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ALERT MEMORANDUM

"Hybrid Capital Instruments" – the Proposed New UK Tax Regime and its Impact on Loss-Absorbing Debt

8 February 2019

The UK government announced its intention to repeal legislation granting favourable tax treatment to certain Tier 1 and Tier 2 regulatory capital in its Autumn Budget 2018. In a move which appears designed to address state aid concerns, a new regime for "hybrid capital instruments" has instead been proposed for application beyond just banks and insurance companies. However, in other respects, the new regime is much more narrowly targeted than the previous one. In particular:

(a) the category of instruments to which the new regime applies is narrower and is no longer directly linked to the instruments' characterisation for regulatory capital purposes; and

(b) fewer benefits apply automatically to instruments which qualify.

The government has also chosen generally not to legislate to address the tax treatment of instruments issued by banks, building societies and investment firms to comply with the Bank of England's statement of policy on implementation of EU minimum requirements for own funds and eligible liabilities (MREL), which took effect on 1 January 2019 for global systemically important banks operating in the UK. The treatment of those instruments will instead be principally addressed through new technical guidance from HM Revenue & Customs.

The new regime introduces some uncertainty, as many issuers will have to look to general existing law (interpreted in light of the HMRC guidance), to determine the tax treatment of their regulatory capital and MREL.

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Background, and the existing regime for regulatory capital

UK tax rules – like those in many other jurisdictions – generally prevent debt instruments with equity-like terms (such as results-dependent interest, interest that exceeds a reasonable commercial return on the principal, write down and/or conversion features, or long-dated or perpetual maturities) from benefitting from certain tax advantages otherwise available to debt. For example:

a. interest may be treated like dividends or other equity distributions, so may not be deductible;

b. holders may be treated like shareholders for the purposes of establishing (or breaking) corporate tax groups; and

c. certain exemptions from stamp duty on transfer of the instrument may not be available.

With effect from 1 January 2014, however, the UK granted special status to additional Tier 1 and Tier 2 securities issued by banks and Tier 1 and Tier 2 securities issued by insurance companies, notwithstanding their equity-like features. In a single set of regulations (the RCS Regulations), interest on these "regulatory capital securities" was excluded from distribution treatment, corporation tax groups were treated as unaffected by the instruments, and an exemption was granted from stamp duties in respect of transfers of and agreements to transfer the instruments. Amongst other things, the RCS Regulations also provided a specific exemption from taxable income recognition on a conversion into common equity or write down of principal in accordance with regulatory requirements or the provisions governing the security, and a specific exemption from withholding tax on interest payments. From 1 January 2017, regulatory capital securities within the RCS Regulations were also carved out from the UK rules on hybrid mismatches from financial instruments.

The proposed new regime

It is now proposed that the RCS Regulations be repealed and replaced with new rules that apply only to loan relationships that are "hybrid capital instruments" (HCIs). Certain transitional rules apply for regulatory capital securities. The remainder of this memorandum considers the position once these transitional rules have lapsed.

What qualifies as an HCI?

To qualify as an HCI, (a) a loan relationship must make provision for the debtor to be entitled to defer or cancel a payment of interest, (b) the instrument must have "no other significant equity features" and (c) the debtor must elect for the HCI regime to apply to the loan relationship. Such election will only take effect in circumstances where a targeted anti-avoidance rule does not apply.

A loan relationship has no other significant equity features if, under the loan relationship: (i) there are neither voting rights in the debtor (ignoring insignificant voting rights in the debtor) nor a right to exercise a dominant influence over the debtor, (ii) any provision for altering the amount of the debt is limited to write-down or conversion events in "qualifying cases", and (iii) any provision for the creditor to receive anything other than interest or repayment of the debt is limited to conversion events in "qualifying cases".

A relevant provision applies in a qualifying case if: (i) 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, (ii) the provision 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 (iii) the provision is included in the loan relationship solely because of a need to comply with a regulatory or other legal requirement. In each case, the provision in question must not include a right exercisable by the creditor.

It is to be noted, however, that the draft rules also provide for the UK Treasury to exercise a regulation-making power to amend the definition of HCI at any time until 31 December 2019, with retrospective effect. Perhaps HMRC already anticipates that changes will be necessary.

What tax advantages apply to HCIs?

A much more limited class of tax advantages apply to HCIs than to regulatory capital securities under the RCS Regulations. In the context of the items mentioned above, the new rules principally:

a. provide that the debtor's entitlement to defer or cancel payments of interest (as the case may be) will not (of itself) cause interest to be treated as a distribution;

b. provide that payments of interest will not be treated as a distribution simply because the notes are long-dated or perpetual;

c. assist in preventing the instruments from impacting corporation tax groups; and

d. provide an exemption from stamp duties on transfers.

Instruments which do not qualify as HCI

If regulatory capital securities or debt issued to address MREL requirements do not qualify as HCI (for example, if the terms do not make provision for the debtor to be entitled to defer or cancel a payment of interest) the tax treatment will follow pre-existing UK tax law.

At the same time as proposing the new HCI regime, HMRC published a "Technical Note" giving an indication of how they will apply that law. It is important to recognise that published guidance of HMRC does not have the force of law and is not necessarily binding on HMRC, and may be withdrawn or altered in future. However, a certain amount of comfort can in practice be drawn from it. In particular, the Technical Note suggests the following:

1. In the context of **distribution treatment**: (i) the deferral of interest where the obligation to make the payment remains will not make the interest results dependent, (ii) terms providing for write-down or conversion that are included to meet regulatory requirements will not normally make an instrument results dependent, nor will they result in the principal amount of the loan being treated as reduced for the purpose of testing the reasonableness of the return, where the write down or conversion is only activated in a "qualifying case" (as defined for the purposes of the HCI rules), and (iii) interest payments on unlisted convertible instruments may not be treated as distributions if the terms of the instruments would have been entered into by independent parties.
2. An accounting credit arising on the **cancellation or permanent write down** of the debt, will in general be taxable unless another exemption is available. A number of potential exemptions might be available, but it will be necessary to consider them in detail in light of the particular circumstances, on a case-by-case basis.
3. **Withholding tax** will be deductible from payments of interest unless another exemption is available. Again, a number of potential exemptions may be available, but their conditions would need to be tested and some of them come with administrative and other costs (such as the costs of listing in the case of the "quoted Eurobond" exemption, and the need to make a prior application for exemption in the case of double tax treaty relief).
4. The existing loan capital exemption from **stamp duties** would not be denied simply because interest is deferrable (but not cancellable) or where the possibility of conversion or write down exists outside the terms of the instrument (for example, by operation of the Banking Act 2009).

What about hybrid mismatches?

It is also worth noting that the Technical Note leaves open the position as to the risk of interest payments being denied deductions under the UK's hybrid mismatch rules. The safe harbour currently available to regulatory capital securities (as defined in the RCS Regulations) will fall away, and there is also uncertainty for MREL.

The Technical Note says that legislation will be introduced to give the government power to introduce (by regulations) a new definition of exempt regulatory capital to "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", but no details have been provided. Wherever we get to with Brexit, the UK has indicated its intention to comply with certain EU rules that take effect on 1 January 2020, which place specific limits (including a 2022 long-stop date) on the scope of any exemption for regulatory capital. The UK may also, in practice, be bound by the EU stance on hybrid mismatches for loss-absorbing instruments post 2022, which remains unresolved. It

cannot be assumed that continued exemption will be the long term outcome.

Commentary

In the context of tax deductibility of interest and recharacterisation as a dividend or other distribution, the new HCI rules would seem to offer limited benefits – in effect (where they apply) they merely ignore entitlements to defer or cancel interest when determining results dependency and they ignore the impact of long-dated or perpetual maturities. Where they apply, the new rules do provide stamp duty and grouping advantages, amongst other things. However, for the impact of other equity-like characteristics on distribution treatment, and for certain rules such as those relating to the release of debt and withholding tax, issuers of loss-absorbing debt are left to their own legal analysis in light of the HMRC Technical Note. For regulatory capital securities this is a significant change from the current position once the transitional rules expire. It also does not provide the form of certainty that might have been hoped for by institutions having to comply with the Bank of England's MREL requirements.

That being said, taxpayers in the UK have become increasingly used to HMRC using guidance to address uncertainties left by legislation, and the government's intention to help out in this area seems relatively clear.

So far as the details are concerned, there also remain some specific items of uncertainty in the drafting of the new rules, and some gaps in the coverage of the Technical Note. For example, looking at the scope of the HCI definition, it is unclear whether a debtor's entitlement to defer or cancel interest payments must meet any minimum requirements. In the extreme, would an entitlement to defer the payment of interest by one or two days, or an entitlement to cancel interest only in one or two identified circumstances, be sufficient?

It is hoped that further guidance will be available in due course, and that the position with regard to hybrid mismatches will be clarified, to remove the uncertainty which the government says it wants to avoid. Unfortunately, this will not be fully possible before 31 December 2019, when the Treasury's power to make retrospective amendments to the HCI definition falls away.

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