

Corporation tax treatment of banks' Tier 2 regulatory capital

Who is likely to be affected?

Banks with Tier 2 capital instruments.

General description of the measure

The corporation tax (CT) rules on distributions will be amended to ensure that (except in cases of tax avoidance) the coupon on Tier 2 capital that forms part of a bank's regulatory capital, whether already in issue or yet to be issued, will be deductible for the issuer in computing its profits. The rules will also be amended to ensure that holders of these instruments will not be treated as equity holders in the issuer for the purposes of the tax grouping rules.

Policy objective

This measure is designed to make it clear that the coupon on Tier 2 regulatory capital instruments will be tax-deductible for the issuer and that these instruments will be treated as 'normal commercial loans' for the purposes of tax grouping rules.

Background to the measure

Banks must ensure compliance with regulatory requirements, including the forthcoming EU Capital Requirements Directive (CRD IV). Tier 2 capital instruments that banks are issuing now include terms that ensure compliance with CRD IV, or with the rules, regulations, requirements, guidelines and policies relating to capital adequacy in force or pending implementation in the UK. In particular, issuing banks may have to make it clear to investors that these instruments could be either written down or converted to share capital in the event that the issuer nears insolvency.

A process of informal consultation with those affected by regulatory capital changes has been in progress since the summer of 2011. These contacts have enabled the Government to respond to concerns that making investors aware of the impact of CRD IV would lead to an unintended tax disadvantage for banks intending to maintain or enhance their Tier 2 regulatory capital.

The measure was first announced by the Financial Secretary to the Treasury in a Written Ministerial Statement on 26 October 2012. HM Revenue & Customs (HMRC) published a Technical Note along with draft legislation on the same date and received constructive responses from interested parties.

Detailed proposal

Operative date

This provision will have retrospective effect on and after 26 October 2012.

Current law

This measure relates to Part 23 Corporation Tax Act 2010 (CTA 2010) which specifies what will be a distribution for corporation tax purposes, and to Part 5 CTA 2010 (Group Relief) which includes rules on group membership.

Proposed revisions

Legislation will be introduced in Finance Bill 2013 to exclude loans that form part of a bank's Tier 2 resources (as defined by the Financial Services Authority (FSA) Handbook) from Part 23 CTA 2010.

Consequently, consideration on Tier 2 regulatory capital instruments will not be within the rules which deny a deduction for securities with certain characteristics. The coupon on these loans will not therefore be prevented from being deductible as interest in computing taxable profits.

The new legislation will also make it clear that the 'normal commercial loan' definition in section 162 CTA 2010 will apply to loans that form part of a bank's Tier 2 resources (as defined by the FSA Handbook). So Tier 2 regulatory capital instruments will be capable of being 'normal commercial loans' in relation to CT grouping rules.

These rules will not apply if the loan forms part of a scheme or arrangement, the purpose or one of the main purposes of which is the avoidance of tax.

Summary of impacts

Exchequer impact (£m)	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18
	nil	nil	nil	nil	nil	nil
	This measure is not expected to have an Exchequer impact.					
Economic impact	The measure is not expected to have any significant economic impacts. It complements wider regulatory reforms aimed at improving financial stability, including higher capital and liquidity standards.					
Impact on individuals and households	This measure will have no impacts on individuals and households as it relates to Banks who will be subject to CRD IV when it comes into force.					
Equalities impacts	There are no impacts on any group which shares a protected characteristic.					
Impact on business including civil society organisations	This measure only impacts on banks. It provides them with certainty on the tax treatment of Tier 2 regulatory capital instruments but will have no other significant impact on business.					
Operational impact (£m) (HMRC or other)	It is unlikely that there will be any operational impact due to this change.					
Other impacts	Other impacts have been considered and none have been identified.					

Monitoring and evaluation

This measure will be subject to ongoing monitoring through receipts and information collected on tax returns. Also, given the relatively limited population likely to be affected by this measure, the impact of the measure will be tracked through ongoing informal consultation with the banks affected and with the regulatory authorities (in particular the FSA).

Further advice

If you have any questions about this change, please contact John Connor on 020 7147 2434 (email: john.connor@hmrc.gsi.gov.uk) or Malcolm White on 020 7147 0565 (email: malcolm.white@hmrc.gsi.gov.uk).

1 Tier two capital of banks

- (1) CTA 2010 is amended as follows.
- (2) In section 162 (meaning of “normal commercial loan”), after subsection (1) insert –
 - “(1A) For those purposes, “normal commercial loan” also includes any loan which is not a normal commercial loan by virtue of subsection (1) but is such a loan by virtue of section 164A(1) (loan forming part of bank’s tier two capital).”
- (3) After section 164 insert –

“164A Loan forming part of bank’s tier two capital

- (1) A loan is a normal commercial loan by virtue of this subsection if it was issued by a bank or a parent undertaking of a bank and forms part of the bank’s tier two capital resources.
- (2) Subsection (1) does not apply in the case of any loan if there are arrangements the main purpose, or one of the main purposes, of which is to obtain a tax advantage for any person as a result of the application of that subsection in respect of that loan.
- (3) For the purposes of this section –
 - (a) “bank” has the meaning given by section 1120,
 - (b) “tax advantage” has the meaning given by section 1139,
 - (c) “parent undertaking” is to be read in accordance with section 420 of FISMA 2000, and
 - (d) the reference to the bank’s tier two capital resources is to be read in accordance with the Handbook of Rules and Guidance made by the Financial Services Authority (as that Handbook has effect from time to time).”
- (4) In section 1029(1) (overview), after paragraph (c) insert –
 - “(ca) section 1032A (payment in respect of bank’s tier two capital).”
- (5) After section 1032 insert –

“Tier two capital

1032A Payment in respect of bank’s tier two capital

- (1) A payment made in respect of tier two securities is not a distribution for the purposes of the Corporation Tax Acts.
- (2) Subsection (1) does not apply in the case of any tier two securities if there are arrangements the main purpose, or one of the main purposes,

of which is to obtain a tax advantage for any person as a result of the application of that subsection in respect of those securities.

- (3) For the purposes of this section –
- (a) “tier two securities” means securities issued by a bank or a parent undertaking of a bank that form part of the bank’s tier two capital resources,
 - (b) “bank” has the meaning given by section 1120,
 - (c) “tax advantage” has the meaning given by section 1139,
 - (d) “parent undertaking” is to be read in accordance with section 420 of FISMA 2000, and
 - (e) the reference to the bank’s tier two capital resources is to be read in accordance with the Handbook of Rules and Guidance made by the Financial Services Authority (as that Handbook has effect from time to time).”
- (6) The amendments made by this section are treated as having come into force on 26 October 2012.

EXPLANATORY NOTE

TIER TWO CAPITAL OF BANKS

SUMMARY

1. This clause prevents the payments on banks' Tier Two regulatory capital instruments from being treated as distributions for tax purposes and ensures that the issue of Tier Two instruments do not break the banks corporate group for tax purposes. Both these changes are subject to an anti-avoidance rule to prevent abuse.

DETAILS OF THE CLAUSE

2. New subsections (1) and (2) insert new section 162(1A) into the Corporation Tax Act 2010 (CTA 2010). New section 162(1A) ensures that loans forming part of a banks' Tier Two capital are treated as 'normal commercial loans' for the purposes of the group relief rules. This change prevents a bank which issues Tier Two instruments from breaking its corporate group for tax purposes.
3. Subsection (3) inserts new section 164A into CTA 2010.
4. New section 164A(1) ensures that where a bank or a parent undertaking of a bank issues instruments which form part of the banks Tier Two capital resources those instruments are treated as though they are normal commercial loans.
5. New section 164A(2) prevents new section 164A(1) from applying where there is an arrangement with a main purpose (or one of the main purposes) of obtaining a tax advantage by ensuring that an instrument issued by a bank or parent undertaking of a bank falls within new section 164A(1).
6. New section 164A(3) defines 'bank', 'tax advantage', 'parent undertaking' and 'Tier Two capital' for the purposes of new section 164A.
7. Sections (4) inserts new subsection (ca) into section 1029(1) CTA 2010. New subsection 1029(1)(ca) ensures that a payment made in respect of Tier Two capital is added to the list of items which are not distributions.
8. New subsection (5) inserts new section 1032A into CTA 2010.
9. New subsection 1032A(1) ensures that a payment made in respect of Tier Two securities is a not a distribution for tax purposes.

10. New subsection 1032A(2) prevents new subsection 1032A(1) from applying where there is an arrangement with a main purpose (or one of the main purposes) of obtaining a tax advantage by ensuring that a Tier Two security instrument falls within new section 1032A(1).
11. New subsection 1032A(3) defines ‘Tier Two securities’, ‘bank’, ‘tax advantage’, ‘parent undertaking’ and ‘Tier Two’ for the purposes of new subsection 1032A.
12. New subsection (6) provides that these changes come into force on 26 October 2012.

BACKGROUND NOTE

13. Once the Capital Requirements Directive IV (CRD IV) is in force, bank’s Tier Two capital must have more loss absorbing features than previously. Tier two capital will also have to count as Tier Two throughout the life of the instrument (including after CRD IV is in force). Both these requirements have caused tax issues in relation to the distributions rules and the group relief rules.
14. If you have any questions about this change, or comments on the legislation, please contact Fiona Hay on 020 7147 2543 (email: Fiona.hay@hmrc.gsi.gov.uk).