I fear that many readers will have missed the big tax story in last month’s Budget. As the Editor of *Tax Journal* was kind enough to point out to me when I suggested the subject for this article, The Times broke the news on 1 April: “Chancellor to banks’ rescue with secret £1bn tax break”.

There followed two full columns devoted to an announcement which appeared in paragraph 2.26 of the *Overview of Tax Legislation and Rates* published on 20 March. This read as follows:

“The Government will, following the conclusion of the Capital Requirements Directive IV, issue secondary legislation to confirm and ensure that banks’ Additional Tier One debt capital instruments, both already in issue and yet to be issued, will be deductible for the purposes of a bank in computing profits for corporation tax.”

Not much of a tax break, you may think – and hardly “secret”. Banks (and insurers) have for many years been able to treat as deductible the coupons they paid on hybrid capital; that is, “tier 1” or “tier 2” instruments which take the legal form of debt but have many of the economic characteristics of equity, so can count towards the issuer’s capital base. The regulatory regime is changing, but the concept remains the same.

**BASEL III AND SOLVENCY II**

A more sober assessment of the announcement has to begin with an account of the regulatory changes that are on the way, and of HMRC’s response to date.

A directive commonly referred to Solvency II appeared in 2009. This envisaged reforms to the capital requirements for EU insurers, designed to improve their ability to withstand an individual or systemic financial crisis. Then in December 2010 agreement was reached on the “Basel III” package, which included measures intended to increase the “loss absorbency” of bank capital.

Under both regimes, the existing distinction between upper and lower tier 2 capital will disappear. There will also be new terminology for the highest tier of hybrid capital: the replacement for what is currently called “innovative tier 1” capital will be known either as “additional tier 1” capital (for banks) or, simply, “tier 1” capital (for insurers).

European legislation supplementing Solvency II has yet to be agreed and it appears that the directive is now unlikely to take effect before January 2015. However, most of the European legislation required to implement the relevant parts of Basel III is substantially agreed. The text of Capital Requirements Directive IV (“CRD IV”) and a related regulation (the “CRR”) was adopted by the European Parliament on 16 April 2013 and, following formal approval from the Council of Ministers, is expected to apply from 1 January 2014.
It has in fact been clear for some time that CRD IV would come into effect before the Solvency II measures and accordingly it is the position for UK banks that has to date been the focus for HMRC.

HMRC’S RESPONSE

The critical UK tax question for issuers of hybrid capital is whether the coupons they pay are respected as (deductible) interest or are instead treated as “results-dependent” distributions under the rule now contained in s 1015(4) CTA 2010. It arises primarily because, to be accepted as part of the issuer’s “regulatory capital” (which includes normal equity), the instruments must give the issuer flexibility to defer payment of the coupons. But so long as the obligation to pay does not fall away entirely, HMRC has generally been willing to accept that s 1015(4) does not apply.

Many tier 1 instruments go further than this, removing any obligation to repay principal except in the event of issuer insolvency – so-called “perpetuals”. HMRC seemed happy with this feature too. But last April it dropped a bombshell: it had concluded that perpetuals were not debt as a matter of the general law, so fell outside the loan relationships regime altogether.

This remarkable development was the subject of a piece I co-authored at the time ("Is a Perpetual Note Debt for Tax Purposes?" Tax Journal, dated 4 May 2012). Happily, HMRC published a short note on 26 June 2012 (the “June paper” – re-issued in September but with very little amendment) which made it clear that instruments already in issue were not in fact affected. The June paper claimed that additional tier 1 instruments issued in compliance with CRD IV would have to be “truly perpetual”, giving the holder “no right to repayment of the principal”. But tier 1 instruments issued under the current regulatory regime, providing for repayment in insolvency, were merely “contingent perpetuals”. Accordingly, “as contingent debts are treated as debts such instruments will be money debts for loan relationship purposes”.

I discussed the June paper in a second article, published in the 27 July issue of Tax Journal. This noted that the threat to existing hybrid capital issues had receded, but many questions remained. In particular, why did HMRC believe that additional tier 1 capital would be “truly perpetual”? And more important still, would there be new legislation to ensure deductibility for interest paid on hybrid capital issued in compliance with CRD IV (or Solvency II)?

TIER 2 CAPITAL

The first chink of light appeared on 26 October 2012. HMRC published a Technical Note which set out draft legislation designed to ensure continuing deductibility for interest paid on banks’ tier 2 capital.

The statement of intent was very welcome, but the drafting approach was convoluted. However, the version which resurfaced on 11 December 2012, as part of the first draft of Finance Bill 2013, took a completely different and much better approach. There is to be a new s 1032A added to CTA 2010 which will simply state that “a payment made in respect of tier two securities is not a distribution for purposes of the Corporation Tax Acts”. There will (inevitably) be a new TAAR too, but in practice this is unlikely to be any more restrictive than the familiar loan relationships TAAR in ss 441 and 442 CTA 2009. There will also be a new section 164A CTA 2010 which ensures that, where tier 2 capital is issued by a subsidiary, it cannot degroup the subsidiary from its parent.

The provisions have now been polished further and I believe that the version published on 28 March should achieve its objective. In fact, the only remaining question is whether the new provisions are needed at all; it is not clear as a technical matter that the contingent write-down of principal make the "consideration given by the company for the use of the principal secured" results-dependent within s 1015(4). But it is obviously very good to have certainty here.
ADDITIONAL TIER 1 CAPITAL

By contrast, there can be no doubt at all that a legislative solution is needed for additional tier 1 capital. CRD IV will require that interest payments are funded out of distributable reserves and are cancelled altogether (not merely deferred) if the issuer gets into trouble, so the interest will quite clearly be “results-dependent”.

With CRD IV essentially settled, it is to be hoped that HMRC will publish the promised legislation in the next month or two. It will be interesting to see whether HMRC sticks to the view expressed in the June paper – that additional tier 1 instruments must be “truly perpetual” – and so includes a provision which deems such instruments to be loan relationships. In the author’s view, such a provision would be entirely unnecessary.

Bank issuers will also be concerned about stamp duty, as the “loan capital” exemption has its own exclusion for results-dependent interest (s 79(6)(b) FA 1986). The point has been drawn to the attention of HMRC and it can be expected to deal with this too.

WHAT ABOUT INSURERS?

The attentive reader will have noticed that none of this promises to assist UK insurers who want to issue hybrid capital which complies with the principles in Solvency II.

It seems likely that, even on HMRC’s expansive view of s 1015(4) CTA 2010, no amendment will in fact be needed to preserve the treatment of tier 2 instruments. That is because, in contrast to the position for banks, the new regulatory regime for insurers does not (currently, at least) provide for the write-down of principal in any circumstances.

It is a different story for tier 1 capital. As under CRD IV, coupons will only be payable out of distributable reserves and the issuer will have to be able to cancel payment altogether. So an amendment to s 1015(4) CTA 2010 is essential if deductibility is to be preserved.

HMRC presumably sees this as tomorrow’s problem, given the likely timetable for the implementation of Solvency II. And indeed Solvency II envisages that instruments issued before implementation should benefit from grandfathering. But the Prudential Regulation Authority (one of the two successors to the FSA) has made it clear that it expects any new issue of tier 1 debt by a UK insurer to comply in full with the expected Solvency II requirements from the outset.

The result is that it is currently impossible for a UK insurer to combine tier 1 status with interest deductibility for a new issue, at least without special structuring. The two authorities ought to adopt a more co-ordinated approach.

But it seems churlish to end on a negative note. Though HMRC (and the Government) can be criticised for taking too long to resolve the tax issues in this area, it is now apparent that the banks will get the answer they need and it is surely only a matter of time before insurers are covered too.

This article was originally published in the 3 May 2013 edition of Tax Journal.