HM Revenue & Customs

The current tax treatment of instruments designed to be compliant with Capital Requirements Directive 4

1. Introduction

1.1 This note sets out the general views of HM Revenue & Customs (HMRC) with regard to the tax treatment, under current law, of the financial instruments that institutions are seeking to issue as qualifying regulatory capital instruments under the current rules and after the implementation of the Capital Requirements Directive (CRD) 4.

1.2 HMRC published their initial views on the impact of the CRD 4 proposals, in particular as regards the features of additional tier 1 and tier 2 capital which will be set out in the Capital Requirements Regulation element of CRD 4, in two discussion papers dated 4 August 2011 (on 'gone concern') and 5 August 2011 (on 'going concern'). Both these papers, and the issues that they identify, are relevant to this note.

1.3 This note sets out HMRC's position on perpetual instruments. HMRC's initial views were set out in the 5 August 2011 discussion paper, in the context of additional tier 1 instruments. However, a number of institutions have recently approached HMRC regarding the tax treatment of perpetual instruments intended to be issued in advance of the new CRD 4 regime for banks and the Solvency II regime for insurers. This note sets out HMRC's views on how the current tax rules operate for perpetual instruments.

1.4 For the avoidance of doubt HMRC will not seek to change the existing tax treatment of any perpetual instruments issued before the publication of this paper (such instruments would normally have been treated as loan relationships unless there are other features that would lead to a different treatment).

1.5 Finally, and again for the avoidance of doubt, this note is not relevant to the tax treatment of instruments issued after CRD 4 is implemented. Finance Bill 2012 introduced a power that will enable HM Treasury (HMT) to determine the tax treatment of regulatory capital instruments issued in accordance with regulatory change ('capital requirement proposals') through regulations. Once the CRD 4 proposals are finalised HMT will set out what that tax treatment of new bank instruments will be and publish draft regulations for consultation.

1.6 All references are to Corporation Tax Act (CTA) 2009 or to CTA 2010 unless otherwise stated.

2. Perpetual debt

2.1 This paper distinguishes between:

- perpetual instruments where the holder has no right to repayment in any circumstances ('truly perpetual' debt); and
- perpetual instruments where the right to repayment only arises as a result of a contractual clause providing for the return of principal in the event of a liquidation ('contingent perpetual' debt).

.2.2 Under the CRD 4 proposals 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.

2.3 The proposals governing additional tier 1 instruments also require that, upon the occurrence of a trigger event, the principal amount of the instruments must either be written down, or converted to common equity tier 1 instruments.

2.4 Paragraphs 3.1-3.6 deal with the tax treatment of truly perpetual instruments and paragraph 3.7 deals with contingent perpetual instruments. Paragraphs 3.8-3.10 deal with instruments with conversion features.

3. Truly perpetual additional tier 1 instruments

3.1 Having undertaken further analysis, HMRC remains of the view that a truly perpetual additional tier 1 instrument cannot be a debt, and hence not a 'money debt', under the loan relationships regime.

3.2 HMRC's view is based on the fact that there can be no debt where there no obligation to repay the principal. Once subscribed for, the issuer of any such instrument can apply the amount subscribed in any way they choose and there is no recourse, legal or otherwise for the holder of the instrument to force repayment. As a result there is no obligation to repay the principal to the holder of the instrument. For the same reason such instruments will not constitute loan capital for stamp duty purposes (however please see sub-paragraphs 3.7 to 3.9 in relation to instruments which convert into share capital).

3.6 Additionally, where there is no obligation to repay the principal the instrument will not meet the definition of an alternative finance investment bond under S507 CTA 2009. Nor could it be brought within the loan relationships regime at Part 5 CTA 2009 by virtue of Chapter 6 of Part 6 CTA 2009.

Contingent perpetual instruments

3.7 By contrast a contingent perpetual instrument does have a contingent repayment term. Provided the sum to be repaid on the happening of the contingent event is ascertainable at the time of issue, it will be a contingent debt. As contingent debts are treated as debts such instruments will be money debts for loan relationship purposes. This analysis is particularly relevant to perpetual instruments where the contingency results from a contractual liquidation clause in respect of a determined sum. Any other contractual terms which may create a contingent right to repayment will be considered by HMRC on a case by case basis.

3.8 However, it should be noted that even if such an instrument constitutes a loan relationship, whether or not the coupon will be tax deductible depends upon whether the distribution legislation is engaged (please see paragraphs 4-8).

4. Distributions (Part 23 CTA 2010)

4.1 In its earlier notes HMRC set out that it was likely that CRD 4 compliant additional tier 1 and tier 2 instruments, based on the current proposals, would be 'special securities' for the purposes of S1000(1)F and S1015(4) CTA 2010. In particular, that the consideration on these instruments would be 'results-dependent' and therefore caught by S1015(4) CTA 2010.

4.2 In the various clearances it has received HMRC has been asked for their view on the meaning of certain key phrases in the statute which are relevant to both additional tier 1 and tier 2 instruments, namely:

- 'under the securities'; and

- 'depends (to any extent) on the results of the company's business'.

Under the Securities

HMRC's view is that this phrase is not of itself the main operative part of S1015(4) CTA 2010. The phrase simply relates to the consideration provided under the relevant security.

Depends (to any extent) on the results of the company's business

This phrase is the heart of S1015(4). In analysing whether a security is a special security under S1015(4) the view of HMRC it is this phrase that is the important and determinative consideration.

5. Implementation of capital requirement proposals as a 'contingency'

5.1 An important issue in interpreting the second of the two phrases above is the degree and extent to which external contingencies affect the terms of the instruments.

5.2 HMRC has considered three possible approaches to future external contingencies relating to an instrument (including the implementation of capital requirement proposals):

- that we should look only at the extent to which the specific terms of the instrument allow for the consideration to vary according to results;
- that we should take into account every possible circumstance, however remote; or
- that there is a limit between these two extremes - ie a 'remoteness test', which involves a wider analysis than simply the terms of the instrument but which is limited to the circumstances that exist or are at least considered likely to exist at the time of the issue of the instrument, so that there must be some direct or indirect causal connection between the possible variation in consideration given for the use of the principal provided under the instrument and the results of the issuer's business.

5.3 HMRC's view is that the better interpretation is that set out in the third bullet. It is accepted that this approach might be difficult to apply in some circumstances as the facts surrounding the issue of the instruments will be a relevant consideration for distribution purposes under Part 23 CTA 2010. In light of this, when considering this point HMRC does not propose to prescribe a threshold for results-dependency and will look at the individual features of an instrument and the surrounding circumstances in each case before reaching a decision.

5.4 In section 6 and 7 of this note, HMRC sets out their general view regarding the distributions treatment for instruments depending on the structure of a bail-in under the capital requirement proposals.

6. Contingency of statutory bail-in

6.1 An instrument which has no express reference or implied term to either be written down or converted to common equity tier 1, but which is subject, along with other comparable instruments, to the possibility that it would be covered by a future statutory bail-in regime (which may amongst other things require the instrument to be written down or converted to common equity tier 1) is likely not to be regarded as results-dependent as the instrument has no contractual term which links the consideration to be provided and any future capital requirement proposals bail-in.

6.2 **An entry in the prospectus that takes the form of a general warning that the instrument may be subject to statutory bail-in will not make the instrument results dependent.**

6.3 For completeness, when a statutory bail-in regime comes into force, HMRC's view is that the consideration on any additional tier 1 or tier 2 instrument covered by such a regime is likely to become results-dependent from that time.

7. Contingency of contractual bail-in

7.1 As a result of the principles outlined above HMRC considers that including the contingency of a reduction in the value of an instrument in a contract is an indicator of results-dependency, on the assumption that there is a causal link between the consideration, the results of the business and the terms of the capital requirement proposals bail-in.

7.2 So where the contingency of the instrument becoming subject to a write-down in the future is part of the contractual terms of the instrument HMRC's view is that the consideration is likely to be results-dependent assuming that the bail-in regime is worded in such a way as to be linked to the results of the business.

8. Additional tier 1 instruments: possibility that the coupon might be 'passed'

8.1 For completeness, HMRC has not changed its view that the CRD 4 rules which provide that the dividends or coupons on additional tier 1 instruments are discretionary and non-cumulative are a strong indicator that under current law the consideration on those instruments is results-dependent. This is likely to apply to any instruments with the same or similar features issued in advance of the introduction of CRD 4.