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The current tax treatment of instruments designed to be compliant with CRD IV

Introduction

On 26 June 2012 HMRC published a paper on their website entitled '*The current tax treatment of Instruments designed to be compliant with Capital Requirements Directive 4*' (the HMRC Paper). The HMRC Paper represents the latest stage in a series of published statements by HMRC following a public consultation in 2011 on the UK tax treatment of regulatory capital instruments designed to be compatible with the European Union's proposed Capital Requirements Directive IV (CRD IV) and the draft EU Capital Requirements Regulation (CRR). This article sets the HMRC paper in the context of current regulatory developments and considers the comments made in the HMRC Paper.

Regulatory developments

CRD IV is the package of measures through which EU implementation will take place of the Basel III reforms proposed by the Basel Committee on Banking Supervision (BCBS) which aim to strengthen the regulatory regime applying to EU credit institutions following the crisis in financial markets in 2007 and 2008. The Basel III proposals are a package of new standards which are scheduled to come into force on 1 January 2013[1] and, based on the European Commission's timetable, are expected to be introduced during a transitional period extending until 2021. The Basel III proposals will be implemented into EU law though changes to the existing Capital Requirements Directive which came into force on 1 January 2007[2]. The proposed package of changes, generally referred to as CRD IV, is to be introduced through an EU Regulation, namely the CRR (published on 20 July 2011 and establishing the prudential requirements institutions need to adhere to), as well as an EU Directive (governing the access to deposit taking activities to be introduced through national law).[3]

The Basel III reforms propose, among other things, that banks and credit institutions should enhance the quantity and quality of capital, the latter requirement to be achieved through stricter definitions of core and non-core Tier 1 capital. Banks will be required to hold an increased percentage of their capital as Tier 1 capital (which is the highest quality of capital), comprising common equity Tier 1 and Additional Tier 1 capital. The increase in capital retention and quality is intended to assist with preventing weaknesses which were identified in bank capital retention during the recent financial crisis, thereby contributing to market confidence and continuing access to liquidity.

Capital requirements

Part 1 of the CRR (mirroring the Basel III proposals) sets out the qualifying elements that comprise Tier 1 capital and Tier 2 capital.[4]

Tier 1 capital constitutes 'going concern' capital, allowing an institution to continue its business and help prevent insolvency. It comprises common equity Tier 1 (namely ordinary shares subject to a series of detailed conditions to ensure that common equity Tier 1 constitutes the most subordinated interests in the institution) and Additional Tier 1 capital. Under the CRR[5], Additional Tier 1 capital must also satisfy the same conditions as common equity Tier 1, including:

- the instrument must be perpetual, and includes no incentive for the issuer to redeem (such as an interest 'step-up' or other incentive);
- the instrument must be subordinated to general creditors, depositors and subordinated debt of the bank;
- the instrument may be callable by the issuer only, and then only after a minimum of five years after issue with prior supervisory consent and must be replaced with capital of the same or better quality;
- distributions (namely interest) on the instrument must be fully discretionary (subject to cancellation at the discretion of the issuer) and non-cumulative; and
- the instrument must have principal loss absorbency either through conversion into common shares at an objective, pre-specified trigger (such as where the common equity Tier 1 capital ratio of the institution is passed) or a write-down mechanism which allocates losses to the principal amount of the instrument at a pre-specified trigger. [6] The key requirement is that the fixed trigger point should be passed at a going concern, rather than at a point of the institution's resolution, and should result in the reduction of the claim on such an instrument in liquidation or upon exercise of a call option.

Tier 2 capital under the CRR is 'gone concern' capital which helps ensure that depositors and senior creditors can be repaid if the institution fails[7]. It comprises those instruments that do not fulfil all of the Tier 1 capital requirements but contains conditions which include subordination to all general creditors and depositors and conditions that the instruments:

- are unsecured;
- have a minimum original maturity of at least five years; and
- may be callable by the issuer only, and then only five years or more after issue. Issuers may not create any expectation that such a call may be exercised.

Furthermore, the terms of both Additional Tier 1 and Tier 2 instruments should include a requirement of being permanently written down or converted into common equity Tier 1 capital at the point of non-viability (PONV) of the issuer[8]. This is a different trigger to the 'going concern' trigger, being a write-down triggered at the discretion of a national regulator as opposed to a fixed pre-defined trigger passed by the institution as a going concern. The 'contractual bail in' feature of the PONV trigger will be common to Additional Tier 1 and Tier 2 capital instruments, with write down or conversion taking place either on the basis of the contractual terms of the instrument or through the use of a statutory power at the appropriate time.

HMRC consultation 2011

UK issuances of 'innovative' Tier 1 and Tier 2 instruments in the form of debt which were made before the adoption of the Basel III reform package by the BCBS generally enjoyed tax deductions for interest paid to investors. Although these capital instruments contained certain regulatory features which created problems in obtaining tax deductibility for interest costs, the market had adopted a number of solutions to those difficulties.[9] Furthermore, the availability of tax deductions for interest coupons on innovative Tier 1 capital was frequently confirmed by HMRC through written clearances.

However, the requirements of the CRR create new tensions for the tax treatment of Additional Tier 1 and Tier 2 capital instruments. HMRC appear to have recognised the potential for these tensions from an early stage in the regulatory development of the Basel III and CRD IV proposals[10], announcing a public consultation on the UK tax treatment of instruments designed to be compliant with CRD IV in the March 2011 Budget. The public consultation organised by HMRC during 2011 involved a series of meetings between representatives of HMRC, HM Treasury, financial institutions and tax professionals. At the end of the consultation, HMRC published their initial views in two discussion papers in August 2011 on the UK tax treatment of instruments designed to qualify as regulatory capital instruments for Additional Tier 1 and Tier 2 purposes. HMRC committed to give further updates 'in the near future'; the HMRC Paper provides that update.

HMRC Paper, published 26 June 2012

The HMRC Paper sets out HMRC's view under current law on a number of UK tax issues relevant to regulatory capital instruments, in particular on:

(a) the nature of perpetual capital instruments when considered in a UK tax context; and
(b) the application of the 'special securities' legislation in s1000(1)F and s1015(4) of the Corporation Tax Act 2010 (CTA 2010) to regulatory capital instruments in the context of whether this legislation could result in the recharacterisation of interest payments and other amounts into non-deductible distributions for UK tax purposes.

It should be noted that the application of the HMRC Paper is limited. HMRC have stated that the views expressed in the HMRC Paper will not change the existing tax treatment for any perpetual regulatory capital instruments issued before 26 June 2012. Furthermore, the HMRC Paper will not affect regulatory capital instruments issued following the introduction of the new CRD IV regime through the CRR. The clear intention of HMRC appears to be that regulations will be introduced under the power in s221 of the Finance Act 2012 (FA 2012) to govern the UK tax treatment of regulatory capital instruments after the date of introduction of the CRR. The instruments which would be affected by the HMRC Paper will therefore be instruments designed to comply with the reforms set out in CRD IV and the CRR, that is, instruments issued on or after 26 June 2012 but issued prior to the coming into effect of any statutory instrument made under the powers contained in s221 FA 2012.

'Perpetual' debt

The HMRC Paper distinguishes between 'truly perpetual debt' and 'contingent perpetual debt'.

- Instruments which are 'truly perpetual' are described by HMRC as being instruments where the holder has 'no right to any repayment in any circumstances'.[11] HMRC's stated view is that 'Additional Tier 1 instruments must be truly perpetual in that the holder of an Additional Tier 1 instrument has no right to repayment of the principal'.[12] The scope of HMRC's description of 'truly perpetual' instruments giving 'no right to any repayment in any circumstances' appears to preclude the inclusion of perpetual instruments containing an issuer call right, as the issuer's exercise of such a call right would result in a debt due to the holder of that instrument.[13]
- 'Contingent perpetual debt' is described by HMRC as a perpetual instrument where the right to repayment only arises as a result of a contractual clause providing for the return of principal on the occurrence of a contingent event, provided that the sum to be repaid on the contingency occurring is ascertainable at the time of issue of the instrument.[14] In para 2.1 of the HMRC Paper, HMRC identify 'contingent perpetual' debt as being debt which includes a contractual clause 'providing for the return of principal in the event of a liquidation'.

> Contingencies other than a contractual liquidation clause in respect of a determined sum would, HMRC state, need to be considered on a case-by-case basis. However, the scope of instruments which should fall within the description of 'contingent perpetual debt' should be wider than just those instruments only containing a contractual liquidation clause (and no other contractual provision providing the holder with a right to repayment). For example, an issuer may have the right to call a capital instrument in the event of a change in law (including a change in tax treatment of interest payments under the instrument). The occurrence of that contingent event should permit the holder of that instrument to receive a sum which is ascertainable under the terms of the instrument. Such a right of repayment should not prevent such an instrument being 'contingent perpetual debt' using HMRC's own terminology.

Having defined 'truly perpetual' capital instruments, HMRC state that a 'truly perpetual' Additional Tier 1 instrument cannot be a debt and therefore cannot be a 'money debt' for the purposes of the loan relationships regime in Parts 5 and 6 of the Corporation Tax Act 2009 (CTA 2009). The key factor in HMRC's reasoning appears to be the absence of an 'obligation' on the issuer to repay principal. This factor is also evident in HMRC's argument that a 'truly perpetual' capital instrument cannot constitute an alternative finance arrangement under s501 CTA 2009 or an alternative finance investment bond under s507 CTA 2009.

'Truly perpetual' instruments would appear, on HMRC's definition, to exclude instruments where holders have a claim in respect of the principal of the instrument on a liquidation. Such a feature is, nevertheless, invariably seen in historic 'innovative' Tier 1 issuances. If the inclusion of a contractual liquidation clause providing for a return of principal in a determined sum results in an instrument being a 'contingent perpetual' instrument (as indicated in the HMRC Paper), it is possible that the class of instruments falling to be 'truly perpetual' would be very small, if existing at all. Deprived of a call right, holders of a perpetual capital instrument would expect their principal to be returned on a liquidation of the issuer after repayment of senior, or non-Tier 1, debt and subject to the Additional Tier 1's loss absorbency. Indeed, it is hard to envisage any regulatory capital issuance being marketed successfully without such a provision.

Consequently, it is tempting to view Additional Tier 1 instruments as falling closer to the 'contingent perpetual instrument' class, albeit as instruments that otherwise offer the holder no right to repayment of the principal prior to the relevant contingency arising.[15]

Results dependency

Consideration of whether an Additional Tier 1 instrument is a loan relationship will be of materially reduced importance if the interest payments under the instrument are capable of recharacterisation as non-tax deductible distributions. The possibility of such a recharacterisation is considered in the HMRC Paper given the various conversion and write-down features which are likely to be present in CRD IV compliant instruments.

In two papers published in 2011 as part of the public consultation process mentioned above, HMRC concluded that interest payments in respect of CRD IV Additional Tier 1 instruments were, based on the criteria for such instruments set down in the July 2011 CRD IV publication, 'likely to be results dependent' in the context of the rules for 'special securities' and in particular that the 'results dependent' provisions of s1015(4) CTA 2010 applied.[16] The provisions of s1015(4) CTA 2010 provide that interest payments are recharacterised as a non-deductible distribution if under the securities the consideration given by the company for the use of the principal secured depends to any extent on the results of the company's business or any part of the company's business. In HMRC's view, this test would need to be considered in the context of both the terms of the regulatory capital instruments themselves and also, in the phrase of HMRC, the 'external contingencies' affecting those terms.

The HMRC Paper amplifies the initial views of HMRC given in August 2011. HMRC provide some analysis of what they consider to be the 'heart of s1015(4)', and thereby the justification for their view that the interest payments on an Additional Tier 1 instrument would not be deductible for tax purposes. The issues surrounding s1015(4) CTA 2010 have been considered extensively by HMRC and tax practitioners for many years. To an extent the HMRC views on the provision are therefore reasonably well known, not least through the various non-statutory clearances obtained from HMRC in the context of issuances of innovative Tier 1 capital instruments in the current regulatory regime, ie the regime which preceded CRD IV, and through guidance published by HMRC.[17]

In the HMRC Paper, emphasis is given to the part of the provision whereby consideration given for the use of the principal secured 'depends (to any extent) on the results of a company's business'.

Interpreting this phrase, HMRC conclude that a key issue is the degree to which external contingencies (such as those arising from the CRD IV regulatory reforms) affect the terms of the instruments in question. HMRC's view (perhaps unsurprisingly) is that the results dependency of an instrument should not be judged merely by reference to the terms of the instrument and how these terms allow for a variation in consideration. This view rejects the argument that the legislative words 'under the securities' limit the examination for the purposes of s1015(4) to the terms of the relevant instruments viewed in isolation. Also unsurprising (and welcome) is the view by HMRC that results dependency should not be viewed by reference to every possible circumstance, however remote.

The 'better interpretation' supported by HMRC is that the external contingencies relevant for s1015(4) CTA 2010 should be those which exist or are 'at least considered likely to exist at the time of the instrument'. A 'direct or indirect causal connection' is required between the results of the issuer's business and the potential variation in consideration given for the principal. This requires an examination of what circumstances were in the issuer's contemplation, or perhaps more practically speaking the contemplation of the board of directors of the issuer, at the time of issuance of the capital instrument under examination. It also requires a wider examination than the mere contractual terms of the instruments themselves.

HMRC acknowledge that their preferred approach may be challenging in some circumstances, precluding the identification of a clear threshold for results dependency. HMRC instead prefer to consider the circumstances on a case-by-case basis, impliedly acknowledging that some form of informal clearance, or at least discussion, will be necessary regarding the tax attributes of regulatory capital instruments.

HMRC do, however, go on to discuss their approach in the context of external contingencies which should feature when the CRD IV regime is finalised:

(a) An instrument is unlikely to be regarded as carrying results-dependent interest where it has no express contractual reference to a statutory 'bail in' regime or implied term to be written down or converted to common equity Tier 1, notwithstanding that the instrument remains subject to a statutory 'bail in' regime which may require such a write down or conversion. An instrument of this nature would lack the contractual term linking the consideration provided to the lender and the statutory requirements of the 'bail in' regime. On such a statutory 'bail in' regime coming into effect in a manner which is linked to the results of the issuer's business, HMRC's view is that an instrument covered by such a regime is 'likely' to be results dependent, even where the terms of the instrument are silent as regards how the instrument performs under that regime.

It is considered that the stated views of HMRC in this context are, however, difficult to reconcile. HMRC's treatment of interest on an instrument as not being results dependent where that instrument includes no express or implied term for contingent reduction is unsurprising; this treatment tends to imply a general approach of judging results depending at the point of issuance.[18] It is difficult to reconcile that position with HMRC's views on the consequences of a statutory 'bail in' regime coming into effect, and leading to interest on a capital instrument becoming results dependent at the time of the regime's commencement.

Such an approach arguably negates the importance in s1015(4) CTA 2010 of identifying the 'consideration given by the company for the use of the principal secured'. Where the 'consideration given' is the promise of the issuer to pay interest and other amounts to the lender, such a promise is made at the date of *issuance* of the instrument. That promise is aligned consistently with the securing of principal, an action which takes place at the date of issuance of the relevant instrument.

An alternative, and preferred, approach to the consequences of a statutory 'bail in' regime coming into force (although not HMRC's stated view) would be that contractual terms in the instrument which expressly, or impliedly, permit a write down on certain external contingencies should not result in interest being results dependent as such contingencies would have been known when the promise of the issuer to pay interest was made at the date of issuance of the relevant instrument. Such an alternative approach would ensure that interest remains tax deductible even after any future date on which the instrument is subject to the statutory 'bail in' regime.

Admittedly, such an alternative approach does not sit comfortably with HMRC's statement that 'external contingencies' relevant for consideration in the context of s1015(4) CTA 2010 include 'circumstances that exist or are at least considered likely to exist'. However, that statement is arguably too broad. On that criteria, taken literally, HMRC's own position that instruments containing no express or implied term referencing a statutory 'bail in' would not carry results-dependent interest would also appear inconsistent.

(b) If the contingency of an instrument being subject to a write down under a 'bail in' regime in the future is part of the contractual terms of the instrument, HMRC consider the interest coupon on such an instrument will be results dependent even if the statutory 'bail in' regime is not yet in force. This conclusion is based on HMRC's assumption that the 'bail in' regime would be linked to the results of the issuer's business, which admittedly seems probable. In such a situation the causal link between the terms of the 'bail in' regime, the results of the business and the consideration for the use of the principal would, in HMRC's view, be established.

(c) HMRC also considers that the discretionary and non-cumulative nature of the coupons on Additional Tier 1 instruments is a 'strong indicator' of the consideration on such instruments being results dependent under current law.

While the views of HMRC regarding s1015(4) CTA 2010 in the context of the CRD IV reforms are perhaps unsurprising, it remains unclear is the extent to which these views are also applicable in a non-regulatory context.

Other developments

HMRC have stated that the HMRC Paper does not deal with the tax treatment of regulatory capital instruments which may be issued under the final form of CRD IV and the CRR. The intention of HMRC would appear to be to publish regulations under the regulation-making power contained in s221 FA 2012 for consultation once the final terms of capital instruments under the CRR is clear. However, given the views expressed in the HMRC

Paper and the uncertainty concerning other tax and accounting issues surrounding Additional Tier 1 and Tier 2 instruments under CRD IV, it is at least possible that the government may favour circumventing such issues with a regime which encompasses all non-core equity capital instruments and prescribing their tax treatment. Something similar has been achieved successfully in the context of the Taxation of Securitisation Companies Regulations 2006, SI 2006/3296, which forms a useful precedent in tax policy terms of what might be achieved for regulatory capital instruments.

Such a regime, prescribing tax deductibility for interest costs on Additional Tier 1 and Tier 2 instruments, would be consistent with the treatment afforded historically to innovative Tier 1 and Tier 2 instruments prior to CRD IV. The possibility of tax deductible Additional Tier 1 and Tier 2 instruments would prevent the UK from being out of step and uncompetitive when viewed against other EU member states offering tax deductibility for comparable instruments.

However, against this there is little comfort in the HMRC Paper that HMRC are persuaded of the technical argument as to why tax deductibility of Additional Tier 1 and Tier 2 instruments should be preserved for going concern and gone concern instruments.

Finally, the discussions concerning the tax treatment of regulatory capital instruments under CRD IV need to be placed in the general context of tax policy concerns regarding over-leverage in the European financial system and a perceived bias away from equity in favour of debt funding on technical grounds. It would not be completely surprising if, in balancing the relative needs of institutions, investors and the UK Exchequer, HMRC came to view that the tax deductibility of Additional Tier 1 and Tier 2 instruments following the finalisation of the CRR may be just as limited as the scope for tax deductibility for the regulatory capital instruments addressed in the HMRC Paper.

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Endnotes

1. *FSA statement regarding CRD IV implementation*, 1 August 2012, which stated that 'it does not appear feasible that the [CRD IV] legislation can enter force in line with the implementation date of 1 January 2013'.
2. 2006/48/EC and 2006/49/EC.
3. CRD IV has been under discussion between the European Parliament, European Commission and Council of Ministers, with discussions originally being aimed at finalising an agreed position by the end of June 2012, enabling adoption by the European Parliament plenary in early July 2012. The timetable has slipped, and it is now clear that the legislation will not be adopted earlier than the autumn of 2012 (see FSA Statement 1 August 2012).
4. 'Innovative' Tier 1 capital, which has been allowed since 1998 up to a limit of 15% of total Tier 1 capital, will be phased out starting on 1 January 2013. Tier 3 capital has been abolished by the BCBS with no transitional provisions, although as Tier 3 consists of short-term subordinated debt (generally with a maturity of two years), such capital could be refinanced (subject to market conditions) before the Basel III and CRD IV reforms are implemented.
5. Article 49 of the CRR (Part I, Title II, Chapter 3, 'Additional Tier 1 Capital').
6. The nature of the write-down of the principal amount under art 49(1)(n) of the CRR is explored further in the EBA Consultation Paper on Draft Regulatory Standards on Own Funds (EBA/CP/2012/02, published 4 April 2012).
7. Article 59 of the CRR (Part I, Title II, Chapter 4, 'Tier 2 Capital').
8. The BCBS announced the requirement for a 'bail-in' feature at the PONV on 13 January 2011, with this requirement applying to all capital instruments issued on or after 1 January 2013 (www.bis.org/press/p110113.pdf). Instruments issued prior to 1 January 2013 that did not contain such a 'bail-in' feature but which met all of the other criteria for Additional Tier 1 or Tier 2 capital set out in Basel III will be eligible for grandfathering for a limited period of time. There are a number of limited exceptions to the introduction of the 'bail in' requirement in capital instruments where national resolution regimes may deliver a write-down through statutory means. It is anticipated that very few jurisdictions will have a resolution regime achieving that result.
9. As regards 'direct issuances' of 'innovative' Tier 1 capital, the issuer would be able to defer scheduled interest payments if paying interest would cause the issuer's insolvency. The issuer was entitled to settle interest obligations through issuing shares under what was known as the 'alternative coupon satisfaction mechanism' (which will not operate in the same manner, if at all, under the Basel III criteria: June 2011 version of Basel III criteria, Part I, footnote 17 to para 55). As deferred interest remained payable on a winding-up of the issuer, HMRC accepted that mere delay in payment of interest would not result in the interest being recharacterised as a non-deductible distribution under the rules for results-dependent 'special securities' in s1015(4) of the Corporation Tax Act 2010. 'Indirect' issuances of 'innovative' Tier 1 capital though preferred interests in English, Jersey or Delaware partnerships also successfully achieved tax deductible interest coupons, but this structuring method is not effective following the Basel III reforms.
10. In a paper published on the HMRC website in May 2011, HMRC suggested that 'instruments reflecting the loss absorbency requirement [in CRD IV] may not be tax deductible under current rules'.
11. HMRC Paper, para 2.1, first bullet.
12. HMRC Paper, para 2.2.
13. This would be a surprising result, as the CRD IV proposals and CRR clearly contemplate the possibility that Additional Tier 1 instruments allow an issuer to call the instrument subject to obtaining regulatory consent (art 49(h) and (i) and art 72 of the CRR proposals; 2011/0202 (COD), Part I, Title I, Chapter 3, published 20 July 2011). The conclusion to be drawn is that the class of instruments falling within HMRC's description of being 'truly perpetual' would be very narrow indeed.

14. HMRC paper, para 2.1, second bullet and para 3.4.
15. It is noted, however, that viewing the class of 'truly' perpetual instruments as being very narrow cuts across HMRC's statement that '[u]nder the CRD IV criteria Additional Tier 1 instruments must be truly perpetual' (para 2.2 of the HMRC Paper), although it is considered that this statement by HMRC is an over-simplification.
16. Paragraph 29 of the HMRC letter to the Basel III Working Group on 'gone concern' capital, 4 August 2011 and para 23 of the HMRC letter to the Basel III Working Group on 'going concern' capital, 5 August 2011.
17. HMRC Company Taxation Manual paras CTM 15520 and CTM 15525.
18. An argument might be advanced that HMRC's position is itself inconsistent with their views of which 'external contingencies' are relevant for consideration in the context of s1015(4) CTA 2010. The HMRC Paper requires 'circumstances that exist or are at least considered likely to exist' to be taken into account; such circumstances arguably would encompass a statutory 'bail in' regime currently anticipated under CRD IV, notwithstanding that the terms of that regime are not yet finalised.