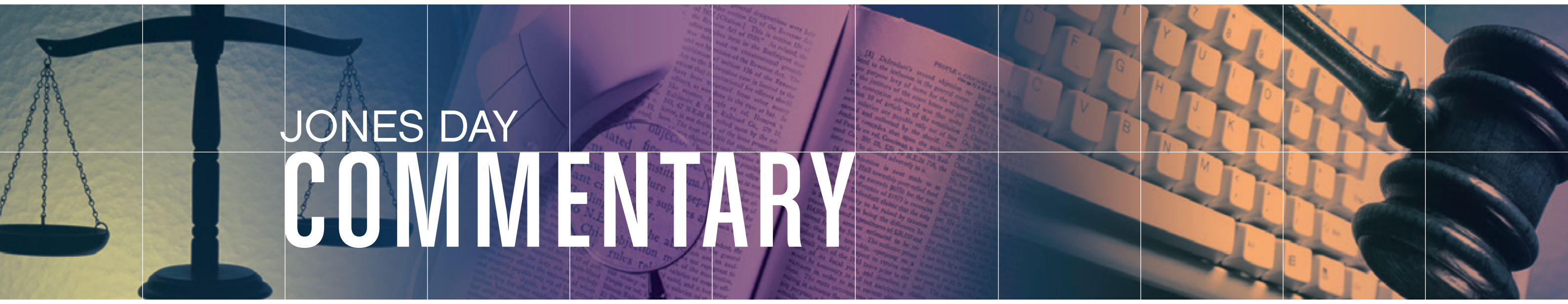
SEPTEMBER 2013



CRD IV UPDATE: SOME GOOD (TAX) NEWS FOR THE UK'S BANKING SECTOR

The Capital Requirements Directive IV and the Capital Requirements Regulation (collectively "CRD IV") implement, within the European Union, the Basel III reforms and provide for the prudential rules for banks, building societies and investment firms. Although CRD IV entered into force on 17 July 2013, the greater part of these new rules will apply from 1 January 2014.

HM Treasury ("HMT") and HM Revenue & Customs ("HMRC") have been aware for some time that the ability of the banking sector to continue to raise tax-deductible regulatory capital (as has historically been permitted) would be much more challenging in relation to instruments that qualify as Additional Tier 1 or Tier 2 under CRD IV when compared to pre-CRD IV regulatory capital debt instruments.

With CRD IV coming into full effect in a matter of months, and in response to the banking sector's concerns regarding deductibility, the UK Government published the draft Taxation of Regulatory Capital Securities Regulations (the "Regulations") on 16 July 2013, which seek to confirm that Additional Tier 1 and Tier 2 securities under CRD IV will be treated as debt for UK tax purposes. The Regulations also deal with various other related issues including the characterization of payments under such securities, exclusions of debits and credits relating to loss absorption features, the application of the derivative contract rules, withholding and stamp taxes.

This *Commentary* describes the key features contained within the Regulations and reports on the outcome from the informal consultation held by HMT and HMRC following the publication of the Regulations.

CONFIRMATION OF DEBT TREATMENT FOR ADDITIONAL TIER 1 OR TIER 2 UNDER CRD IV FOR UK TAX PURPOSES

The Regulations confirm that securities issued by a "credit institution" or an "investment firm" as defined in the Capital Requirements Regulation (the "CRR") (or a parent undertaking thereof) and which qualify as Additional Tier 1 or Tier 2 under CRD IV will be treated as a loan relationship—effectively as debt—for UK tax purposes.

Generally, shares will not fall within the scope of the Regulations. One exception is in relation to building society deferred shares. To the extent building society deferred shares qualify as Additional Tier 1, such shares will be treated as a loan relationship, thereby enabling deductions to be claimed by building society issuers in respect of the return on such shares.

To address concerns that interest payments in respect of Additional Tier 1 or Tier 2 securities under CRD IV could, given the inclusion of certain equity like features, fall to be regarded as nondeductible distributions for UK tax purposes, the Regulations state that payments in respect of such securities (other than a repayment of principal) will be treated as payments of interest in respect of a loan relationship.

WITHHOLDING TAX AND STAMP TAXES

Helpfully, the Regulations introduce two new exemptions in relation to Additional Tier 1 or Tier 2 securities under CRD IV: a new withholding tax exemption for payments of interest in respect of such securities and an exemption from all stamp duties (including stamp duty reserve tax) on transfer of such securities.

The pre-existing quoted Eurobond exemption would typically have been relied upon in order to address UK withholding tax concerns in respect of interest payments on such securities. In contrast, the new withholding tax exemption contained in the Regulations is generous in that it does not require the Additional Tier 1 or Tier 2 security in question to be listed on a recognised stock exchange, and it could also potentially benefit parent undertaking issuers of such securities.

CREDITS AND DEBITS ARISING IN RESPECT OF LOSS ABSORPTION MECHANISMS

The inclusion of loss absorption features within the terms of a regulatory capital security (for example, a temporary or permanent write down of an Additional Tier 1 security or a conversion mechanism into Common Equity Tier 1 on the occurrence of certain triggers) and the future introduction of a statutory bail-in regime gives rise to the possibility of accounting debits and credits arising to both the issuer of, and the investor in, such securities, which would also need to be taken into account for tax purposes.

The Regulations address this issue by providing that no credit or debit is required to be brought into account under the loan relationship rules as a result of a temporary or permanent write down of the regulatory capital securities, on a conversion into Common Equity Tier 1, or on a write up of such a security that was previously written down.

The exclusion of the recognition of credits and debits under the loan relationship rules in the circumstances described above is a relief from the perspective of issuers of such securities on the basis that taxable credits are most likely to arise at a time when the bank is already in financial difficulty. Whilst the bank may have tax losses available to it at the time that such loss absorption feature were to be triggered that could be used to mitigate the effect of recognising a taxable credit, the removal of the uncertainty of whether that would definitely be the case is to be welcomed.

The sting in the tail, however, is that this same exclusion of debits and credits applies to investors in such securities too. Accordingly, the Regulations in their current form would deny an investor tax relief for the loss the investor would suffer in respect of its investment in the securities that might otherwise be available to it if the debit in question arises in the circumstances detailed above. Based on comments made by HMRC after the publication of the Regulations (as to which see below), it is anticipated that the final form of the Regulations will remove the exclusion on the recognition of debits and credits relating to the application of a loss absorption mechanism in relation to investors.

EMBEDDED DERIVATIVES

The Regulations currently provide that the derivative contracts tax rules will not apply in respect of securities that are Additional Tier 1 or Tier 2 under CRD IV. Accordingly, debits and credits relating to embedded derivatives that might be recognised for accounting purposes in respect of such securities (for example, recognition of an embedded derivative might be appropriate where a conversion feature is included within the terms of the security) will not need to be brought into account under the derivative contracts tax rules. See, however, below for HMT and HMRC's further views on the approach they may adopt in relation to the application of the derivative contracts tax rules to such securities.

A TARGETED ANTI-AVOIDANCE RULE

No piece of new UK tax legislation would be complete without its own targeted anti-avoidance rule, and the Regulations do not disappoint in this regard. Where there are arrangements whose main purpose, or one of the main purposes, is to obtain a tax advantage for any person as a result of the application of the Regulations to the relevant regulatory capital security, certain aspects of the Regulations do not apply. In particular, the treatment under the Regulations of payments (other than repayments of principal) in respect of the regulatory capital security as interest would not apply and there would then be a material risk of such payments being nondeductible for tax purposes.

CONSULTATION AND NEXT STEPS

In keeping with the informal consultation approach and the positive engagement with the banking sector and advisors since early 2011 in relation to the tax treatment of regulatory capital securities, two meetings were held by HMT and HMRC following publication of the Regulations to invite comment. The key points which came out of those discussions were:

- In its current form, the Regulations apply only to a security issued by a credit institution, an investment firm or a parent undertaking thereof where that security qualifies as either Additional Tier 1 or Tier 2 capital resources of the credit institution or the investment firm. It seemed to be accepted by HMT and HMRC that the Regulations as drafted may be unduly restrictive in their application when compared to what may be permissible under the CRR (for example, issuances of regulatory capital securities by subsidiaries of banks or special purpose vehicles would not currently fall within the scope of the Regulations even if permissible under the CRR). HMT and HMRC stated they would consider what amendments could be made to the Regulations to bring them closer to what is permissible under the CRR.
- The Regulations apply criteria and definitions that are contained in the CRR to identify which regulatory capital securities potentially fall within its scope. In its current form, there is some uncertainty whether or not regulatory capital securities issued in compliance with non-EU regulatory regimes would fall to be taxed in accordance with the Regulations. For the same reason, there is some doubt whether branches of foreign banks would similarly fall within the scope of the Regulations. HMT and HMRC have recognised that there may be some unintended gaps in the Regulations and have resolved to consider how best to address those issues.
- HMT and HMRC confirmed that they intend to amend the restriction in the Regulations on an investor in a regulatory capital security, bringing into account a debit for tax purposes following the operation of a loss absorption mechanism (see above). The expectation is that an investor will be permitted to bring into account for tax purposes any accounting debits that arise in relation to a regulatory capital security as a result of the operation of the loss absorption mechanism.
- Consideration is to be given by HMT and HMRC as to whether the tax treatment afforded by the Regulations should be based on a day 1 analysis of whether the securities in question qualify as Additional Tier 1 or Tier 2 under the CRR or whether this should be a rolling test. Under the current form of the Regulations, the test would appear to be a rolling one so that securities might benefit from the tax treatment prescribed by the Regulations on issue; however, if, for whatever reason, those securities ceased to qualify as Additional Tier 1 or Tier 2, the Regulations would then no longer apply.
- Although the Regulations currently provide for the tax rules on derivative contracts not to apply to regulatory capital securities (see above), HMT and HMRC are rethinking their approach to excluding such securities from those rules. HMT's and HMRC's concerns stem from the possibility of asymmetrical tax results arising if the derivative contract rules were not to apply to such securities. It is possible, therefore, that the next draft of the Regulations may remove or modify the current exclusion of the application of the tax rules on derivative contracts.

HMT and HMRC currently plan to issue a revised draft of the Regulations soon and will continue to engage in an informal consultation with the banking sector and advisors until the end of September 2013. Their stated aim is for the Regulations to be enacted in final form by the end of November 2013, just prior to the date on which the greater part of the provisions in CRD IV take effect. Whilst the first draft of the Regulations has certainly been welcomed in trying to address many of the tax issues that Additional Tier 1 and Tier 2 securities under CRD IV potentially give rise to, there is still much work to be done if these deadlines are to be met.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

John Ahern
London
+44.20.7039.5176
jahern@jonesday.com

Amrit Dehal
London
+44.20.7039.5295
adehal@jonesday.com

Catherine Richardson
London
+44.20.7039.5715
crichardson@jonesday.com