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Loss on sale of variable interest bond can only be offset against capital gains

The Supreme Tax Court has held that the pre-2009 loss on the sale of a bond with a floating interest rate could only be offset against capital gains on the sale of investments in the same or in future years.

A natural person taxpayer sold a “hybrid” bond at a loss in 2008. He sought to treat the loss as “negative interest income” under a provision equating assured gains and losses on the redemption of a bond with interest adjustments. His object under the law as it then stood was to deduct the loss currently from his other income. The tax office, however, saw the loss as only deductible against capital gains on the sale of investments in the current or in future years. Under the then law, this deduction was often something of an illusion, given that portfolio gains were not taxable unless the investment had been held for less than a year.

The Supreme Tax Court sided with the tax office. The “hybrid” bond was, in effect, a variable interest bond, that is, a floater. Initially, it carried a fixed rate of interest – 8.625%% p.a. The issuer had a redemption option exercisable on January 30, 2013. If he chose not to exercise the option, the bond continued at a variable interest rate of 3-month EURIBOR plus a risk premium of 7.3%. There was no further provision for redemption, although the bond was quoted on the capital market. It was therefore something of a speculative instrument. In particular there was no fixed yield for the term of the bond established at the time of its issue. There was thus no application of the provision to spread assured redemption gains or losses over the term of the bond as interest substitutes. The purpose of that provision was to counter attempts to build a yield into a redemption price, thus converting taxable interest income into an exempt redemption gain.

In the meantime, this case has lost much of its relevance. For 2009 the Income Tax Act was amended to treat capital gains as elements of investment income. Income on private investments is now taxed at a flat rate of 25% and there is no mingling with income from other sources. On the other hand, the provision restricting the offset of capital losses to capital gains now only applies to the sale of shares and profit sharing rights.

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Keywords

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