Hybrid Capital Instruments

Technical Note
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Introduction

This is a Technical Note on tax rules for loan relationships that are hybrid capital instruments and the alignment of tax treatment for certain linked loan relationships. For further information please contact Darryl Wall or Ursula Crosbie:

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Chapter 1: Overview and aim

1.1 Some companies raise funds by issuing instruments (referred to as "hybrid capital") that sit close to the border between debt and equity. Their features often include an entitlement for the debtor to defer or cancel interest payments. They are often long-dated or perpetual and while they have a fixed capital value at the outset, their terms may provide for release or conversion into shares in certain circumstances.

1.2 The distinction between debt and equity is important for the UK tax system. In particular, coupon payments on instruments that are considered to be debt are typically deductible for tax purposes, whereas dividends paid on equity instruments are normally disallowed. However, by their nature, determining the correct treatment for hybrid instruments can be problematic and this can lead to uncertainty for companies.

1.3 This is a particular difficulty for the financial sector, where banking companies (under Basel III) and insurance companies (under Solvency II) are required to hold a certain amount of capital. The instruments issued to raise this capital must contain certain features to allow for loss-absorbency in the event of the bank or insurer coming under financial strain and having depleted levels of capital.

1.4 The Treasury made the Taxation of Regulatory Capital Securities Regulations 2013 ("RCS Regulations") to provide certainty of treatment for these instruments.

1.5 In June 2018 the Bank of England finalised its approach to setting a minimum requirement for own funds and eligible liabilities (MREL) that banks, building societies and investment firms need to maintain to ensure that these institutions' own financial resources can be used to absorb any losses and recapitalise the business[1].

1.6 For global systemically important banks operating in the UK the MREL requirements take effect from 1 January 2019. To meet these requirements banks are permitted to issue types of hybrid capital instruments that are not covered by the existing RCS Regulations.

1.7 The government has taken this opportunity to review the operation of the RCS Regulations to ensure tax rules remain effective for all instruments counting towards MREL requirements, and achieve the policy aims of providing tax certainty, reducing tax volatility, and allowing coupon deductibility for hybrid capital instruments in all sectors, but only so long as they are, in essence, debt instruments.

[1] https://www.bankofengland.co.uk/paper/2018/boes-approach-to-setting-mrel-2018

1.8 As a result of the review, the RCS Regulations will be revoked and replaced with new tax rules for:

- hybrid capital instruments, which are debt-like instruments that can be issued by any sector; and
- tax mismatches, which align the tax treatment of linked loan relationships.

1.9 This technical note explains these proposed changes further.

Chapter 2: Hybrid capital instruments – outline of legislation

2.1. The policy intention is to provide coupon deductibility for commercial hybrid capital instruments that are, in essence, genuine debt instruments.

2.2. New section 475C Corporation Tax Act (CTA) 2009 defines "hybrid capital instrument". It must be a loan relationship on which the debtor is allowed to defer or cancel interest payments. Additionally the loan relationship must have no other significant equity features and the debtor must have made an irrevocable election into the new rules within six months of issue. The election is ineffective where there are arrangements, the main purpose, or one of the main purposes, of which is to obtain a tax advantage for any person.

2.3. Section 475C(2) defines "no other significant equity features". The loan relationship will have no significant equity features if:

- it gives neither voting rights in the debtor nor a right to exercise a dominant influence over the debtor;
- it contains no provision for altering the amount of the debt other than, in qualifying cases only, conversion into the debtor's (or quoted parent's) ordinary share capital or a reduction in the amount of the debt (provided that, where the reduction is temporary, any subsequent write-back cannot increase the debt beyond its original amount); and
- the creditor is only entitled to receive more than interest and repayment of the debt following conversion, in qualifying cases, into the debtor's ordinary share capital or the share capital of its quoted parent company.

2.4. The government is aware that certain instruments with a takeover or change of control provision do not meet the current definition of a hybrid capital instrument. This is because although they only provide for conversion in a qualifying case, this conversion may potentially be into share capital of a parent entity that does not meet the current definition used for the debtor's "quoted parent".

Finance Act 2019 introduced the new rules on taxation of hybrid capital instruments, including Section 475C, and contained a power in the legislation (paragraph 19 of Schedule 20) to enable the government to make amendments via secondary legislation. This was included as a pragmatic solution to allow the government to ensure that the new rules operate as intended where concerns come to light post publication.

The government intends to use that power to make an amendment to the definition of a conversion event in Section 475C(5) to ensure that a takeover or change of control provision will not exclude instruments that only allow for conversion in a qualifying case and that are, in essence, debt. The amendment will apply retrospectively to allow coupon deductibility for affected instruments from the new rules' existing commencement date of 1 January 2019.

The government intends to publish draft regulations for consultation with interested parties before the amendment takes effect. The final regulations will be laid before the House of Commons by 31 December 2019.

2.7 Qualifying cases include instruments which make provision that the debt is altered or converted only if the debtor is experiencing solvency or liquidity problems. Qualifying cases also include instruments whose terms allow conversion or reduction of the debt in order to comply with a regulatory or other legal requirement.

2.8 However, instruments are not hybrid capital instruments if these rights are exercisable by the creditor.

2.9 Where an instrument meets the s475C definition of a hybrid capital instrument, in addition to the main rule in s420A, the new tax rules make the following provisions.

i) Any amount recognised in equity or shareholders' funds is brought into account in the same way as if it had been a profit or loss item, except for exchange gains and losses. Instruments issued in accounting periods beginning before 1 January 2016 already have this treatment. The new rules therefore apply this treatment, with effect from 1 January 2019, for those hybrid capital instruments brought into effect for accounting periods beginning on or after 1 January 2016, whether or not previously covered by the RCS Regulations (new section 320B CTA 2009).

ii) Where exchange gains or losses arise on loan assets or derivative contracts intended to hedge exchange rate risks on a hybrid capital instrument that is equity accounted, those exchange gains or losses are disregarded for tax purposes (paragraph 9 of the Schedule).

iii) The instruments will constitute "normal commercial loans" for the purposes of group relief and the definition of qualifying corporate bonds (new subsection 162(1B) CTA 2010).

iv) The ability to defer or cancel the interest payable on a hybrid capital instrument does not, by itself, make any amount payable a distribution for the purposes of Part 23 CTA 2010 (new section 420A CTA 2009).

v) A hybrid capital instrument is not a special security by reason of meeting the conditions to be an equity note for the purposes of section 1015(6) CTA 2010 (new subsection 1015(1A) CTA 2010).

vi) However, the remainder of the distribution rules apply to hybrid capital instruments, so that their coupons are only deductible to the extent that they are not distributions (new section 420A(3) CTA 2009). For example, if the instrument carries an excessive rate of interest and is therefore a non-commercial security, as defined by section 1005 CTA 2010, part of the payment may be interest (the reasonable commercial return) with the remainder a distribution.

vii) The transfer of a hybrid capital instrument is exempt from all stamp duties (paragraph 20 of the Schedule).

2.10 The new tax rules also contain the following transitional rules for loan relationships that were regulatory capital securities for the purposes of the RCS Regulations 2013 immediately before 1 January 2019:

i) Credits and debits are brought into account as though the embedded derivative rules do not apply and fair value measurement was not generally accepted accounting practice. This allows these instruments to continue be taxed as a single loan relationship at amortised cost through to 31 December 2023.

ii) The exception from the duty to deduct income tax under section 874 and 889 Income Tax Act 2007 is maintained for these instruments for payments made before 1 January 2024.

iii) Companies that have issued instruments which qualify as Tier 1 or Tier 2 instruments under Commission Delegated Regulation 2015/35 do not have to bring into account any debits or credits arising from those loan relationships being converted into shares or subject to write-down (whether permanent or otherwise) before 1 July 2019. This will allow regulatory authorities time to work with industry to fully consider the impacts of the revocation of the RCS Regulations for the insurance and reinsurance industry.

2.11 The HCI rules will include a main purpose test which excludes an instrument from being an HCI where ‘the main purpose, or one of the main purposes of, the arrangements is to secure a tax advantage for the company or any other person’.

HMRC will take the following into consideration in applying this test:

- Companies have a choice between debt and equity in raising funds for commercial purposes. If they choose debt and include permitted coupon waiver/deferral features or write down/conversion features (whether to qualify as regulatory capital/MREL or otherwise) this will not normally indicate a tax purpose.

- If a company issues hybrid debt to protect or enhance its credit rating in respect of more senior debt instruments this would not normally indicate a tax purpose.

- Whether a tax avoidance purpose is the main, or one of the main, purposes is ultimately a question of fact which depends on all the circumstances of the particular case.

- In line with HMRC's general approach in this area, we do not propose to give clearance on specific instruments covering the application of the anti-avoidance rule. HMRC's guidance on non-statutory clearances can be accessed at www.gov.uk/guidance/non-statutory-clearance-service-guidance

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Chapter 3: Hybrid capital instruments – interaction with other rules

Credits arising on the release of debts

3.1 Hybrid capital instruments are subject to the normal rules when they are released (written down) including partial releases and releases in consideration for shares. In this context a debt is released when the creditor has waived the debtor's obligation to repay. This includes a formal, legal waiver and permanent releases (or write-downs) to comply with the law or regulatory requirements. In the general case, any credits that arise are taxable. However, there are exceptions in section 322 CTA 2009, of which we expect Conditions B, D and E will be most relevant.

3.2 Whilst a permanent write-down of a debt by the creditor's or third party's actions may be a "release" a temporary write-down is not. This is because the reduction in the contractual liability reflects the provision in the loan agreement for the amount repayable to change in certain circumstances, rather than the creditor unilaterally giving up any rights to repayment.

3.3 Condition B applies if the hybrid capital instrument is released in consideration of shares forming part of the ordinary share capital of the debtor. In this context "ordinary share capital" includes core capital deferred shares that form part of the capital of a building society.

3.4 Condition D applies if the release is in consequence of the exercise of a stabilisation power under the Banking Act 2009 or certain other powers the Bank of England may exercise when a bank is in financial distress.

3.5 Condition E applies if, immediately before the release, it is reasonable to assume that, without the release and any arrangements of which the release forms part, there would be a material risk that the debtor company would be unable to pay its debts within the next 12 months. To determine whether this test is met it may be necessary to consider how markets would react if there was no release, particularly where this would leave the institution with equity levels below the accepted minimum for the industry or in breach of requirements placed upon it in law. For example if the write-down occurs only at a level where, without a release, there would be a material risk of a collapse of confidence in the institution within 12 months, then condition E is likely to be met.

3.6 Conditions B, D and E only apply where the release takes place in an accounting period for which the amortised cost basis of accounting is used for the loan relationship. In many cases hybrid capital instruments are classified as an equity instrument. On initial recognition these will be recognised at cost (less any costs of issuance). In such cases there are no amounts to be amortised over the term of the instrument. HMRC considers that hybrid capital instruments accounted for in this way will meet the amortised cost condition in section 322(1)(b) CTA 2009.

3.7 Connected company debtors and creditors, with some exceptions, are not taxable on debits and credits arising on release or conversion of loan relationships.

Exception from duty to deduct income tax

3.8 Payments made on all regulatory capital securities (as defined by regulation 2 of the RCS Regulations) will retain the exception from the duty to deduct income tax for interest payments made before the day on which the Finance Bill receives Royal Assent. For regulatory capital securities issued before 1 January 2019 this exception will be maintained until 31 December 2023.

3.9 Hybrid capital instruments issued on or after 1 January 2019 will not benefit from the exception in the RCS Regulations and income tax may be deductible from interest paid in accordance with sections 874 and 889 Income Tax Act 2007. Other existing exceptions, including those in sections 875 to 888E Income Tax Act 2007, will continue to apply.

3.10 Section 882 Income Tax Act 2007 provides that the duty to deduct income tax under section 874 does not apply to a payment of interest on a quoted Eurobond. Section 987 defines “quoted Eurobond” and this includes the requirement that the instrument “carries a right to interest”. HMRC accept that a hybrid capital instrument can carry a right to interest even if its terms provide the debtor with the right to cancel a payment of interest under the loan relationship. An amount payable in respect of a hybrid capital instrument can therefore be a payment of interest on a quoted Eurobond if all other conditions are met.

Exemption from stamp duties

3.11 The hybrid capital instruments rules provide an exception from all stamp duties on the transfer of these instruments.

3.12 Some instruments that do not meet the definition of a hybrid capital instrument may defer interest payments by reference to a trigger within the instrument. These instruments would not be excluded from the definition of “loan capital” for the purposes of section 78 Finance Act 1986 as the exclusion at section 79(6) operates by reference to the amount of the interest not the timing of it. Therefore if interest is deferrable (but not cancellable) this term alone would not jeopardise the loan capital exemption and such instruments would be exempt from stamp duties.

3.13 Section 79(5) dis-applies the loan capital exemption from stamp duty at section 79(4) if, at the time the instrument is executed, it carries a right of conversion into shares or other securities. Banks issue instruments that do not carry conversion rights but could be required to convert under the Banking Act 2009. As conversion is a requirement of the Banking Act rather than being a term of the instrument itself HMRC accept that such an instrument does not carry a right of conversion and this will not by itself stop the loan capital exemption from applying. Similarly if a reduction in the amount of the debt (whether temporary or permanent) were required under the Banking Act, rather than being a term of the instrument, then HMRC also accepts that, by itself, this would not cause the instrument to fall within the exclusion from the definition of loan capital at section 79(6)(b).

Bifurcated accounting (embedded derivatives) and fair value measurement

3.14 Regulatory capital securities (as defined by regulation 2 of the RCS Regulations) issued prior to 1 January 2019 will continue to bring debits and credits into account as though the instrument were a single loan relationship for which recognition at fair value, in whole or part, were not generally accepted accounting practice. This will apply for accounting periods ending on or before 31 December 2023 (with split treatment for accounting periods straddling that date).

3.15 Hybrid capital instruments issued on or after 1 January 2019 will have not have such tax treatment and will need to bring debits and credits into account in accordance with generally accepted accounting practice, subject to any other statutory override.

Instruments classified as equity for accounting purpose

3.16 The issuer that has issued an instrument classified as equity for accounting purposes will typically get a deduction for coupons on a 'paid' basis, the timing being in line with their accounting treatment. This is because the company will normally have no obligation to pay the coupon until it is declared. The instrument is likely to be held at 'cost' in the company's statement of equity.

3.17 The holder is likely to either measure the instrument at 'cost', with coupons recognised on a 'paid' basis, or on a fair value basis.

3.18 Where the legislation mandates an amortised cost basis for tax purposes, for example in respect of loans between connected companies, and the company holds the instrument at 'cost' in either scenario outlined above, HMRC does not expect there to be any need for adjustments to be made and, as a result, the tax treatment should simply follow the accounts.

3.19 Where the legislation mandates an amortised cost basis for tax purposes, for example in respect of loans between connected companies, and the company holding the instrument adopts a fair value basis of accounting for the instrument, the company will be required to adjust the amounts recognised for tax purposes. In such cases, HMRC would expect the treatment to align with the position of the issuer in respect of an instrument classified as equity for accounting purposes, with the instrument recognised at 'cost' and the coupons recognised on a 'paid' basis.

Distributions

3.20 Part 23 CTA 2010 contains provisions about what is, and what is not, a distribution. For hybrid capital instruments there are some limited modifications of these rules.

- The entitlement to defer or cancel a payment of interest is ignored when determining whether the instrument is results dependent (section 1015(4)).
- A hybrid capital instrument cannot be an equity note (section 1015(6)).

3.21 For all instruments, whether or not hybrid capital instruments, the deferral of interest where the obligation to make the payment remains will not make an instrument results dependent for the purposes of section 1015(4).

3.22 HMRC Brief 24/14 sets out HMRC's views about whether provisions to "bail in" an instrument issued by a financial institution make that instrument results dependent for the purposes of section 1015(4). The return on all securities depends on the solvency of the borrower, but this does not make those instruments results dependent within section 1015(4). This logic extends to legally imposed viability rules short of insolvency. Therefore, terms providing for write-down or conversion that are included to meet regulatory requirements will not normally make an instrument results dependent.

3.23 On the same reasoning, such terms will also not normally make an instrument a non-commercial security within section 1005.

3.24 Under section 1015(3), interest payments can be reclassified as distributions if the instruments are convertible into shares and "are neither listed on a recognised stock exchange nor issued on terms which are reasonably comparable with the terms of issue of securities listed on a recognised stock exchange". HMRC's view is that instruments that are not listed on a recognised stock exchange will be on "reasonably comparable" terms if those terms would have been entered into by independent parties. HMRC expects genuine instruments that are issued commercially to meet this requirement.

3.25 When considering whether section 1000(1) conditions E and F (non-commercial securities and special securities) apply, the amount of the principal secured must first be determined. As set out in CTM15501, this is the minimum amount the holder of the security is entitled to receive on maturity of the security under the terms of issue, subject to specific adjustments provided for in statute. However, where an instrument has a write-down or conversion feature which is only activated in a "qualifying case" (as defined in new section 475C(6)), that feature would not be regarded as reducing the minimum amount the holder is entitled to receive.

Perpetual Debt

3.26 Perpetual instruments where the holder has no right to repayment in any circumstances are not loan relationships as they do not give rise to a money debt. Instruments that give rise to a right of repayment in the event of liquidation are not truly perpetual instruments, and will normally be considered as giving rise to a money debt. They may therefore be loan relationships. This is expected to be the case for all hybrid capital instruments.

Interaction with Hybrid Mismatch Rules

3.27 The Hybrid and other Mismatch rules in Part 6A TIOPA 2010 contain a specific carve out for regulatory capital at Section 259N(3)(b), which exempts all regulatory capital that falls within the definition provided by the RCS Regulations. The government has already announced that, in order to enable compliance with the EU Anti-Tax Avoidance Directive (ATAD), this exemption will be replaced by a power which will enable a new definition of exempt regulatory capital to be provided by regulations. The government's intention is to use this power to introduce a new exemption which will mirror the existing exemption based on the RCS Regulations, and also offer an exemption for certain new regulatory capital issued as a result of the MREL requirements which come into force in January 2019. Further regulations will be issued in due course to deal with the hybrid mismatch regulatory capital requirements set out in the ATAD, which are due to come into force in January 2020.

Chapter 4: Eliminating tax mismatches for certain debt

4.1 Tax mismatches can arise in any sector when a company has issued debt externally and then lends the funds raised to fellow group companies. Section 349 CTA 2009 requires a loan relationship between connected companies to be taxed on an amortised cost basis. If the linked external loan relationship is accounted for at fair value a tax mismatch would arise.

4.2 Such a mismatch could arise where a holding company issues instruments to satisfy MREL requirements and then lends the majority of those funds to a subsidiary bank. The Bank of England require the terms of the internal instrument to give a resolution authority the right to release or convert the instrument. Under IFRS 9, this term may require the instrument to be accounted for at fair value. The external instrument would, ordinarily, be accounted for at amortised cost but in order to eliminate an accounting mismatch it may be designated at fair value. The internal loan relationship, despite being accounted for at fair value, would be taxed on an amortised cost basis under section 349, but the external loan relationship would be taxed on fair value movements. Eliminating an accounting mismatch has therefore created a tax mismatch which has the potential to give rise to large taxable debits or credits that do not reflect the underlying economic reality and create tax volatility.

4.3 The proposed solution in new Section 352B CTA 2009 is, therefore, to allow the external loan relationship to be taxed on an amortised cost basis if it has a qualifying link to one or more loan relationships between connected companies.

4.4 A qualifying link arises if the capital raised is wholly or mainly used to fund loan relationships between connected companies.