

# Budget analysis Banks

**W**ho would have realised that a new tax on banks would be shrugged off by the markets, with some financial stocks marked up? But a bank levy was widely trailed and the market reaction indicated that the levy was at the more modest end of expectations. It could also be seen as offset by the impact of the reduction in corporation tax rates announced in the Budget. Perhaps a surprising point when you think about the banks' tax losses (which have just become less valuable) but in principle reducing both corporation tax rates and capital allowances should benefit financial services more than some other sectors.

There may, however, be more to come. The new bank levy, to be introduced from 1 January 2011, may be followed by a further special tax, a financial activities tax (FAT), of which more below.

## The bank levy

So what do we know about the bank levy? We don't have a great deal. In brief:

- It is designed as a financial crisis response both to encourage prudent funding and to ensure a 'fair contribution' from the banks in respect of the systemic risks they pose. It is something that the IMF advocated earlier this year in a report to the G20.
- It will be based on a percentage of balance sheet liabilities, excluding liabilities which are regarded as forms of safe funding. These are (a) tier 1 capital (as things stand, ordinary share capital and premium, retained reserves and, subject to limits, certain perpetual preference shares and equity-like hybrid instruments), (b) insured retail deposits (those within the financial services compensation scheme), (c) repos over sovereign debt and (d) policyholder liabilities in respect of retail insurance business within banking groups.
- It will be based on the worldwide consolidated balance sheets of UK banking groups and building societies, the balance sheets of UK branches and subsidiaries of foreign banking groups (another reason for some international banks headquartered in the UK to consider inversions?) and the balance sheets of UK banks forming a part of non-banking groups.
- Only larger institutions, with relevant aggregate liabilities in excess of £20 billion, will be included. It is understood that most building societies will not be caught.
- The rate will generally be 0.07% (with a lower 0.04% starting rate for 2011) but the rate will be halved for longer term wholesale funding liabilities (outstanding maturities of over a year). In other words, if you are lending long you are encouraged not to borrow too short – a Northern Rock message.
- There will be no corporation tax relief for the levy.
- There will be anti-avoidance rules.

**SPEED READ** Banks have another new tax to understand, with little detail yet about how it will work, especially in the international context. As a form of crisis response the bank levy is to be imposed on riskier balance sheet liabilities. There is also the prospect of another special tax on financial activities, which may target remuneration (again). Other announced developments will be followed closely by the banks, including the general corporation tax reform (and what it may mean for interest and other tax reliefs), a possible general anti-avoidance rule and the latest stage in the reforms of CFCs and branch taxation.



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That's about it for now. We will know more towards the end of the year after a consultation period starting later in the summer. Of course, a few issues stand out already, including some that are familiar from the recent bank payroll tax experience:

- What will be included as a bank or within a banking group? This was a particular source of difficulty in connection with BPT. Perhaps it will be less troubling here with the minimum size threshold.
- What are the international implications? The US has announced similar proposals (the financial crisis responsibility fee) and France and Germany have joined the UK in announcing plans to introduce a bank levy. Other countries are unenthusiastic. The view of many is that appropriate regulatory measures are more relevant than taxes. At the time of writing

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international adoption outside the US and the EU following the G20 summit on 26 and 27 June seems unlikely: clearly there is scope for a drift in business of some non-UK based banks away from the UK. This in turn is a factor that may also help keep the rates low.

- There is nevertheless double taxation to address: if the UK applies a worldwide levy to a UK based group and other countries impose a local levy what will be done? What happens if the levies use different principles? It is understood that HMRC recognise that double taxation issues will need to be resolved.

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- How will the levy be computed for UK branches of foreign banks? We are told that the capital attribution methodology used for corporation tax purposes will be followed but how well will this deal with the approach to other excluded liabilities and the distinction between short and long term funding? Branches may be funded by fictional intra-entity loans from head office. For subsidiaries of foreign banks there are similar questions about intra-group funding.
- What will all of this mean for whether the levy is truly borne by the banks or is passed on to their customers? This is not just a new business point. Unless the banks accept that they should not pass the levy on there will be unwelcome (and time consuming) scrutiny of the increased costs provisions of loan agreements.

### What else could be in store?

If we move on to consider what else is in prospect for the banks as a financial crisis response it is instructive perhaps to look at some other tax issues raised by the IMF for the G20 as well as Budget announcements, since the Government seems to have placed some weight on the IMF approach. The following is based on an interim report put to the G20 in April ('A fair and substantial contribution by the financial sector'), before the final report for the G20 meeting in Toronto. Possibilities addressed by the IMF include:

- An FAT, which is recommended by the IMF in addition to a bank levy (or a financial stability contribution, as the IMF calls it). This could be a tax on profits and remuneration, which represents a tax on 'value added' (and is said to be a form of substitute for the absence of VAT in the banking market, though a VAT is also raised as a possibility). The Government has announced that it wishes to explore such a tax. The emphasis in what little the Government has said has been on the remuneration element. If limited to that it would have rather a different context. Presumably it would be crafted to encourage pay restraint rather than as a 'tax on jobs'. The bank payroll tax period has, of course, expired.
- A financial transactions tax (or Tobin tax), which is reviewed but not favoured by the IMF and does not seem to be a part of current Government thinking.
- Limitations on tax losses, which are mentioned briefly. There has been some concern about this in the UK but, again, there is no indication at this stage that the Government is considering it. Of course, we don't know whether it may emerge as a part of the overall review of the corporation tax system rather vaguely announced in the Budget, of which we are to hear more in the autumn.
- A reduction of the tax bias favouring debt finance over equity finance, through interest relief restrictions (or alternatively a form of relief for equity). On financial institutions in particular the IMF has said that the proliferation prior to the

crisis of hybrid instruments attracting interest deduction yet allowable as regulatory capital, indicates 'tax incentives at work that conflict with regulatory objectives'. There are brief comments indicating a similar concern in a recent Basel Committee paper ('Strengthening the resilience of the banking sector'). It has been rumoured that interest relief restriction may also form a part of the corporation tax review announced in the Budget.

- A tougher approach to tax planning. The Budget, in addition to some specific proposals dealing with financial products, has announced a new review of a general anti-avoidance rule. This matters to banks both for their own planning and for what they facilitate. And of course banks have been regarded by HMRC as a special risk case, hence measures such as the recent Code of Practice. It is worth bearing in mind that the Labour Government embarked on such a review in 1998 shortly after it came to power and nothing came of it.

### Other Budget announcements affecting banks

Of course there are other announcements in the Budget which are not financial crisis related but are of particular relevance to banks. They include:

- The latest on CFCs, with a delay of the main reform now until 2012. Banks often have large numbers of foreign subsidiaries and don't always find it easy to meet the special exempt activities rules that apply to banking groups. CFC reform is a pressing issue for some. There will be a good deal of interest in what the interim measures for 2011 will be and in whether there is any overall change in the direction of travel (which has been pretty good recently, though subject to concerns about whether the EU case law has really been addressed).
- Overseas branch taxation reform, with the possibility now of a new branch exemption coupled with relief for foreign branch losses (no doubt subject to clawback as profits arise). Banks often operate through branches and have been keener than some other taxpayers on reform in this area. Remarkably it now seems to be the plan that branch taxation reform should occur in 2011, before the main CFC reform.
- The VAT increase to 20%, which hits banks, as largely exempt businesses, in respect of supplies to them.
- On individual taxation, some obvious concerns for international banks about yet another review of the treatment of non-domiciliaries.
- A 22% rate differential between the highest CGT and income tax rates, so that there should still be some activity in retail financial products. There is no new anti-avoidance rule about capital profits from capital secure and other similar investments. ■