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UK Treatment of Capital Instruments Under Basel III – A Taxing Issue

Background

The Basel III rules which have now been finalised by the Basel Committee on Banking Supervision will have a significant impact on the amount of capital required to be held by banks and the nature of such capital.[1] The revised rules have given rise to uncertainty as to the tax treatment in many jurisdictions of capital instruments which qualify for regulatory capital recognition.

In the UK, banks have generally been able to structure both their tier 1 and tier 2 capital instruments in a way which enables them to be treated as debt for tax purposes. This means, among other things, that issuers of such instruments can obtain a tax deduction for interest or coupons paid on the instruments which would not be available if the instruments were treated as equity. As set out in more detail below, the new Basel III rules will, however, make very significant changes to the features, characteristics and terms that such instruments must contain, making their tax treatment uncertain under existing UK tax legislation. The UK government has therefore asked HM Revenue and Customs ("HMRC") to identify specific tax issues arising from the Basel III proposals and to consult with the industry to seek to identify any legislative changes to the UK tax rules that may be needed.

On 22 June 2011, HMRC published a discussion paper and working group minutes on the tax treatment of these new capital instruments.[2] We set out below some of the issues raised by HMRC.

Overview of Basel III Changes

The Basel III reforms will require banks to hold significantly more capital than is currently the case under the existing Basel II framework. Although banks' aggregate minimum capital requirement will remain at 8% of risk weighted assets, the composition of such capital will change significantly and will be subject to additional capital buffers. The minimum amount of tier 1 capital will be raised from 4% to 6% during a transitional period between 1 January 2013 and 1 January 2015. Tier 1 capital must be composed of a minimum amount of 4.5% of common equity tier 1 capital (defined narrowly to include common shares, share premium and retained earnings). In addition, banks will also be required to build up a capital conservation buffer of up to 2.5% of risk weighted assets (or be subject to restrictions on their ability to declare dividends) and may also be subject to additional counter-cyclical buffers that can be imposed by local regulators. The Basel Committee has also recently announced that

[1] See our client alert, "Basel III: The (Nearly) Full Picture," http://www.mofo.com/files/Uploads/Images/101223-Basel-III-The-Nearly-Full-Picture.pdf.
[2] HMRC discussion paper: "The tax treatment of regulatory capital instruments" and HMRC "Capital Instruments Working Group meeting," http://www.hmrc.gov.uk/basel3/discussion.pdf and http://www.hmrc.gov.uk/basel3/working-group-meeting.pdf.

global banks regarded as systemically important will be required to maintain an additional buffer of between 1 and 2.5% (potentially rising to 3.5% in some cases) of risk weighted assets which will also be required to comprise of common equity. The cumulative effect of these provisions is that some banks may need to maintain a common equity ratio of 9.5% or more, compared with the existing minimum requirement of 2%.

As is currently the case, banks will be able to meet some of their minimum capital requirements through the use of capital instruments which have features of both debt and equity, or "hybrid" capital instruments. Under Basel III up to 1.5% of the minimum tier 1 capital requirement can be met through the issuance of "additional tier 1 capital." In addition, up to 2% of a bank's aggregate minimum capital requirement will be permitted to comprise tier 2 capital (although the existing distinction between lower and upper tier 2 instruments has been abolished). The requirements for the terms of these instruments will however change significantly from the current Basel II rules. In particular, it is likely that the vast majority of hybrid capital instruments currently in issue which qualify as tier 1 capital will cease to benefit from such recognition subject to transitional relief described further below.

The new Basel III requirements for the recognition of hybrid instruments as either tier 1 and tier 2 capital as described further below will enhance the equity-like features of such products and therefore have the potential to give rise to uncertainty in many jurisdictions as to the appropriate tax treatment for such instruments. It is these concerns that have led the UK government to request that HMRC undertake its current consultation process.

Basel III Requirements for Capital Instruments

Basel III sets out characteristics that must be met for an instrument to be treated as either additional tier 1 or tier 2 capital. In the case of tier 1, the requirements include that the instruments must be perpetual with no step-up or call provisions at the option of the holder and carry fully discretionary and non-cumulative dividends. Requirements for tier 2 instruments include that they have an original maturity of at least five years, are subordinated to depositors and general creditors, and dividends/coupons do not contain any credit-sensitive feature. In addition, in a paper published in January 2011,[3] the Basel Committee stated that to ensure capital instruments are capable of bearing losses on a "gone concern" basis (i.e., when the relevant entity is no longer financially viable) all tier 1 and tier 2 instruments would be required to be subject to a write-down or conversion into common equity on a specified trigger event. Such trigger will relate to the relevant regulatory authority determining that a write-off or conversion is necessary to avoid having to inject public funds, or making a decision that an injection of public funds into the entity is necessary.

Although the Basel III rules in relation to capital will not start to be phased in until 2013, banks are already carefully considering how to best structure instruments to comply with the new rules. The rules contain "grandfathering" provisions for existing instruments that comply with the current rules but the regulatory capital recognition currently afforded to such instruments will be phased out on a linear basis over a 10-year period from 2013. Banks are therefore likely to be seeking to refinance many of these instruments sooner rather than later. Some banks also have existing capital needs, including as a result of existing instruments maturing, and will increasingly want to ensure that new instruments will receive appropriate treatment under Basel III. Clarification as to the tax treatment of such instruments is a critical element of this planning.

CoCos and Bail-in Capital

One likely way for banks to seek to raise capital in the new environment is through the issue of contingent convertible instruments ("CoCos") which provide for the instruments to be converted into equity or to be subject to a principal write-down upon the occurrence of a specified trigger. CoCos could potentially form part of a bank's additional tier 1 or tier 2 capital although such instruments would not be eligible to form any of the additional

[3] See our client alert, "The Minimum 'Bail-in Criteria' for Regulatory Capital," http://www.mofo.com/files/Uploads/Images/110121-Minimum-Bail-In-Criteria.pdf.

capital buffers, including the buffer for systemically important banks, which must comprise only common equity. There have already been a number of issuances of CoCos in the EU in recent years, including by Lloyds Bank, Rabobank and Credit Suisse. These instruments vary in terms of whether they convert into equity or have a write-down feature and also vary in terms of the trigger for write-down or conversion. The trigger has generally been set by reference to the common equity tier 1 ratio of the issuer falling below a certain level. Although the Basel Committee has noted that CoCos are instruments that, depending on the level the trigger is set at, can be used to absorb losses either at the point of non-viability or on a going concern basis,[4] it has not yet provided specific guidance on their use in meeting the requirement in its January 2011 paper that additional tier 1 and tier 2 instruments absorb losses at the point of non-viability.

In its discussion paper, HMRC notes that in the context of requiring banks (particularly those regarded as systemically important) to be subject to an appropriate recovery and resolution framework, there is significant international discussion on requiring banks to issue debt (or a certain amount of debt) with either statutory or contractual "bail-in" features enabling regulatory authorities to require the write-down or conversion of debt to help facilitate an orderly resolution of the institution. Such requirement is therefore similar to the Basel III loss absorbency requirements and, as the Basel Committee notes in discussions on CoCos referred to above, bail-in debt and CoCos with low trigger points are designed to absorb losses at the point of non-viability. HMRC observes in its discussion paper that although such bail-in proposals are not part of the Basel III framework they raise similar tax issues.

CRD 4

At the time HMRC published its discussion paper, the EU Commission had not published its legislative proposal to amend the Capital Requirements Directive to comply with the Basel III rules (generally referred to as "CRD4"). HMRC acknowledged it would need to consider the draft of CRD4 in formulating its advice to HM Treasury. The EU Commission published its proposals on 20 July 2011. The following points are relevant in relation to additional tier 1 and tier 2 capital instruments:

- The CRD 4 proposals do not contain any specific contractual requirement in relation to the Basel Committee's requirement in its January 2011 paper for tier 1 and tier 2 instruments to have "gone concern" loss absorbency triggers as specified above.
- To ensure that tier 1 additional capital instruments absorb losses on a "going concern" basis (i.e., whilst the entity is still regarded as viable), such instruments will be required to include a trigger event providing for the write-down or conversion into equity of such instruments where the relevant institution's common equity tier 1 ratio falls below 5.125%.
- Additional tier 1 instruments are expressly prohibited from containing coupon pushers or dividend stoppers.

UK Tax Issues

HMRC acknowledges that the tax treatment of new capital instruments designed to meet the Basel III requirements will be an important competitiveness issue for banks in the EU and globally. It also notes that the new requirements for such instruments under Basel make the tax treatment under the present tax rules uncertain in a number of respects. HMRC has stressed that it has no set views on what the tax treatment of various capital instruments should be (and has no steer from the government in this regard) and it is looking for an exploratory debate with market participants so that it can report back to HM Treasury to assist the UK government in determining what changes it needs to make to relevant UK tax law.

[4] Basel Committee on Banking Supervision Consultative Document: "Globally systemically important banks: Assessment methodology and the additional loss absorbency requirement," http://www.bis.org/publ/bcbs201.pdf.

HMRC's discussion paper concedes that "there are many complex tax rules dealing with financial products which will all need to be considered..." The key areas it highlights include:

- The impact of convertibility or write-down features included in these instruments on the deductibility of interest/coupon payments by the issuer.
- How the recharacterisation of payments of coupon or interest payable under the instruments as a distribution will be treated under relevant provisions of the Corporation Tax Act 2010 on the basis of (a) the requirement that interest or coupons only be paid out of distributable profits (and the requirement that coupons be non-cumulative), (b) the instruments being treated under UK tax law as providing a non-commercial return on the principal amount of the notes and (c) equity notes in relation to additional tier 1 capital raised intra-group.
- The possible application of stamp duty and Stamp Duty Reserve Tax ("SDRT") on the instruments.
- A write-down of principal under the terms of such instruments potentially giving rise to tax charges under the loan relationship rules.
- Possible transfer pricing issues arising out of the additional capital requirements resulting in the "capital function" of businesses increasing in importance relative to the "people function" in attributing profits for the purpose of taxing permanent establishments.

Not surprisingly given that HMRC's review process has only just begun, the discussion paper primarily raises questions to be addressed, rather than providing answers and solutions. It is by no means surprising that the rules and issues to be considered are complex, as many are of an anti-avoidance nature, based on a soon to be outdated regulatory structure. The analysis is further complicated by the fact the accounting rules for the classification of capital instruments are complex and also in the process of change as part of the work to converge international accounting standards. In relation to accounting standards, HMRC notes that in view of the new Basel III requirements for additional tier 1 capital instruments, it is difficult to see how any form of debt treatment would be possible under existing standards. HMRC has however asked for views on the degree to which some form of debt accounting may be possible for such instruments.

The following points arising from the discussion paper and subsequent working group meeting are worth noting:

- In relation to the ability of the issuer to claim a tax deduction for payments of interest or coupons on instruments, it is concluded that many of the new instruments are likely to include certain features which, on the face of it, will fall afoul of the existing UK anti-avoidance provisions; for example, the convertibility and write-down features. This issue has been the subject of an initial discussion of the working group which also discussed the effect of the conversion and write-down features on the distribution rules, which can recharacterise interest or coupon payments as a distribution if, for example, the rate of return is not commercial having regard to the minimum amount payable on maturity or the debt has equity rights included. The fact that tier 1 and tier 2 instruments will now be required to include provisions which could result in a write-down of the instruments, potentially to zero or a conversion into equity, clearly provide a challenge in this regard.
- The impact of the loan relationship rule was noted, in particular the fact that the write-down of an instrument would usually give rise to a tax charge as it would effectively constitute a profit for the debtor. A conversion into equity would not, however, trigger such a charge. It was noted that at present there is no symmetry between the tax treatment of the issuer and holder of the instrument in the event of a write-down.
- In respect of stamp duty, HMRC's initial view is that the stamp duty relief for loan instruments will not be available in the case of convertible instruments. However, the stamp legislation does not currently make explicit provision for convertibles.

- There are a number of other tax issues the working group has raised including transfer pricing and alternative finance.
- The starting point for taxing debtors and creditors is generally the accounting treatment of the relevant instruments. However, as the accounting treatment of the new capital instruments is uncertain, this adds additional uncertainty to the appropriate tax treatment for such instruments.

Next Steps

In the past, UK banks have consistently been able to ensure that tier 1 capital instruments, whilst containing certain equity-like features, are treated as debt for tax purposes. Given the current UK legislation and the features of the proposed new capital instruments, there is significant concern that such instruments may be treated as akin to equity for tax purposes. This is particularly important having regard to the fact that the tax treatment of the new instruments will be important for the international competitiveness of UK banks.

It is encouraging that HMRC is undertaking consultation on this issue at a relatively early stage. Although HMRC has not expressed any views to date on what it believes should be the appropriate tax treatment for such instruments, it seems inevitable that UK legislation will need to change to deal with the new instruments and that the government and HMRC are likely to be sympathetic to ensure an appropriate tax treatment of such instruments is achieved and UK banks are not placed at a competitive disadvantage as a result of the UK tax treatment of such instruments. The consultation process is still at an early stage, however, and it is therefore not clear how the government will ultimately decide to deal with this issue.

In view of the fact that the Basel III will start to be phased in from 1 January 2013, the stated aim of HMRC is to report back to HM Treasury later this year with a view to changes to the tax legislation being introduced in the Finance Bill 2012.

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