market.

2 THE FINANCIAL BACKGROUND

2.1 In this country, unlike a number of continental European countries, there is no strong culture of investing in bonds. Besides, a lot has changed since the AIS was introduced in February 1986:

- traditional portfolio advice to invest one-third in bonds and two-thirds in equities has largely been displaced;
- good-class bond rates have come down from (say) 10-15% to 4-5%;
- this means that dealing costs cut deeply into the margin. An example is given below.
- top tax rates on unearned income have come down from 98% in 1978/79 through 60% in 1985/86 to the present 40%, much reducing the scope for avoidance;
- whereas bond-washing (ie, buying ‘ex’ and selling ‘cum’) was practised on a large scale by companies and Lloyd’s underwriters, they have both been taken out of the AIS (companies by the loan relationship rules and underwriters by being brought within Case I). So the AIS now falls wholly on individuals and trusts;
- although currently there may be significant liquidity in the private sector because of a fear of investing in equities, the number of people with significant amounts of cash to invest in bonds is probably not particularly large. Cash tends to be held for the short term only;

- the present low and (hopefully) stable interest-rate regime is likely to encourage people that invest in bonds to hold them for longer periods;
- the introduction of self-assessment puts the onus on the taxpayer to complete his return correctly. The Revenue will not normally scrutinise his return to see if he has picked up the accrued interest. There is now a greater danger of non-compliance by default, therefore.

2.2 A comparison between tax saving and dealing costs is interesting. For a given sum invested in bonds with normal, six-monthly interest payments in such a way as to maximise the benefit of bond-washing over a year, there will be two purchases and two sales. Typical dealing costs for a transaction of under £100,000 through a traditional broker come to around 0.5% for each transaction, making 2% a year. That is the equivalent to the whole of the potential tax saving at the 40% rate on a bond yielding 5%, thus eliminating any benefit. (It is of course possible to reduce these costs, particularly for bigger transactions, as we point out later.)

2.3 Gilts were taken out of the CGT regime in 1969 and qualifying corporate bonds in March 1984. Freedom from CGT potentially increased the benefit of bond-washing. Nevertheless, the financial scene is so different now compared with 1969 and 1984 that bond-washing is unlikely to be anything like as large a factor as it was then. While it would be wrong to place too much emphasis on a snapshot at a particular time, it does seem likely that if there was no AIS today, there would be much less pressure to introduce it.

3 WHO IS THE AIS AIMED AT?

- 3.1 When the regime was introduced in 1985, interest rates and tax rates were such that there was considerable incentive to indulge in bond-washing, and Lloyd's underwriters, life companies and the like did so on a large scale. It was understandable, therefore, that an anti-avoidance provision should be brought in.
- 3.2 Unlike most anti-avoidance provisions, however, it affects ordinary dealings and ends up as a significant and complex burden on compliance. The question is whether it remains an appropriate deterrent against the bond-washing and whether, without it, bond-washing might be carried out on a significant scale.

4 THE REVENUE AT STAKE

- 4.1 The higher the threshold, the greater is the incentive for wealthier individuals to give standing instructions to their brokers to buy 'ex' and sell 'cum', or even to do it themselves. At worst, one could also expect 'bond-washing' packages to be marketed and, perhaps, provocative advertisements to be seen carried in the weekend press. This would all depend, however, on the transaction costs being kept low enough for the tax saving to be worthwhile.

- 4.2 Set out below is an example of the gross amount of revenue at risk if the threshold is raised to £50,000 or £100,000 or a rather more extreme £500,000. This assumes a 5% yield on fixed-interest securities, with purchases ‘cum’ and sales ‘ex’ done in six-monthly cycles to coincide with the interest date.

<i>Threshold</i>	<i>Income becoming capital</i>	<i>Tax saved at 40%</i>
£	£	£
50,000	2,500	1,000
100,000	5,000	2,000
500,000	25,000	10,000

- 4.3 The potential tax saving of £1,000 or £2,000 for the lower two thresholds is not a large sum per individual. Transaction costs would reduce the benefit, or even eliminate it, as indicated earlier, though the bigger the deal the lower they would become. For instance, a deal of over £100,000 with a traditional broker could reduce the costs to 0.2% or 0.3%. For the more sophisticated and confident, an on-line deal on an execution-only basis would reduce them (including the bid/offer spread) to quite a low level. We have not calculated how low that might be. A spreadsheet calculation that the Revenue have shown us relates to a particularly favourable example with a high nominal rate of interest and a price above par, and does not take into account the capital loss to redemption. It would be useful for us to agree what a ‘do-it-yourself’ transaction might cost.
- 4.4 The effect on revenue would depend upon how many people would go in for such deals. They would have to have cash available (the interest cost of borrowing would kill the benefit), and they would have to have an inclination to invest in this way compared with other forms of investment. We are not in a position to estimate the number of people likely to be tempted into doing such deals and the amount of revenue at stake.

5 ABOLITION OF THE AIS

- 5.1 If the AIS was abolished altogether, the compliance burden would be removed. It is difficult to say whether a large amount of revenue would be at risk. We have already suggested factors that limit the amount of bond-washing, including the changed financial climate.
- 5.2 The Tax Faculty remains of the view, stated on many occasions, that urgent steps should be taken to simplify a tax system that has become far too complicated for the ordinary taxpayer to understand. Outright abolition of the AIS would be a good step to take.

- 5.3 We recognise, however, the possible policy issues and conflicts that this might create. It is one thing to fail to curb such activities but quite another to abolish a specifically-targeted anti-avoidance provision.
- 5.4 This suggests that there are two possible approaches to the problem:
- bring all fixed-interest securities back into the capital gains tax regime; and
 - confine the AIS to a much narrower range of circumstances.

6 BRINGING FIXED-INTEREST SECURITIES INTO THE CGT REGIME

- 6.1 Gilts were subject to CGT when the tax was introduced but exempted in 1969, possibly as an aid to the Government's fund-raising. Qualifying corporate bonds became exempt in 1984, possibly because of the loss of revenue with CGT losses then being indexed and because of the need to provide a level playing-field with gilts.
- 6.2 To bring both within the CGT regime would considerably reduce the benefit of bond-washing. Indeed, it would be likely to eliminate the practice entirely. It could carry other advantages such as dispensing with the artificial distinction between qualifying corporate bonds and non-qualifying ones. Profits would be taxed when realised, which is a reasonable basis. The same records would need to be kept as for equities, which would be much simpler than accounting for the AIS. Brokers would not need to keep separate records of the accrued income. There might at times be a loss of revenue through interest-rate increases reducing prices, with the opposite effect for rate reductions, so there is no reason to suppose an undue bias on tax collection one way or the other.
- 6.3 We have not considered this approach further at this stage as it would require a considerable amount of research into the broader consequences, but we believe it is an option that should be considered seriously.

7 CONFINING THE RANGE OF CIRCUMSTANCES FALLING WITHIN THE AIS

Raising the AIS threshold

- 7.1 We do not think that a doubling of the threshold to £10,000 would deliver sufficient benefits as to be a worthwhile exercise. It would release a number of people from the need to report the accrued income in their returns but for most people, including advisers and brokers, the compliance burden would be much the same as set out earlier.
- 7.2 Raising the threshold to £50,000 (as suggested by the Faculty in its responses on the rewrite) or £100,000 (as suggested by the CIOT last year in its 'Ten quick wins') would be much more satisfactory. It would mean that, although there would still be the need for monitoring at the margin, in nearly all cases the AIS could be ignored by investors and their advisers. It is possible that not all that much revenue be at stake, for reasons we have

indicated. Brokers would still have to record the accrued income in case the client's threshold is exceeded, of course.

- 7.3 We recognise, though, that Ministers may be troubled at the scope for tax avoidance and the Revenue may not wish to go to such lengths.

Disapply the AIS where security held for minimum period

- 7.4 If the AIS was applied only where the security had been held for a fairly short period, a large number of ordinary transactions would fall outside its scope. For instance, given that most securities have 6-month or 12-month interest periods, confining AIS adjustments to securities disposed of within (say) 18 months of acquisition would lift the compliance burden in by far the majority of cases.

- 7.5 Although it would still be possible to buy 'ex' and sell 'cum', three lots of six-monthly interest would actually be received and taxed in the normal case, and the money would be tied up for nearly 18 months. Therefore, the increase in the return on capital that could be achieved through bond-washing would be quite small.

- 7.6 Three problems would remain:

- the broker would still have to provide a note of the accrued interest on purchases and sales, not knowing how long the security will be held. This would be the case, however, whatever change is made to the AIS short of full abolition;
- the investor would not know whether to adjust for the initial interest as this would depend on how long he retained the security. This could, perhaps, be circumvented by providing that any AIS adjustment, if required, should be postponed till disposal. This would not be ideal, however, because someone buying 'cum' would be denied relief till disposal and may even be left with unrelieved accrued interest, not having sufficient interest at the end to set it against. Moreover, in a large number of cases, we suspect that taxpayers would lose track of the credit;
- some securities have interest periods of a year or longer. Indeed, some may be designed to attract bond-washing through having long interest periods. The benefit of bond-washing is reduced to some extent, of course, because of the longer period before the it is realised.

- 7.7 If avoidance was still regarded as a major revenue problem, one of two additional safeguards could be built in, though we would prefer to avoid the additional complications:

- one is that the let-out for a holding period of more than the illustrative 18 months could be made conditional on the interest period for the sale 'cum' comprising less than (say) 50% of the holding period - so, for instance, the AIS would apply if the security was sold cum-interest of 12 months after being held for 20 months;
- the other is that the AIS would cease to apply after 18 months in the case of quoted securities only, though we would prefer the problem to be tackled for all securities.

8 CONCLUSIONS

8.1 The main points we wish to make for substantive reform of the AIS are as follows.

The case against the AIS

8.2 The AIS suffers from the following defects:

- it is difficult to understand the complex rules and apply them, making the scheme costly to administer and creating compliance problems;
- current financial conditions are very different from what they were in 1985/86, so the potential for tax saving through bond-washing and the need for an anti-avoidance provision directed at it has become far less;
- it is unfortunate that, while it is difficult to know to what extent it curtails the avoidance it was designed to combat, it manifests itself in a common and complex compliance burden on those who have no intention of avoiding tax. This is almost unique among anti-avoidance rules;
- to abolish it would be a major step forward in simplifying an excessively complex tax system.

8.3 We appreciate the policy issues associated with outright abolition. We have therefore suggested three possible other approaches, as follows.

Extending the CGT regime

8.4 The first is to bring gilts and bonds within the CGT regime. This would have much wider consequences, of course, and would need examining in much more detail. However, there could be other simplification benefits such as eliminating the distinction between qualifying and non-qualifying corporate bonds.

Raising the threshold

8.5 The second is to raise the minimum investment level above £5,000. The increase would have to be significant to have a substantial impact on the problem – perhaps £50,000 or £100,000 would be a suitable figure. Even then, it would not do away with the need for brokers to supply the figures for accrued interest on each deal.

Introducing a time limit

8.6 The third would be to take securities out of the AIS once they had been held for (say) 18 months. We would hope that this would substantially limit the risk to the revenue but, if necessary, certain safeguards could be built in. Again, brokers would have to supply the necessary figures.

9 FOLLOW-UP

- 9.1 We hope that the above analysis has convinced the Revenue of the pressing need for reform. We have made a number of suggestions and, to the limited extent we are able, we have tried to indicate their effect.
- 9.2 We would be happy to discuss the issues further.

FJH
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