GOOD NEWS FOR BANKS IN THE BUDGET: PROVIDING CERTAINTY ON THE TAX TREATMENT OF REGULATORY CAPITAL

History

There has always been a measure of uncertainty as to how regulatory capital instruments are treated. For many years the regulatory capital needs of banks has been recognised either informally or formally in the UK tax system. Until 2013 this was by way of a matrix of legislative provision and formal/informal revenue practice that allowed banks to get tax relief for the cost of certain capital even where that capital might have been regarded as non-deductible equity for non-banks.

In 2013, a combination of greater need for regulatory capital and rigid rules for the required capital to comply with Basel III led to formalisation of the UK tax rules for bank regulatory capital in the form of the 2013 Regulatory Capital Securities Regulations (the "**UK Regulations**"). These gave certainty of treatment for matters such as tax deductibility, withholding tax and stamp duty and eliminated tax beartraps arising from the accounting treatment which often split the capital into debt and derivative elements. The UK Regulations were then extended in 2016 to ensure that regulatory capital would not lose tax deductibility, even if accounted for as equity.

State Aid

Earlier this year, in a letter to a number of Member States, the Commission suggested that specific regimes designed to negate the natural tax effects of regulatory capital securities (such as the UK Regulations) may be unlawful State aid. The argument was that these regimes favour financial institutions over others in a "legally and factually comparable situation". The argument is extremely controversial, not least because it is unclear how other businesses, not required to issue regulatory capital, can possibly be said to be in a comparable situation to banks. Nonetheless, the Netherlands (we speculate for reasons that are unrelated to the strength of the Commission's argument) have announced plans to abolish their equivalent regime with effect from 1 January 2019. It remains to be seen if the Commission will take action against the UK and others. If it were to press the issue and succeed in repealing the existing regimes (likely with no grandfathering) then banks' regulators are likely to be flooded with requests to allow the banks to redeem the relevant instruments. The effect on the markets and the industry would be profound.

MREL/TLAC

New regulatory requirements introducing a need for MREL and TLAC also put stress on the UK Regulations. The aim of MREL and TLAC is to ensure that financial institutions have sufficient loss absorbing capacity for bail-in tools to be effectively deployed where the entity is in resolution. There are similarities to other regulatory capital, but certain features are likely in some cases to cause tax issues that are not resolved by the UK Regulations.

Solutions

The solution announced today is to replace the UK Regulations with new tax rules for all hybrid capital instruments, whether issued by a bank or any other type of business.

In practice, it seems unlikely any or many UK taxpayers (other than banks) will wish to take advantage of this new tax freedom so we expect the tax impact will be small. Probably for this reason, the Budget Red Book shows the measure has having negligible impact on the Exchequer over the next six years.

Comment

Today's announcement is not surprising. The UK Government has sought to steer between the competing dangers of a full blown state aid investigation, the market disruption that would follow withdrawal of the UK Regulations and the need to preserve the UK tax base. It is unclear if the changes announced today will discourage the Commission from a state aid investigation but they are a welcome indication that the UK Government is committed post-Brexit to a vibrant and fully functioning UK bank sector.

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