Tier 1.

Linklaters

Tax treatment of Tier 1 instruments following Basel III

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Introduction

On 16 December 2010 the Basel Committee published "*Basel III: A global regulatory framework for more resilient banks and banking systems*" and on 13 January 2011, the Basel Committee published requirements for non-core tier 1 and tier 2 capital instruments to include loss absorption mechanisms which are triggered at the point of the relevant issuer's "non-viability". Together, these two papers contain the full "Basel III" guidelines. The European Commission will use the Basel III guidelines as the basis for revising the Capital Requirements Directive to create "CRD IV", which will replace "CRD II" (which recently came into effect, on 31 December 2010). Basel III is required to be implemented by 1 January 2013.

Under the Basel III guidelines, tier 1 capital will need to equal at least 6 per cent. of a bank's risk-weighted assets, of which 1.5 per cent. may be in the form of "Additional Tier 1 Capital".

The purpose of this review is to consider, at a very high level, the tax issues associated with the main eligibility criteria for Additional Tier 1 Capital under the Basel III guidelines in a number of European jurisdictions.

We do hope that you find this review useful. If you have any questions on any of the issues raised or on issues associated with tier 1 capital generally, please do contact one of the authors or your usual Linklaters LLP tax contact.

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Overview of the Basel III Guidelines

On 16 December 2010 the Basel Committee published "*Basel III: A global regulatory framework for more resilient banks and banking systems*", and on 13 January 2011 the Basel Committee published requirements for non-core tier 1 and tier 2 capital instruments to include loss absorption mechanisms which are triggered at the point of the relevant issuer's "non-viability". Together, these two papers contain the full "Basel III" guidelines. The European Commission will use the Basel III guidelines as the basis for revising the Capital Requirements Directive to create "CRD IV", which will replace "CRD II" (which recently came into effect, on 31 December 2010). Basel III is required to be implemented by 1 January 2013.

Under the Basel III guidelines, tier 1 capital will need to equal at least 6 per cent. of a bank's risk-weighted assets, of which 1.5 per cent. may be in the form of "Additional Tier 1 Capital".

The main eligibility criteria for instruments to be counted as Additional Tier 1 Capital are as follows:

(i) They must be subordinated to depositors, general creditors and subordinated debt.

(ii) They can have no maturity date and no incentives to redeem or other "innovative" features.

(iii) They may be callable at the initiative of the issuer only after a minimum of five years subject to:
- prior supervisory approval;
- the issuer not creating an expectation that the call will be exercised; and
- the issuer not exercising a call unless the called instrument is replaced with capital of the same or better quality or the issuer demonstrating that its capital position is well above the minimum capital requirements after the call is exercised.

(iv) The issuer must have full discretion to cancel distributions/payments. Such cancellation of distributions/payments must not impose restrictions on the issuer except in relation to distributions to common stockholders. There can be no "alternative coupon satisfaction mechanism".

(v) Dividends/coupons must be paid out of distributable items.

(vi) Instruments classified as liabilities must have principal loss absorption through either (i) conversion to 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 objective trigger point.

(vii) Instruments by "internationally active banks" must, at the option of the regulator, be written off or converted into equity on the occurrence of a non-viability event. The trigger event is the earlier of: (1) a decision that a write-off, without which the issuer would become non-viable, is necessary, as determined by the relevant regulatory authority; and (2) the decision to make a public sector injection of capital, or equivalent support, without which the issuer would have become non-viable, as determined by the relevant regulatory authority.

(viii) The instrument cannot have any features that hinder recapitalisation.

(ix) If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a special purpose vehicle), proceeds 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.

Belgium

Principles of Belgian Tax Law Relevant to Tier 1 Capital

As a general matter, neither Belgian tax legislation nor the administrative regulations contain rules for distinguishing debt obligations from equity instruments. It is a generally acknowledged principle that, in order to characterise a given instrument or transaction for Belgian tax law purposes, it is necessary to apply Belgian civil law principles unless the tax legislation contains a specific derogation.

In court cases where the Belgian Tax Administration took the position that, despite the existence of a document purporting to evidence a loan, the transaction was in fact a hidden capital contribution, the Belgian Supreme Court held that an equity investment essentially requires the parties to intend to share in the profits as well as in the losses of the issuer. Other factors which the Supreme Court regards as indicative of an equity investment are:

> the absence of a definite repayment date;
> the borrower being under-capitalised;
> a right of control over management;
> the absence of any guarantee or security; and
> subordination to other creditors.

In practice, all the debt and equity features of a hybrid instrument need to be weighed against each other: the instrument will only be viewed as debt if the debt features outweigh the equity features. Substance prevails, but the fact that tier 1 securities can be issued and listed in the form of debt will also carry a certain amount of weight.

In addition, tax deductibility can only be achieved if the tier 1 securities are recorded in the statutory Belgian GAAP accounts of the issuer as a liability. The distinguishing criteria under Belgian GAAP are the same as the criteria mentioned above. The accounting treatment of the securities in consolidated accounts under IFRS is not in itself relevant.

Previous Belgian Deductible Tier 1 Structures

The Belgian Ruling Commission has given advance tax rulings confirming that a non-innovative tier 1 instrument with an automatic conversion once the stock price of the underlying share exceeds a certain amount and an alternative coupon satisfaction mechanism ("**ACSM**") qualifies as debt for Belgian tax purposes.

The Belgian Ruling Commission has also confirmed that a non-innovative tier 1 instrument without an automatic conversion but with an ACSM qualifies as debt for Belgian tax purposes. In reaching this conclusion, it accepted that an implied maturity date could be derived from the pricing of the coupons on this instrument (the coupons were priced on the basis of, among other things, the 40-year mid swap rate).

On the other hand, the Belgian Ruling Commission has categorised a tier 1 instrument on which the coupons were non-cumulative and equal to a fixed percentage of the dividend paid per share as an equity instrument, notwithstanding the fact that the instrument was issued in the form of debt.

Impact of Basel III Guidelines

In this section, the Basel III requirements for instruments to be regarded as Additional Tier 1 Capital and whether they affect the classification of an instrument as debt from a Belgian tax perspective, are discussed.

The requirements listed in the Overview at the beginning of this publication under the points (i) subordination, (ii) undated maturity, (v) payment of coupons out of distributable items and (viii) absence of features hindering recapitalisation, will not prevent an instrument from being regarded as debt for Belgian tax purposes. The more difficult requirements are those outlined in points (iii), (iv) and (vi), which are discussed further below.

No Expectation that the Instrument will be Called

The fact that any call of the instrument by the issuer is subject to prior approval from the regulator and to the replacement of the instrument with capital of the same or better quality is not viewed by the Tax Authorities as an equity feature.

The Belgian Ruling Commission is likely to pay particular attention to the way the coupon is priced. Any pricing of the coupon on the basis of a long-term swap rate may be viewed as giving rise to an implied maturity date and therefore as a debt feature (be it rather weak).

Full Discretion to Cancel Coupons – No Dividend Pusher – No Alternative Coupon Satisfaction Mechanism ("ACSM")

The Supreme Court considers that an intention to share in the profits and losses of an issuer is indicative of an equity instrument.

As noted above, an instrument whereby the amount of the non-cumulative coupon was set as a percentage of the dividend effectively paid to shareholders was viewed as a strong equity feature by the Belgian Ruling Commission. But the Belgian Ruling Commission might be somewhat more flexible if the coupon were to be a fixed amount (despite the discretion to cancel the entire coupon).

However, even if a positive Belgian tax ruling could be obtained on this point, the discretion to cancel coupons may trigger a Belgian withholding tax ("**WHT**") issue.

In practice, direct tier 1 issues are entered into the so-called X/N clearing system as operated by the Belgian National Bank in order to ensure that they can benefit from a WHT exemption. This requires that the securities qualify (i) as debt securities for Belgian tax purposes and (ii) as so-called "fixed income securities" for Belgian tax purposes.

There are no specific tax rules or regulations which provide criteria for determining whether a security is a fixed income security. However, it is considered that a debt instrument qualifies as a fixed income security if the amount of interest income is causally linked to the period of time for which the security is held. Taking into account the issuer's full discretion to cancel coupons, it is unclear whether such instruments will qualify as fixed income securities.

This WHT issue may lead issuers to consider alternatives, such as structuring an indirect issuance in Luxembourg and so relying on another Belgian WHT exemption which does not require the fixed income security condition to be met.

Loss Absorption by Conversion into Ordinary Shares or by Means of Principal Write-Down

The Belgian Tax Administration has accepted that the mere fact that an instrument is convertible (even mandatorily convertible) does not prevent it from qualifying as a debt instrument.

Hence, contingent convertibles (the so-called "**CoCo**" structures) (debt instruments that convert into ordinary equity on the occurrence of a particular trigger event) may be of interest in a Belgian tax context.

The conversion of the securities into ordinary shares would not give rise to taxable profits in the hands of the issuer.

If loss absorption is structured as a principal write-down mechanism, Basel III also requires that the write-down (i) reduces the claim of the instrument in liquidation, (ii) reduces the amount repaid upon exercise of a call and (iii) reduces the coupons.

Such features would be problematic from a Belgian tax perspective and are likely to prevent the instrument from qualifying as debt. There are no publicly available examples in Belgium of direct issues by banks containing a principal write-down mechanism (and certainly no examples which demonstrate the additional consequences of such a write-down as imposed by Basel III).

Taking the above into account, it seems advisable to structure the loss absorption as a conversion into ordinary shares and not as a principal write-down.

For completeness, note that a write-down would result in a taxable profit for the issuer but such taxable profit may be set-off by tax losses. As the trigger event would only arise if the bank was in a stressed financial position, there may be sufficient tax losses to absorb the taxable profit.

Conclusion

The full discretion to cancel non-cumulative coupons without ACSM will make it very difficult to structure tax deductible tier 1 securities in Belgium.

However, the possibility that the Belgian Ruling Commission might adopt a flexible approach and conclude in specific circumstances that a Basel III compliant instrument should qualify as debt rather than equity for Belgian tax purposes cannot be ruled out.

Even if the Belgian Ruling Commission is willing to confirm that such instruments qualify as debt for Belgian tax purposes, there may still be a Belgian WHT issue in direct issues as it is far from certain that such instruments could still qualify as fixed income securities for Belgian tax purposes. This WHT issue may lead issuers to consider alternatives, such as structuring an indirect issuance in Luxembourg and relying on another Belgian WHT exemption which does not impose such a condition.

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France

Principles of French Tax Law Relevant to Tier 1 Capital

Under French law, there are no specific rules that apply to interest accruing on hybrid tier 1 instruments. Interest will give rise to a tax deduction for the issuer if the instrument is regarded as debt for legal and statutory accounting purposes and if the instrument is booked as a liability in the issuer's accounts. It follows that, in principle, the debt or equity classification of a hybrid instrument for tax purposes is not independent from its legal characterisation and does not rely on specific tax criteria. This explains the paucity of both statements of practice issued by the French tax authorities and case law addressing this issue, not only in the context of tier 1 issuances but also more generally in respect of all forms of hybrid instruments.

This is not to say that "interest" charged in respect of any instrument purporting to be debt will always be deductible. However, historically, the French tax authorities have not taken a "substance over form" approach[1] and the limitations on tax deductibility in the French tax code mainly concern interest paid to related parties, which is viewed as a constructive dividend in certain circumstances, irrespective of the features of the instrument itself.

Previous French Deductible Tier 1 Structures

Since 2003, most of the hybrid tier 1 issuances by French companies have taken the form of undated deeply-subordinated bonds (*titres super subordonnés*) issued under a specific provision of the French commercial code which expressly states that such instruments shall be treated as debt for legal purposes. Such issuances, in our experience, have been consistently classified as debt for statutory accounting and tax purposes. The characterisation of tier 1 instruments as debt under the commercial code does not depend on the satisfaction of any specific tests, but is consistent with the fact that such undated deeply-subordinated bonds do not carry the most significant rights or features of equity, as defined in French law: namely, voting and information rights, the right to receive a dividend if one is declared or the right to liquidation surplus and pre-emptive rights. It should also be stressed that the history of the legislation clearly establishes that its purpose is to allow French banks to issue instruments that qualify as tier 1 for capital adequacy purposes and possibly qualify as equity under IFRS, while at the same time being treated as debt for French legal, accounting and tax purposes, which accordingly give rise to deductible interest.

It is also interesting to note that recently the French tax authorities have indirectly shed more light on what they are willing to treat as "debt" for tax purposes, in the context of sukuk bonds. In order to encourage Islamic finance in the French legal environment, they have relaxed their standards by accepting that certain instruments (such as sukuks or indexed instruments) will be treated in the same way as debt, so long as certain conditions are met. In particular, the holders of the instrument should be repaid before the shareholders of the issuer, including before the holders of preferred shares, and they should not have any of the shareholders' rights, notably voting rights or rights to a liquidation surplus. In addition, the instrument must include an "expected rate of return" which must be capped at a market rate (EURIBOR, LIBOR, etc.) and increased by a margin consistent with market practices for debt instruments. If these conditions are met, broadly speaking, the amounts paid on such instruments will be deductible for the issuer. Admittedly, these rules do not target tier 1 issuances, but it is interesting to note that they are not inconsistent with the classification of tier 1 as debt instruments.

Impact of the Basel III Guidelines

The requirements set out in the above "Overview of Basel III Requirements" are unlikely to create an insurmountable hurdle to securing a tax deduction in France in respect of coupons paid under Basel III-compliant instruments. It is, however, worthwhile examining some of these requirements further.

Permanence

As under French law there is neither an explicit nor implicit requirement that an instrument have a scheduled maturity in order to be recognised as debt, this condition should not be problematic. In the past, the tax authorities have also tacitly acknowledged that undated instruments such as *titres subordonnés à durée indéterminée* qualify as debt for tax purposes.

The section of the French commercial code relating to undated deeply-subordinated bonds does not contain any provisions requiring such securities to have a scheduled maturity, and in practice such securities are routinely issued without a fixed maturity date. To the best of our knowledge, to date there has been no challenge from the tax authorities on this issue and tax practitioners generally view the absence of a scheduled maturity date as having no bearing on the debt classification of the instrument.

Even though they are expressed to be repaid when the issuer is liquidated, undated issues tended to be structured so that there would be an incentive for the issuer to redeem the instruments within 10 or 15 years, subject to the prior approval of the French *Commission bancaire*. Some instruments have already been issued without any such incentive, however, as is consistent with the Basel III Guidelines, and the tax treatment of the interest paid on such instruments does not appear to have been affected.

[1] In a statement of practice relating to the thin capitalisation rules, the French tax authorities mention hybrid instruments combining equity and debt features and state that the thin capitalisation rules should apply whenever a "case-by-case analysis" would lead to the conclusion that the instrument in question should be treated as debt for tax purposes. The tax authorities, however, have neither indicated the legal basis for this analysis nor the criteria under which it should be carried out.

Cancellation of Coupons and Flexibility of Payments

Until now, the terms and conditions of tier 1 instruments issued by French credit institutions generally provided that the issuer could suspend the payment of interest in certain circumstances (in substance, the payment of interest would be optional if the issuer had not declared dividends in a specified period); interest payments were also suspended on the occurrence of a supervisory event. Under the Basel III Guidelines, this "coupon pusher" mechanism would be replaced with a "dividend stopper" under which no dividend will be paid if a coupon has not been paid to the holders of the tier 1 instruments. Furthermore, the interest under such instruments is usually not cumulative.

From an economic perspective, it is true that interest paid at the discretion of the borrower coupled with a coupon pusher or a dividend stopper, and no deferment of unpaid interest, could be viewed as contingent on the profits of the borrower. Yet this does not equate to carrying the same return as an equity security. Firstly, the interest rate is usually expressed to be set and will in fact provide investors with an exposure to the issuer's results which is capped (at least with respect to the upside). Secondly, the shareholders' rights to the issuer's profits remains junior to that of the holders of tier 1 bonds at all times. More generally, other instruments with contingent interest features, including those where the contingency is dependent on the borrower's profits, have been recognised as debt under French tax law. In particular, the tax authorities have accepted that amounts paid on sukuk bonds or indexed loans or instruments could be linked to the performance of assets held by the issuer or to the issuer's income while remaining deductible for tax purposes. This provides further comfort that the coupon paid on tier 1 instruments can be linked to the results of the issuer while allowing a tax deduction.

Loss Absorption by Means of Principal Write-Down

The first issue created by a write-down or a write-off provision in the terms and conditions of the instrument, whether on a going- or gone-concern basis, is whether such instrument can still be regarded as debt. This concern stems from French legislation, which provides that, upon maturity, the borrower must repay what it borrowed in the same quantity and quality. There is therefore an argument that where the lender has no fixed right of redemption, the instrument is not debt.

However, in practice this provision is generally construed as not precluding write-downs or write-offs, in particular where they are explicitly warranted by the financial condition of the borrower. Furthermore, so far as we are aware, there has been no challenge to the deductibility of interest accruing on indexed bonds or credit-linked notes, even where the terms and conditions of such instruments allow them to be redeemed at less than par. This is also generally consistent with the statement of practice mentioned above in respect of sukuk bonds and indexed instruments, which expressly envisages that such instruments can be repaid at less than par and still be treated as debt.

With respect to undated deeply-subordinated bonds, the legislative history of the relevant provisions also clearly establishes that the purpose of such bonds, where issued by credit institutions, is to qualify as tier 1 capital while allowing the related finance charges to be tax deductible. As the loss absorption feature is crucial in the classification of the instrument for capital adequacy purposes, it would be inconsistent for this feature to prevent the tax deductibility of coupons accruing on the instrument. We are aware that the French *Direction de la législation fiscale* has issued private letter rulings confirming to the issuers of undated deeply-subordinated bonds with loss absorption and suspension of interest clauses, that such bonds would be respected as debt for tax purposes

Any write-down should be treated as a cancellation of debt, which is taxable income for the borrower. If the write-down is only temporary and is subsequently reversed, the reinstatement of the debt previously forgone should give rise to a deduction in the same amount, up to the amount of the original write-down.

Loss Absorption by Conversion into Ordinary Shares

Debt instruments mandatorily convertible into new and/or existing shares of the issuer are regarded as debt for French legal and tax purposes until such time as they are converted into shares, and the interest accruing on such instruments remains tax deductible until conversion. Consequently, the requirement under the Basel III Guidelines that, as an alternative to a complete write-off, a tier 1 instrument be converted in whole or in part into shares upon the occurrence of a trigger event should not have an impact on the treatment of the instrument until conversion.

Conclusion

While the Basel III Guidelines have undoubtedly strengthened the "equity" features that tier 1 issuances must include, we do not expect that they will interfere with tax deductibility. This is mainly because the statute under which such instruments are issued by French banks is (in the light of its legislative history) clear that such instruments are inherently hybrid and should be treated as equity for capital adequacy purposes while remaining debt from a tax standpoint.

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Germany

Principles of German Tax Law Relevant to Tier 1 Capital

Introduction

The new regulatory capital requirements under Basel III will spur on the search for instruments that not only comply with the generally increased regulatory requirements but are also tax efficient for the issuing bank. In particular, as core tier 1 capital is likely to solely or largely comprise paid-up share capital which will not be tax deductible, it will be beneficial to find tax efficient ways of raising Additional Tier 1 Capital.

In the past, prior to the implementation of CRD II in Germany, Additional Tier 1 Capital was restricted to certain legal forms of instruments with certain features (e.g. silent partnerships). The new definition of Additional Tier 1 Capital under CRD II describes certain minimum characteristics, but otherwise provides more flexibility from a regulatory viewpoint. In particular, this definition currently allows hybrid debt instruments to be structured as Additional Tier 1 Capital. The new Basel III rules, however, impose further requirements (e.g. dated instruments will not be permitted) which will disable some of the structuring options available to date.

From a German tax viewpoint the interesting question with respect to any hybrid Additional Tier 1 Capital instrument will continue to be whether such instrument can still be regarded as debt. In addition, withholding tax may be an issue as it may make the instrument unattractive for certain types of investors who do not benefit from tax treaty protection.

Tax-Specific Equity Test

German tax law provides for a specific two-limb test that classifies hybrid debt instruments as equity for tax purposes if both of the following features are present:

> Profit-dependent payments: This limb applies where payments (i.e. interest payments) are linked to the profits of the issuer. It is not necessary for the amount of the payment to correlate with the amount of the profits of the issuer. It is enough that the payment is a fixed rate of interest that would be cancelled or reduced if the issuer did not have sufficient profits.
> Participation in liquidation proceeds: This has generally not been a feature of hybrid capital instruments and is generally not required by the new Basel III rules. However, the German tax authorities have issued guidance that a hybrid debt instrument with a term of more than 30 years should be treated as if the investor participates in the liquidation proceeds for the purposes of the equity test.

The classification of a financial instrument as equity for German tax purposes can be avoided if the instrument does not meet one limb of the above test.

The tax-specific test is generally not dependent on the accounting treatment of the instrument under German GAAP. Of course in practice, the tax and accounting treatment of a hybrid instrument as debt or equity will often be the same.

Withholding Tax on Interest

German withholding tax applies to payments of interest and other amounts if such payments are profit-dependent. The profit-dependency test for withholding tax purposes is not exactly the same as for the equity test outlined above, but potentially broader, and therefore withholding may arise in circumstances where a payment is not strictly profit contingent. It may, for example, be enough that the interest is related to the sales figures of the company.

Previous German Deductible Tier 1 Structures

In the past Additional Tier 1 Capital was primarily raised through structures employing silent partnerships because, as noted above, under the German regulatory framework prior to CRD II only certain legal instruments were eligible. There were also indirect structures that created regulatory capital on a consolidated level.

Interest paid under these structures was generally tax deductible because the regulatory minimum term of the instruments used to be five years prior to CRD II, and is currently 30 years, neither of which time periods is in excess of the 30 years, which could lead to a reclassification of the instrument as equity according to the view of the tax authorities (cf. above: Tax-Specific Equity Test).

Withholding tax could generally not be avoided and was either accepted or could in some cases be mitigated through further structural tweaks (e.g. two-tier structures).

Impact of Basel III Guidelines

A general discretion to cancel interest, as required by Basel III, should not pose a particular tax concern as it does not necessarily establish any link between the profits of the issuer and the payment of interest. The same applies in our view when it comes to mandatory interest cancellation because of insufficient capital or upon the request of the German regulator. The “ban” on dividend pushers or alternative coupon settlement mechanisms is actually helpful in this respect because the first of these “de-links” coupon payments from dividend payments, and the second makes it clear that coupon payments may only be in cash form.

Basel III also provides that interest can only be paid out of “distributable items”. If this is read as meaning that the interest may not be paid if the payment results in the issuer suffering a balance sheet loss it is likely to be considered as profit-dependent for both withholding tax purposes and the first limb of the equity test. It will be interesting to see whether it will be possible to find a solution that satisfies the regulatory needs on

the one hand but is sufficiently de-linked from the profits of the issuer on the other hand.

Further discussions will also be required to shed light on the question of whether a Basel III-compliant instrument can be structured to avoid the second limb of the equity test (i.e. participation in liquidation proceeds) applying. In this respect, loss absorption through either a principal write-down or a conversion into equity of the issuer does not generally cause concern because the investors will by definition not participate in any liquidation proceeds or hidden reserves of the company. This may explain to some extent the recent interest in contingent convertible instruments ("**CoCos**"). CoCos clearly have the advantage that the conversion should not lead to the cancellation of indebtedness, as opposed to principal write-downs.

More problematic, in our view, is the statement of the German tax authorities that hybrid instruments with a term of more than 30 years may be treated as equity instruments. Contrary to the historical and current regulatory framework that allowed the issuance of five- or 30-year dated instruments, respectively, Basel III will require the instrument to be perpetual to qualify as Additional Tier 1 Capital. In addition, there must be no incentive to redeem. This will deprive banks from using a step up after five or 10 years to prompt an early termination that could have helped to show that the instrument in fact has an economic lifetime of less than 30 years.

It is questionable whether indirect structures where a non-German entity issues a Basel III-compliant instrument would be able to mitigate the issues, as Basel III requires that the proceeds from the indirect issuance are made available to the bank in a form which meets or exceeds all of the other criteria for an inclusion in Additional Tier 1 Capital.

Conclusion

The increased regulatory requirements under Basel III will make it more difficult to structure hybrid Additional Tier 1 Capital instruments that escape the equity test for German tax purposes, taking into account the current administrative practice of the tax authorities. There are, however, still a lot of unknowns as to how Basel III will be implemented by the European Union and subsequently by the domestic legislator and, consequently, there remains hope that some of the uncertainty may be resolved in favour of the taxpayer.

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The Netherlands

Principles of Dutch Tax Law Relevant to Tier 1 Capital

An instrument which qualifies as debt under Dutch civil law will also be treated as debt for Dutch tax purposes, unless the instrument concerned is regarded as equity of the borrower within the meaning of a particular statutory Dutch tax provision. Rather than containing a specific definition, this provision causes debt to be treated as equity for Dutch tax purposes by reference to certain features as developed in case law. Under relevant case law as it currently stands, loans will only be treated as equity when they have each of the following three characteristics:

(i) the consideration for the use of the loan amount is contingent on the profit of the borrower;
(ii) the loan is subordinated to all creditors; and
(iii) the loan has no fixed maturity, but is only repayable in case of bankruptcy, moratorium on payments or liquidation of the borrower.

In this context, if a loan has a term that exceeds 50 years, it will be treated as having no fixed maturity. In addition, a coupon that is in small part fixed, but almost entirely contingent on profits, will cause the consideration to be regarded as contingent on the profit of the borrower for these purposes. If a coupon cannot be cancelled but its payment may be deferred, the consideration will not be regarded as contingent on profit.

If a tier 1 instrument falls within the scope of the above rules, it will be treated as equity for Dutch tax purposes. Coupons will then be non-deductible. Moreover, the borrower will in principle be required to withhold Dutch dividend tax in respect of coupons.

Previous Dutch Deductible Tier 1 Structures

Loss absorption (through a write-down or conversion of debt into equity) and the issuer having full discretion to cancel distributions/payments (with or without an alternative coupon satisfaction mechanism ("**ACSM**")) would not necessarily constitute profit contingency for Dutch tax purposes. However, although certain guidance is available to support this, it will not usually provide the desired level of comfort.

As a result, recent (direct) issues of tier 1 capital usually relied on a step-up in the coupon or other incentives to call, or a contingent undertaking to call, before the expiration of 50 years. The instrument concerned would then in substance fail to qualify as a perpetual instrument for Dutch tax purposes. This would avoid non-deductible coupons and withholding tax. The Dutch tax authorities have usually been prepared to clear this in advance by way of a tax ruling.

Impact of the Basel III Guidelines

Following the Basel III guidelines, tier 1 issues will not be permitted to have a maturity date or incentives to redeem. Subject to certain conditions they may be callable at the initiative of the issuer, but the issuer is not allowed to create an expectation that the call will be exercised. This certainly makes it harder to design an instrument that fails to satisfy one of the above three features, in particular the perpetual nature of the instrument. However, it may still be possible to successfully argue that the instrument concerned is in fact a dated instrument (rather than a perpetual one) for Dutch tax purposes by reference to including a right or undertaking to call at the initiative of the issuer. It may be advisable to seek advance clearance on this issue from the Dutch tax authorities.

Leaving aside the use of a non-subordinated instrument, the final way of avoiding non-deductible coupons and withholding tax in the Netherlands is to ensure that there is no profit contingency. Whether this will be possible is likely to remain somewhat uncertain, in particular in circumstances where the Dutch tax authorities are not prepared to clear in advance the consequences of loss absorption and the issuer having full discretion to cancel distributions/payments (without ACSM), as required by Basel III. It is not yet clear how this will develop.

Conclusion

The Basel III guidelines as recently published further tighten the possibilities for structuring tier 1 instruments in a manner that is efficient for Dutch tax purposes. Until recently, non-deductible coupons and withholding tax were usually avoided on the basis of the argument that the relevant instrument should be treated for Dutch tax purposes as in fact being a dated one. We would expect this argument to continue to be valid under Basel III.

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Portugal

Principles of Portuguese Tax Law Relevant to Tier 1 Capital and Previous Portuguese Deductible Tier 1 Structures

Introduction

The general deductibility provision of the Portuguese Corporate Income Tax Code ("**CIT**") allows expenses incurred on "*third-party capital*", i.e. debt, to be deductible. However, neither Portuguese tax legislation nor rulings nor case law defines debt, or sets any criteria for distinguishing between equity and debt instruments. Therefore, as a rule, tax deductions on tier 1 capital depend on whether the underlying instrument qualifies as debt for statutory accounting purposes.

Before the implementation of IFRS in Portugal, Portuguese GAAP allowed tier 1 instruments to qualify as debt where they qualified as such for legal purposes, thus enabling the tax deductibility of any payments made on such instruments booked as costs in the issuer's Profit & Loss Account, irrespective of substance (e.g. payments made on profit-participating bonds were deductible). Therefore, it was possible to secure tax deductions for payments made on tier 1 issues.

With the implementation of IFRS, the definition of debt for accounting purposes has changed and therefore the tax deductibility of payments made on tier 1 instruments classified as equity, as well as the tax deductibility of any losses resulting from the requalification into equity of tier 1 instruments previously classified as debt, is no longer possible.

General Regime: Portuguese Tax Generally "Follows the Accounts"

As noted above, under the current regime, Portuguese corporate taxable income is based on accounting profit, as determined by the accounting rules resulting from the implementation of the IFRS in Portugal, subject to the adjustments imposed by the Portuguese CIT Code. Consequently, in the absence of specific tax adjustments, tax deductions on tier 1 instruments will only be available if the underlying payments are booked in the Profit & Loss Account in respect of instruments accounted for as debt. An override to this general requirement applies if the deductions result from the application of the effective interest method to financial instruments measured at amortised cost, in which case tax deductibility is available even if the deductions relate to equity items and/or are not booked in the Profit & Loss Account (see below).

However, the IFRS rules on the recognition and measurement of financial instruments and the eligibility criteria adopted by the Bank of Portugal for instruments to be counted as Additional Tier 1 Capital (which already cover most of the Basel III guidelines criteria as described above, and apply to a minimum of 8 per cent. of a bank's risk-weighted assets) create significant uncertainty as to the accounting treatment of tier 1 instruments.

Given the general rule according to which "tax follows the accounts", the same level of uncertainty applies to the tax deductibility of payments made on such tier 1 instruments, even if from a legal perspective they qualify as debt.

It is worthwhile noting that the absence of tax rules, rulings and case law on the distinction between debt and equity has not allowed practitioners, tax authorities and Portuguese courts to consider in detail the typical issues surrounding tier 1 capital in many other jurisdictions. Concepts such as "results-dependent consideration", "reasonable commercial return", "flexibility on payments" and "loss absorption" have not been relevant for tax purposes and as such have not been directly addressed, as in the past most of the instruments traditionally qualified as debt for both legal and accounting purposes. However, they have been taken into consideration by the Bank of Portugal for purposes of implementing Basel III guidelines.

Effective Interest Method Override and Other Accounting Principles

The existing "override", according to which tax deductibility is allowed where the effective interest method is used on financial instruments measured at amortised cost, is unlikely to be of assistance when considering Basel III-compliant tier 1 capital. This is because, in principle, the amortised cost method applies to instruments such as non-perpetual bonds, non-convertible bonds and irredeemable bonds, which do not qualify for tier 1 capital under Basel III guidelines criteria.

IFRS rules classify several instruments historically accounted for as equity as now constituting debt instruments. Redeemable shares and preferred shares, historically accounted for as equity, are now to be accounted for as debt under the applicable IFRS, thus allowing tax deductions at the level of the issuer, and the applicability of tax rules on the elimination of double taxation at the level of the recipient, with significant tax savings. However, Basel III guidelines criteria do not allow these instruments to qualify as tier 1 capital.

Impact of Basel III Guidelines

The existing rules approved by the Bank of Portugal on tier 1 capital already incorporate most of Basel III guidelines criteria. However, under the current rules, it is still possible to issue tier 1 capital in the form of non-perpetual bonds provided that the initial maturity is not less than 30 years. This possibility, together with a thorough analysis of the additional conditions of the issue and of the existing tier 1 capital criteria, may be of use when structuring Additional Tier 1 Capital before the full implementation of Basel III guidelines criteria.

Direct tier 1 issues, either in the form of equity or debt instruments, are not subject to Portuguese Stamp Duty.

Conclusion

The methods historically used to raise deductible tier 1 capital in Portugal will no longer be effective following the implementation of IFRS in Portugal and the adoption of Basel III guidelines criteria. Although IFRS on the recognition and measurement of financial instruments generally creates new opportunities for tax planning, its combination with Basel III will bring an additional level of complexity to tier 1 issues, thus imposing a higher level of sophistication on direct and indirect issues.

The existing criteria for tier 1 capital have been in force since 31 December 2010 and, although incorporating most of the Basel III guidelines, still leave some room for deductible tier 1 issues. It is interesting to note that the ruling under which the Bank of Portugal approved the existing criteria safeguarded existing tier 1 instruments which no longer qualify as tier 1 under the new rules until the end of 2040 (within some thresholds and without safeguarding its previous tax treatment). Considering the existing tier 1 criteria and the scope of application of IFRS, and assuming an identical transitional provision upon the implementation of Basel III guidelines, the next two years may provide good opportunities for structuring tax deductible tier 1 issues.

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Spain

Principles of Spanish Tax Law Relevant to Tier 1 Capital and Previous Spanish Deductible Tier 1 Structures

As a general rule, in order to determine the tax deductibility of issues of hybrid tier 1 capital, the relevant instrument must qualify as debt for Spanish legal purposes and, in particular, for accounting purposes.

In effect, the taxable income of Spanish corporates for Corporate Income Tax purposes is based on their accounting profit, determined in accordance with Spanish GAAP (which in general follows IFRS), subject to tax adjustments arising from differences between tax and accounting criteria. For these purposes, the individual and consolidated accounts of Spanish banks are currently prepared under Circular 4/2004 of the Bank of Spain which, subject to certain exceptions, follows IFRS.

Therefore, in the absence of specific tax rules, the Spanish tax treatment will follow Spanish GAAP (which, in relation to financial/equity instruments, follows IFRS principles) and, in principle, a tax deduction can only be claimed in respect of those amounts recorded as an expense in the Profit & Loss Account in respect of hybrid instruments which are accounted for as debt.

Special Regime for Tier 1 Capital: Preference Shares

Aside from the general regime for debt instruments referred to above, there is also a special tax and regulatory regime for preferred shares (*participaciones preferentes*) provided for by Law 13/1985 on Capital Adequacy, as supplemented, *inter alia*, by Law 19/2003 (the "**Law 19 Regime**"). The transposition of EU Directive 2009/111/EU into Spanish law will result in amendments to Law 13/1985. A draft bill of amendment of Law 13/1985 is currently being processed in the Spanish Parliament (the "**Draft Bill**") and we expect that will come into force in the following months.

Under Law 13/1985 as amended by the Draft Bill, preferred shares issued by Spanish banks will be regarded as tier 1 capital for financial regulatory purposes provided that they comply with the following conditions:

(i) the preferred shares must be issued by (a) a bank or financial institution, or (b) any entity resident in Spain or in an EU territory not classified as a tax haven according to Spanish regulations, wholly directly or indirectly controlled (i.e. by the holding of voting rights) by a bank or financial institution, and whose exclusive purpose is the issue of preferred shares (i.e. an SPV);

(ii) if the preferred shares are issued by an SPV, the net funds raised must be permanently deposited with the "dominant" bank or financial institution such that the funds are directly linked to the risks and financial situation of the parent financial institution or its consolidated group or sub-group;

(iii) the coupon may be specified in the terms of the preference shares, however:
   - the Board of Directors of the issuer or of its parent company must have the discretion to cancel the payment of the return for a unlimited term with non-cumulative effect;
   - in the event that the issuer, its parent company or its consolidated group or sub-group do not fulfil certain regulatory capital requirements the payment of the return must be cancelled;
   - the Bank of Spain must also have the right to request the cancellation of the payment of the return based on the financial and solvency situation of the issuer, its parent company or its consolidated group or sub-group;
   - the cancellation of the payment of the return agreed by the issuer or requested by the Bank of Spain shall not be taken into account in order to determine the insolvency status of the debtor, according to the Spanish Insolvency Law; and
   - the payment of the return may be replaced by the delivery of ordinary shares of the issuer or of the parent company, when such replacement is contemplated in the terms and conditions of the relevant issue and subject to the relevant regulatory requirements.

(iv) other than in certain exceptional circumstances specified in the terms and conditions of the offer, the preferred shares must not confer any voting rights;

(v) the preferred shares must not grant preferential subscription rights to their holders in respect of new issues of preferred shares;

(vi) the preferred shares must be perpetual, although the issuer may redeem them after the fifth anniversary of the issue date, subject to prior authorisation from the Bank of Spain. The Bank of Spain may only authorise such redemption if neither the financial situation nor the solvency of the credit entity and its consolidated group or sub-group are affected, and such authorisation may be conditional upon the substitution of the redeemed preference shares for other equity instruments of equal or higher quality.

(vii) the preferred shares must be listed on an organised secondary exchange;

(viii) in the event of the liquidation or dissolution of the issuing financial institution or of the parent financial institution, the preferred shares must entitle the holders to repayment of their nominal value together with all accrued but unpaid distributions on them, which have not been subject to cancellation as explained in point (iii). The holders of the preferred shares must rank behind all creditors of the issuing financial institution or of the parent financial institution of its consolidated group or sub-group, whether or not subordinated, and rank senior only to ordinary shareholders;

(ix) the terms and conditions of the preference shares must contemplate specific mechanisms which assure their holders participation in current or future losses (either through the conversion of the preference shares into ordinary shares or through the reduction of their nominal value) in the event that the issuer, its parent company or its consolidated group or sub-group have significant losses or their regulatory capital ratios have substantially fallen, and

(x) the nominal value of the total preference shares issued cannot exceed 30 per cent. of the basic regulatory capital (*recursos propios básicos*) of the consolidated group or sub-group. In the event this percentage is exceeded, the credit entity shall be required to seek approval from the Bank of Spain of a plan to reduce it. The Bank of Spain may amend this percentage.

The Draft Bill contains a grandfathering provision which provides that (i) preference shares issued before the entry into force of the expected amendments and which do not comply with the requirements set out in the new regime will continue to be treated as regulatory capital (*recursos propios*) of the relevant credit entities, within limits to be established; (ii) the preference shares subscribed by the Spanish Banking Restructuring Fund (*Fondo de Reestructuración Ordenada Bancaria*) within the framework of the legislation approved on June 2009 on the restructuring of the financial system and to strengthen the equity of financial entities will also be treated as regulatory capital; and (iii) the new legislation will not affect the tax treatment applicable to the existing preference shares and other debt instruments issued before its entry into force.

Provided that the preferred shares satisfy all of these requirements, the return referred to in (iii) above should be deductible for the Corporate Income Tax purposes of the issuer and tier 1 capital treatment would be achieved in respect of them. However, the Draft Bill does not mention anything about the accounting treatment of such instruments, and this is currently causing some confusion in the market. Preferred shares which meet the requirements of the legislation currently in force, Law 13/1985, are generally treated as debt for accounting purposes following IFRS principles. However, the additional requirements set out in the Draft Bill are likely to result in the characterisation of such instruments as equity for accounting purposes. In view of the likely accounting treatment, it is not clear whether it will be possible to obtain a tax deduction for interest, although we are of the opinion that there are strong arguments to defend the tax deduction. However, given that the Draft Bill is still relatively new, the Spanish Tax Authorities have not yet expressed an opinion.

Special Regime for Tier 1 Capital: Other Hybrid Instruments

As regards other hybrid tier 1 capital instruments, in a ruling dated 25 September 2007 the Spanish Tax Authorities found that debt instruments issued indirectly by a Spanish bank through a SPV which satisfied most of the requirements set out above (including features to improve the loss absorbency position and Board of Directors approval to pay interest), should be regarded as preferred shares falling within the Law 19 Regime ensuring tier 1 capital treatment and the tax deductibility of "interest" payments.

However, the ruling referred to instruments treated as debt for accounting purposes and there are still many uncertainties in relation to issues of hybrid tier 1 capital instruments which are treated as equity for accounting purposes and which, under such a flexible interpretation of the Law 19 Regime, might be deemed to be compliant with the requirements for the issue of preferred shares.

Additionally, in view of the coming Draft Bill, the uncertainty has increased and it is also less clear whether the regime will apply to "indirect" structures in the future.

Impact of Basel III Guidelines

Although many of the requirements of Basel III will be implemented by the Draft Bill, there may be further requirements. In this section, we look in more detail at the effect on tax deductibility of certain features.

Loss Absorbency by Means of a Principal Write-Down

The Spanish Civil Code provides that a debt must be repaid by the borrower. Therefore, if an instrument issued by a Spanish bank provides for the possibility of a write-down of the principal amount of the debt or for the cancellation of accrued and unpaid coupons, it may not be possible to characterise such instruments as debt.

Notwithstanding this, in practice we are not aware of the Spanish Tax Authorities challenging the characterisation as debt of instruments in which the holders were not guaranteed the full repayment of the principal amount of such instruments. However, the Spanish Tax Authorities may adopt a different approach where, together with a temporary write-down feature, hybrid instruments include other "equity" features.

Mandatory Convertible

Following the publication of the Basel III requirements, the issue of mandatory convertibles has been of much interest in the Spanish market. It is understood that a mandatory convertible that can only be share-settled will be treated as equity as an accounting matter (to the extent it can only be settled with an equity instrument). Should that be the case, the interest will not be registered as an expense for accounting purposes and tax deductibility would, in our view, not be available.

According to the market practice, a mandatory convertible with a cash option will tend to be regarded as debt as an accounting matter. However, in these circumstances the embedded derivative will give rise to taxable income in accordance with its valuation (on a mark-to market basis) in the Profit and Loss Account.

Contingent Convertible or "CoCo" structures

In certain markets CoCo structures seem to be attractive, however until now, the Spanish market has not expressed an interest in this type of structure. Under this structure, in which debt instruments convert into ordinary equity on the occurrence of a particular trigger event, it will be crucial to determine the accounting treatment. In a nutshell, and considering the

"flexibility of payments" and "loss absorption features" offered by a conversion into ordinary shares, the tax deduction for interest could be jeopardised on such instruments, because they are characterised as equity for accounting purposes.

Conclusion

In summary, if the new features proposed by the Draft Bill lead to tier 1 instruments being characterised as equity for accounting purposes, then, in principle, interest on them should not be deductible for Spanish tax purposes.

The alternative would be the issue of preferred shares under the Law 19 Regime, to take advantage of the availability of a tax deduction for interest, seemingly irrespective of the accounting treatment. In this regard, "indirect" issues are likely to remain practicable on the basis that the instruments are characterised as debt for accounting purposes. However, for direct issues and those accounted for as equity, there are many uncertainties.

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Sweden

Principles of Swedish Tax Law Relevant to Tier 1 Capital and Previous Swedish Deductible Tier 1 Issues

In order to give rise to a tax deduction, an issue of hybrid tier 1 capital must qualify as debt. There are no specific Swedish tax rules defining what constitutes debt or interest. Civil law in general, and corporate law in particular, determine what circumstances are relevant and what specific terms cause an instrument to be regarded as debt, or a deduction in respect of interest to be disallowed for tax purposes.

The Swedish Companies Act allows companies to borrow funds where both the repayment of the principal amount of the debt incurred and any interest accruing on the debt are linked to company performance. From a corporate law standpoint, therefore, contingent debt is still considered to be debt, and payments in respect of such debt are regarded as either repayments of principal or as interest (rather than dividends), even in situations where the return on the instrument mirrors a return on equity.

Provided that the instrument qualifies as debt, the issuer can normally deduct any coupon against its corporate income for tax purposes (provided the coupon is paid on arm's length terms). As a general rule, payments and/or value accretion that are fixed or otherwise follow from the terms of the instrument are tax deductible.

However, special restrictions apply to "profit sharing interest" (*vinstandelsränta*) paid on "profit sharing debentures" (*vinstandelslån*), which is deductible only in certain circumstances. For Swedish tax purposes, a loan is profit sharing if the interest is related to the profits of, or dividends paid by, the borrowing company. If it is the repayment of the nominal amount of the debt incurred, and not the interest accruing on such a debt, that is linked to company performance, then the loan should not be deemed to be a profit sharing loan for Swedish tax purposes. Nor should the restrictions apply to profit sharing interest if (i) the loan is offered on the public market, (ii) the loan is provided by someone other than a shareholder or affiliated person of the borrower, (iii) the borrowing company is listed, or (iv) the Swedish Tax Agency grants an exception. In this context, affiliation is caused by, *inter alia*, direct or indirect ownership, or participation in the management or control, of an entity.

Since 1 January 2009, there are further rules restricting tax deductions for certain intra-group interest expenses. However, these rules only target intra-group loans when the relevant debt arises as a result of a direct intra-group transfer of shares.

By restricting the deductibility of interest in only a few limited circumstances, the Swedish legislator has accepted hybrid instruments (including those that are performance linked) and other contingent debt instruments as debt for both corporate and tax law purposes, provided that there is a formal liability to repay any sum borrowed or at least a strong incentive for the issuer to repay the debt (see further below) , even if there is some uncertainty as to the extent to which repayment will eventually be made. In addition, contractual terms that concern e.g. the time to maturity and repayment, or the circumstances relating to the issue price, the denomination, subordination features, gross-up clauses for withholding taxes and the incurring of break costs for early termination, all of which are common features of debt instruments, seem to have no or only a limited effect on the tax classification insofar as it concerns the deduction for coupons paid or accrued.

Impact of the Basel III Guidelines

The requirements set out in the above "Overview of Basel III Requirements" should, in our view, not create an insurmountable hurdle to securing a tax deduction in respect of coupons paid under Basel III-compliant instruments. It is, however, worthwhile examining some of these requirements further.

It should also be noted that this area of law is, both in terms of legislation and case law, currently uncertain and little clarification has been provided so far by the Swedish legislator.

Permanence

The permanence requirement should not give rise to any additional Swedish tax issues. Currently tier 1 instruments can be structured as perpetual debt in Sweden and, while there are some issues to consider if the perpetual debt constitutes a profit sharing debenture (see above), as a general proposition coupons on perpetual debt should, in our view, be deductible.

Cancellation of Coupons

Provided that a loan is considered true debt rather than equity, a borrower can normally deduct all of its borrowing costs against its corporate income for Swedish tax purposes, provided the costs are at arm's length. However, restrictions apply to profit sharing interest. As noted above, a loan is deemed to be profit sharing if the coupon is related to the profits of, or dividends paid by, the borrowing company, which is often the case for instruments complying with this requirement of Basel III. There are, however, exceptions to these restrictions (see further above).

Flexibility of Payments

Providing the issuer with an option as to whether or not to make coupon payments would give rise to many of the issues described above.

Loss Absorbency by Means of Temporary Write-Down

The first issue is whether the mere possibility that the debt may be written down in the future prevents a deduction for coupons. Based on the rather specific tax rules provided by the legislator, it would, in our view, be difficult to limit the deductibility of coupon payments in a situation where (i) the explicit restrictions do not apply (see above) and (ii) corporate or private law would not lead to the reclassification or the recharacterisation of debt into equity. Further, as noted above, the Swedish legislator seems

to have accepted hybrid instruments (including those that are performance linked) and other contingent debt instruments as debt, provided that there is a formal liability to repay any sum borrowed or at least a strong incentive for the issuer to repay the debt (such as combining the write-down with a "dividend stopper" under which no dividend will be paid prior to the write-up of the debt).

However, the possibility of a temporary write-down may cause the debt to be classified as a profit participating debenture (*kapitalandelslån*) for tax purposes. The significance of this from a tax perspective depends on whether or not the profit participating debenture belongs to a trade portfolio (*handelsportfölj*) or should be considered as a capital gains tax item (capital asset) in the hands of the issuer.

An increase or decrease in value of a capital asset, save for certain receivables and debt denominated in a foreign currency, gives rise to tax consequences only when the asset is sold or otherwise divested and not, as would be the case if the profit participating debenture were part of a trade portfolio, on a current basis. In addition, capital gains and losses arising on redemption of certain profit participating debentures do not give rise to a tax charge for the issuer.

The relevant legislation indicates that, despite the fact that a profit participating debenture in the hands of the issuer is not an asset but a liability, such liability constitutes a capital gains tax item. This is, however, contingent on the profit participating debenture not being part of the issuer's trade portfolio.

If a profit participating debenture is considered as a capital asset for Swedish tax purposes, neither a write-down/write-up of the principal amount nor a capital gains/capital loss on maturity of the instrument should trigger any tax consequences for the issuer.

If, however, it is not considered to be a capital asset, tax may be incurred on a write-down, unless mitigating steps are taken.

Loss Absorbency by Mandatory Conversion into Ordinary Shares

The mere fact that an instrument, e.g. a contingent convertible or "**CoCo** style" instrument, is mandatorily convertible should not prevent it from qualifying as debt. However, it would give rise to many of the issues described above.

The holder should not be subject to capital gains taxation on a conversion of the instrument.

The issuer's ability to claim a deduction for coupon payments depends on whether the principal amount and the coupon on the instrument are dealt with separately. If it is predetermined at the outset that the instrument will bear no explicit coupon, there is, according to case law, a risk that the deduction will be disallowed if the payment is made in the form of the issue of shares.

Conclusion

Given the lack of specific tax rules defining what constitutes a debt and with very little guidance to be found in Swedish doctrine or case law, this area of law is subject to uncertainty.

However, while the Basel III Guidelines have undoubtedly strengthened the "equity" features that tier 1 issuances must include, the requirements should not interfere with tax deductibility since the Swedish legislator generally accepts hybrid instruments and other contingent debt instruments as debt from a tax standpoint.

Given the uncertainty in this area, however, providing the Tax Agency with relevant information about any tier 1 instrument when claiming a tax deduction in respect of the coupon paid could be considered in order to extinguish or reduce the risk of tax penalties (*skattetillägg*) should the coupon be considered non-deductible.

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United Kingdom

In the 2011 Budget Report published by the UK Government on 23 March 2011, the following statement was made: “The Government will set up an industry working group from April 2011 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 in 2012.”

The following is a summary of the current UK law applicable to the deductibility of payments, the types of tax deductible tier 1 instruments that have been seen historically in the UK market in light of current UK law, and the issues arising from the Basel III proposals. This illustrates why a change in law in this area is likely to be necessary if UK banks are to continue to be able to issue tax deductible tier 1 instruments to ensure they remain competitive with banks in other jurisdictions which have tax regimes permitting regulatory capital to qualify for a tax deduction.

Principles of UK Tax Law Relevant to Tier 1 Capital

Introduction: UK Tax Generally “Follows the Accounts”

In order to give rise to a tax deduction, an issue of tier 1 capital needs to be debt as a legal matter. The distinction between debt and equity as a matter of English law remains largely determined by form rather than substance. “Perpetual” debt and debt that is convertible or exchangeable into shares on a mandatory basis should still be regarded as debt for UK tax purposes.

Having established that an instrument is debt for tax purposes, the “loan relationship” rules prima facie require profits and losses in respect of that instrument to be determined by following the accounting computation of profit or loss. This is the case even if the instrument is treated as equity for accounting purposes (with profits and losses being recognised in equity or shareholders’ funds). A consequence of tax “following the accounts” is that if an instrument is regarded for accounting purposes as containing an embedded derivative (with profits and losses on that embedded derivative being recognised on a fair value basis) or an embedded equity instrument the starting point is that such an embedded derivative or equity instrument exists for tax purposes as well. If an embedded derivative is recognised, the resulting fair value profits are generally relievable or taxable (subject to the “overrides” to the accounting treatment described below). Profits or losses attributable to an embedded equity instrument are typically outside the scope of UK tax.

Overriding the Accounting Treatment

The general presumption in favour of “following the accounts” is subject, however, to a number of “overrides”. These “overrides” are crucial to the understanding of the tax treatment of tier 1 instruments because they often operate to deny deductions even where an expense is recognised for accounting purposes.

> **Results-dependent consideration:** No deduction is permitted in respect of a debt security if the security is one under which the consideration given by the issuer for the use of the “principal secured” is to any extent dependent on the results of the issuer’s business or any part of it. Historically both practitioners and HM Revenue & Customs have taken the view that the slightest link between the “results” of a issuer’s business and the “consideration given for the use of the principal secured” causes the entirety of interest on that security to be non-deductible. It is this rule that precludes a deduction for any interest on a security that provides for the entitlement to interest to depend on the profit or solvency of the payer.

> **Reasonable commercial return:** Another relevant “override” is that a deduction is not available for interest that exceeds a reasonable commercial return for the use of the “principal secured” by the instrument concerned. Of course in an arm’s length deal the interest payable should be objectively “reasonable”. The difficulty tends to arise from the definition of “principal secured”. HM Revenue & Customs have previously argued that the “principal secured” of an instrument is the lowest amount at which it can be redeemed in accordance with its terms. So HMRC have argued that a FT-SE linked bond that could in theory redeem for zero if FT-SE falls to zero has a “principal secured” of zero so that any return on that zero of “principal secured” is by definition “unreasonable”. That was an extreme view that was not shared by most practitioners. Legislation was enacted (to reverse the effect of HMRC’s view) to provide a “safe harbour” for instruments that could be redeemed at less than their face value. However, this “safe harbour” does not apply to instruments that to a significant effect reflect the performance of the issuer’s own shares or shares of an associated company. Therefore, the reasonable commercial return issue remains a potential trap for instruments that could be redeemed in the issuer’s own shares (or shares in an associated company) where the value of those shares could be lower than the face value of the debt.

> **Loans for unallowable purposes/tax arbitrage:** Tax deductions can be disallowed if a loan is entered into for a tax avoidance or tax arbitrage purpose. UK issuers have historically wanted to obtain clearance from HM Revenue & Customs that a deductible tier 1 issue would not be regarded as a transaction designed to give rise to a deduction for what is in substance equity. For that reason, it has been common to seek specific confirmation that these rules would not apply. Since the Basel III proposals do not affect this aspect of the analysis, however, these rules are not considered in any more detail in this section.

> **Embedded equity derivatives:** A further relevant “override” is that certain embedded derivatives that relate to equity are disregarded for tax purposes.

Previous UK Deductible Tier 1 Structures

Previous deductible tier 1 structures have only really needed to address the "results-dependent consideration" rule. No particular difficulty arose with the "reasonable commercial return" rule since the securities in question were all redeemable in cash, did not reflect the value of shares of the issuer or any associated company and could therefore benefit from the "safe harbour". Because of the "results-dependent consideration" rule it was not possible to issue an instrument that simply linked the entitlement to interest to the solvency or distributable profits of the issuer. Broadly, two general approaches were taken to solving this problem.

> Under a "direct" issue, the issuer was given the ability to defer interest if paying interest would cause it to be insolvent, and was entitled to settle any particular interest payment by issuing shares under an alternative coupon satisfaction mechanism ("**ACSM**"). Deferred interest would remain payable on a winding-up. It was argued, and HMRC accepted, that the mere ability to defer interest did not trigger the "results-dependence" prohibition since it did not affect the right to receive interest but only the date on which that interest would be paid. Moreover, the issue of shares by way of ACSM was accepted to count as payment of interest even though it did not actually cost the issuer itself (as opposed to shareholders suffering dilution) any money.

> "Indirect" issues took a different approach. Investors would subscribe for preferred partnership interests in a Jersey, Delaware (or even English) limited partnership. The partnership interests entitled holders to a fixed return and built in all the features required in order to constitute tier 1 capital. The partnership then invested in an upper tier 2 instrument issued by the issuer the terms of which did not give rise to any "results-dependent" interest. From a UK perspective, the interest on the upper tier 2 debt was deductible in the ordinary way and the fact that holders of the preferred partnership interests might not receive a particular interest payment because of the tier 1 features embedded in them did not alter that conclusion.

Following the Basel III requirements, neither of these structures will be effective. The "direct issues" relied on the ability to apply an ACSM that is no longer permitted. The indirect issues will not be effective any more because of the requirement that the on-loan by the partnership must itself be in a form which meets or exceeds all of the other criteria for inclusion in the tier 1 capital fund.

Impact of Basel III Guidelines

Since Basel III has rendered obsolete all existing UK deductible tier 1 structures, the search has been on to create a successor. In this section we seek to identify the hurdles that any successor tier 1 structures will need to overcome on the basis of current law. As noted above, the UK Government has announced that there may be a change of law in this area to take effect in 2012. Ultimately it is to be hoped that such a law change facilitates the creation of a successor structure. However, in formulating any law change the industry working group will need to take into account the issues mentioned below

No particular difficulty arises from the requirement for instruments to be subordinated, perpetual and callable only in limited circumstances (requirements (i) to (iii) set out in the Overview at the beginning of this publication). However, real difficulties arise from the "flexibility of payments" requirements (summarised in (iv) to (vi) of the Overview) since those are at odds with the prohibition on "results-dependent" interest.

In addition, the "loss absorbency features" (summarised in paragraphs (vi) and (vii)) pose new and interesting issues that have not previously needed to be considered in the tier 1 capital context.

Loss Absorption by Conversion into Ordinary Shares – "CoCo Structures"

There has recently been much interest in contingent convertibles or "CoCo" structures – i.e. debt instruments that convert into ordinary equity on the occurrence of a particular trigger event. If the "flexibility of payments" issue described above can be solved, CoCo style instruments may be of interest in the UK although, as noted below, there are some hurdles to overcome.

> If the instrument converts directly into the issuer's own ordinary shares the "reasonable commercial return" point potentially arises. In virtually all cases the ordinary shares issued will have a value less than the instrument's principal amount since by definition the conversion will take place at a time when the issuer is in a stressed financial position. The "safe harbour" from HMRC's interpretation of the "principal secured" of a security is not available for securities that to a significant extent reflect the value of the issuer, or an associated company's shares. Therefore the safe harbour may not be available, although there remains scope for argument as to whether HMRC's view on what constitutes the "principal secured" of a security is correct. It is also possible to argue that the conversion into ordinary shares is so unlikely to happen that the security does not to a "significant extent" reflect the value of those shares.

> The precise formulation of the conversion mechanic could potentially help. If the instrument redeems at par with the proceeds being subscribed in the ordinary equity, it might be possible to argue that this redemption mechanic should be respected and that the instrument is redeeming at par (and not at the value of the shares that are being issued). That argument may be even more robust if the shares are issued by a different company from the issuer of the note and if the terms on which the ordinary equity is acquired are governed

by an instrument separate from the bond (for example a deed poll that is binding on all bondholders). Indeed a number of banking groups in the UK have a group structure where the regulated bank is a subsidiary of the ultimate holding company of the group, so in many cases this will be a natural structure to adopt.

> There is also a point arising out of the prohibition on "results-dependent consideration". That prohibition focuses on whether the "consideration for the use of the principal secured" depends on results. A CoCo could result in the issuer's obligation to return the principal amount of the instrument being satisfied by shares whose value might be regarded as depending on the results of the issuer's business. It is probably the case that the "results dependent consideration" is focusing on the consideration given for the use of the principal (and not the terms on which the principal itself is to be returned). In addition, the points made above about respecting a redemption mechanic that consists of the securities being redeemed at par and the proceeds applied in subscribing the ordinary shares are equally valid.

> The issuer will want to consider whether the contingent conversion mechanic gives rise, as an accounting matter, to an embedded derivative or equity instrument over its own shares. If it does, it will want to consider whether that embedded instrument gives rise to accounting and/or tax volatility (if it is an embedded derivative) or an effect on the group's equity position (if it is an embedded equity instrument).

> On a positive note, if the conversion mechanic is triggered the issuer should not suffer a tax charge even if its liability is extinguished by means of the issue of potentially worthless shares. There is a specific relief from taxability for profits arising to an issuer in respect of a debt for equity swap.

Loss Absorbency by Means of Principal Write-Down

Another possible approach to "loss absorbency" is to provide for the principal amount of the instrument to be written down following a trigger event. An instrument with this feature has recently been issued in the market (although not in the UK). As noted above, such an instrument would also need to provide flexibility of payments and this in itself will be an impediment to implementing this type of issue in the United Kingdom. However, assuming a way can be found around that issue, principal write-down gives rise to the following additional issues:

> If the trigger event happens and the principal amount of the instrument is partially written down, interest will accrue going forward on a reduced principal amount. If the trigger event relates in some way to the results of the issuer's business, there would therefore be a direct link between a holder's entitlement to interest and the question of whether or not the trigger event has occurred. That is likely to be regarded as a further example of the "results dependent consideration" problem. A similar point arises in relation to accrued interest if the trigger event occurs part way through the interest period with interest that has accrued since the previous interest payment date being written off.

> The "reasonable commercial return" issue, however, should not arise since in the absence of any link to shares in the issuer or an associated company the safe harbour referred to above should be available.

> There is likely, however, to be a tax charge on the issuer if the trigger event takes place, the principal amount of the instrument is written down and a credit arises as an accounting matter either on the face of the profit and loss account or in equity or shareholders' funds. In practice, since the trigger event would arise only if the bank is in a "stressed" financial position, there may be losses available to absorb any charge arising. However, it will not of course be possible to predict that in advance.

Conclusion

None of the methods that have historically been employed to raise deductible tier 1 capital in the United Kingdom are effective any more. In addition, the requirement for "flexibility of payments" makes it extremely difficult to structure any straightforward "direct issue" debt instrument that both counts as tier 1 and qualifies for a UK tax deduction. There are also some issues associated with the requirement for loss absorbency, whether that is achieved by means of a CoCo type structure or by means of a principal write-down structure.

The Budget announcement may well result in a change of law in 2012 which removes these hurdles. If not, some "structured" alternatives may be worth considering. For example, the UK's "securitisation company" regime appears to offer some opportunities and there may also be some scope for planning using provisions of the UK tax code relating to "alternative finance arrangements" although any structuring of this kind is likely to rely on some degree of goodwill from HM Revenue & Customs. Overall, therefore, a change in law which introduces a specific tax regime that permits regulatory capital to qualify for a tax deduction (as in jurisdictions like France) or which at least amends the distribution rules to remove some of the difficulties under current law is likely to be the preferred approach.

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