CLIFFORD
CHANCE

Client briefing
May 2011

Basel III – Taxation – Level Playing Field in Europe?

Introduction

This briefing outlines key tax issues in a number of European jurisdictions which may arise for a bank issuing Basel III compliant Additional Tier 1 Capital instruments.

The Basel III proposals do not prescribe a particular legal form for the instruments. However, this note proceeds on the basis that the instruments would take the form of bonds (rather than, say, preference shares) and that such bonds would be listed on a recognised stock exchange.

Executive Summary

The Basel III proposals are the latest attempts by the bank regulators to shore up the capital requirements for banks. On their face, the proposals set out a definition of Additional Tier 1 Capital that should, ideally, provide a level playing field across different jurisdictions. However, as set out in this paper, a level playing field is not achieved because of the differences in tax rules across jurisdictions. Going forward, it is clear that, absent changes in law or guidance from the relevant authorities, the ability of issuers to issue Additional Tier 1 Capital in a tax-efficient manner will vary significantly depending on where they are located. Issuers in France, Luxembourg, and Spain should be able to issue Additional Tier 1 Capital without any adverse tax consequences. In contrast, the issue of Additional Tier 1 Capital by issuers in Germany, the UK, and Italy would (under current law) be subject to either withholding tax and/or restrictions on deductibility for interest payments. The Netherlands and Belgium are in a third category where the outcome will depend on the tax authorities confirming their interpretation of existing law. Some jurisdictions (such as the UK) have already indicated that they are willing to look at changes in law to address difficulties raised by Basel III. This is obviously a welcome development, as all banks should be able to have access to capital on the same terms to ensure fair competition and a robust financial system.

Table

Please see Annex A.

Outline description of Additional Tier 1 Capital Instruments

Please see Annex B.

If you would like to know more about the subjects covered in this publication or our services, please contact:

Belgium
Thierry Blockerye +32 2533 5061
Alexandre Ooms +32 2533 5073
France
Eric Zeller +33 14405 5268
Germany
Uwe Schimmelschmidt +49 697199 1628
Hubert Schmid +49 697199 3389
Italy
Carlo Galli +39 028063 4525
Domenico Dell'Orletta +39 028063 4244
Luxembourg
François-Xavier Dujardin +352 485050 254
Vincent Marquis +352 485050 429
The Netherlands
Frank de Vos +31 20711 9110
Willem Specken +31 20711 9102
Spain
Jose Ignacio Jiménez-Blanco +34 91590 7514
UK
David Harkness +44 207006 8949
Mark Persoff +44 207006 8898

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance LLP, 10 Upper Bank Street, London, E14 5JJ, UK
www.cliffordchance.com

Country Summaries

Belgium

Belgian tax law does not contain specific definitions of equity and debt; the position is governed by Belgian civil law principles. The Belgian tax authorities will consider the overall characteristics of the instruments in order to determine debt or equity characterisation. The solus accounting treatment (which also looks at Belgian civil law principles) is critical. If the instruments are accepted as debt (and are accounted for as such) then interest on the instruments will be tax deductible. In the past, the Belgian tax authorities have confirmed on several occasions by way of private rulings that hybrid tier 1 capital instruments can be classified as debt from the Belgian tax perspective. It is not clear whether identical rulings can still be obtained in the context of Basel III. It is possible that the condition that the issuer has full discretion to pay interest or the existence of a mandatory write down feature may preclude confirmation that such instruments are debt.

A write down of the instruments would give rise to taxable profit for the issuer; a conversion into newly issued shares should not.

Belgian tax law contains a withholding tax exemption for interest on bonds cleared in X/N and which is paid to certain so-called "eligible" investors (holders of X accounts in the X/N system: mainly institutional and non-resident investors). If the bonds are not cleared in X/N, then the interest payments are likely to be subject to withholding tax, and an indirect issue through a Dutch or Luxembourg SPV would offer a structural solution for the withholding tax issue.

France

As a matter of French law, interest under the instruments will be deductible for corporate tax purposes. This is subject to two conditions. First, the instruments must qualify as debt securities under French law (which they would). Second, the instruments must be accounted for as a liability in the solus accounts of the issuer and interest must be recorded as a financial charge. The requirement that the payment of interest is at the full discretion of the issuer raises the question whether the payment of (discretionary) interest constitutes an "abnormal act of management". In that case, interest would not be tax deductible. If the issuer can justify that the payment is in its commercial interests, interest should be tax deductible. The mandatory conversion feature (if included) would not affect the legal qualification of the instruments as debt.

A write down of the instruments would be treated as a waiver of debt, taxable for the issuer. Conversion of the instruments into shares of the issuer should not give rise to a tax charge for the issuer.

Payments of interest (and principal) on the instruments will not be subject to French withholding tax.

Germany

The accounting treatment of the instruments under IFRS does not impact their tax treatment. German GAAP accounting provides an indication as to whether the instruments would qualify as debt or equity, but specific tax rules determine the debt or equity nature of the instruments for tax purposes. Based on a tax circular dealing with debt and equity-type hybrid instruments, the instruments will qualify as equity if they convey "a participation in the profit of the issuer and a participation in the liquidation proceeds upon a liquidation of the issuer". Since payment of interest is subject to (i) a sufficient regulatory equity position, (ii) distributable items and (iii) the discretion of the issuer, and given that the interest is non-cumulative, the instruments will be considered profit participating instruments. An undated instrument with no fixed maturity qualifies as a participation in the liquidation proceeds of the issuer. For the above reasons, the instruments would qualify as an equity instrument for tax purposes. Consequently, interest will not be tax deductible. To date there is no official guidance dealing specifically with the tax treatment of Basel III Additional Tier 1 Capital instruments. The contingent mandatory conversion of the instruments (if included) is not relevant for the classification of the instruments as equity as long as no conversion has occurred. As a consequence of the equity status of the instruments interest paid would not be deductible either for corporation tax or for trade tax purposes.

A write down of the instruments is not taxable. Conversion of the instruments into shares of the issuer is tax neutral for the issuer.

Interest paid on the instruments is subject to a withholding tax of 26,375%.

Italy

The solus accounting treatment of the issuer will inform the Italian tax analysis. If the issuer accounts for the instruments as debt, then interest on the instruments should be deductible for corporate tax purposes. This is subject to the following point. For expenses to be deductible for corporate tax purposes they must relate to the business activity of the issuer. As the payment of interest is at the full discretion of the issuer, the issuer must be able to justify that the payment of interest is made in its commercial interests.

A write down of the instruments would give rise to taxable income for the issuer. Conversion of the instruments into shares of the issuer should not give rise to a tax charge for the issuer.

Interest payments under the instruments will be subject to withholding tax. This is because the instruments would not contain "an unconditional obligation to pay, at maturity, an amount not lower than their nominal value". The rate of withholding tax is 27 per cent. This rate may be reduced by any applicable double tax treaties (generally, to 10 per cent). A change in law to eliminate this withholding tax liability is currently being considered.

Luxembourg
Luxembourg tax law does not contain specific provisions on the qualification of an instrument as debt or equity. No single element is decisive when treating an instrument as debt or equity. The Luxembourg tax authorities would perform a comprehensive analysis of all features of the instrument in order to classify it. The general principle is that the solus accounting treatment of the instrument is followed for tax purposes. However where tax law provides for a specific treatment the tax position may depart from the accounting position. This includes the substance-over-form principle contained in Luxembourg tax law. In the present case, the instruments should be treated as debt instruments, such that interest would be deductible for corporate tax purposes.

A write down of the instruments would give rise to taxable income for the issuer. Conversion of the instruments should not give rise to a corporate tax charge for the issuer.

As the instruments should be classified as debt, payments of interest (and principal) will not be subject to withholding tax.

Spain
Under Spanish tax law, the instruments will be treated as debt and interest on the instruments will be deductible for corporate tax purposes.

A write down of instruments will give rise to taxable profit for the issuer. A conversion of the instruments will give rise to Spanish corporate tax to the extent that the market value of the shares issued upon conversion is lower than the amount of the instruments converted into equity.

Payments of interest (and principal) under the instruments will not generally be subject to Spanish withholding tax.

The Netherlands
For Dutch tax purposes, the crucial question is whether the instrument "effectively functions as equity" as defined in case law. If so, then the interest is not tax deductible. Pursuant to prevailing case law a debt instrument "effectively functions as equity" if it meets the following cumulative criteria: (a) subordinated to all non-preferred creditors; (b) no fixed maturity or a maturity exceeding 50 years with no (early) repayment obligation except in the event of liquidation, moratorium or bankruptcy, and (c) the return is (almost entirely) dependent on profits of the issuer.

The contingent mandatory conversion feature (if included) would not of itself give rise to equity characterisation of the instruments prior to conversion. The accounting treatment may be different from the tax treatment. Given that the instruments are subordinated and perpetual (with no incentive to redeem), the treatment as debt or equity will depend on whether the conditions for the payment of interest are such that the interest must be regarded as (almost entirely) dependent on the profits of the issuer. To date there is no official guidance on this question. The better view is that the instruments should not be re-characterised as equity. Given the strict definition of profit given in Dutch case law, solvency dependency should not be identified with profit dependency.

A write down of the instruments would give rise to taxable profit for the issuer (assuming that the instruments are treated as debt). Conversion of the instruments into shares of the issuer would not give rise to taxation for the issuer.

If the instruments are classified as debt, then payments of interest (and principal) will not be subject to withholding tax. If, however, the instruments are classified as "effectively functioning as equity", interest payments would be subject to dividend withholding tax.

UK
The UK tax position for the issuer, governed by the loan relationship rules, will generally follow the issuer's solus accounting treatment. Therefore it will be necessary first to consider whether the issuer would account for the instruments as (1) a liability (with no embedded equity instrument or derivative) or (2) as an equity instrument or (3) on a bifurcated basis – i.e. as a liability with either an embedded equity instrument or an embedded derivative. Under the loan relationships rules, the issuer would obtain a deduction for interest payments even if the instrument was accounted for as an equity instrument (rather than as a liability). However, recognition of interest payments would likely be on a "paid" basis rather than on an accruals basis. Also, if the issuer bifurcates the instrument for accounting purposes, the analysis is more complicated. If, for example, the instrument were bifurcated into a host loan contract and an embedded equity instrument, then to the extent that interest is apportioned to the equity instrument, no deduction would be obtained for that interest cost. However, a number of UK tax rules, in particular the "distribution" rules, may override general loan relationships rules. The distribution rules could apply to treat interest paid on the instrument as a non-deductible "distribution" for tax purposes. Two rules in particular may result in interest being so re-characterised. The first is where the interest paid exceeds a reasonable commercial return on the principal secured. HMRC could argue that where the

terms of the instrument are such that the issuer may not be required to repay the entire amount advanced, then the principal secured is less than that amount, and as such the interest in question may exceed a reasonable commercial return. There is a statutory "safe" harbour, but it is unclear whether this would apply to a Basel III compliant instrument which contained a contingent mandatory conversion feature. The second is that interest is also treated as a distribution where the interest paid is dependent to any extent on the results of the company's business. This is potentially in point with respect to interest paid on a Basel III compliant instrument – in particular because the issuer would appear to be precluded from paying interest (and such interest payments would be cancelled) if the issuer had insufficient "distributable items".

Generally speaking, it is likely that a write down (or the expectation of a write down) would give rise to taxable income for the issuer. Conversion into ordinary shares of the issuer should not generally give rise to a tax charge for the issuer.

Interest payments under the instruments will not be subject to withholding tax provided they are listed on a "recognised stock exchange".

The UK Government has recently convened an industry working group to explore any tax issues associated with the development of new bank capital instruments in light of the Basel III proposals and, if necessary, will legislate for Finance Act 2012.

Annex A

Additional Tier I Capital http://www.bis.org/publ/bcbs189.pdf http://www.bis.org/press/p110113.pdf	Corporation Tax limitations on Deductibility?	Withholding Tax	Taxes on Trigger Events	Stamp Taxes	Structural Solutions
Belgium	Yes	Yes	Write Down: Yes Conversion: No	No/Marginal	Yes
France	No	No	Write Down: Yes Conversion: No	No	Not Necessary
Germany	Yes	Yes	Write Down: No Conversion: No	No	No
Italy	No	Yes	Write Down: Yes Conversion: No	No	?
Luxembourg	No	No	Write Down: Yes Conversion: No	No	Not Necessary
Spain	No	No	Write Down: Yes Conversion: Yes	No	Not Necessary
The Netherlands	?	?	Write Down: Yes Conversion: No	No	No
UK	Yes	No	Write Down: Yes Conversion: No	No	?

Annex B
Outline description of Additional Tier 1 Capital Instruments

Under the Basel III proposals, key features of Additional Tier 1 Capital instruments include the following:

- They must be fully paid up, fully subordinated, and not subject to any arrangement that enhances the seniority of the claim vis-à-vis bank creditors.
- They must be perpetual, with no step-ups or other incentives to redeem. They may be callable at the initiative of the issuer only after a minimum of five years, but even then only in limited circumstances. Any repayment of principal must be with prior supervisory approval.
- The bank must have full discretion to cancel coupon payments, and cancellation must not be an event of default or impose any restrictions on the bank. Cancellation means extinguishment of payments. Instruments cannot contain features requiring the bank to make payments in kind.
- Coupons must be paid out of distributable items.
- They cannot have a credit sensitive dividend feature – i.e. a coupon re-set periodically based on the bank's credit standing.
- Instruments cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.
- "Dividend pushers" are prohibited.
- Instruments must have principal loss absorption through either (i) conversion into common shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The trigger point is expected to be if the institution's common equity tier one ratio falls below 5.125% or a level higher than that as determined by the institution. The write-down must reduce the claim of the instrument in liquidation, reduce the amount repaid if a call is exercised; and reduce or extinguish coupon payments on the instrument.
- Instruments cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.
- If instruments are issued out of a special purpose vehicle, the proceeds raised must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 Capital.
- All non-common Tier 1 (and Tier 2) instruments must give the relevant authority the option to require the instruments to be written off or converted into common equity upon the occurrence of the trigger event unless the jurisdiction of the bank in question has laws in place which require such instruments to be written off upon such event or otherwise require such instruments to fully absorb losses before tax payers are exposed to loss. Trigger event means the earlier of (1) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and (2) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority.

For full details, see http://www.bis.org/publ/bcbs189.pdf (at pages 15-17) and http://www.bis.org/press/p110113.pdf.

Clifford Chance contacts

To discuss any of the issues in this publication, please contact one of our tax experts below:

Belgium
Thierry Blockerye
Partner, Tax
T +32 2533 5061
E thierry.blockerye@cliffordchance.com

Belgium
Alexandre Ooms
Associate, Tax
T +32 2533 5073
E alexandre.ooms@ cliffordchance.com

France
Eric Zeller
Partner
T +33 14405 5268
E eric.zeller@cliffordchance.com

Germany
Uwe Schimmelschmidt
Partner
T +49 697199 1628
E uwe.schimmelschmidt@cliffordchance.com

Germany
Hubert Schmid
Partner
T +49 697199 3389
E hubert.schmid@cliffordchance.com

Italy
Carlo Galli
Partner
T +39 028063 4525
E carlo.galli@cliffordchance.com

Italy
Domenico Dell'Orletta
Tax Advisor
T +39 028063 4244
E domenico.dell'orletta@cliffordchance.com

Luxembourg
François-Xavier Dujardin
Partner
T +352 485050 254
E francois-xavier.dujardin@kremer.cliffordchance.com

Luxembourg
Vincent Marquis
Senior Associate
T +352 485050 429
E vincent.marquis@kremer.cliffordchance.com

The Netherlands
Frank de Vos
Partner
T +31 20711 9110
E frank.devos@cliffordchance.com

The Netherlands
Willem Specken
Senior Counsel
T +31 20711 9102
E willem.specken@cliffordchance.com

Spain
Jose Ignacio Jiménez-Blanco
Partner
T +34 91590 7514
E joseIgnacio.jimenez-blanco@cliffordchance.com

UK
David Harkness
Global Head of Tax, Pensions and Employment
T +44 207006 8949
E david.harkness@cliffordchance.com

UK
Mark Persoff
Partner
T +44 207006 8898
E mark.persoff@cliffordchance.com