ARTICLE
MAY 2012

Is a perpetual note debt for tax purposes?

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For many years, banks and insurers have issued hybrid instruments to satisfy part of their regulatory capital requirements. The current version of the concept is called innovative Tier 1 capital. It is attractive because, although treated for regulatory purposes as equivalent to equity, it is nevertheless regarded for tax purposes as debt and in principle the coupons are therefore deductible.

To achieve this, the notes/bonds are in substance a hybrid of debt instrument and preference share. The issuer can typically make payments of interest only if it meets a solvency test at the time of, and after, payment; and it may be entitled (or required) to defer payment of interest indefinitely (but cannot then pay dividends either). There is usually no fixed redemption date and the issuer is not obliged to repay principal unless and until it goes into liquidation (but can do so after a set period, subject again to a solvency test). Given these features, such instruments are often referred to as "perpetual debt".

Clearly, perpetuals sit close to the boundary between debt and equity. For regulatory and accounting purposes they may be treated as equity. For tax purposes, however, it has long been accepted by HMRC that they do constitute debt and that, so long as the obligation to pay the coupon does not fall away altogether, deferral of interest will not cause it to be a non-deductible "results-dependent" distribution within CTA 2010 s 1015. There are specific provisions dealing with "equity notes", now in CTA 2010 ss 1015 to 1017, which can lead to payments under very long-dated or perpetual securities being treated as distributions. But these rules (whose existence rather supports the notion that a perpetual constitutes debt) apply only where the securities are held by persons associated with or funded by the issuer group.

Recently, however, the tax treatment of regulatory capital instruments has been the subject of renewed focus in light of the series of major changes to regulatory capital requirements heralded by the so-called "Basel III" and "Solvency II" reforms (for banks and insurers respectively). These are likely to tighten further the conditions to be met in order to qualify as Additional Tier 1 capital, as it will be called; they may for example include a requirement to write down principal (which would certainly make the interest "results-dependent"), or convert into common equity, on the occurrence of certain triggering events.

HMRC held some working group sessions in the middle of last year to discuss the implications of the Basel III reforms and, in that context, indicated that it was reconsidering whether perpetual debt does in fact constitute debt at all. It appears that this change of heart might apply to all perpetuals, not just instruments introduced to meet the requirements of Basel III and Solvency II. As can be imagined, this is causing something of a flutter amongst issuers and their advisers. If a perpetual is not debt, what is it? And where would this leave issuers who have, for many years, been treating interest on their innovative Tier 1 capital as deductible under the loan relationships regime?

IS IT DEBT?

The basic question is not a new one and HMRC's view appeared relatively settled. When the loan relationships regime was first introduced, a list of "frequently asked questions" prepared by the Revenue specifically mentioned perpetual debt as an example of a loan relationship. HMRC's manuals continue to reflect that position to this day.

The doubts that have now surfaced seem to focus on the feature that perpetual debt has no fixed redemption date. HMRC may have concluded that the issuer has no obligation whatsoever to redeem, and the holder no right to receive redemption proceeds, with the result that there is no debt. If there is no debt, there can be no "money debt" within the meaning of CTA 2009 s 303 and, therefore, no loan relationship.

In our view this is probably wrong. An issuer of perpetual debt instruments is always required to redeem them if it is put into liquidation, so has a contingent obligation to repay the principal; and a contingent debt, one might say, is still a debt. For this reason, *Gore-Brown* and other company law textbooks agree that a perpetual should as a general matter be regarded as debt.

We are not aware of any conclusive case law on the question. But two leading tax cases point in the same direction. In *Reed International Ltd v IRC* [1975] STC 427, the House of Lords, in considering the meaning of "funded debt" for stamp duty purposes, appeared to have no conceptual difficulty accepting that debt of indefinite duration could nonetheless be debt; indeed neither party seems to have disputed this. And in *Marren v Ingles* [1980] STC 500, Lord Fraser, although acknowledging that the meaning of the word depended very much on its context (which was of course quite different in that case), noted that "debt" could include a contingent debt which may never become payable, as well as a sum the amount of which is not yet ascertained.

Nor is there any indication that the term "debt" is to be construed restrictively in the context of the loan relationships regime. Rather the reverse. Thus it is specifically provided in CTA 2009 s 476 that "debt" includes debt the amount of which is to be ascertained by reference to matters which vary from time to time. And the definition of "money debt", now in CTA 2009 s 303, allows for debt which "*(a) falls to be settled … by the issue or transfer of any share in any company, (b) has at any time fallen to be so settled, or (c) may at the option of the debtor or the creditor fall to be so settled*".

We have already noted that the issuer of a perpetual has a contingent obligation to repay the principal amount. Other features typical of a debt falling within the main loan relationship rules include the initial advance made by the subscriber and interest that is calculated by reference to the amount advanced (and continues to accrue, even if payment is deferred).

OTHER POSSIBILITIES: EQUITY OR ANNUITY?

HMRC may contend that these rights are no different from the rights of a preference share holder. But that would ignore the special characteristics of equity. A share is clearly more than a collection of personal contractual rights. It creates a proprietary right in the company, the interest of the shareholder being composed of rights and obligations defined both by statute and the company's constitution. And at least in the case of an English company, any coupon must always be funded from distributable reserves.

Above all, in a winding up of the issuer the perpetual debt holder and the shareholder participate in different capacities. Section 107 Insolvency Act 1986 puts it like this: "*…the company's property in a voluntary winding up shall on the winding up be applied in satisfaction of the company's liabilities pari passu and, subject to that application, shall (unless the articles otherwise provide) be distributed among the members according to their rights and interests in the company*". We are not experts in insolvency law, but this suggests to us that there are two (and only two) ways in which an investor can participate in a winding up: by virtue of entitlements in respect of *liabilities* of the company, or as a *member*. There can surely be no doubt that the holder of a perpetual falls into the first category (and, just as clearly, outside the second). If there is a liability under the instrument at winding up and there is a matching advance on issue, the obvious conclusion is that there is a "debt" throughout.

The only other possibility is that a perpetual should in fact be regarded as an annuity. That does not seem right as a legal matter, given the right to repayment on a winding up of the issuer. Nor does it reflect commercial reality. The investor would be surprised to be told that it had exchanged a lump sum for a series of payments, and in practice the issuer is unlikely to wait until it is wound up before repaying the principal.

If a perpetual is not debt one might ask how it fits into the tax code at all.

CLARITY NEEDED

If pressed, we would admit to some sympathy for HMRC's position here. One might say that innovative Tier 1 capital pushes the concepts of debt and deductible interest as far as they can go without losing their character altogether. But the answer is surely to legislate for any clarificatory changes that HMRC would like to see, in the normal way. It cannot be sensible to uproot a fundamental legal concept such as "debt" and simply hope for the best.

When HMRC publishes its promised update on the tax treatment of Additional Tier 1 instruments, they will have an opportunity to address clearly and comprehensively the basis on which perpetuals can constitute debt for tax purposes. This question goes much deeper than the particular tax consequences of the Basel III and Solvency II reforms. Any uncertainty over the nature of perpetual debt instruments is far from satisfactory, both for companies currently considering issuing such instruments and those which have outstanding innovative Tier 1 capital.

On that note, we do not see how HMRC could say that a perpetual is not debt as a matter of law but nonetheless allow existing issuers to continue to accrue loan relationship deductions, particularly in light of its concerns following the *Wilkinson* case. If HMRC is really convinced that there is no debt, the only answer would be retrospective legislation which ensures that the position is as it has been understood to be since the introduction of the loan relationship regime (and indeed for many years before).

AN INTERIM SOLUTION

For those required to grapple with this question before there is a clear statement of HMRC's position, we can suggest an additional feature for innovative Tier 1 capital issues that should put beyond doubt their character as debt and therefore loan relationships, without endangering the desired treatment for regulatory capital purposes.

This would involve the issuer assuming an obligation to settle the outstanding principal, by a (distant) long-stop date, through the issue of preference shares. As we have noted, the definition of money debt in CTA 2009 s 303 expressly includes a debt which falls to be settled by the issue of shares in any company. Providing for an issue of shares by a long-stop date appears to remove any concerns that HMRC could have about perpetual instruments.

RESULTS-DEPENDENT INTEREST

Recent experience indicates that HMRC is also nervous about perceived attempts to "future-proof" current innovative Tier 1 issues, for example by building in rights to allow variation of the terms, or substitution with new securities, in order to comply with future regulatory changes. This raises a perennial concern for issuers of hybrid capital, namely whether interest payable by the issuer falls within CTA 2010 s 1015(4) and is therefore to be recharacterised as a (non-deductible) distribution. Section 1015(4) operates where "*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 it.

The drafting is wider than it should be, but at least the test is applied only at the point of issue. If there is "future-proofing", the trigger for altering the terms of the instrument (or its substitution) will be a change in regulatory requirements – likely to occur entirely independently of the business results of any particular issuer – followed by a decision by the issuer to amend or substitute the issue. This could only bring s1015(4) into play if it is read as applying where the issuer *could in certain circumstances choose* to make the consideration dependent to any extent on the results of its business.

On a purposive reading, one might well conclude that this takes the concept of results-dependency too far. But given the breadth of the drafting, it is hard to dismiss such a reading of s1015(4) altogether.

Here, commercial realities may provide the answer. Investors are unlikely to accept that the issuer should be able to reduce their contractual rights in the event of regulatory change, particularly when the extent of any such change has not yet been determined. So in practice it should be possible to satisfy HMRC that any permissible amendment or substitution will not be such as to engage s 1015(4).

We can end on a positive note. Apart from a certain sensitivity around the Basel III and Solvency II reforms, there is no indication that HMRC is seeking to disown its long-held view on results-dependency in this area. So deferral of interest is fine if the obligation to pay remains – so long as there is a debt!

This article was published in the 4 May 2012 edition of Tax Journal.