UK Enacts Finance Act 2010 Effecting 50% Tax on Bankers’ Bonuses

UK Bank Payroll Tax on Certain Bonuses Paid by Financial Institutions: Final Legislation and Additional Developments

SUMMARY

In the UK Pre-Budget Report delivered on 9 December 2009, the Chancellor of the Exchequer unveiled the heavily trailed Bank Payroll Tax (the “BPT”), a 50% tax on bonuses in excess of £25,000 paid to certain employees by certain financial institutions operating in the UK: see our client memoranda of 10 December 2009 and 23 December 2009. France enacted a similar tax on 9 March 2010: see our client memoranda of 25 January 2010 and 10 March 2010. The BPT is imposed upon the employer, not the employee. It continues to prove highly controversial. In certain quarters, the BPT (along with other recent UK tax and regulatory changes) has raised questions about the continued competitiveness of the UK as a location for international financial services business. Nonetheless, the Conservative Opposition has not opposed this measure. In principle, the BPT is a “one-off” levy which applies to awards of performance-related remuneration (i.e., “bonuses”) in excess of £25,000, between 9 December 2009 and 5 April 2010. In the UK Budget delivered on 24 March 2010, the Government confirmed that the BPT would not be extended beyond 5 April 2010. Legislation imposing the BPT is included in the UK Finance Act 2010 which came into force on 8 April 2010. Since our original client memoranda of 10 December 2009 and 23 December 2009, there have been ongoing submissions by interested parties to the UK tax authorities, HM Revenue & Customs (“HMRC”) about the scope of the BPT. HMRC has revised its guidance regarding the scope of the tax several times, notably at the end of 2009 and in February and March 2010. This memorandum sets out the updated picture regarding the BPT, based on the enacted legislation and the most recent published position of HMRC.
DISCUSSION

Who pays the BPT?

The BPT is a tax not on employees, who remain subject to income taxation and employee’s National Insurance Contributions in the normal way (at a combined marginal rate, with effect from 6 April 2010, in excess of 50%). Rather, the BPT is a tax imposed at 50% on “bonuses” in excess of £25,000 paid by so-called “taxable companies” (see below). The BPT is not deductible for UK corporation tax purposes and is payable in addition to UK employers’ National Insurance Contributions (which are chargeable at 12.8% on all “earnings”, although this rate is set to rise also from 6 April 2011). “Taxable companies” prima facie include (i) all UK-resident “banks” (not just those which received financial support from the Government during the credit crisis); (ii) “relevant foreign banks” (see below); (iii) any other company which is a member of a “banking group” (see below) and which is a UK-resident “investment company”, a UK-resident “financial trading company” or a “relevant foreign financial trading company”; or (v) a UK-resident “investment company” or “financial trading company” which belongs to the same “group” as a building society.

The “taxable person” category is therefore wide and complex. It includes not just UK-residents but also “relevant foreign banks”, i.e., non-UK-resident regulated financial institutions, carrying on regulated trading activity (especially deposit-taking) through a UK “permanent establishment” (typically, a branch). HMRC considers that where more than 50% of the income of the entity is attributable to relevant regulated activities, that entity would be either a UK-resident “bank” or a “relevant foreign bank” for the purposes of the BPT. Subject to exceptions discussed below, “taxable persons” also include certain investing and/or financial trading affiliates of a UK-resident “bank”/building society or of a non-UK-resident “bank” which carries on regulated trading activity in the UK. An anti-avoidance rule prevents affiliates sidestepping the BPT by artificially disaffiliating from the relevant bank.

Following intensive discussions with HMRC, insurance companies are not “taxable persons” nor are certain UK mutual fund vehicles (notably, “investment trusts” and “open-ended investment companies”). Nevertheless, there was considerable concern that a number of forms of asset management activity unconnected with classic banking activity, as well as prime brokerage, were originally caught by the BPT legislation. HMRC has now tightened the definition, which is based to a large extent on quite complex rules in Part 3, Schedule 1 of the UK Finance Act 2010, together with the UK financial services regulatory rules. However, 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 in the UK, or which would be subject to this level of regulation if their registered or head office were in the UK;
- non-deposit takers which are only carrying on UK-regulated activity for an insurance company in the same group;
- UK firms which are non-deposit takers and whose “capital resources requirement” (for UK regulatory purposes) is less than £100 million;

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- 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 outside banking groups.

A “group” consists of companies affiliated, directly or indirectly, by ownership of more than 50% of share capital (ignoring fixed-rate preference shares). In order to be a “banking group”, a “group” must, in summary, be headed by a UK-resident bank or a “relevant foreign bank”, or by an investment 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 income from companies (such as investment companies) that are not financial trading companies (except where that income is derived from a wide variety of lending activities or from companies dealing on their own account).

EMPLOYEES AFFECTED BY THE BPT

The BPT applies to the remuneration of “relevant banking employees”. These are employees whose duties relate wholly or mainly (whether directly or indirectly) to lending or to a variety of other UK-regulated financial services activity (notably, deposit-taking, dealing in investments as agent or principal – including trades, arranging deals in investments, advising on investments and acting as custodian of investments). These regulated activities do not include certain activities on behalf of an insurance company, nor dealing nor arranging in the course of discretionary investment management for a non-“linked” client.

An employee will be subject to the BPT if it is reasonable to expect that employee to devote the majority (i.e., more than 50%) of their time to the duties described in the previous paragraph. HMRC do not intend a detailed time-based analysis of an employee’s activities to be required, although companies are free to carry out such an analysis in line with the 50+% test described above. “Relevant banking employees” need not be “front-office” employees if their activities are connected to the relevant activity. HMRC have made clear that activities undertaken on behalf of clients and customers of a banking group, rather than on behalf of the banking group itself, (“non-proprietary activities”) shall not be within the scope of relevant employment unless such activity is directly or indirectly concerned with lending, or with UK-regulated financial services activity of the kind described above. HMRC have also indicated that the test of indirect connection is to be widely drawn. Therefore, activities ancillary to the relevant UK-regulated activity, such
as providing IT or legal support, are within the scope of relevant employment for the purposes of the BPT, if they relate “wholly or mainly” to that regulated activity.

Relevant banking employees need not be UK-resident in the tax year 2009-10 (i.e., the year running from 6 April 2009 to 5 April 2010) to be subject to the BPT. It is enough that the duties of the relevant employee were partly performed in the UK at some point in that tax year, and that the relevant employee was present in the UK for more than 60 days in the tax year 2009-10. An employee is present in the UK on any day on which he or she is in the UK at midnight on that day, although there is a limited exception for certain transit passengers. The 60-day rule is a welcome refinement to the original BPT proposals, and indicates that non-UK-resident employees who worked for short periods of time in the UK in the tax year 2009-10 should not be subject to the BPT. However, there is no apportionment mechanism for the BPT. Therefore, if the 60-day threshold is exceeded, all relevant remuneration from the relevant banking employment of a non-UK-resident employee will be subject to the BPT in full. This could lead to harsh results and a significant risk of double taxation, particularly if that employee is also affected by the French bonus tax.

**TYPES OF REMUNERATION AFFECTED BY THE BPT**

BPT is chargeable at 50% (and payable on 31 August 2010) on a self-assessment basis on “chargeable relevant remuneration” in excess of £25,000 awarded between 9 December 2009 and 5 April 2010 in respect of “relevant banking employees” of the relevant “taxable company”. Anti-fragmentation rules prevent exploitation of the £25,000 threshold. The legislation is wide enough to apply to remuneration provided indirectly e.g., via payments to employee benefit trusts.

Not all remuneration is “relevant remuneration”. In particular, the focus is on earnings and other benefits in money or money’s worth, whose amount can vary according to the performance (i) of the business of the “taxable company” or a “connected” person (e.g., a holding company or a subsidiary of the “taxable company”); or (ii) of the relevant employee. The BPT will not be imposed in respect of share incentives provided under certain HMRC-“approved” share incentive and share option schemes, although it can apply in respect of other “unapproved” share incentives, which are likely to be much more valuable in practice. Thus share-based remuneration generally is not excluded from BPT, notwithstanding the desire of the UK regulatory authorities to see performance-based remuneration tied more closely to a financial institution’s medium-term performance.

The BPT will also not apply to compensation paid where, before 9 December 2009, there is a conditional or unconditional obligation to pay remuneration, in cash or in kind, whose quantum can no longer be varied on a discretionary basis after that date. This carve-out could, for example, cover restricted stock awards made prior to 9 December 2009 where the only outstanding conditions to full vesting post-8 December 2009 are that the relevant employee must remain in specified employment for a defined period. HMRC have clarified that variation of an award based on a purely objective yardstick (e.g., profits)
is not variation on a discretionary basis, but where the final amount of an award is to be agreed by a committee, such a scenario would be an example of variation on a discretionary basis.

“Relevant remuneration” is in any case not treated as awarded during the chargeable period for BPT purposes if (i) it is to be provided at intervals in respect of performance, etc. for periods post-5 April 2010; and (ii) there is no “main purpose” of BPT avoidance underlying these arrangements for deferred payment.

There are a number of special rules for quantifying the remuneration subject to the BPT. These rules are significantly different from the rules for computing employment income for income tax purposes. In particular, there are rules for making reasonable estimates where the remuneration is not fixed when it is awarded. Remuneration is also to be quantified on the basis that any restrictions (e.g., vesting conditions, or forfeiture provisions linked to employee share awards) are ignored. This obviously boosts somewhat artificially the amount subject to the BPT. In addition, there is provision for valuing awards of remuneration by reference to the higher of money’s worth and open market value, after ignoring restrictions in the manner already described. There is no provision for a BPT refund if, for example, an award of restricted stock is subject to the BPT but does not ultimately vest, or an estimate of remuneration awarded otherwise turns out to be excessive.

ANTI-AVOIDANCE

There are wide-ranging “targeted anti-avoidance rules”. The first of these prevents the BPT being avoided by “arrangements” made between 9 December 2009 and 5 April 2010, under which remuneration may be provided in respect of an employee after 5 April 2010. The making of those “arrangements” is itself treated as an award of remuneration pre-6 April 2010. “Arrangements” need not be contractually binding. HMRC consider that a discussion between an employee and a line manager regarding recommendations to be made to the person or persons having authority to make an award is generally not an “arrangement”. However, a formal or informal agreement, understanding or decision by or with a person having authority to make an award would be an “arrangement” potentially subject to BPT. Where a company defers all decision-making about its discretionary incentive pay until 6 April 2010 onwards, and did not enter into any arrangements on or before 5 April 2010 with employees regarding what they might expect to receive by way of bonus, BPT should not be triggered.

The second anti-avoidance rule overlaps with the first but is wider. It applies where, before 6 April 2010, “arrangements” were made where (i) a “main purpose” of at least one party to those arrangements is reduction of the BPT liability; and (ii) the effect of the arrangements would otherwise be that remuneration is provided post-5 April 2010, or in a form which escaped the BPT. In such cases, the BPT charge applies on the basis that the amounts in question are fully within that charge.
A third anti-avoidance rule prevents the BPT being avoided by making loans to employees, where a “main purpose” of making, or committing to make the loan is avoidance of the BPT or any other UK tax.

Finally, there is a rule (modelled on existing UK income tax legislation) which subjects to the BPT amounts earned by an individual who is not, formally, an employee of a “taxable company” but who personally provides “banking services” to such a company via an intermediary entity (e.g., a personal service company or partnership owned by that individual). For employment law purposes, such individuals may be self-employed. Nevertheless, the BPT will apply if the individual would be a “relevant banking employee” of the “taxable company” if the “intermediary” were ignored. The guidance provided to date by HMRC indicates that they intend to read this “intermediary” rule broadly.

CONCLUSION

Although there have been a variety of proposals and actions in a number of countries (notably, France) which have been directed at incentive compensation paid by financial institutions, the BPT is one of the most punitive. Furthermore, the BPT is now expected to yield over £2 billion of revenue, more than twice the amount initially forecast.

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