EXPLANATORY MEMORANDUM TO

THE TAXATION OF HYBRID CAPITAL INSTRUMENTS (AMENDMENT OF SECTION 475C OF THE CORPORATION TAX ACT 2009) REGULATIONS 2019

2019 No. 1250

1. Introduction

1.1 This explanatory memorandum has been prepared by Her Majesty's Commissioners for Revenue and Customs (HMRC) on behalf of Her Majesty's Treasury (the Treasury) and is laid before the House of Commons by Command of Her Majesty.

1.2 This memorandum contains information for the Select Committee on Statutory Instruments.

2. Purpose of the instrument

2.1 These regulations amend existing legislation covering the tax treatment of hybrid capital instruments which allow deferral or cancellation of interest payments (see 7.2 below). If these instruments meet certain specified conditions, including making an election, then any interest payable will be deductible for the corporate issuer and taxable for the corporate holder and no stamp duty or stamp duty reserve tax will be payable on transfers of those instruments.

2.2 The amendments to the legislation ensure that it works for hybrid capital instruments with a standard form of takeover or change of control clause, and allow extra time to make an election in certain circumstances.

3. Matters of special interest to Parliament

Matters of special interest to the Select Committee on Statutory Instruments

3.1 Schedule 20 to the Finance Act 2019 is deemed to always have had effect with the amendments made to section 475C Corporation Tax Act 2009 (section 475C) by these Regulations. This means that the amendments will have effect from 1 January 2019 (and 12 February 2019 in relation to stamp duty and stamp duty reserve tax). Authority for the retrospective effect is given by paragraph 19(5) of Schedule 20 to the Finance Act 2019, which can be exercised up until 31 December 2019.

3.2 The regulations enable relief from tax only and will not create any additional tax liabilities for the entities affected, either retrospectively or prospectively.

Matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business (English Votes for English Laws)

3.3 As these regulations are subject to the negative resolution procedure there are no matters relevant to Standing Orders Nos. 83P and 83T of the Standing Orders of the House of Commons relating to Public Business at this stage.

4. Extent and Territorial Application

4.1 The territorial extent of this instrument is the United Kingdom.

4.2 The territorial application of this instrument is the United Kingdom.

5. European Convention on Human Rights

5.1 John Glen MP, Economic Secretary to the Treasury, has made the following statement regarding Human Rights:

"In my view the provisions of the Taxation of Hybrid Capital Instruments (Amendment of Section 475 of the Corporation Tax Act 2009) Regulations 2019 are compatible with the Convention rights."

6. Legislative Context

6.1 Schedule 20 to Finance Act 2019 introduced new rules on the taxation of hybrid capital instruments, including new section 475C. Schedule 20 to the Finance Act 2019 is deemed to always have had effect with the amendments made to section 475C by these Regulations.

6.2 New section 475C sets conditions for a debt instrument to qualify as a hybrid capital instrument. This in turn enables any company to obtain tax deductions for interest paid on qualifying hybrid capital instruments, subject to certain conditions. It also ensures that no stamp duty or stamp duty reserve tax will be payable on transfers of those instruments.

6.3 Previously, tax deductions and the exemption from stamp duty and stamp duty reserve tax were available for debt instruments of this type issued by financial sector companies, in accordance with the Taxation of Regulatory Capital Securities Regulations 2013 (S.I. 2013/3209) (RCS Regulations). Following regulatory changes, the RCS Regulations were repealed and replaced by the new rules in Schedule 20 to Finance Act 2019.

6.4 The conditions currently contained in section 475C only permit conversion of the hybrid capital instrument into ordinary share capital in limited circumstances. Where the instrument provides for alteration of the amount of the debt or repayment of more than principal or interest, section 475C(5) only permits conversion into ordinary share capital of the company which issued the debt instrument (the debtor) or its quoted parent company.

6.5 Section 475C(5)(b) uses a pre-existing definition of a "quoted parent company" at section 162 Corporation Tax Act 2010 (section 162). In accordance with this definition, the "quoted parent company" of the debtor is, broadly, a company whose shares are listed on a recognised stock exchange and who owns at least 75% of the ordinary share capital of the debtor.

6.6 The use of the section 162 definition means that, as currently enacted, section 475C excludes certain debt instruments contrary to the policy intention. This is because some of these instruments contain a form of takeover or change of control clause which can result in the instrument converting into the ordinary shares of a quoted company which (together with its associates) controls the debtor without owning at least 75% of its ordinary share capital. Some clauses can also result in the instrument converting into the ordinary shares of a non-quoted company which (together with its associates) controls the debtor.

6.7 These regulations therefore amend the definition used in section 475C(5)(b) to ensure that the legislation will have its intended effect. If an instrument contains a takeover or change of control clause which could result in a conversion into ordinary share

capital of a company which (together with its associates) controls the debtor, then this will not cause the instrument to fall outside of the rules.

6.8 Section 475C also requires companies to make a one-off election within a set deadline for an instrument to be treated as a hybrid capital instrument.

6.9 Section 475C(8)(b) sets out that the company has six months from the date that it becomes a party to the loan relationship to make the election. Where a company became a party to the loan relationship before 1 January 2019, paragraph (3)(2) of Schedule 20 to Finance Act 2019 provides that the deadline is 30 September 2019 instead.

6.10 These regulations extend the deadline in situations where a loan relationship is only able to qualify as a hybrid capital instrument following the amendment referred to above to the definition in section 475C(5)(b). For instruments affected by that amendment, the debtor company will have six months from the date of these regulations coming into force to make an election.

6.11 These regulations also extend the deadline in situations where the debtor company amends the terms of a loan relationship so that the loan relationship is capable of qualifying as a hybrid capital instrument. In these circumstances, the company will have six months from the beginning of its following accounting period to make an election. If the debtor company amends the terms of a loan relationship part way through an accounting period, the loan relationship can only qualify as a hybrid capital instrument from the beginning of the next accounting period.

6.12 Schedule 20 to the Finance Act 2019 is deemed to always have had effect with the amendments made to section 475C by these Regulations. This means that the amendments will have effect from 1 January 2019 (and from 12 February 2019, when Finance Act 2019 received Royal Assent, in relation to stamp duty and stamp duty reserve tax) in line with the commencement date for section 475C. The amendments will therefore apply for all periods in which section 475C is in force.

7. Policy background

7.1 The rules in Schedule 20 to Finance Act 2019 were introduced to ensure that interest payments arising from certain debt instruments with limited equity features are deductible from the issuer's taxable profits.

7.2 Certain instruments (known as hybrid capital) issued by companies to raise capital have some debt-like and some equity-like features. Instruments which provide an interest-like return with no possibility for the holder to share in the profits of the issuer are properly regarded as debt. However, some instruments include equity-like features such as a right for the issuer to cancel or defer interest payments. Further, although they may have a fixed capital value at the outset, the instrument may contain terms that allow it to be released, written down or converted into shares in certain circumstances. These features can lead to uncertainty as to whether the coupon payments are taxed as interest (which is typically deductible) or as distributions of profit (which are not).

7.3 Previously the RCS Regulations only confirmed the tax treatment for companies in the financial sector. The RCS Regulations set out the tax treatment in relation to regulatory capital which banks and insurers are required to hold so that they can absorb losses, withstand economic shocks and continue to meet their obligations to depositors and policyholders. It can include hybrid capital in the form of debt

instruments with some features of equity. The RCS Regulations enabled tax deductions for interest paid on these hybrid capital instruments.

7.4 In June 2018 the Bank of England finalised its approach to setting a minimum requirement for own funds and eligible liabilities that banks, building societies and investment firms need to maintain. To meet these requirements banks are permitted to issue types of hybrid capital instruments that are not covered by the RCS Regulations.

7.5 The government took this opportunity to review the treatment of hybrid capital instruments across all sectors to ensure that, subject to certain conditions, interest payments on all debt-like instruments are deductible, thus removing tax uncertainty.

7.6 Since the Bank of England's new approach was finalised in June 2018 and applies from 1 January 2019, it was not possible to conduct a public consultation before enacting the updated rules in Schedule 20 to Finance Act 2019. However, Schedule 20 included a power to enable the government to make amendments to the new rules with retrospective effect. The power can be exercised up until 31 December 2019. This was included as a pragmatic solution to allow the government to ensure that the new rules operate as intended where concerns come to light post implementation.

7.7 One of the criteria used in the new rules covers a provision for the debt instrument to convert into shares of the debtor's parent. However, the legislation as currently enacted defines the parent company in a way that excludes some instruments that should be within the scope of the new rules.

7.8 As such, unless the legislation is amended, certain companies will not be able to obtain the intended relief for interest payments on these instruments. Numerous debt instruments issued by financial sector companies to fulfil regulatory requirements would be affected because they will no longer be entitled to the deductions provided under the RCS Regulations. This was not the intention of the new rules and will result in increased costs for the companies in question.

7.9 The rules include a requirement to elect into the hybrid capital instruments regime within six months of a company entering into the loan relationship, or by 30 September 2019 where the company was already a party to the loan relationship at 1 January 2019. The requirement to make an election within a short time was included to allow HMRC to closely monitor the operation of the rules and to ensure they are not abused. It was not included to deny an instrument from qualifying as a hybrid capital instrument where the tax rules or the terms of the instrument were amended after the time limit for making an election.

7.10 The government is therefore using its power to amend the new rules to ensure that they work as intended.

8. European Union (Withdrawal) Act/Withdrawal of the United Kingdom from the European Union

8.1 These regulations do not relate to withdrawal from the European Union.

9. Consolidation

9.1 There are no plans to consolidate the legislation.

10. Consultation outcome

10.1 The draft regulations were published for a five week consultation beginning 5 July 2019 during which a publicly advertised meeting was held. This was attended by lawyers and accountants who advise banks and insurers on the issue of hybrid capital instruments. It was also attended by representatives of several major banks and the Association of British Insurers.

10.2 The consultation response was largely positive and did not identify a need to change the proposed legislation allowing instruments with standard takeover or change of control clauses to qualify as hybrid capital instruments. There was some concern that the time limit for making an election into the rules might expire before the regulations came into force. This concern has been addressed by extending the deadline for affected instruments.

11. Guidance

11.1 On 29 October 2018, HMRC published a technical note to provide guidance on the new rules introduced at Schedule 20 to Finance Act 2019. This technical note was updated on 18 April 2019 to include an explanation of the government's intention to amend the definition of a parent company.

11.2 In addition, HMRC has circulated draft guidance to affected companies, accountancy and legal firms and relevant representative bodies which builds on the technical note. HMRC is in the process of updating its published guidance to incorporate this material, which will reflect feedback received. This will include an explanation of the amendments being made by these regulations.

12. Impact

12.1 The impact on business, charities or voluntary bodies is limited to the small number of banks and insurers who have issued hybrid capital instruments that include standard takeover or change of control clauses. These regulations simply ensure that the new rules introduced at Schedule 20 to Finance Act 2019 operate as intended. The small number of businesses impacted by this change will incur insignificant one-off costs of familiarisation with the amendment. There are not expected to be any ongoing costs to those businesses from the amendment.

12.2 There is no, or no significant, impact on the public sector.

12.3 A Tax Information and Impact Note covering this instrument will be published on the website at https://www.gov.uk/government/collections/tax-information-and-impact-notes-tiins.

13. Regulating small business

13.1 The legislation does not apply to activities that are undertaken by small businesses.

14. Monitoring & review

14.1 Issuing companies are under an obligation to submit an election to HMRC in respect of each instrument by 30 September 2019 (if the instrument existed prior to 1 January 2019) or within six months of issuing a new hybrid capital instrument. These elections provide HMRC with details of each instrument that is taxed in accordance with the new rules. They will allow HMRC to closely monitor the operation of the rules and ensure that they are not abused. HMRC will not hesitate to take whatever action is

necessary, including proposing further legislative change, if it detects abuse of the new rules.

14.2 The regulations do not include a statutory review clause. They amend United Kingdom tax legislation and therefore fall within the exceptions at section 28(3)(a), Small Business, Enterprise and Employment Act 2015.

15. Contact

15.1 Alison Winston (Telephone: 03000 524433 or email: alison.winston@hmrc.gov.uk) or Ursula Crosbie (Telephone: 03000 589086 or email: ursula.crosbie@hmrc.gov.uk) at Her Majesty's Revenue and Customs can be contacted with any queries regarding the instrument.

15.2 Richard Thomas, Deputy Director for Financial Products and Services, at Her Majesty's Revenue and Customs can confirm that this Explanatory Memorandum meets the required standard.

15.3 John Glen MP, Economic Secretary to the Treasury can confirm that this Explanatory Memorandum meets the required standard.