UK Bank Levy

UK Announces Consultation on the Detail of 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. A consultation has now been published which sets out further detail as to how the bank levy will operate.

The tax will apply to both UK-headed banks and non-UK headed banks 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 and UK branch balance sheets of foreign banking groups; and (3) the balance sheets of UK banks and UK bank branches 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: (1) Tier 1 capital; (2) insured retail deposits; (3) repos secured by sovereign debt; and (4) policyholder liabilities of retail insurance business within banking groups. Some adjustments to balance sheets may be required to ensure a uniform method of netting derivative assets and liabilities. It is proposed that the percentage will be 0.07%, with a lower rate of 0.04% for 2011. Funding of greater than one-year maturity will be charged at half the rate otherwise applicable (i.e. 0.02% for 2011 and 0.035% thereafter).

The tax will not be covered by the UK’s existing double taxation treaties. The government plans to initiate discussions with other countries that introduce similar taxes (France and Germany have committed to introduce similar taxes) to avoid double taxation under 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 sheets from 1 January, 2011, to be known as bank levy (the “Bank Levy”). On the same day, the governments of UK, Germany and France issued a joint statement stating the intention of each of them to introduce a tax of this sort. Once fully in place the Bank Levy is expected to generate around £2.5 billion annually. Only limited detail accompanied the Budget announcement but HM Treasury has now published further detail in the form of a consultation on the Bank Levy. The purpose of the consultation is to seek views on how best to implement the Bank Levy.

The consultation sets out some alternatives and asks some specific questions on the detail of the Bank Levy, as summarised below. Comments will be accepted until 5 October, 2010. It is proposed that draft legislation will be published once the consultation has expired, with final draft legislation published towards the end of 2010. This would be enacted in the Finance Act 2011.

The stated government rationale for the Bank Levy is twofold. The Bank Levy 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.

Other changes relevant to the taxation of banking groups operating in the UK were announced along with the Budget. The government announced that it “will explore the costs and benefits of a Financial Activities Tax” and that it continues to consider bank remuneration, a message that has been reiterated by ministers since the Budget, although no further detail is available. Generally applicable changes which will affect the banking sector include a rise in the rate of VAT from 17.5% to 20% from 4 January, 2011 and a reduction in the mainstream corporation tax rate from 28% to 24% in stages from April 2011 to April 2014. The government has also announced consultation on the introduction of a General Anti-Avoidance Rule for tax.

In addition the government continues to consider wider regulatory reform in the banking sector.

WHO PAYS THE BANK LEVY?

In summary the Bank Levy will apply to:

1. The global consolidated balance sheet of UK banking groups and building societies;

2. The aggregated UK subsidiary and UK branch balance sheets of foreign banking groups operating in the UK; and
3. The balance sheets of UK banks and UK bank branches in non-banking groups, but only where their relevant aggregate liabilities that are subject to Bank Levy amount to £20 billion or more. Bank Levy will not be deductible for UK corporation tax purposes.

DEFINITIONS

While the scope of the Bank Levy is different, it is proposed to adopt certain key definitions from the Bank Payroll Tax legislation (see our client memoranda of 10 December and 23 December, 2009 and 15 April, 2010).

This includes the key question as to what constitutes a bank for these purposes. This is determined by reference to UK financial services regulatory rules (on the interpretation of the UK tax authority (“HMRC”) an entity would ordinarily be considered a bank if more than 50% of its income is attributable to “relevant regulated activities”). During the course of discussions on the Bank Payroll Tax, 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 regulatory test. As a result certain exclusions were introduced for the purposes of the Bank Payroll Tax and it appears to be the intention that these exclusions will also apply for the purposes of the Bank Levy. The following should, in particular, be excluded:

- companies 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;
- firms which are non-deposit takers and whose “capital resources requirement” (for UK regulatory purposes) is less than £100 million;
- permanent establishments in the UK of non-resident firms which are not deposit takers, and whose “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.

In order to be a “banking group”, a “group” must, in summary, be headed by a bank, or by a holding company which directly or indirectly owns more than 50% of such a bank. In any case, a “group” will not be a “banking group” where 90% or more of the group’s trading income is derived from one or more of: regulated insurance activities; asset management activities; activities ancillary to, or which would not have been carried out but for, insurance or asset management activities; or from non-financial trading companies (except where that income is derived from a wide variety of lending activities or from companies dealing on their own account).
The definition of “group” is different from that used for Bank Payroll Tax. A company will be a member of a "group" if its financial statements are included in the consolidated financial statements of a group under IFRS or US GAAP.

**RELEVANT ENTITIES**

For UK headed groups, it appears that the relevant entities would be all members of the group. It is therefore expected that the tax would be determined by reference to the global consolidated balance sheet under IFRS. Non-UK businesses and non-banking businesses run by such groups will therefore be within the scope of the tax.

For non-UK headed groups, it appears that the relevant entities would be any UK company in the group, any UK branch of any member of the group and any subsidiary of either. Non-UK businesses and non-banking businesses held though UK entities will therefore be within the scope of the tax. In many cases it is unlikely that appropriate financial statements will already be required. The consultation asks what methodology should be used in order to draw up aggregated financial statements that can be used for the purposes of determining liability to tax, particularly where branches are concerned (see below). This may create uncertainty and a hefty compliance burden for such groups.

The application of the Bank Levy to such non-UK headed groups is justified by HM Treasury on the basis that, in summary: (1) the Bank Levy is not about building a fund for future interventions (which would be unlikely to directly benefit these groups) but rather about general losses which could arise from systemic failure, a risk which HM Treasury considers arises equally from non-UK headed groups operating in the UK; and (2) to exclude such groups would give them a competitive advantage.

For non-banking groups, it appears that only UK companies or UK branches carrying on banking business would be within the scope of the tax (and, while not altogether clear, not subsidiaries of such entity carrying on other business, whether or not in the UK).

**BRANCHES**

The government had initially announced that a UK branch’s relevant aggregate liabilities would be determined using principles which 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 (referred to as the capital attribution tax adjustment (“CATA”) method).

Three possibilities for attribution of liabilities of the legal entity to the branch, loosely based on the CATA method, are proposed in outline: (1) the liabilities should be those actually attributed to the branch on the assumption that it is a separate enterprise, as adjusted by the notional Tier 1 and Tier 2 capital attributed to the branch under the CATA method; (2) the branch should be attributed a proportion of the actual liabilities (including Tier 1 — the notional Tier 1 calculation under CATA would be disregarded for this purpose) of the legal entity in the same proportion as the attribution to the branch of the total assets of the
legal entity under the CATA method (before any risk weighting is taken into account); or (3) the branch should be attributed a proportion of the liabilities (other than Tier 1, which would be allocated in accordance with CATA) of the legal entity in a way which somehow reflects the attribution of assets of the legal entity to the branch after risk weighting. The consultation indicates that HM Treasury has some conceptual concerns with the first possibility.

**TAX BASE FOR THE BANK LEVY**

The Bank Levy is to be imposed on the total liabilities and equity of the relevant entities as reported in their accounts. However, there are a number of important exclusions on which the consultation process will focus. These exclusions (discussed below) are based on work carried out by the IMF.

It is intended that the main Bank Levy rate will be 0.07% from 2012 with an interim rate for 2011 of 0.04%. However, longer-maturity funding (i.e. funding with 1 year remaining to maturity at the relevant balance sheet date) will be subject to half the rate of Bank Levy otherwise applicable (i.e. 0.02% in 2011, rising thereafter to 0.035%). For these purposes, intra-group liabilities owed by the UK part of a non-UK group to the group parent or another non-UK entity will be treated as “short term”, unless this intra-group liability is backed by external long term funding. It is not clear how readily the group can demonstrate linkage between its external funding and intra-group liabilities, or, indeed, how easy it will be to identify longer-maturity funding from the relevant balance sheet.

**DERIVATIVES**

One important question raised is the treatment of derivatives when determining the liability base. Under IFRS and UK GAAP, the situations in which a financial asset and a financial liability can be netted against each other appear to be somewhat narrower than under US GAAP. The UK Treasury is concerned about competitive distortion if, in the light of these accounting differentials, the treatment of derivatives were to be based on the accounting convention of the relevant institution’s home state. A suggested solution is to use, instead, the Basel II standard for calculating credit exposure in respect of derivative contracts. This apparently provides for netting in a wider range of circumstances than is permitted under IFRS; and also better reflects balance sheet exposure in the event of default.

**EXCLUSIONS**

The first key exclusion is Tier 1 capital, which is to be defined in the light of the Basel and EU regulatory requirements.

The next exclusion is for “insured” retail deposits. These would include any deposits subject to an explicit government guarantee. Because there is no generally accepted definition of a “retail deposit”, this limitation is intended to provide an objectively verifiable basis for excluding, from the Bank Levy, liabilities which are likely to be less volatile than wholesale funding.
There is an important exclusion for repo liabilities secured by sovereign or supranational debt. This reflects the hitherto relatively low risk associated with these instruments and the deep market for such repo collateral. The consultation asks whether this exclusion should be limited to high quality assets currently permitted by the UK Financial Services Authority (“FSA”) to be included in the liquid assets buffer of a bank. If the exclusion were limited in this way, it would then cover repos of: (1) high quality debt securities issued by a government or central bank of an EEA state, Australia, Canada, Japan, Switzerland or the US and which met FSA criteria for credit rating and currency denomination; as well as (2) securities issued by a designated multilateral development bank or supranational institution.

The fourth exclusion is for retail life and non-life insurance liabilities of UK banking groups, on the basis that these banks will be required to contribute to policy protection schemes anyway in respect of these liabilities.

There is likely to be further debate regarding the Bank Levy’s taxable base. The definition of longer-term liabilities qualifying for the reduced rate of Bank Levy fails to take into account adequately 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 Tier 1 capital. There is a good case that such liabilities should benefit from more than a 50% discount on the standard rate of the Bank Levy.

**ADMINISTRATION**

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. In particular, the relevant financial statements, computations and supporting documents will be submitted as part of the company tax return for the relevant accounting period of the “responsible company” (see below). Furthermore, the corporation tax quarterly instalment payment system will apply to the Bank Levy.

The levy will be a joint and several liability of all UK-resident companies and any non-UK companies with UK branches, which fall within the banking group.

In order to streamline the administrative process, a single UK company group member (the “responsible company”) will be responsible for filing the tax return regarding the Bank Levy and paying it on behalf of the group. The default position is that the responsible company will be the ultimate parent company in respect of UK banking groups; and for non-UK banking groups, the intermediate UK parent company which holds the UK banking group. However, the group can choose to designate another company as the responsible company. HMRC must agree any such nomination. In particular, the nominated company must have the same period of account as the period of account for the balance sheet on which the Bank Levy is based.
ANTI-AVOIDANCE AND DOUBLE TAXATION ISSUES

Although drafting has still to be produced, there is very likely to be a “targeted” anti-avoidance rule to counteract steps at least one of whose “main purposes” consists of reducing or eliminating the Bank Levy, e.g. by means of funding transactions around the group’s balance sheet date so as to alter its funding profile. Furthermore, the UK tax shelter disclosure rules will be extended so as to require “real time” disclosure of certain arrangements to avoid the Bank Levy. Thirdly, the Bank Levy will be a “tax” for the purposes of other anti-avoidance rules targeting arrangements aimed at securing a “tax advantage” (notably, the anti-avoidance rules in the UK corporation tax code regarding the tax treatment of corporate debt and derivatives).

However, the consultation document states that the “targeted” anti-avoidance rule will not apply to a genuine switch by a banking group to sources of funding which are either excluded from the taxable base for Bank Levy purposes, or which attract the lower rate of Bank Levy.

The Bank Levy is not a tax which is covered by the UK’s double taxation treaties. The UK will, however, consult in order to minimise the scope for the Bank Levy, in conjunction with equivalent taxes (e.g. in France and Germany), to give rise to double taxation.

* * *
ABOUT SULLIVAN & CROMWELL LLP
Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance and corporate transactions, significant litigation and corporate investigations, and complex regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 700 lawyers on four continents, with four offices in the U.S., including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP
This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Jennifer Rish (+1-212-558-3715; rishj@sullcrom.com) or Alison Alifano (+1-212-558-4896; alifanoa@sullcrom.com) in our New York office.

CONTACTS

London

Michael McGowan          +44-20-7959-8444          mcgowanm@sullcrom.com
Andrew Howard            +44-20-7959-8501          howarda@sullcrom.com