UK Bank Levy

UK Publishes Draft Legislation for its New Tax on Banks

SUMMARY
In his Budget statement delivered on 22 June, 2010, the Chancellor of the Exchequer announced that the UK will introduce a tax based on banks' balance sheets from 1 January, 2011, to be known as “bank levy”. Once fully in place this tax is expected to generate around £2.5 billion annually. Further detailed draft legislation and accompanying guidance have been recently published, setting out in detail how the bank levy will operate.

The tax will apply to both UK-headed banks and to non-UK headed bank groups with operations in the UK. In particular, the tax will apply to: (1) the global consolidated balance sheet of UK banking groups and building societies; (2) the aggregated UK subsidiary, UK sub-group and UK branch balance sheets of non-UK banking groups; and (3) the balance sheets of UK banks, UK bank branches and UK bank sub-groups in non-banking groups.

Once the relevant balance sheet has been identified, the tax will be calculated annually as a percentage of the total equity and liabilities shown on the relevant balance sheet excluding in particular: (1) Tier 1 capital; (2) insured deposits; (3) policyholder liabilities of insurance business within banking groups; and (4) certain tax and pension fund liabilities. Some adjustments to balance sheets may be required in order to net certain assets and liabilities e.g. cash-collateralised derivatives. It was initially proposed that the percentage rate of levy would be 0.07%, with a lower rate of 0.04% for 2011. Funding liabilities of greater than one-year maturity and certain uninsured deposits would be charged at half the rate otherwise applicable. A final decision on rates will be announced towards the end of 2010, and rates may rise above the rates originally proposed. The proposed rates are in any case significantly higher than the rate to be imposed under the French bank levy.
The tax will not be covered by the UK’s existing double taxation treaties. The government has begun discussions with other countries that are introducing similar taxes (France and Germany have committed to introduce similar taxes) to avoid double taxation issues arising because of such taxes.

BACKGROUND
In his Budget statement, delivered on 22 June, 2010, the Chancellor of the Exchequer announced that the UK will introduce a tax, based on banks’ balance sheet liabilities and equity, from 1 January, 2011, to be known as bank levy (the “Bank Levy”). This announcement and the consultation that accompanied it were the subject of our client memorandum dated 11 July, 2010. As announced in the Chancellor’s speech dated 20 October, 2010, in which he delivered the results of the Government’s spending review, draft legislation on the Bank Levy has now been published. This indicates that the Government has taken its policy decisions on the design of the Bank Levy, though comments on the draft legislation are sought with a deadline of 19 November, 2010. Final legislation will be published towards the end of this year although it will only be enacted in next year’s Finance Bill.

The stated government rationale for the Bank Levy is twofold. It is intended: (1) “to encourage banks to move away from riskier funding”; and (2) “to ensure that banks make a contribution that reflects the potential risk to the UK financial system and wider economy from bank failures...”. The Bank Levy is expressly not insurance against bank failure or a contribution to a resolution fund – the revenue raised will not be segregated for any purpose.

The Bank Levy is expected to raise around £2.5 billion annually. Changes to the design of the Levy from the proposals outlined in the consultation include: the replacement of the £20 billion liability threshold for triggering the Bank Levy, with a Bank Levy-free allowance of the same amount per taxable group; a deduction from the tax base for “high quality liquid assets”, instead of the exclusion for sovereign repos which was originally proposed; and uninsured customer deposits (except for those from financial institutions) now being subject to the half rate applied to long-term liabilities. The £20 billion allowance will be apportioned between long- and short-term liabilities according to their relative proportions on the relevant balance sheet, after excluded items, netting, etc. (see below) have been taken into account.

THE SCHEME OF THE BANK LEVY
The Levy will be payable on or after 1 January, 2011 by reference to the position at the end of an accounting period of a group’s parent or of a relevant standalone entity. For periods of less than one year, or periods beginning before and ending after 1 January 2011, the amount of the charge is reduced proportionally. The most complicated aspect of the Bank Levy comes in determining the amount of “chargeable equity and liabilities” and this is discussed below. Once this has been done, it is necessary to determine how much of the chargeable equity and liabilities are “long-term”. Long-term equity and liabilities will be charged at half the rate of other, “short-term”, liabilities, after excluded items, netting, etc.

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have been taken into account. The £20 billion Levy-free allowance is split proportionately between long-term and short-term liabilities. The Levy rates, which are yet to be determined, will be applied to the excess of long-term and short-term liabilities once the allowance has been deducted.

Long-term liabilities are: equity, other liabilities that are not and cannot be required to be repaid within 12 months and non-“protected” deposits (other than deposits from financial institutions). The meaning of “protected deposits” is discussed in “Excluded Liabilities” below. Intra-group liabilities owed to entities not subject to the Bank Levy are “long-term” only if the relevant group is able to demonstrate that their terms are such that they would be so regarded by the UK regulator, the Financial Services Authority (“FSA”), or the group can demonstrate that it funds those liabilities through long-term liabilities or “excluded liabilities” to third parties. There is a discrepancy between the draft legislation and the draft guidance on this point. The draft guidance indicates that intra-group debt which cannot be traced to external funding will be split into long-term and short-term liabilities according to the group’s external funding ratio of short-term debt.

The draft legislation fails to take into account adequately those very long-dated subordinated obligations which can count towards the regulatory capital base, even if they do not satisfy the criteria to be treated as “excluded” Tier 1 capital. There is a good argument that such liabilities should benefit from more than a 50% discount on the standard rate of the Bank Levy, but for the time being, HM Treasury has not conceded this.

**WHO PAYS THE BANK LEVY?**

In summary, the Bank Levy will apply to:

- UK banking groups and building society groups;
- Non-UK banking groups, whose members include UK banks or UK bank branches; and
- Non-banking groups, whose members include UK banks or UK bank branches; and standalone UK banks and UK bank branches.

There will be no exemption for custodian banks as such. Bank Levy will not be deductible for UK corporation tax purposes, unlike the corresponding French levy which is in any case more narrowly targeted. It should, however, be noted that UK corporation tax rates are currently lower (28%) than French corporation tax rates and are scheduled to drop to 24% in stages over the next few years.

**DEFINITION OF A BANK**

The key question of what constitutes a bank for these purposes is determined by reference to FSA rules. Subject to what follows, an entity will be a “bank” if it is a deposit-taker or its activities consist wholly or mainly of specified regulated activities. During discussions on the 2009 Bank Payroll Tax legislation (see our client memoranda of 10 December and 23 December, 2009 and 15 April, 2010 on this legislation), on which this “bank” definition is based, there was concern that a number of forms of asset management activity unconnected with classic banking activity, as well as prime brokerage, could be caught by the...
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regulatory definition of a “bank”. As a result, notifications were made and the following should, in particular, be excluded from the Bank Levy:

- entities which do not take deposits and which are not “full-service” financial institutions subject to the highest level of regulation;
- non-deposit takers which are only carrying on UK-regulated activity for an insurance company in the same group;
- entities which are non-deposit takers and whose (or whose group’s) “capital resources requirement” (for UK regulatory purposes) is less than £100 million;
- permanent establishments in the UK of non-UK resident firms which are not deposit takers, and whose (or whose group’s) “capital resources requirement” (for UK regulatory purposes) is less than £100 million;
- a regulated pension scheme manager or a company operating a vehicle for collective investment or acting as a discretionary investment manager for non-“linked” clients;
- prime brokers subject to the highest level of UK regulation;
- certain commodities trading firms; and
- firms carrying out regulated activities solely in relation to “spread betting”, or solely in relation to commodities.

A “group” takes its meaning from international accounting standards (“IFRS”) relating to the preparation of consolidated financial statements. However, where the parent of a group is tax-resident in a territory outside the UK where generally accepted accounting practice includes US GAAP, the membership of the group will be determined in accordance with the equivalent US GAAP definition.

In order to be a “banking group”, a “group” must, in summary, be headed by a bank (including a bank with no taxable presence in the UK that would be a “bank” if it carried on its activities in the UK), or by a holding company where a bank is the top trading company in the group structure. In any case, a “group” will not be a “banking group” where either (i) 50% or more of the group’s trading income derives from activities carried on by entities which are not financial traders (but not counting a wide variety of lending activities or dealing on own account); or (ii) 90% or more of the group’s trading income is derived from such activities and from regulated insurance activities, specified asset management activities, and activities ancillary to those insurance or asset management activities. The 50% test is a new relaxation introduced following the consultation.

Whether a banking group is “UK” or non-UK (“foreign”) depends on the tax residence of its parent.

AGGREGATING THE LIABILITIES OF RELEVANT GROUPS/ENTITIES

When computing a group’s liabilities subject to the Bank Levy, it is necessary to take account of all members of a UK banking or building society group. This is an unattractive feature of the legislation from the standpoint of financial services groups headquartered in the UK because the liabilities of the entire worldwide group are then potentially within the scope of the Bank Levy. For non-UK banking groups and non-banking groups, it is only necessary to take account of certain entities and not of the entire worldwide group (see below). HM Treasury has stated that it does not regard the treatment, in this respect, of UK

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banking and building society groups as a contravention of the freedom of establishment and the free movement of capital under EU law. This is open to question.

Applying the Bank Levy to non-UK-headed groups is justified by HM Treasury on two bases. First, the Bank Levy is not about building a fund for future interventions (which would be unlikely to directly benefit non-UK-headed groups) but rather about general losses to the taxpayer which could arise from systemic failure. HM Treasury considers that this risk arises equally from non-UK-headed groups operating in the UK (cf. the recent problems regarding Icelandic banks’ UK operations). Second, excluding such non-UK-headed groups would give them a competitive advantage.

The draft legislation sets out very detailed rules for aggregating the liabilities subject to the Bank Levy. Applying these rules may present quite a significant compliance burden for some groups, despite improvements made during the consultation process. The calculation process in relation to a UK banking group or building society group is as follows. The first step is to identify that group’s equity and liabilities at the end of the relevant chargeable period from the group’s IFRS or UK GAAP-compliant consolidated accounts for that period. If UK GAAP-based accounts are being relied on, then these must reflect Financial Reporting Standard (“FRS”) 23 (dealing with changes in foreign exchange rates) and FRS 26 (recognition and measurement of financial instruments). Items which constitute “excluded liabilities” (see below) are then subtracted, as are liabilities which can be netted (see “Derivatives and Netting” below). A further deduction is then made for certain liabilities of any banking joint venture in which the group may participate, the aim being to avoid double-counting those liabilities, to the extent that the joint venture accounts for them separately. Lastly, the group’s equity and liabilities are further reduced by the group’s “relevant high-quality liquid assets”. These are an asset buffer mandated for UK regulatory purposes and comprising high-quality sovereign or supranational debt securities; certain deposits with central banks; and (in limited cases) holdings in money market funds. They further reduce the group’s liability base, provided that they are not already backed by liabilities which have been left out of account for other reasons (notably “excluded liabilities”). At least for the time being, “high-quality liquid assets” must be deducted first from the group’s “long-term” equity and liabilities, which would otherwise attract a reduced rate of Levy in any case. Given the deduction for these “high-quality liquid assets”, the proposed exclusion for repo liabilities in respect of sovereign debt has been abandoned.

The rules for calculating the liabilities subject to the Bank Levy for groups/entities other than a UK banking group or building society group are more complex but adopt many of the principles described in relation to a UK banking group or building society group (notably, the deductions for “excluded liabilities”, netting and “high quality liquid assets”). Much of the extra complexity stems from the need to synthesise for Bank Levy purposes a tax balance sheet which does not necessarily correspond to existing financial statements. The task is clearly easier where, for example, a “foreign banking group” already contains a UK sub-group which is preparing its own consolidated accounts under IFRS or UK GAAP. Adjustments will be made to exclude liabilities between group companies which are within the Bank Levy. Adjustments
can also be made to amounts within equity, in accordance with consolidation principles, where those amounts arise within a UK sub-group for which consolidated accounts have not been prepared.

The basic approach regarding these groups/entities (other than UK banking groups/building society groups) is that the Bank Levy will be charged upon the equity and liabilities in:

(a) the IFRS/UK GAAP-compliant financial statements of any standalone UK banking company and the allocated equity and liabilities (see “Branches” below) of any non-UK bank operating through a UK branch; or

(b) the aggregated equity and liabilities of a non-UK banking group’s UK sub-groups, its banking or non-banking subsidiaries and its UK branches; or

(c) the aggregated equity and liabilities of any banking operations (i.e. UK-resident banks, non-UK banks operating in the UK and any UK banking sub-groups) which form part of a non-banking group.

A new de minimis rule applies when computing the Bank Levy in respect of a “foreign [i.e. non-UK] banking group” or a “non-banking group”. This enables the equity and liabilities of certain entities/sub-groups within such a group to be ignored if they are less than £50 billion at the end of the relevant chargeable period. However, the aggregate group/entity liabilities which may be disregarded under this rule are capped at £200 billion. In any case, this de minimis rule will not apply to the attributed liabilities of the UK branch of a non-UK bank (see below).

**BRANCHES**

HM Treasury initially announced that a UK branch’s relevant aggregate liabilities would be determined using principles known as the capital attribution tax adjustment (“CATA”) method. These OECD-approved principles will be familiar to tax teams within UK bank branches as they are currently used to limit the amount of interest that may be deducted in calculating the taxable profit of a UK branch. The way in which this method is to apply for aggregating UK branch liabilities has now been set out in more detail.

The first step is to work out the total assets (not just the “risk-weighted” assets) of the entity to which the UK branch belongs. The CATA principles are then used to attribute to that branch a slice of the entity’s total assets. The CATA principles are to be applied on the basis that bank assets should be attributed to the jurisdictions where the individuals reside who provided the skills to create those assets. Under the CATA principles, the UK branch is not to be treated as having any loan assets with other parts (e.g. head office) of the same legal entity. Equally, no branch asset is regarded as created where the UK branch lends money in a purely intermediary capacity to another regulated UK entity within the charge to the Bank Levy.

The third step is to compute the fraction of total entity assets (after netting – see below) comprised by the assets attributed to the UK branch. This fraction is then used to attribute to the UK branch a proportion of
the total entity liabilities after netting, and after deducting all “excluded liabilities” (see below) as well as any liabilities to other entities within the charge to the Bank Levy.

EXCLUSIONS FROM THE TAX BASE FOR THE BANK LEVY

The Bank Levy is prima facie imposed on the total liabilities and equity of the relevant group/entities aggregated in the manner described above. However, there are important exclusions which have been further refined during the consultation. These exclusions (discussed below) are based on work carried out by the IMF.

It was initially intended that the main Bank Levy rate would be 0.07% from 2012 with an interim rate for 2011 of 0.04%. A further announcement will be made towards the end of 2010 about the rate of the Bank Levy. It may be increased, bearing in mind the wider range of exclusions and the £20 billion Levy-free allowance for all affected entities/groups. “Long-term” liabilities will be subject to half the rate of Bank Levy otherwise applicable.

DERIVATIVES AND NETTING

One important question raised in the consultation was the treatment of derivatives when determining the liability base. Under IFRS and UK GAAP, the situations in which a financial asset and a reciprocal financial liability can be netted against each other appear somewhat narrower than under US GAAP. HM Treasury has now proposed that when determining liabilities for the purposes of the Bank Levy, legally effective netting arrangements can be taken into account (so as to reduce those liabilities) in a wide range of situations. In particular, netting for the purpose of reducing relevant liabilities will not be confined to liabilities involving derivatives. Therefore, groups will no doubt wish to verify the legal effectiveness of their netting arrangements given the scope such arrangements offer for reducing their Levy liability.

EXCLUDED LIABILITIES

These liabilities are ignored altogether when computing the Bank Levy. The first key exclusion is Tier 1 capital, defined as the equity and liabilities of an entity/group which would be eligible to be treated as Tier 1 capital, under the FSA’s Handbook of Rules and Guidance.

The next exclusion is for “protected” deposits. These include any deposits subject to an explicit government guarantee (notably the UK Financial Services Compensation Scheme or a non-UK equivalent). Where a deposit taker must pay protection scheme levies calculated by reference to a percentage of all its deposits or of all its deposits of a class to which the particular deposit belongs, then if that percentage exceeds the percentage of the particular deposit covered by the protection scheme, that particular deposit is treated as “protected” to the extent of that higher percentage. There is still no agreed generic definition of the “sticky” non-volatile deposits which are intended to fall within this exclusion. Hence this exclusion may be further refined in the light of future regulatory developments.
The first and second exclusions (especially the first) encourage banks to use safer, but potentially more expensive, sources of funding. This is consistent with ongoing regulatory moves to strengthen the balance sheets of banks. However, the effect is to raise the cost to banks (and hence to their customers) of lending, at a time when HM Treasury is keen to see banks lending more, especially to the small business sector.

The third exclusion is for “relevant insurance liabilities”. These are liabilities of UK or non-UK authorised insurers to policyholders under long-term insurance contracts; liabilities representing unappropriated valuation surpluses; or liabilities representing interests in “collective investment schemes” (e.g. unit trusts or open-ended investment companies).

Revaluation reserves under IFRS or UK GAAP in respect of property, plant and equipment are also excluded liabilities, as are liabilities for the Bank Levy itself and for other current or deferred tax in consolidated accounts which are compliant with IFRS or UK GAAP.

There is a fifth exclusion for liabilities under defined benefit retirement plans, to the extent reflected in financial statements which comply with IFRS or UK GAAP.

Lastly there are exclusions for liabilities to pay fees under the UK Financial Services Compensation Scheme and equivalent non-UK schemes; for client monies segregated according to UK (or equivalent non-UK) regulatory rules; and for liabilities representing notes issued as currency.

**ADMINISTRATION**

It was suggested in the initial consultation document that a single UK company group member would be responsible for filing the tax return regarding the Bank Levy and paying it on behalf of the group. However, details of the mechanics of the collection and management of the Bank Levy, including the entity responsible for filing and payment, have not yet been published and there is a placemarker for these provisions in the draft legislation. The published response to the consultation states that it is intended that the Bank Levy will be accounted for and paid under the existing Corporation Tax Self Assessment (“CTSA”) system, subject to appropriate amendments, and the corporation tax quarterly instalment payment system will apply to the Bank Levy.

Intra-group payments relating to meeting or reimbursing the cost of the Bank Levy are to be disregarded for corporation tax, and, as mentioned above, the Bank Levy will not be deductible for corporation tax purposes.

**ANTI-AVOIDANCE**

Any arrangements in respect of which the “main purpose, or one of the main purposes” of either of the parties to the arrangements is to reduce a liability to the Bank Levy will be disregarded. HM Treasury
have emphasised that, in their view, the anti-avoidance provisions are “targeted”, and the legislation specifies that arrangements only fall within the anti-avoidance provision where an officer of the UK tax authorities (“HMRC”) is not satisfied they have a certain effect on a “relevant body” (being a UK bank, a relevant non-UK bank, or a building society; or a group of entities that would be a banking group, a building society group or a relevant non-banking group). That effect must be to reduce the “relevant body’s” reliance on funding sources that would increase its chargeable equity and liabilities for Bank Levy purposes while correspondingly increasing its reliance on funding sources that would be disregarded when calculating its Bank Levy liability, or which could reduce that liability. It seems that “relevant bodies” cannot self-assess on the basis that a restructuring of their funding profile falls outside the anti-avoidance provisions without first satisfying an officer of HMRC that such restructuring has one of the specified effects. The draft legislation therefore does not appear to assist an institution that is reducing its overall funding levels.

If this requirement for satisfying an officer of HMRC is to be retained, it is hoped that HMRC will establish clear guidance for its officers making such decisions to ensure uniformity of approach as far as possible, because as the rules stand, there seems a lot of scope for administrative discretion.

The Bank Levy will constitute a “tax” for the purposes of the many other anti-avoidance rules targeting arrangements aimed at securing a “tax advantage” (notably, the anti-avoidance rules in the UK corporation tax code regarding corporate debt and derivatives).

**DOUBLE TAXATION ISSUES**

The introduction of similar bank levies in other countries, such as France and Germany, means that relevant groups operating cross-border are likely to be exposed to double taxation. The draft legislation is permissive, rather than enacting concrete provisions to avoid double taxation. It sets out two ways in which the UK proposes to address the issue. The first method is to give effect under domestic law to any applicable treaties or agreements (e.g. letters of exchange) that may be entered into between the UK and another jurisdiction that provide for relief from double taxation, so long as the relevant non-UK levy “corresponds” to the Bank Levy. The non-UK levy will “correspond” to the Bank Levy notwithstanding that its proceeds are to form a fund used for a particular purpose (unlike the Bank Levy) and/or that it is levied by a sub-national body (e.g. a province). The second method is to create regulations that provide for relief from double taxation, subject to a “reciprocity condition” that the other jurisdiction should have also made appropriate provision for avoidance of double taxation in relation to the Bank Levy and the equivalent non-UK levy. The secondary legislation in either case may provide for restrictions on double taxation relief, e.g. where there is avoidance. Both methods may apply retrospectively.

Where another jurisdiction has enacted provisions allowing relief from an equivalent non-UK levy in respect of payments of the Bank Levy, HMRC are permitted to disclose “such facts as may be necessary” to the authorities of the other jurisdiction so as to enable the correct amount of relief to be given.
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There are two further points of note regarding double taxation issues. First, it appears that the UK will be giving such relief for non-UK levies by way of credit, not exemption. If so, this is a departure from recent trends in relation to UK corporate taxation. These have been to replace the credit method in relation to certain types of income with the exemption method, partly for administrative ease and partly because of issues regarding compatibility with EU law. Second, in its current form, it is doubtful whether the Bank Levy would be a creditable tax in the US for a US-headed group with UK banking operations.

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