EXPLANATORY MEMORANDUM TO

THE TAXATION OF REGULATORY CAPITAL SECURITIES REGULATIONS 2013

2013 No. [XXXX]

1. This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs and is laid before the House of Commons by Command of Her Majesty.

2. Purpose of the instrument

2.1 The purpose of this instrument is to make provision in relation to the tax consequences of securities issued to meet new regulatory requirements imposed by EU legislation. The Regulations will provide issuers and holders of these new forms of regulatory capital, Additional Tier One securities (AT1) and Tier Two securities (T2), which credit institutions or investment firms will be required to issue with certainty of tax treatment

3. Matters of special interest to the Select Committee on Statutory Instruments

3.1 None

4. Legislative Context

4.1 Section 221 Finance act 2012 allows HMT to make regulations to make provision about the tax consequences in relation to securities issued in relation to any regulatory requirement imposed by EU legislation.

4.2 The Basel III requirements, which are adopted in Europe via the Capital Requirements Directive IV and the Capital Requirements Regulation (CRR) introduce new regulatory prudential requirements with which financial institutions will have to comply when issuing institutions new forms of regulatory capital (AT1 and T2). The CRR applies from 1 January 2014 and therefore these Regulations come into force on that date.

4.3 AT1 and T2 securities will replace existing types of regulatory capital security which are treated as debt under the existing tax legislation. However, the features of AT1 and T2 securities are such that they make the tax treatment of these instruments uncertain as the current tax legislation was not drafted to deal with such instruments. These Regulations provide that where AT1 and T2 securities are issued other than in the form of shares (except for AT1 issued by a building society) they will also be taxed on the basis that they are debt instruments.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

6.1 The Financial Secretary to the Treasury has made the following statement regarding Human Rights:
In my view the provisions of the Taxation of Regulatory Capital Securities Regulation 2013 are compatible with the Convention rights.

7. Policy background

7.1 To comply with the requirements of CRR, AT1 and T2 securities must have a number of features which are designed to aid loss absorbency in the event of a financial crisis. These features make the tax treatment of new AT1 and T2 securities uncertain as the current tax rules were not designed with these securities in mind.

7.2 The regulatory capital securities which AT1 and T2 replace are treated as debt for tax purposes and as AT1 and T2 share features with debt type instruments it has been decided that debt treatment is appropriate for these securities.

7.3 These Regulations make provision for the new type of AT1 and T2 securities to which the regulations apply ("regulatory capital securities") to be taxed as debt and so provide credit institutions or investment firms with certainty of tax treatment to ensure that tax uncertainty does not discourage these entities from issuing more loss absorbent forms of capital.

7.4 The loan relationship rules will apply to regulatory capital securities subject to certain specific rules in relation to the issuer of these securities and, in the case of a connected company, the holder of these securities (these specific rules do not apply to holders of RCS that are unconnected to the issuer). These specific rules provide that the corporation tax provisions treating an embedded derivative or equity instrument as a separate contract are disapplied, fair value accounting of the security is not permitted for tax purposes and no credits or debits are brought into account in relation to certain conversions, write-downs and subsequent write-ups of the security arising as a result of a bank, investment firm or building society breeching a regulatory trigger or nearing insolvency. This will reduce potential tax burdens where an entity is in financial difficulty.

7.5 The Regulations also provide that payments (other than repayments of the principal amount) in respect of regulatory capital securities are not distributions for tax purposes but are treated as income chargeable under Chapter 2 Part 4 of Income Tax (Trading and Other Income) Act 2005 (interest) for income tax purposes this would include not just interest payments but any premium paid or discount received. The Regulations provide an exception from the duty to deduct tax in relation to these payments.

7.6 Transfers of regulatory capital securities will be exempt from stamp duty.

7.7 These Regulations will not apply to a regulatory capital security if there are arrangements were the main or one of the main purposes is to obtain a tax advantage in respect of that security.

7.8 The Regulations provide that the issuer is not required to deduct tax from payments made on a regulatory capital security. An issuer cannot rely on the exception from the general duty to deduct tax from interest paid by banks or authorised persons dealing in financial instruments.

7.9 The Loan Relationship and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations 2004 (the Disregard Regulations) are amended to apply to regulatory capital securities that are accounted for as equity in the same way that they currently apply to a company's own share capital. This will ensure that where an issuer of a foreign currency regulatory capital security enters into either a foreign currency loan relationship asset or a derivative contract to reduce their exposure to exchange gains and losses any gain or losses on the loan relationship or derivative contract will not be brought into account. In addition regulation 6 of the Disregard Regulations is amended to limit the effect of regulation 6(5) and 6(5B) elections where the hedged item is a regulatory capital security to which the company applies fair value accounting.

7.10 Transitional provisions will ensure that where a regulatory capital security is issued before these Regulation come into force but which meet the definition of regulatory capital security and are accounted for using fair value accounting any increase or decrease in carrying value of these securities is brought into account as either a credit or a debit. This will ensure there is continuity in the tax treatment and that amounts are not left out of account or brought into account more than once.

- **Consolidation**

This instrument will not be consolidated.

8. Consultation outcome

8.1 This instrument was consulted on for 8 weeks and as a result of the responses to that consultation a number of changes have been made to deal with the variety of ways in which new AT1 and T2 securities can be accounted for. Further drafts of the Regulations have been share on an informal basis with stakeholders as they have been developed.

9. Guidance

9.1 Guidance on this instrument will be provided in the form of amendments to existing HMRC guidance.

10. Impact

10.1 The impact on business, charities or voluntary bodies is negligible.

10.2 The impact on the public sector is negligible.

10.3 A Tax Information and Impact Note covering this instrument will be published on the HMRC website at http://www.hmrc.gov.uk/thelibrary/tiins.htm.

11. Regulating small business

11.1 The legislation does not apply to small business.

12. Monitoring & review

12.1 HMRC will monitor the affect of this instrument to ensure that it operates as intended and this will form part of a review of AT1 and Tier Two securities in 2017.

13. Contact

Fiona Hay at Her Majesty's Revenue and Customs Tel: 03000 585 882 or email: fiona.hay@hmrc.gsi.gov.uk can answer any queries regarding the instrument.