



HM Treasury

# Restricting tax relief for banks' compensation expenditure

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March 2015





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# Contents

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		Page
Chapter 1	Introduction	3
Chapter 2	Defining compensation	5
Chapter 3	Detailed design	9

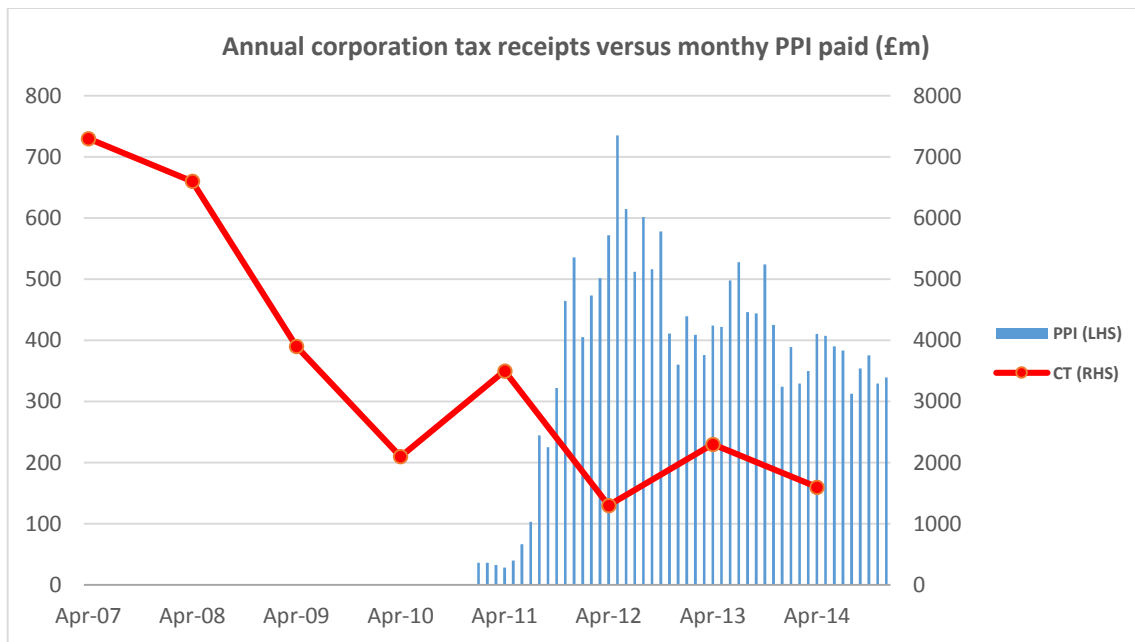


# 1 Introduction

**1.1** Fines and punitive damages are generally treated as non-deductible expenses for corporation tax purposes. This means that state and regulator imposed fines in respect of banks' misselling and misconduct (e.g. benchmark manipulation, money laundering and sanctions violations) have had no direct impact on UK tax receipts, and have instead benefitted the Exchequer due to a change in rules enacted by this government.<sup>1</sup>

**1.2** This is not true for customer compensation payments. These payments are generally treated as deductible expenses for corporation tax purposes, reflecting the fact that these payments are non-punitive and often the straightforward reimbursement of income upon which businesses have already been taxed.

**1.3** As such, the large compensation payments that banks have made in relation to the misselling of payment protection insurance (PPI) and interest rate hedging products (IRHP) have had a direct impact on banks' post-crisis corporation tax payments.



Source: HMRC and FCA

**1.4** The scale of this compensation has been unprecedented. Over £24 billion in compensation has already been paid out or provided for in relation to PPI misselling, with an equivalent figure of £1.8 billion for the misselling of IRHP. This is reflected in banks' corporation tax payments, which averaged around £2 billion across 2010-11 to 2013-14 compared to around £7 billion pre-crisis.

**1.5** The level of these compensation payments, and their impact on tax receipts, has crucially persisted year-on-year. New provisions in relation to PPI exceeded £1.6 billion in the fourth quarter of 2014 alone; cumulative provisions are now well in excess of initial government and market expectations and continuing to grow.

<sup>1</sup> Until April 2012, bank fines were returned to the regulator and used to discount fees paid by banks which hadn't been fined the following year. Under the Financial Services Act 2012, these rules were reformed so that the regulators pass the revenue received from fines (over and above the cost of enforcement cases) to the Exchequer.

**1.6** In this context, the government believes that the existing tax rules in this area have become unsustainable. It is not acceptable that corporation tax receipts continue to be depressed by banks' past misconduct, which in some instances took place over ten years ago.

**1.7** The government is therefore taking action to address this, by making banks' future compensation payments non-deductible for corporation tax purposes<sup>2</sup>. This will help to protect the Exchequer from banks' past management failures and ensure the sector makes an appropriate contribution to restoring the public finances.

### **Timing and engagement**

**1.8** The consultation will run for a 2 month period, closing on 29 May 2015. HMT and HMRC officials intend to hold a number of working groups towards the end of this period

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<sup>2</sup> More strictly, the measure will apply to amounts recorded in the profit and loss account as expenses in relation to bank compensation payments (which includes the recognition of new provisions).



## 2 Defining compensation

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### Targeting the measure

**2.1** There have been a number of examples of banking sector misconduct and misselling in recent years which have necessitated large compensation payments. These include the following:

- Misselling of PPI: Customers were pushed into buying PPI products or uninformed that these products formed part of their contract.
- Misselling of interest rate hedging products: Customers were pushed into buying interest rate hedging products, often with poorly disclosed exit costs.
- Misselling of card protection and identity fraud insurance: Customers purchasing these products were often misled or given unclear information.

**2.2** The government believes it to be essential that these types of compensation payment are made non-deductible as a result of this measure.

**2.3** However, it also recognises the case for excluding compensation that is less exceptional and less specific to the banking sector. This may include employee remuneration, personal injury claims and refunds arising from administrative errors which are quickly identified and addressed. (This may also include goodwill payments made to valued customers where there has been no actual wrongdoing on account of these customers.)

**2.4** The government believes that an appropriate balance could be achieved by targeting the measure towards banks' compensation payments made to customers (retail and wholesale) in relation to the provision of financial services.<sup>1</sup> Nonetheless, it is willing to consider alternative ways of targeting the measure, with three options identified below for the purposes of discussion.

**Question 1:** What types of compensation do you consider to be less specific and less exceptional to the banking sector?

**Question 2:** To what extent would these types of compensation be impacted by the definition in paragraph 2.4?

### Option 1: Linking to the regulatory regime

**2.5** The first option would be to make banks' compensation payments non-deductible where they relate to a breach of relevant FCA regulatory standards.

**2.6** The government is sceptical about the merits and practicality of this approach. It is understood that the FCA does not generally take formal action in respect of these standards, particularly where a bank is already making voluntary payments or an informal solution can be agreed in its place (which is favoured on account of accelerating consumer relief).

**2.7** With financial ombudsman and court rulings applying to only a minority of cases, HMRC would therefore be left with the task of assessing banks' compensation payments (and the underlying activities to which they relate) against the FCA regulatory guidelines in order to determine their deductibility. This is not likely to be practical nor appropriate.<sup>2</sup>

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<sup>1</sup> This would rely on the general legal meaning of compensation and target payments recognised in companies GAAP-compliant accounts.

<sup>2</sup> The FCA have their own experts for assessing whether financial advice or the sale of a financial product was appropriate for a given customer.

**2.8** An alternative approach would be to make banks' compensation payments non-deductible where they are made as part of an FCA consumer redress scheme or made in response to a formal FCA investigation.

**2.9** However, the government understands that redress schemes are a last resort for the FCA and that formal investigations are generally conducted on an individual bank basis in relation to very specific issues, not say the mis-selling of a financial product in its entirety. On this basis, neither of these approaches is likely to be appropriate.

**Question 3:** Is there a way of linking the measure to the regulatory regime in a way that achieves the government's objectives and remains administrable by HMRC?

### **Option 2: Defining through tax legislation**

**2.10** The government is not attracted to the idea of specifying a list of products/services for which compensation is non-deductible (e.g. PPI and IRHP mis-selling) given the difficulties in capturing all relevant products/services, and the fact that there are likely to be many different explanations for the compensation that these products/services give rise to.

**2.11** It may instead be possible to form an objective definition of non-deductible compensation for the purposes of the measure, designed in a way that is broadly consistent with the FCA's regulatory standards but allowing for greater ease of interpretation and application by HMRC.

**2.12** However, the government would need assurance that any such definition at least captures the issues cited in paragraph 2.1 i.e. misinforming customers, misleading customers, mistreating customers and deliberate misconduct which is detrimental to a customer's interests.

**2.13** The government would also need to be confident in HMRC's ability to assess banks' payments against this definition (significant given the concerns raised above about HMRC's ability to apply regulatory standards) and be comfortable that this definition did not set an unhelpful precedent for future disputes between banks and their customers, which could potentially be the case if it is narrower or wider than FCA standards.<sup>3</sup>

**2.14** On this basis, a more viable approach could be to make all customer compensation payments in relation to the provision of financial services non-deductible, but have a set of specific and clearly defined exclusions which HMRC believe can be realistically enforced e.g. administrative errors identified and addressed within a bank's accounting period. The government welcomes views on what these exclusions could be, reiterating the importance of the conditions set out in paragraphs 2.12 and 2.13.

**Question 4:** To what extent could a definition of non-deductible compensation be included in tax legislation, in a way that addresses the concerns raised in paragraphs 2.12 and 2.13?

**Question 5:** If the government was to instead define deductible compensation, what should be covered here and how exactly would this be defined?

### **Option 3: Indirect methods**

**2.15** If the approaches above are considered impractical, the government would be willing to consider more indirect ways of targeting the measure towards the types of compensation outlined in paragraph 2.1.

**2.16** One approach could be to apply the measure to all customer compensation in relation to the provision of financial services, but only make this compensation non-deductible where it exceeds an annual threshold applied at group level.

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<sup>3</sup> It would also need to be sure that this definition could apply to both retail and wholesale customers, recognising that industry standards are generally geared towards the former.

**2.17** Decisions would need to be taken on the level of the threshold, the extent to which (and mechanism by which) the threshold level is adjusted according to banks' size and the process for allocating the threshold around a group's entities. However, the government first welcomes views on the high-level approach and the potential issues for banks in not having certainty on the tax treatment of their compensation expenditure until year-end.

**2.18** Another approach could be to confine the measure to compensation payments made in relation to the provision of financial services in a preceding accounting period, or the provision of financial services that took place over 12 months ago.

**2.19** This would rely on an assumption that a clear distinction can be drawn between different types of compensation payments (and the activity that these compensation payments relate to) based on the time it takes for them to be settled. This is an assumption which needs careful consideration.

**Question 6:** To what extent do you think a threshold or time-limit could be an effective means of targeting the measure?

**Question 7:** Are there any issues and/or unhelpful incentives that these approaches could give rise to?



## 3 Detailed design

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**3.1** In addition to the considerations around how the measure is targeted, there are a number of detailed design questions that the government would like to explore as part of the consultation. These include the definition of entities within scope, the treatment of provisions, the treatment of expenses associated with compensation payments and the design of any threshold used to target the measure.

### Entities in scope

**3.2** It is proposed that the measure would apply to regulated banking entities, using the definition in place for the bank loss-relief restriction.<sup>1</sup>

**3.3** This definition looks to capture all banking and building society groups, including both retail and investment banks. The government welcomes views on this scope and any potential issues it may create for the options outlined above e.g. if non-deductibility was linked to FCA regulatory standards which were geared towards retail banking.

**3.4** The relevant test here will be whether a compensation payment relates to provision of financial services by a regulated banking entity within the same group, rather than a test of whether the entity making the compensation payment meets this definition. This should remove the scope for banking groups to circumvent the impact of the measure by making compensation payments out of non-regulated entities.

**Question 8:** Do you have any comments or concerns with the proposed scope of the measure?

### Payments in scope

**3.5** The government believes that the measure should apply equally to mandatory and ex-gratia payments if the underlying cause of the payment is considered to be the same i.e. if a bank is compensating a customer for misleading a customer in the sale of a given product, this payment should be non-deductible whether this is a voluntary payment, a payment mandated by the FCA, or a payment made for some other reason.<sup>2</sup>

**3.6** The government also believes that the measure should apply to any interest component of a compensation payment (i.e. the recognition of interest forgone on any income now being repaid to a customer) and should apply equally to cash and non-cash compensation, such as the waiving of fees or the restructuring of financial products on favourable terms to the customer.

**3.7** Finally, the government believes that there is a case for making certain expenses associated with banks' compensation payments non-deductible, such as legal fees and the administrative costs in quantifying, agreeing and processing payments.

**3.8** The government understands that banks' provisions for PPI often encompass these types of expense, but welcomes views on the practicality of doing this for a wider range of payments and any unhelpful incentives/distortions that the non-deductibility of these expenses may give rise to e.g. a disincentive for banks to proactively compensate their customers.

**3.9** A simplified approach, particularly for banks that do not outsource claims management functions, could be to assume that associated expenses represent a flat percentage of a bank's final compensation payment and treat this as a taxable credit when computing banks' corporation tax income. The government welcomes views on this approach.

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<sup>1</sup> <http://www.publications.parliament.uk/pa/bills/cbill/2014-2015/0193/15193.pdf> (see page 134)

<sup>2</sup> There may be a distinction here between a goodwill payment that a bank is making to a valued customer, and a payment that is made to a customer for some wrongdoing albeit not mandated by the FCA or ombudsman service.

**Question 9:** What issues need to be considered in applying the measure to voluntary and/or non-cash compensation?

**Question 10:** What are the arguments against applying the measure to expenses associated with relevant compensation payments, such as administrative costs?

### **Treatment of provisions**

**3.10** The tax treatment of compensation expenditure currently follows the accounts. This means that banks obtain tax relief for any accounting provisions made in respect of estimated future compensation expenditure, with this relief available at the point a provision is made rather than when the compensation is paid. Subsequent adjustments to these accounting provisions (i.e. if compensation paid turns out to be lower/higher than the amount provided for) are then either taxed or relieved.

**3.11** This measure will operate according to the same principle. Banks will not be entitled to tax relief for accounting provisions made in respect of non-deductible compensation expenditure. Subsequent adjustments to these provisions will then be disregarded for tax purposes i.e. the release of an accounting provision relating to non-deductible compensation expenditure will not be included in a bank's taxable income. This should ensure that banks do not face a tax charge for compensation that is provided for but never ultimately paid.

**3.12** This approach will require banks to trace deductible and non-deductible provisions within their accounts, to ensure that only adjustments to non-deductible provisions are disregarded for tax purposes.

**3.13** The government believes that this should be manageable, but welcomes views on this in the context of the three options cited above. The alternative approach would be to deny banks tax relief for any provisions that relate to compensation expenditure, with this tax treatment then reassessed at the point at which the provision is utilised i.e. if a provision is used for compensation outside the scope of this measure, tax relief would become available at this point.

**Question 11:** Do you agree with the government's proposed treatment of provisions? To what extent would banks be able to trace deductible and non-deductible provisions in their accounts?

### **Insurance**

**3.14** The government understands that banking entities may have taken out insurance against the cost of certain compensation expenses. This insurance may be provided by another entity within the group or a third party.

**3.15** In the absence of any explicit provision, this measure will have the effect of making the gross amount of an entity's compensation expenditure non-deductible for tax purposes, irrespective of whether this expenditure is covered by a taxable insurance receipt.

**3.16** The government believes that this is an appropriate result where insurance has been provided by a captive insurer, in ensuring that groups cannot avoid the impact of the measure by reallocating compensation expenses between their constituent entities (without actually reducing the group's overall liability).

**3.17** The government welcomes views on the treatment of insurance provided by third parties and the case for making a distinction here.

**Question 12:** Are there alternative ways of addressing the avoidance risks associated with captive insurance? To what extent should insurance provided by third-parties be treated differently here?

## Commencement

**3.18** As stated above, the government intends to legislate this measure in a post-election Finance Bill. The measure would then become effective at the earliest possible start date e.g. the date of the measure's inclusion in a post-election Budget.

**3.19** There are a number of different options for the measure's commencement. One option would be to apply the measure to compensation expenses incurred after the effective start date, apportioning any provisions made in accounting periods straddling this date on a time basis. To illustrate this, consider the following three examples, all of which assume a start date of 1 July 2015.

- A bank with a calendar year accounting period makes unprovided compensation payments (recorded as expenses) of £200m across 2015, of which £75m falls after 1 July 2015. The bank is entitled to a deduction of £125m in calculating its taxable profits.
- A bank with a calendar year accounting period recognises a new £500m provision for future compensation payments in its 2015 accounts. This provision is time-apportioned by reference to the 1 July 2015 start-date, irrespective of the profile of the provision in the bank's quarterly account. The bank is entitled to a deduction of £250m in calculating its taxable profits.
- A bank with a 31 March year-end makes unprovided compensation payments (recorded as expenses) of £100m between 1 April 2015 and 31 March 2016, of which £60m falls after 1 July 2015. The bank also recognises a new provision of £200m for future compensation payments in its year-end accounts. The bank is entitled to a deduction of £90m in calculating its taxable profits.

**3.20** The government believes that the time-apportionment of provisions recognised in straddling accounting periods is a reasonable approach, offering protection against banks inflating their provisions ahead of the measure's start date and reducing the need for an anti-forestalling rule.<sup>3</sup> That said, the government is interested in views on this approach and any alternative options for the measure's commencement.

**Question 13:** Do you have any comments on the proposed commencement of the measure?

### Threshold approach (specific to Option 3)

**3.21** As set out in paragraph 2.15, if it is not possible to define non-deductible compensation or link this to a breach of the regulatory regime, more indirect methods could be considered for targeting this measure. One method would be to apply the measure to a broad definition of compensation, but only make this non-deductible where it exceeds a given threshold each year.

**3.22** It is envisaged that this threshold would apply at group-level and operate via a similar mechanism to the worldwide debt cap, with one company assuming responsibility for allocating the threshold amongst group members.<sup>4</sup>

**3.23** It is not envisaged that banks would be entitled to carry forward any unused threshold to future periods, but the government welcomes views on this and any undesirable incentives it may create for banks to stagger their provisions across multiple periods.

**3.24** A separate decision would need to be taken on the level of the threshold and the extent to which it is adjusted by some metric of banks' size and/or customer base. One option could be to say that banking groups get a threshold worth X percent of some balance sheet metric e.g. gross assets across regulated banking entities. The government would welcome views on the potential issues that may arise from calculating a balance sheet metric across a subset of group entities and the issues, for foreign-headed banks, in calculating this metric on a comparable IFRS basis. (The

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<sup>3</sup> It should be noted here that tax-motivated manipulation of provisions could still be viewed as a breach of the banking code of practice.

<sup>4</sup> An alternative approach would be to say that a proportion of each compensation payment within the group is deductible, with this proportion being the threshold level divided by total group compensation (capped at 100 percent).

potential volatility of this metric, and the difficulties for banks in understanding their position in real-time, should also be considered.)

**3.25** Another option would be to say that banking groups are entitled to a threshold of X per regulated banking entity customer. This could be based on the single customer view information that banks are required to hold for FSCS purposes, although it would need to be considered whether an equivalent metric is available for non-deposit taking banks.

**3.26** A final option would be to have a threshold based on group income i.e. deductible compensation restricted to X percent of regulated entities' profit before tax. It may be necessary to use a long-term income metric (e.g. income averaged over a set number of years) to avoid disadvantaging groups that recognise large compensation expenses in years of relatively low profitability and to avoid creating perverse incentives for groups not to provision in these years.

**Question 14:** What would you consider to be an appropriate and workable metric for adjusting a threshold according to banks' size?

**Question 15:** Do you have any concerns with the government's proposed approach for operating the threshold?

### **Accounting considerations**

**3.27** The government welcomes more information on how banks' generally control, monitor and account for different types of compensation expenditure. In particular:

- the types of future compensation that banks typically provide for;
- the extent to which associated expenses (e.g. administrative costs) are included in these provisions;
- the extent to which banks distinguish in their accounts between goodwill payments where there has been no customer wrongdoing, voluntary payments that stem from wrongdoing on behalf of a customer and mandatory payments; and
- how banks account for compensation payments settled within a period i.e. are these payments netted off against corresponding income or shown as a separate line in accounts.

**3.28** The government welcomes views on how the answers to these questions, and any further detail on the accounting treatment of banks' compensation expenditure, should be used to inform decisions on the measure's detailed design.

**Question 16:** How can the detailed design of the measure best take account of banks' general approach to controlling, monitoring and accounting for compensation expenditure?





## **HM Treasury contacts**

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