Draft Regulations - The Taxation of Regulatory Capital Securities Regulations 2013 - Update

Technical Note
December 2013

Regulatory Capital Securities Technical Note

This technical note sets out the policy intention and technical detail of the proposed legislative changes to make provision for the tax treatment of financial institutions' regulatory capital instruments. It replaces the previous technical note dated 16 July 2013 and takes into account consultation responses.

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Further draft of Regulations

The comments below set out HMRC's view of how the new Regulations will operate. All references are to Corporation Tax Act 2009 unless otherwise provided.

General

Regulations made under the power contained in section 221 FA 12 are subject to the affirmative procedure and the tax rules provided by these Regulations will apply prospectively.

1. Citation, commencement and effect

1.1 These Regulations will have effect from 1 January 2014, to coincide with the date the Capital Requirements Regulation ("CRR") has legal effect.

1.2 Securities issued on or after 1 January 2014 which meet the relevant criteria will receive the tax treatment provided by these Regulations, subject to the anti avoidance provision.

1.3 Securities issued before 1 January 2014 which meet the relevant criteria will receive the tax treatment provided by these Regulations once these Regulations come into effect, subject to the anti avoidance provision. This means the Regulations have effect:

- for income tax purposes in relation to payments made on or after 1 January 2014,
- for corporation tax purposes in relation to accounting periods beginning on or after 1 January 2014. For this purpose of these Regulations a new accounting period will be deemed to commence on 1 January 2014, so that the tax treatment provided by these Regulations is prospective,
- for capital gains tax purposes in relation to disposals on or after 1 January 2014,
- for stamp duty purposes in relation to instruments executed on or after 1 January 2014,

- for SDRT purposes in relations to agreements made on or after 1 January 2014, or if the agreement is conditional, in relation to agreements where the condition is satisfied, on or after 1 January 2014.

1.4 Regulation 11 sets out the transitional provisions for securities which meet the criteria but which are issued before 1 January 2014.

2. Regulatory Capital Securities

2.1 This regulation provides that the tax rules prescribed by these Regulations apply to Regulatory Capital Securities ("RCS"). These are securities that qualify either as AT1 or T2 for the purposes of the CRR. Once the security satisfies the criteria, the tax treatment set out in the Regulations will apply throughout the life of the security, subject to the anti avoidance provision.

2.2 The tax rules provided by these Regulations are limited to qualifying CRR AT1 or T2 securities issued directly or indirectly by a UK entity and that form part, or did form part, of the basis of an entity's consolidated situation, or an entity's own, Additional Tier 1 capital resources or Tier 2 capital resources for the purposes of CRR. Qualifying CRR AT1 or T2 RCS are Additional Tier 1 or Tier 2 instruments. "Additional Tier 1 instrument" means a security which qualifies as an Additional Tier 1 instrument under Article 52 of CRR. "Tier 2 instrument" means a security which qualifies as a Tier 2 instrument under Article 63 of CRR. "Consolidated situation" refers to CRR Article 4 paragraph 1(47).

2.3 In the case of a non-UK issuer with a UK permanent establishment, the CATA rules in CTA 09 will operate to attribute a deemed amount of regulatory capital on the basis that the UK permanent establishment was a single enterprise under the single enterprise principle. The CATA rules will arrive at a deemed notional amount of regulatory capital. Where the deemed amount includes either AT1 or T2 capital the Regulations will ensure that the coupon on the AT1 or T2 security are brought into account under Part 5 on the basis that the securities have met the criteria set out in regulation 2.

2.4 RCS do not include securities that are shares, except in the case of an AT1 instrument issued by a building society.

3. RCS treated as loan relationships

3.1 The Regulations will provide that the RCS are loan relationships for corporation tax purposes and will be taxed under Part 5. The loan relationship rules will apply to the RCS in the normal way. This is however subject to some specific rules set out below which apply to the issuer of these instruments and, in the case of a connected company, the holder of these instruments. These specific rules do not apply to holders of RCS that are unconnected to the issuer.

3.2 Regulation 3(2)(a) provides that sections 415, 416 and 585 do not apply to the RCS. This means that, even where an instrument is bifurcated for accounting purposes, it is treated as a single loan relationship to be taxed within Part 5. This is relevant where the instrument is accounted for as a compound instrument under IAS 32 (or equivalent) or where there is an embedded derivative under IAS 39 (or equivalent).

3.3 Regulation 3(2)(b) provides that the RCS must not be accounted for using fair value accounting for tax purposes. This also covers the situation where an element of the RCS instrument is fair valued. So, in particular, this prohibits the fair value accounting of the whole instrument, an embedded derivative or for fair value profit and losses on the instrument to be recognised in respect of a designated hedging relationship.

3.4 This will not disturb the position where a RCS is accounted for as a financial liability that is measured at amortised cost or accounted for as an equity instrument that is recognised through equity. Nor will it disturb the position where an RCS is a compound instrument that is bifurcated into a liability component (measured at amortised cost) and an equity component (recognised through equity). In the case of a compound instrument, the tax position should simply follow the accounts – although it will be necessary to bring into account both the amounts recognised in profit or loss and amounts recognised direct to equity.

3.5 Regulation 3(2)(c) provides that no credits or debits are to be brought into account in respect of the principal amount of the security being written down (or written back up following a write down) on a temporary or permanent basis or converted to common equity tier 1 in accordance with regulatory requirements (UK or EU regulatory requirements) or the provisions governing the security. This is to ensure that the conversion or write-down of an instrument will not in itself trigger a tax liability on the issuer. In the absence of formally exercised statutory regulatory requirement and direction powers, this provision does not cater for liability management exercises. If, however, a liability management exercise is undertaken in direct response to the formal exercising of a statutory regulatory requirement and direction power then the specific circumstances should be discussed with HMRC and HMRC will review the possible application of this provision on a case by case basis.

3.6 These rules will also apply to a connected company holder to ensure symmetry of treatment between the connected party issuers and holders.

3.7 Regulation 3(3) ensures that where it is relevant to ascertain the carrying value of the regulatory instrument for tax purposes, the carrying value is the tax adjusted carrying value as specified in sections 316 to 319.

4. RCS treated as normal commercial loans

4.1 This regulation provides that for the purposes of the taxation of chargeable gains and the corporation tax grouping rules RCS are normal commercial loans.

4.2 Securities issued to corporate holders will be within the rules for Loan Relationships and therefore for the purposes of TCGA 92 will automatically be Qualifying Corporate Bonds. For non-corporate holders the normal rules within TCGA 92 will apply so for example if the securities were capable of being redeemed in a currency other than sterling then they would not come within the definition of a QCB.

5. Treatment of payments

5.1 This regulation provides that any payments made under the RCS which are not repayments of principal are not distributions for tax purposes; the payments will be taxed as income chargeable under Chapter 2 Part 4 of ITTOIA (interest) for income tax purposes. This includes coupon payments and also any premium paid or discount received. Repayments of principal are excluded from the meaning of payments.

6. Exception from the duty to deduct income tax

6.1 This regulation provides a specific exception from the duty to deduct tax from yearly interest in section 874 ITA 07, and in the case of a building society from payments in respect of building society securities in section 889 ITA 07.

7. Exemption from stamp duties

7.1 This regulation provides that transfers of RCS are exempt from stamp duties.

8. Anti-avoidance

8.1 This regulation provides that the tax treatment provided by regulations 3 to 7 does not apply if there are arrangements where the main purpose or one of the main purposes is to obtain a tax advantage for any person in respect of the security.

9. Duty to deduct from payments in respect of RCS

9.1 This regulation provides a disapplication of two exceptions from the duty to deduct tax from yearly interest when the payment is made in respect of a RCS. The exceptions in section 878 (interest paid by banks) and section 885 ITA 07 (authorised persons dealing in financial instruments) are disapplied for payments made in respect of RCS. These changes ensure that the tax rules reflect the manner in which banks and investment firms acquire and use funding for their businesses. Accordingly, Statement of Practice 4/96 will be withdrawn in due course and guidance will be issued reflecting HMRC’s current view on other matters referred to in SP 4/96.

10. Amendment of the Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Loses) Regulations 2004

10.1 The Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004 (SI 2004/3256) have been amended so that RCS that are accounted for as equity may be treated in the same way as a company's own shares. An amendment has also been made to the effect of a reg 6(5) or reg 6(5B) election in respect of RCS instruments that are designated as fair value through profit and loss.

10.2 Where an instrument is equity accounted, there is no retranslation of movements in exchange rates at the year end. Additionally, to the extent that an exchange gain or loss arises on redemption of the security, this will be recognised in the statement of changes in equity, and would therefore be excluded from being brought into account for tax under section 328. Where a company has entered into a loan relationship asset or a derivative contract which matches the equity instrument, then exchange movements on the loan asset or derivative contract will be disregarded in the same way as if the instrument was matched against own shares. This will apply where the company intends, in acquiring or continuing to be party to the asset or derivative, to eliminate or reduce the exchange rate risk arising from the issued instrument. (See CFM 62850 for further details.)

10.3 This change enables issuers of equity accounted RCS to be able to manage their exposure to exchange rate movements. It will also apply where a company economically hedges the equity component of a compound instrument. It will not apply in respect of hedges of the debt component of a compound instrument.

10.4 A company can make an election under regulation 6(5) or 6(5B) for regulation 9 not to apply. This allows companies to simply follow the accounts and rely on hedge accounting. There is however a specific rule in regulation 6(5A)(b) and 6(5C)(b) to deal with the situation where the hedged item is connected party debt (where the tax statute require amortised cost basis of accounting). A similar rule has been included to deal with RCS instruments that are accounted for on a fair value basis. Where this is the case, regulation 9 is not prevented from applying in respect of either a regulation 6(5) or a regulation 6(5B) election.

11. Transitional provisions

11.1 This regulation provides that at the date the Regulations come into effect, where an instrument has already been issued, is on first principles a loan relationship and the specific rules in regulation 3(2) affect the carrying value, then an adjustment is to be brought into account to reflect the amount the carrying value has increased or decreased. This is to ensure that amounts do not fall out of account and are not brought into account more than once.

11.2 Where an instrument was previously bifurcated into two or more instruments, the carrying value of the instrument is taken to be the aggregate of the bifurcated components. As such, the requirement in regulation 3(2)(a) not to apply sections 415, 416 and 585 should not affect the overall carrying value of the instrument.

11.3 Where the instrument (or a bifurcated component) was previously accounted for at fair value, there is likely to be an adjustment required to reflect that regulation 3(2)(b) prohibits fair value accounting under these Regulations.

11.4 This adjustment only applies where the RCS instrument falls to be treated as a loan relationship under normal principles.

12. Repeals and revocations

12.1 This regulation repeals the tax rules introduced as part of Finance Act 2013 in respect of banks' Tier 2 capital.

13. Annex 1 - worked examples

13.1 Below sets out how HMRC expects the Regulations to apply in the case of five illustrative examples.

13.2 The examples involve simplified instruments to best illustrate the key points and the resultant tax treatment. HMRC is aware that certain regulatory requirements may necessitate modification to the terms of such instruments, which may in the future have a material effect on the accounting and tax treatment.

13.3 In each case an assumed accounting treatment is stated. The accountancy treatment outlined below is, one possible analysis which could apply in certain cases. Alternative analyses could equally potentially apply. HMRC does not express any view as to whether a particular accounting is appropriate in each of the foregoing examples.

13.4 It is assumed in each example that the instrument qualifies as a loan relationship on first principles and will be a Regulatory Capital Security ("RCS") once the Taxation of Regulatory Capital Securities Regulations come into effect.

13.5 All references are to the Corporation Tax Act 2009 unless otherwise provided.

14 Example 1

14.1 Consider a Tier 2 ("T2") instrument with the following terms:

- £100m
- 10 year term
- Mandatory coupon payments
- Permanent write-down in full on a trigger event

14.2 Assume that the accounting treatment is as follows:

- Instrument is bifurcated for accountancy into a debt host (being the principal and coupons) with an embedded derivative (arising from the write-down clause).

- The debt host is measured on initial recognition at its fair value of £130m. It is subsequently measured at amortised cost, with the £30m 'premium' amortised over the term of the instrument in line with an effective interest rate method.

- The embedded derivative is measured on initial recognition at its fair value of £30m (asset). It is subsequently measured at fair value, with the movements recognised as either profits or losses.

14.3 On write down, the debt host (to the extent it is written down or extinguished) will be derecognised, as will the embedded derivative, with any difference recognised as an item of profit or loss.

14.4 Tax treatment

14.5 The existing tax treatment would typically be to respect the accounting bifurcation. The debt host is taxed as a loan relationship under Part 5, with tax relief in line with the accounts (effectively the coupon payments less the amortisation of the £30m premium). The embedded derivative will be taxed as a derivative contract under Part 7, with the fair value movements taxed in line with the accounts (assuming the debt is repaid, there should be an overall profit of £30m recognised).

Under the Regulations, the T2 instrument will be treated as a single loan relationship within Part 5 and fair value accounting for the embedded derivative will not be permitted. The tax treatment will follow the position had the embedded derivative not been bifurcated, with the whole instrument measured on an amortised cost basis of accounting. As a result, the instrument will have a carrying value of £100m, with the coupon payments recognised on an accruals basis.

14.6 Commencement

14.7 Assume that immediately before commencement of the Regulations the carrying value of the debt host is £120m (liability) and the carrying value of the embedded derivative is £35m (asset).

14.8 On the commencement of the Regulations there will be a transitional adjustment based on the difference of the new carrying of the whole instrument of £100m and the aggregate carrying value of the components immediately before commencement (£85m being £120m less £35m). A debit of £15m will therefore be brought into account representing an increase in the carrying value of the overall instrument. This effectively represents the reversal of the net movement that is the fair value profit on the embedded derivative and the amortised premium on the debt host previously brought into account.

14.9 Holder

14.10 Where the holder of the T2 instrument is an unconnected third party the holder will bring amounts into account on the basis of entries in their accounts. However, where the holder of the T2 instrument is connected to the issuer the Regulations the holder will be required to bring into account debits and credits on the basis that fair value accounting is not permitted and that the T2 is a single instrument. For connected holders therefore the tax treatment will be expected to mirror that set out above for the issuer.

15 Example 2

15.1 Consider a Tier 2 ("T2") instrument with the same terms as with example 1:

- £100m
- 10 year term
- Mandatory coupon payments
- Permanent write-down in full on a trigger event

15.2 Assume however that the accounting treatment is as follows:

- Instrument is not bifurcated for accountancy and is instead measured as a single instrument at fair value through profit and loss (eg. because it has been designated as FVTPL).

- The instrument is measured on initial recognition at its fair value of £100m. It is subsequently measured at fair value, with the movements recognised as either profits or losses.

15.3 On write down, the instrument (to the extent it is written down or extinguished) will be derecognised with any difference recognised as an item of profit or loss.

15.4 Tax treatment

15.5 Under the Regulations, the T2 instrument will be treated as a single loan relationship within Part 5 and fair value accounting for the instrument will not be permitted. The tax treatment will follow the position had the whole instrument measured on an amortised cost basis of accounting. As a result, the instrument will have a carrying value of £100m, with the coupon payments recognised on an accruals basis.

15.6 Commencement

15.7 Assume that immediately before commencement of the Regulations the carrying value of the instrument is £80m (liability), being its fair value.

15.8 On the commencement of the Regulations there will be a transitional adjustment based on the difference of the new carrying of the whole instrument of £100m and the aggregate carrying value of the instrument immediately before commencement (£80m). A debit of £20m will therefore be brought into account representing an increase in the carrying value of the instrument. This effectively represents the reversal of the net movement that is the fair value profit on the instrument host previously brought into account.

15.9 Holder

15.10 Where the holder of the T2 instrument is an unconnected third party the holder will bring amounts into account on the basis of entries in their accounts.

However, where the holder of the T2 instrument is connected to the issuer the Regulations the holder will be required to bring into account debits and credits on the basis that fair value accounting is not permitted and that the T2 is a single instrument. For connected holders therefore the tax treatment will be expected to mirror that set out above for the issuer.

16 Example 3

16.1 Consider a T2 instrument with the following terms:

- £1000m
- 10 year term
- Mandatory coupon payments of 10%
- Permanent write-down in full on a trigger event

16.2 The company enters into an interest rate swap (“IRS”) to hedge the fair value risk in the fixed coupon payments under the T2 instrument. This is designated as a hedging instrument of the fair value risk for accounting purposes.

16.3 Assume that the accounting treatment is as follows:

- The T2 is measured at amortised cost, with no separate embedded derivative or equity instrument recognised for accounting purposes.
- The change in the fair value of the T2 instrument related to the interest rate risk is recognised in profit or loss and as an adjustment to the carrying value of the T2 instrument.
- The IRS is accounted as fair value through profit or loss.

16.4 Tax treatment

16.5 The tax treatment will be as follows:

- The fair value adjustment to the carrying value of the T2 instrument is not permitted by regulation 3(2)(b), so that the tax treatment of the T2 instrument will follow the position as if the whole instrument been measured on an amortised cost basis of accounting (without any hedge adjustments).

- Regulation 9 of the Disregard Regulations (SI 2004/3256) will apply to derecognise the fair value movements on the IRS and instead apply an ‘appropriate accruals basis of accounting’. This will be the position regardless of whether the company has made an election under regulation 6(5) or 6(5B) of the Disregard Regulations.

16.6 Commencement

16.7 Assume that immediately before commencement of the Regulations the carrying value of the debt host is £1,150m (liability). Assume also that before commencement the carrying value of the IRS is a £150m asset.

16.8 On the commencement of the Regulations there will be a transitional adjustment based on the difference of the new carrying of the whole instrument of £1000m and the carrying value of the instrument immediately before commencement of £1,150m. A credit of £150m will therefore be brought into account representing a decrease in the carrying value of the instrument. This effectively represents the reversal of the fair value adjustment previously made to the T2 instrument.

16.9 Regulation 9 of the Disregard Regulations is unlikely to have applied prior to the application of the Regulations, but will apply following the commencement of the Regulations. As a result, regulation 9(2A) of the Disregard Regulations will bring into account such amount as is just and reasonable, principally to ensure that no amounts fall out of account. As such, a debit of £150m will be brought into account on transition in respect of the IRS.

16.10 Holder

For unconnected holders they will be taxed on the basis of entries in their accounts. For connected holders that the tax analysis will be expected to mirror the treatment set out above for the issuer.

17 Example 4

17.1 Consider an Additional Tier 1 (AT1) instrument with the following terms:

- $100m
- Undated
- Discretionary coupon payments
- Conversion on trigger event into a fixed number of shares

17.2 Assume that the accounting treatment is as follows:

- Instrument is accounted for as an equity instrument. The subscription proceeds of $100m are taken directly to equity, as are the coupon payments and amounts paid on redemption.

- In the event of conversion to shares, this will accounted for as a transfer within equity.

17.3 Tax treatment

17.4 The current treatment would typically be that the whole instrument is taxed as a loan relationship. Coupons recognised in equity would be brought into account (under s308 /s321). However, in many cases the coupon payment would be treated as a distribution and hence excluded from the loan relationship rules under section 465. Likewise, any profit or loss on redemption would be brought into account under Part 5. However, any exchange gain or loss on redemption would be excluded as being an amount recognised to the statement of changes in equity (s328).

17.5 Under the Regulations, the AT1 instrument will be taxed the same way apart from regulation 5(1)(a) prescribes that the coupon payments is not to be treated as a distribution.

17.6 Commencement

17.7 On the commencement of the Regulations there will be no transitional adjustment as the carrying value of the equity instrument before and after the date of commencement will remain at its cost of $100m.

17.8 Holder

17.9 For unconnected holders they will be taxed on the basis of entries in their accounts. For connected holders the tax analysis will be expected to mirror the treatment set out above for the issuer.

18 Example 5

18.1 Consider an AT1 instrument with the following terms:

- $100m
- Undated
- Discretionary coupon payments
- Conversion on trigger event into a variable number of shares ($100m / Share Price)

18.2 Please note that this example is for illustrative purposes only and ignores certain current and future regulatory requirements in respect of convertible instruments. HMRC understands, for example, that convertible instruments are likely to incorporate a floor price to satisfy the regulatory requirements. This could alter the accountancy treatment and is therefore not considered in this example.

18.3 Assume that the accounting treatment is as follows:

- The instrument is a compound instrument which is bifurcated for accountancy into a debt component (being the obligation to issue shares on a trigger event) and an equity component (being the discretionary coupons and the redemption right on liquidation).

- The contingent settlement provision means that the liability will be accounted for at par based upon the possibility of immediate conversion, and is therefore measured on initial recognition at $100m. The amount attributed to the equity element is $nil. Neither element is subsequently remeasured.

- None of the subscription proceeds are attributable to the equity component. Coupon payments are recognised direct to equity.

- On redemption the liability will be derecognised and the redemption proceeds are allocated between the debt and equity components of the compound instrument.

- In the event of a conversion, the liability will be derecognised and the issued equity recognised at fair value (which is expected to equal the carrying value of the liability discharged). Any difference between the fair value of the equity component and the carrying value of the liability component is recognised as a profit or loss.

18.4 Tax treatment

18.5 The existing tax treatment would typically be to respect the accounting split between liability and equity. The debt component is taxed as a loan relationship under Part 5, with tax relief in line with the accounts (although no such amounts are expected). The equity component will be a relevant contract within Part 7, but would not normally meet the accounting conditions to be a derivative contract for tax purposes.

18.6 Under the Regulations, the AT1 instrument will be treated as a single loan relationship within Part 5. The actual accounting will not involve fair value accounting for either the debt component or the equity component. As a result, the amounts in the accounts can be followed in the normal way. In particular, it would be expected that the coupons recognised in equity would be brought into account (under s308 / s321). Likewise, any profit or loss on redemption would be brought into account under Part 5. However, any exchange gain or loss on redemption in respect of the equity component would be excluded as being an amount recognised in the statement of changes in equity (s328). Regulation 5(1)(a) prescribes that the coupon payments is not to be treated as a distribution.

18.7 Commencement

18.8 On the commencement of the Regulations there will be no transitional adjustment as the carrying value of the combined instrument after commencement will equal the aggregate of the carrying value of the separate components before commencement (in both cases the combined carrying value will be £100m).

18.9 Holder

18.10 The tax treatment for unconnected holders will follow the entries in the accounts. For connected holders the tax treatment will be the same as set out above.