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The UK bank levy: an update

Introduction

Draft legislation on the UK's new levy on balance sheet liabilities (the 'Levy') was published on 21 October 2010, 24 November 2010 and 9 December 2010, shedding more light on the final form which the Levy is likely to take. There are a number of changes in the draft legislation to the provisions set out in the consultation document published on 13 July 2010 (the 'Consultation Document') including, for example, allowing a deduction against equity and liabilities for 'relevant high quality liquid assets' and an apparent extension to the scope of entities which may be subject to the Levy. Further details are added by the consultation response document (the 'Response Document'), published on 21 October 2010, an HMRC Technical Note published on 9 December 2010 and a draft HMRC guidance manual on the Levy (also published on 9 December 2010).

The policy behind the legislation for the Levy, however, remains the same. As stated, in the Foreword to the Response Document, the Levy 'incentivises banks to reduce their dependence on short term wholesale funding and move towards more resilient sources of funding'. The design of the Levy remains based, broadly, on the proposal in the International Monetary Fund Report to the G20, 'A Fair and Substantial Contribution by the Financial Sector' (the 'IMF Report') which is focused on a balance sheet-based charge on key banking institutions.

Draft legislation: 'groups'

The Levy will apply to total long and short-term equity and liabilities of UK resident banks, building societies, 'relevant foreign banks', 'UK banking groups', 'foreign banking groups', 'relevant non-banking groups' and 'building society groups' after apportioning (where applicable) the balance sheet, deducting a £20bn allowance and other exempted items, and giving relief for netting and assets held as liquidity buffers. The Levy will have effect in relation to periods of account ending on or after 1 January 2011.

The definitions of 'UK banking group' and 'foreign banking group' are built upon the definition of 'banking group' used for the purposes of the bank payroll tax ('BPT') legislation introduced by Sched 1 of Finance Act ('FA') 2010. The definition of 'relevant foreign bank' is also largely the same as in the BPT legislation. The principal difference between the new definitions used for the Levy and those used for BPT arises from the balance sheet-based approach which is adopted for the purposes of the Levy, and thus the use of the accounting meaning of 'group' for Levy purposes instead of the use of the chargeable gains group provisions for identifying banking groups for BPT purposes. The draft legislation in the Levy also generally substitutes 'entity' for 'company' throughout.

By contrast, the definition of 'relevant non-banking group' represents a new addition to the family of banking tax definitions. A relevant non-banking group is, in general terms, a group which includes one UK resident bank or one relevant foreign bank, and which is neither a banking group nor a building society group. The differences between a banking group and a relevant non-banking group are subtle but may prove significant for some groups. The first and main difference is that the exempt activities test does not apply to a relevant non-banking group. The exempt activities test may therefore prove to be an empty promise for some groups which satisfy the test but include a UK resident bank under which a large group or sub-group is held. Since the exempt activities test does not apply to 'relevant UK banking sub-groups', the effect of this difference may be to deny the benefit of the exempt activities test to certain groups. Another, less obvious, difference arises from the fact that a group with an investment entity parent which includes a UK resident bank (or a relevant foreign bank) that is a subsidiary of another entity (which is not an investment entity) will not be a 'banking group', whereas that group would be a 'relevant non-banking group' if the UK resident bank (or relevant foreign bank) was a subsidiary of another entity (which is not an investment entity). The definition of 'relevant non-banking group' therefore captures groups which include joint ventures involving UK resident banks or relevant foreign banks and where the other significant joint venture member consolidates the joint venture and is not an investment entity. Similarly, groups which have parent entities which are not investment entities or banks, and which include a UK resident bank or relevant foreign bank, will not fall within the definition of 'banking group' but will constitute 'relevant non-banking groups'. Groups which are consolidated under a non-financial trading entity and which comprise a UK resident bank or relevant foreign bank are therefore also caught by the definition of 'relevant non-banking group'.

Viewed in general terms, the constituency of taxable entities and groups has the appearance of being a class of entities which was selected by policy makers prior to the drafting of the relevant definitions with the intention of ensuring that particular banking groups fall within the scope of the Levy. The availability of an allowance of £20bn of chargeable liabilities before the Levy is charged has the effect of reducing the practical application of the Levy to a relatively small number of banking institutions and groups. Indeed, HM Treasury appears to consider that the number of institutions and groups affected will be between 30 and 40. This threshold is supplemented by an expanded exempt activities test. For this exclusion to operate, either (i) at least 90% of the relevant group's trading income for the chargeable period must derive from exempt activities; or (ii) at least 50% of the relevant group's trading income for the chargeable period must derive from 'non-financial activities', the latter being a new exclusion (when compared to the BPT legislation). The narrowness of the new exclusion regarding non-financial activities possibly militates against its application in wide circumstances, however.

Regardless of the manner in which the various definitions in the Levy have been framed, it is hard to avoid the suspicion that the Government has merely identified those institutions which it regards as posing a systemic risk to the UK's financial system, and tailored the legislation accordingly.

Draft legislation: accounting themes

The use of a balance sheet-based approach to group identification for the purposes of the Levy may also lead to complex issues regarding the parameters of the Levy. The draft legislation imports the meanings of the terms 'group', 'parent' and 'subsidiary' from international accounting standards ('IAS') relating to the preparation of consolidated financial statements. In certain limited circumstances where a parent entity is resident outside the UK, the relevant group may be identified in accordance with US GAAP.

Importation of accounting consolidations standards and interpretations, such as under IAS 27 and SIC-12, brings with it the possibility that a variety of non-UK financing vehicles and platforms which are consolidated for accounting purposes but not taxation purposes may fall within the scope of the Levy. Where such financing vehicles are essentially pass-through entities for cash-flow purposes and merely serve to enable products to be marketed to a wider capital markets investor base, the policy reasoning behind including such vehicles within the Levy appears to be out of step with the primary purpose of propelling the UK banking sector toward 'more resilient sources of funding'.

Difficulties may also arise when it comes to identifying the relevant amounts from the balance sheets of the relevant entities or groups for the purposes of the Levy computation. While 'assets', 'equity' and 'liabilities' take their IAS meaning, the amounts determined in respect of liabilities, for example, may be measured under a different GAAP in certain circumstances. The legislation, being silent on this point, appears to permit the amount recognised (whatever GAAP applies) to be used in the Levy computation. However, HMRC's draft guidance appears to require amounts to be adjusted where there are 'significant differences' between the local GAAP amounts and the amounts which would be determined under IAS and UK GAAP[1].

Draft legislation: tax base

Just as the entities and groups falling within the scope of the Levy have been carefully identified as those which pose a systemic risk, so have the equity and liabilities which are to be the subject of the Levy. In all, there are 10 categories of 'excluded' equity and liabilities which are excluded from the calculation altogether. The principal exclusions are for Tier 1 capital, insured retail deposits and insurance liabilities (long term contracts of insurance, unappropriated surpluses and participants' interests in collective investment schemes).

Once the relevant equity and liabilities have been excluded, two further adjustments are made. Firstly, where there are enforceable netting agreements in place with third parties, the liabilities owed to that third party may be reduced by the amount owed to the taxable entity (or in group situations, with certain modifications, the group). This is intended to conform with the manner of netting used for Basel II purposes. Secondly, where the parent entity of a group is a joint venture and has liabilities which are already subject to the Levy, the liabilities which are already within the scope of the Levy are excluded from the scope of the charge. A double charge might otherwise occur where a joint venture member (a UK resident bank, for example) reports some of the liabilities of the joint venture and does not consolidate for IAS purposes.

An asset-based deduction is also allowed for an amount equal to the value of 'high quality liquid assets'[2], a concession made by the Government in response to assertions during the legislative consultation process that financial institutions should not be penalised in respect of liabilities incurred as a result of a need to maintain their liquidity buffers. The deduction is also available for financial assets secured on high quality liquid assets. The deduction is not available for high quality liquid assets (or financial assets secured upon high quality liquid assets) which have already been used to reduce liabilities under netting arrangements. Long-term liabilities (which are, broadly, those not repayable within 12 months) must be reduced before short-term liabilities. The deduction for high quality liquid assets sits alongside an exclusion for liabilities under repos of high quality liquid assets (a provision reinstated in the draft legislation published on 9 December 2010, but which had been dropped following the publication of the Consultation Document).

The extent of the tax base of these taxable entities or groups will depend upon which category the entity or group falls within. For a standalone UK resident bank or building society, the exercise is a relatively simple one based around identifying the amounts from the balance sheet. One of the more difficult questions for the Government at the outset of the consultation was how to apportion the equity and liabilities of relevant foreign banks. This has been resolved in the draft legislation by using a mirror image of the capital attribution method under the separate enterprise principle at Corporation Tax Act 2009, ss21 to 28. The chargeable equity and liabilities of the bank are calculated normally but are then apportioned to the UK branches in the same proportion as the assets of the bank would be for corporation tax purposes. While this was one of the methods contemplated in the Consultation Document, it represents another example of an asset-based concept being used by a levy focused upon liabilities. This may be the best approximation that can be achieved, both in terms of neatness and territoriality, but there is the possibility that the proportion in which assets are allocated to the UK under the separate enterprise principle will not necessarily match the proportion of UK creditors which, for example, may be left exposed in the event of the failure of a bank which is paying the Levy.

For a UK banking group or a building society group the tax base is calculated on the basis of the group consolidated financial statements. The extent of the tax base in the case of a foreign banking group or a relevant non-banking group is, however, highly prescriptive. In general terms the starting point (namely the identification of the equity and liabilities from which the relevant exclusions, adjustments and deductions are made to arrive at 'chargeable equity and liabilities') for a foreign banking group is to identify the largest sub-group or groups which can be consolidated under a UK resident entity (a 'UK sub-group') as well as any UK resident entity or relevant foreign bank not within a sub-group but still within the group. The equivalent starting point for a relevant non-banking group is to identify the largest sub-group or groups which can be consolidated under a UK resident bank (a 'UK banking sub-group') as well as any UK resident bank or relevant foreign bank not within a sub-group but within the group. The legislative drafting that yields this result is complex and, as a technical matter, the entities are split into four categories (types A, B, C and D) in order to accommodate the possible use of differing GAAPs in relation to each category. Liabilities in respect of UK joint ventures reported by a foreign banking group or relevant non-banking group also fall within the scope of the Levy. Subject to certain exceptions, where the chargeable equity and liabilities in any of the type A, B, C or D categories amounts to less than £50m, that amount may be ignored up to a cumulative limit of £200m.

Where a group is a foreign banking group or a relevant non-banking group, further adjustments need to be made to ensure that intra-group equity and liabilities are excluded, but only to the extent that equity would have been excluded upon consolidation of a UK sub-group and to the extent of liabilities between entities whose equity or liabilities fall within the scope of the charge. Liabilities to other members of the group are not excluded but may be netted (in the same manner for which netting is allowed for third party creditors).

The remaining steps of the Levy calculation entail the division of chargeable equity and liabilities into short-term and long-term liabilities, the application of the £20bn allowance proportionately to the short-term and long-term liabilities and the subjection of the remaining short-term and long-term liabilities to the higher and lower rates of the Levy.

Draft legislation: double taxation, avoidance and collection

Questions still persist regarding the availability of double taxation relief for the Levy at the same time as an equivalent levy raised by a foreign jurisdiction. Regulation making powers have been included in the draft legislation to give effect to arrangements concluded with other jurisdictions as well as to provide for unilateral relief. Although the draft legislation refers to double taxation relief being afforded for 'any equivalent foreign levy', a number of conditions appear to attach to the identification of such a levy by HM Treasury. The HMRC draft guidance[3] makes reference to such a levy needing to follow the proposals for the design of bank levies as set out in the IMF Report, being based upon a balance sheet and being 'similar in intent to the UK bank levy'. In this context, HM Treasury has already announced that the UK and French governments have agreed on a mechanism to ensure the absence of double taxation of banking groups subject to both the Levy and the French bank levy, but as at the time of writing no announcement has been made regarding other jurisdictions which may be treated by HM Treasury as having introduced an 'equivalent foreign levy'.

As would be expected a targeted anti-avoidance provision applies, with an assumption that (but for the avoidance arrangements) a bank would have incurred short term liabilities. Amendments to the draft legislation made on 9 December 2010 appear to be intended to ensure that the reduction of a bank's liability under the Levy through that bank attempting to (for example) hold more excluded equity and liabilities should not result in that bank being identified as having a main purpose of avoiding liability under the Levy. More generally, the Draft Guidance[4] confirms that it is not intended by HMRC that the anti-avoidance provisions within the Levy will apply to prevent relevant groups and relevant entities that adopt 'lower risk funding strategies' from benefiting from a reduced charge to the Levy. The usefulness of this general statement needs, however, to be contrasted against other statements in the Draft Guidance which suggest that HMRC will distinguish between the adoption of policies seeking to increase excluded equity and liabilities 'on an ongoing basis' and where such an increase is merely '"window dressing" to achieve a short term effect around the balance sheet date'.

For collection purposes, the Levy will be treated as if it were corporation tax which, in a group situation, will be chargeable on the 'responsible member'. However, the Levy will also be the joint and several liability of all members of the group within the charge to corporation tax or, in the case of relevant non-banking groups only, UK resident banks, relevant foreign banks and any other members of a UK banking sub-group within the charge to corporation tax. Securitisation companies within the UK's interim or permanent securitisation regimes will not be jointly or severally liable for the Levy. A responsible member may be nominated, but in a default scenario the responsible member will be the parent entity (for UK banking groups and building society groups) or (for foreign banking groups and relevant non-banking groups) the member which has the largest amount of chargeable equity and liabilities and which is also jointly and severally liable to the Levy.

Conclusion

Notwithstanding the publication of near-final legislation on the Levy on 9 December 2010, it seems unlikely that the final stage in the development of taxation responses to the crisis in the UK's banking sector has been reached. Ongoing international developments,[5] and the aspiration towards a coordinated response for progressive bank taxation, may still influence the tax policy of the UK Government in this area. The G20 has continued to discuss how best to co-ordinate international efforts. Most recently, at the Seoul G20 Summit, discussion has centred on how to increase the resilience of systemically important financial institutions ('SIFIs') and how best to resolve such institutions when they fail. This raises the interesting suggestion that thought in international policy circles is moving towards creating a framework for orderly defaults by SIFIs and away from the current uneasy compromise of de facto guarantees being given by governments when a decision is forced, accompanied by a denial that all similar institutions will be treated in a similar fashion in the same circumstances. Whether governments will be persuaded to abolish their bank levies if a coherent and effective model for dealing with SIFI failures without taxpayer guarantees is achieved, remains unclear.

However, by setting out its stall early, the UK Government must be hoping that banks will choose the devil they know over the possible overseas alternatives. Those alternative jurisdictions may not have adopted a balance sheet-based levy yet, but the debate continues.

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Endnotes

1. See HMRC draft guidance manual on the Levy (the 'Draft Guidance') at paragraphs BLM322310 to 322316 and BLM374000 to 374300.
2. As defined by the FSA Handbook at section BIPRU 12.7.2(1) to (4).
3. Draft Guidance at paragraph BLM730000.
4. Draft Guidance at paragraphs BLM610000 and BLM641000.
5. See *FITAR* Volume 15, Issue 8 (October 2010), pp2-8.