The new regime for hybrid capital instruments

December 2018

A new, non-sector specific, hybrid capital instrument (HCI) regime will apply in place of the regulatory capital securities regime from 1 January 2019. The new HCI regime represents a move away from the 'blanket fix' approach under the Taxation of Regulatory Capital Securities Regulations, SI 2013/3209 ('the RCS regulations'). It does not simply provide for payments on a HCI not to be distributions. Rather, the legislation focuses on making the minimum changes necessary. The new regime should be welcomed for showing the UK's continuing to commit to a policy of allowing tax deductible regulatory capital, but it will mean more work for tax advisers. Without a regulatory capital treatment gateway condition, advisers will need to go back to the pre-RCS regulations approach of assessing all terms and conditions of each instrument to check that each meets the definition of HCI; and advisers should be alert to the fact that simply being within the HCI regime is not enough to guarantee the issuer's tax treatment.

It is rather fitting that the UK's new hybrid capital instruments (HCI) regime was announced almost 20 years to the day since the October 1998 issuance of guidelines by the Basel Committee that gave birth to the so-called 'innovative Tier 1 capital' for banks. Under the 1998 guidelines, instruments could constitute Tier 1 capital, notwithstanding that they took the legal form of debt rather than equity, providing that they satisfied certain key requirements, including that they must be:

- issued fully paid, permanent (perpetual) and non-cumulative;
- able to absorb losses within the bank on a going concern basis; and
- junior to the bank's depositors, general creditors and subordinated debt.

Those guidelines gave rise to the possibility that a UK bank could issue an instrument which was treated as equity for regulatory capital purposes whilst retaining its legal form of debt for tax purposes and, consequently, as a tax deductible coupon. Following discussions with the British Bankers' Association (BBA), the Inland Revenue (as it then was) accepted this in July 1999, in what was clearly a policy decision. The correspondence, circulated by the BBA, referred to the Inland Revenue understanding the drivers for issuing Tier 1 capital. Interestingly, however, before BEPS was even a twinkle in the OECD's eye, it put down a marker that the comfort would not extend to arrangements designed to exploit cross-border tax asymmetries (i.e. where the holder obtained a better tax treatment because the UK's jurisdiction treated the instrument as equity).

There were, at that time, no special rules for such instruments issued by banks. Rather, the terms and conditions of each instrument had to be carefully considered in light of all the existing requirements to obtain deductibility. Two of the key pieces of analysis were that:

- a perpetual debt was still a 'money debt' and consequently capable of being a loan relationship because it fell to be repaid on a winding up of the issuer (albeit generally only to the extent that the holder would have been paid out had the debt been preference shares instead); and

- the 'solvency condition' (broadly speaking, the requirement that any payment had to be deferred if the issuer would not be solvent after making it) went to the timing of payments, not quantum, and consequently did not give rise to a results dependency issue for deductibility (or stamp duty exemption or grouping) purposes.

Instead, the Inland Revenue would look to police the issue of such instruments through the 'unallowable purpose' test (now in CTA 2009 s441). The theory was that a bank (and later an insurer) would often have a 'good' purpose for issuing these more expensive instruments (as the holder of an instrument with equity-like features will naturally require a higher return to compensate for the increased risk). However, non-regulated entities were unlikely to have such a purpose; and if they issued such instruments to obtain a higher tax deduction, the increase in the coupon over the issuer's normal cost of funds would be vulnerable to challenge.

Over time, changes in the regulatory environment caused such instruments to become more equity like in nature, calling into question their tax treatment under ordinary principles. This led to the introduction of a separate regime for regulatory capital securities found in FA 2012 s221 and the Taxation of Regulatory Capital Securities Regulations, SI 2013/3209 ('the RCS regulations'). Broadly speaking, this regime applies to additional Tier 1 (AT1), restricted Tier 1 (RT1) and Tier 2 (T2) debt instruments issued by banks and insurers; and whether the regime applies to an instrument is driven largely by its regulatory treatment.

Key features of the RCS regulations include providing for:

- credits and debits on a conversion or write down to be ignored;
- the continued recognition of coupons accounted for as distributions (generally, amounts recognised in equity or shareholders' funds ceased to be recognised for loan relationship purposes when the rules were reformed with effect from 1 January 2016);
- instruments to be treated as normal commercial loans for grouping purposes and to be exempt from stamp duties;
- coupon payments not to be distributions; and
- an exemption from withholding tax.

Regulatory capital securities are also excluded from being 'financial instruments' for the purposes of the hybrid mismatch rules in TIOPA 2010 Part 6A by TIOPA 2010 s 259N(3)(b).

For the last five years or so, therefore, providing advice on the tax consequences of the issue of a regulated capital security by a UK issuer has been relatively straightforward. It has often amounted to little more than checking that the instrument in question met the regulatory capital requirements for entry into the new regime; and that there was no reason to believe the regime targeted anti-avoidance rule (TAAR) could be in play.

Recent changes

However, the UK has recently had cause to revisit this area. According to the HCI technical note published with the Budget on 29 October 2018 (see bit.ly/2r4JAdy), this has been prompted by the Bank of England finalising its approach to minimum requirements for own funds and eligible liabilities (MREL) earlier in the summer. And it is certainly true that banks had been looking to HMRC to provide certainty in relation to changes they are required to make to meet MREL requirements by the end of 2018. But there are certainly other inferences that could be drawn from the announcement by the Dutch Ministry of Finance at the end of June that it was withdrawing its equivalent rules, in part due to a State aid concern raised by the European Commission, and the Commission's intention to address concerns in all member states with comparable measures. A concern that a regime might be seen as selective may, of course, be addressed by replacing it with a regime open to all…

So the RCS regulations are to be revoked with effect from 1 January 2019, subject to some limited transitional provisions, and replaced by the new HCI regime, as set out in the Finance (No. 3) Bill clause 88 and Sch 19. Key to the new regime is the definition of an HCI in CTA 2009 s 475C, which provides that a loan relationship is an HCI of a debtor for an accounting period if:

- it makes provision under which the debtor is entitled to defer or cancel a payment of interest;
- it has no other significant equity features; and
- the debtor has made an election in respect of the loan relationship which has effect for the period.

For these purposes, a loan has no other significant features if under it:

- there are neither voting rights in the debtor (ignoring insignificant voting rights) nor a right to exercise a dominant influence over the debtor;
- any provision for altering the amount of the debt is limited to write-down or conversion events in qualifying cases; and
- any provision for the creditor to receive anything other than interest or repayment of the debt is limited to conversion events in qualifying cases.

And a provision is for a qualifying case if the provision in question does not include a right exercisable by the creditor, and the provision:

- applies only in the event that there is a material risk of the debtor becoming unable to pay its debts as they fall due;
- applies only in the event that the value of the debtor's assets is less than the amount of its liabilities, taking into account contingent and prospective liabilities; or
- is included in the loan solely because of a need to comply with a regulatory or other legal requirement.

Practical considerations

Without a regulatory capital treatment gateway condition — clearly not compatible with a regime intended to be open also to non-regulated entities — advisers will need to go back to the pre-RCS regulations approach of wading through the terms and conditions of each instrument line by line to check that each meets the definition of HCI (where that is desired). In general, as long as it carries a cancellable or deferrable coupon, it would be surprising if an instrument which would currently be treated as a regulatory capital security were not an HCI; however, that is certainly possible where, for example, additional features have been included within an instrument (e.g. optional conversion) beyond the minimum regulatory requirements.

And the tax adviser's job does not stop there. Unlike with the RCS regulations, simply being within the HCI regime is not enough to guarantee the issuer's tax treatment. HMRC has taken a bottom-up approach here, going back to the RCS regulations, looking at everything they do and asking, in effect, whether it is absolutely necessary to have an equivalent in the HCI regime. Where the answer was 'no', there is no equivalent.

Perhaps most importantly, there is no basic rule that any coupon payment on an HCI is not a distribution for tax purposes. At first blush, it might look as if there is. The new CTA 2009 s 420A(2) provides that the Corporation Tax Acts have effect 'as if any qualifying amount payable in respect of the hybrid capital instrument were not a distribution'. However, a 'qualifying amount' is limited by CTA 2009 s 420A(3) to any payment which would not be a distribution if you ignored any provision entitling the debtor to defer or cancel a payment of interest.

Subject to one further qualification, therefore, you effectively have to run a 'normal' distribution analysis on the loan to check for issues, ignoring only problems caused by the right to cancel or defer a coupon (which is there to address HMRC's view that the right to cancel a coupon (but not defer it) creates a results dependency issue). The qualification is that HCIs are effectively carved out of the equity notes rules. Without that carve-out, it would not be possible for cross-border intra-group AT1 and RT1 instruments to carry deductible coupons.

Anyone performing that distributions analysis will necessarily have to place some reliance on HMRC's published guidance in this area. The technical note recalls HMRC's views in HMRC Brief 24/14 as to whether provisions to 'bail in' an instrument issued by a financial institution make that instrument results dependent. HMRC accepts that 'terms providing for write-down or conversion that are included to meet regulatory requirements will not normally make an instrument results dependent'. It also accepts that 'on the same reasoning, such terms will also not normally make an instrument a non-commercial security within s 1005'. Whilst this is likely to be good enough to enable issuer opinions to be given in practice, it is several degrees of certainty below the current position.
Indeed, for many the reference to Brief 24/14 will bring back unwelcome memories, given that HMRC had taken the opposite view in guidance published in 2012. Brief 24/14 includes, under the heading 'Original view', the following:

'Previously, HMRC took the view … that any "additional tier 1" (AT1) or "tier 2" (T2) instruments subject to a statutory bail-in regime would become "results dependent" for the purposes of section 1015(4) CTA 2010 from the time that the regulatory regime came into force. Consequently, those instruments would be considered "special securities" and their coupons treated as distributions. HMRC took the same view in relation to other instruments that specifically referred to the bail-in provisions in their terms of issue or prospectuses.'

Given there has been no underlying change of law here, this is clearly not an ideal situation and raises a number of questions. What if HMRC was actually right the first time around? What if HMRC changes its mind again? Given the number of similar interpretations that are required to ensure these rules do not impede a number of ordinary commercial transactions (e.g. sub-participations are generally acceptable for banks: see HMRC's *Company Taxation Manual* at CTM15520), it might well be time that the distributions code as a whole is subject to a review.

Indeed, that is not the only area of the technical note that might best be described as 'pragmatic'. 'Convertible securities' are 'special securities' unless they are listed on a recognised stock exchange or are on reasonably comparable terms with securities listed on a recognised stock exchange. The technical note states: '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.' It also states: 'HMRC expects genuine instruments that are issued commercially to meet this requirement.' This is helpful but not easy to square with the legislation, which contains no reference to arm's length terms or bona fide commercial reasons. Likewise, HMRC's view that the 'principal secured' (relevant to several of the distributions tests) is not reduced by a write-down or conversion feature activated only in a 'qualifying case'.

In terms of other equivalents:

- an HCI will be a 'normal commercial loan' for grouping purposes;

- amounts recognised in equity or shareholders' funds will be picked up under the loan relationships rules;
- the disregard regulations (SI 2004/3256) will apply to HCIs as they are applied to regulatory capital securities; and
- HCIs will be exempt from stamp duties.

HMRC is expected to use the new regulation making power to be introduced in TIOPA 2010 s259N(3)(b) to be introduced by Finance (No. 3) Bill clause 19(4)(a) to replace the exclusion from the definition of 'financial instrument' for hybrid mismatch purposes for regulatory capital securities with an exclusion for HCI with effect from 1 January 2019. There is an expectation that this will be revised to match the narrow (and, interestingly, banking sector specific!) exclusion permitted by article 9(4) of the EU Anti-Tax Avoidance Directive with effect from 1 January 2020.

Keen observers will note that there is no equivalent dealing with either credits on conversion or write down, or withholding tax. The latter, in HMRC's view, probably rightly, is unnecessary given the quoted Eurobond exemption, the UK's extensive treaty network, the qualifying private placement exemption and the UK/UK corporate taxpayer exemption.

With regards to credits on conversion or write down, the technical note suggests HMRC was expecting that one of the exclusions in CTA 2009 s322 would usually apply to prevent any credit arising on a conversion or write-down being taxable. Condition B is clearly likely to apply where the instrument is converted; and Condition D where there is a write-down in consequence of the exercise by the Bank of England of its stabilisation powers. For other cases, it seems HMRC was expecting that Condition E would be satisfied. Condition E applies if, immediately before the relevant 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. The technical note suggests that Condition E is likely to be met where, without a release, there would be a material risk of a collapse of confidence in the institution within 12 months (think queues around the block outside Northern Rock branches in the financial crisis).

However, whilst it seems that the Prudential Regulation Authority (PRA) accepts that analysis in relation to banks, it is not on the same page with regards to insurers which can limp on, wounded, for several years (think Equitable Life). On 31 October 2018, the PRA published a consultation paper (CP 27/18) noting that: 'The mandatory triggers for RT1 instruments are set at a level where it is not likely that there would be a material risk of a collapse of confidence in the institution within 12 months.' It also stated that it would be reasonable to conclude at the point of issuance of an RT1 instrument that Condition E would be unlikely to apply on any future write-down of the instrument.

In the PRA's view, it is necessary to take any potential tax charge into account to ensure that the loss absorbing capacity of such instruments is not overstated. However, the current proposal should leave existing instruments unaffected (and therefore not trigger any 'tax event' redemptions). The proposal in the consultation paper is that in relation to any external RT1 instrument which writes down on a trigger issued on or after 1 February 2019, the issuing firm should deduct an amount reflecting the maximum tax charge generated on write-down when calculating its own funds requirement.

Final thoughts

Overall then, the HCI regime should be welcomed as a positive development. For banks and insurers, it is good to see the UK continuing to commit to a policy of allowing tax deductible regulatory capital and not following the Dutch approach. And utilities, which have been eyeing up instruments of this sort for some time, may be beneficiaries of an opening up of the playing field.

However, there may yet be more wrinkles, pitfalls and oddities to emerge as everyone gets to grips with applying the new rules in practice, reviewing their existing issued instruments and making appropriate elections into the HCI regime. Could the lack of mandated amortised cost treatment cause an issue, for instance? It is certainly unfortunate that, in the distributions area in particular, so much is dealt with only in guidance that should really be addressed in primary legislation.

This article was first published in the 7 December 2018 edition of Tax Journal

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