Perpetual harmony: HMRC sets out its stall

William Watson

At the beginning of May, I co-wrote an article (“Is a perpetual debt for tax purposes?” Tax Journal, dated 4 May 2012) which considered whether a “perpetual” note should be regarded as debt for tax purposes. It is not usually a good sign to be returning to a subject so soon. But HMRC has picked up the theme, in a paper that is undated but was published on 26 June 2012 and is titled The current tax treatment of instruments designed to be compliant with Capital Requirements Directive 4. I am glad to say that it contains some good news.

The June Paper also discusses the new form of regulatory capital that UK (and other EU) banks are expected to start issuing once the relevant legislation has come into force; this will consist of "Additional Tier 1 capital" and a new form of Tier 2 capital (that is, debt which looks less like equity than Additional Tier 1 capital – or, in the jargon, is less "loss-absorbent").

PERPETUAL DEBT

Many UK banks and insurers provide part of their regulatory capital in the form of instruments which are in substance a hybrid of debt and preference share. There is usually no fixed redemption date and the issuer is not obliged to repay principal unless it goes into liquidation. There will typically be restrictions on the payment of interest too, for example by reference to a solvency test. In its current incarnation, the concept is referred to as "Innovative Tier 1 capital".

The article of 4 May was prompted by the discovery that HMRC had changed its mind about the treatment of such instruments. HMRC appears to have concluded that there is no obligation to repay principal, no debt and therefore no “money debt”.

Happily, the June Paper rows back from this position. It does so by distinguishing between "truly perpetual" instruments, where "the holder has no right to repayment in any circumstances", and "contingent perpetual" instruments, where there is a right to repayment in the event of liquidation. It is only "truly perpetual" instruments that do not give rise to a debt.

The reasoning here is curious. I am not aware that “truly perpetual” bonds have ever been issued in the UK. Indeed it is not obvious, to me at least, why HMRC believes that Additional Tier 1 instruments will have to be “truly perpetual”, as is stated in paragraph 2.2 of the June Paper; it seems more likely that they will be repayable.
in the liquidation of the issuer, albeit after all "standard" debt has been repaid, just as is the case for Innovative Tier 1 capital. One cannot help wondering whether HMRC's adviser in this area simply failed to realise that all “perpetuals” in fact provide for repayment in liquidation.

But the position set out in the June Paper is certainly a welcome development, as otherwise HMRC would be saying that coupons paid on existing issues of hybrid capital are not deductible. In short, panic over!

NEW REGULATORY FRAMEWORK

The remainder of the June Paper discusses various aspects of the "results-dependency" test now found in CTA 2010 s 1015(4) as it may apply to what one might call “next generation” regulatory capital issued by UK banks.

I do not have space here to describe the regulatory framework in any detail. Suffice to say that the European Council has published two draft Directives (“CRD 4” and the “CMD”) and a draft Regulation (the “CRR”) which are intended to implement the “Basel III reforms”, agreed in December 2010. The overall objective is to increase the “loss absorbency” of bank capital. The reforms are expected to start taking effect from 1 January 2013.

The regulatory rules for EU insurers are moving in a similar direction, but under different legislation; the primary EU statute is the Solvency II Directive (2009/138/EC).

The two regimes will have many features in common and the UK tax issues are likely to be very similar. But the June Paper focuses specifically on the regime for banks and this article does the same.

THE PROPOSED CHANGES

Since the EU legislation is still in draft form, one cannot be certain exactly what rules will apply to banks' hybrid capital in future. But the outline position may be roughly as follows (focusing of course on those changes that are likely to be relevant to the issuer’s tax treatment):

1. the instruments will have to provide for write-down of principal (“on a permanent or temporary basis”) or conversion to common equity, if the issuer no longer satisfies a specified capital ratio;

2. distributions (i.e. interest) must only be paid out of distributable profits, they must be cancellable at the discretion of the issuer and then non-cumulative, and any such cancellation must not trigger cancellation of distributions on pari passu or lower ranking capital (currently an important commercial protection for holders of hybrid capital); and

3. the CMD provides for statutory write-down, from 1 January 2015, in specified circumstances.

Points (1) and (2) are expected to apply only to Additional Tier 1 capital, whereas (3) will cover Tier 2 as well. The write-down mechanism is often referred to as a (contractual or statutory) “bail-in”.

SLAUGHTER AND MAY
RESULTS-DEPENDENCY

I can return at last to more familiar ground, in the shape of CTA 2010 ss1000(1)F and 1015(4). Securities are “special securities”, and therefore interest will be a distribution for tax purposes, if the securities meet any of the conditions in s 1015; and s 1015(4) provides as follows:

“Condition C is that under the securities the consideration given by the company for the use of the principal secured depends (to any extent) on the results of—

(a) the company’s business, or

(b) any part of the company’s business.”

This has long been a problematic rule because the drafting is so wide. It gives HMRC considerable scope for the Humpty Dumpty approach to interpretation, as is shown in its discussion of the rule at CTM 15520 - 15525. That approach is evident, too, in the remainder of the June Paper.

In the context of the proposed regulatory reforms, the central point at issue is whether s 1015(4) looks only at the (contractual) terms of the securities, or whether it can also be triggered by “external contingencies”.

HMRC starts by dismissing the argument that the words “under the securities” confine the enquiry to the terms of the securities. I think that is right. However, there is no discussion of the next two phrases: “the consideration given by the company” and “for the use of the principal secured”.

The first of these cannot mean what the lender actually receives, otherwise all debt would be “results-dependent”. The critical distinction is, perhaps, between “what the borrower promises to pay” and “what the lender is entitled to”. The latter paraphrase would support the views expressed in the June Paper, but the former is I think a more natural reading of the words “consideration given by the company”.

Next, the words “for the use of the principal secured” also deserve attention. They bring to mind the classic definition of interest: payment by time for the use of money. One might say that the promise to repay principal is consideration for the advance of the principal, but not for its use. Moreover, “secured” means essentially “repayable” (rather than “advanced”).

Though the point is not an easy one, I conclude that a contractual term which provides solely for a contingent reduction in the return of principal should not generally be within the scope of section 1015(4).

HMRC prefers instead to focus on the final part of section 1015(4): “depends (to any extent) on the results of the company’s business”. It then posits three ways of determining the scope of the enquiry: looking only at the terms of the instrument; taking account of “every possible circumstance, however remote”; and its preferred “remoteness test”, which goes beyond the terms of the instrument but “is limited to the circumstances that exist or are at least considered likely to exist at the time of the issue of the instrument”.

This seems to me to confuse two different questions. A “remoteness test” is appropriate in determining whether there is a sufficient causal link between the consideration and the results of the company’s business. Whether one should take “external contingencies” into account at all is surely a matter of the meaning of the words “consideration given by the company”.
PRACTICAL APPLICATION

The June Paper ends by setting out HMRC’s views on four specific points.

To start with the easiest, in section 6.1: the mere possibility (or probability) of a future regime for “statutory bail-in” (item (3) in my list of proposed changes) should not make the consideration results-dependent. This is surely right, though HMRC’s conclusion here seems to be at odds with its earlier suggestion that circumstances “considered likely to exist at the time of the issue of the instrument” must be taken into account.

In section 6.2, HMRC goes on to state that when a statutory bail-in regime takes effect, issuers of existing instruments should accept that the consideration they have given is “likely to become results-dependent from that time”. This involves saying that one must look beyond contractual terms for the “consideration given”, that a contingent reduction in the “principal secured” is relevant, and that the test can be applied after issue (notwithstanding the passage quoted at the end of the preceding paragraph). I think HMRC is probably wrong here.

The third scenario considered by HMRC is an instrument which expressly allows for write-down – item (1) in my list – once the reforms come in. HMRC’s case for results-dependency is certainly stronger here. But the words “for the use of the principal secured” in s1015(4) provide a good counter-argument.

Finally, section 8 of the June Paper touches on the new rules that will apply to the payment of distributions – item (2). These will, says HMRC, be a “strong indicator” of results-dependency. In my view that is, if anything, understating the position.

Thus the prospects for deductibility of interest paid on future issues of hybrid capital do not look at all good under current law, especially as interpreted by HMRC. Finance Act 2012 s 221 has given Government the power to the deal with the problem through secondary legislation and we can expect further consultation from HMRC in the Autumn. It will be interesting to see what emerges.

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