Treatment of Additional Tier 1 Capital

Part 36-00-18

This document should be read in conjunction with section 845C of the Taxes Consolidation Act 1997 (‘TCA’), the Capital Requirements Directive package comprising Directive 2013/36/EU and Regulation (EU) No. 575/2013 of the European Parliament and of Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012 (Capital Requirements Regulation).

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Revenue
Cáin agus Custaim na hÉireann
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Executive Summary

Section 845C was introduced by Finance Act 2015 following the transposition of the Capital Requirements Directive (‘CRD’) and the Capital Requirements Regulation (‘CRR’) (together known as ‘CRD IV’) in 2014 which implement Basel III in the EU.

Basel III is a set of international banking regulations developed by the Bank for International Settlements to promote stability in the international financial system following the 2007-2009 financial crisis. The financial crash had demonstrated that banks were not prepared to absorb market shocks adequately.

This EU legislative package was introduced in order to strengthen the resilience of the banking sector so that it would be better equipped to absorb future financial shocks. It contains prudential rules requiring financial institutions to control risks and hold at all times not less than the minimum capital levels, as defined by capital requirements.

Tier 1 capital is the primary funding of a bank. Under the CRD IV it is made up of two components, one of which is Additional Tier 1 (‘AT1’) capital. The CRD IV prescribes the features that an AT1 capital instrument must possess.

Section 845C was introduced by Finance Act 2015 to provide clarity on the tax treatment of AT1 capital instruments. Finance Act 2019 amended the section to extend the tax treatment to other substantially similar or ‘equivalent’ instruments. This manual explains the implications of section 845C in relation to certain capital instruments, particularly with reference to the change introduced by Finance Act 2019.

1 Section 845C and the tax treatment of AT1 and ‘equivalent’ instruments

Section 845C was introduced by Finance Act 2015 in order to provide clarity on the tax treatment of AT1 instruments which are instruments issued by regulated financial institutions. It was amended by Finance Act 2019 to extend that tax treatment to instruments that are substantially similar or ‘equivalent’ but issued by non-financial institutions. This section of the manual will outline the tax treatment consequences for AT1 instruments and these other ‘equivalent’ instruments.

For the purposes of section 845C, AT1 and equivalent instruments are regarded as ‘debt’ instruments. There are two main tax treatment consequences for AT1 instruments and their equivalent instruments flowing from this, as follows:

a) a ‘coupon’ is regarded as interest and, consequently, may qualify for tax deductibility where relevant criteria are met; and

b) there is an exemption from the obligation to deduct withholding tax in respect of coupon payments made under the instruments by deeming the instruments to be quoted Eurobonds for the purpose of section 64 TCA. This exemption applies to ensure AT1 instruments and their equivalent are treated as debt instruments for withholding tax purposes.

A ‘coupon’ is a distribution within the meaning of Article 4 of the CRR. However, as above, section 845C clarifies that for the purposes of its tax treatment it shall be regarded as interest and not as a distribution or a charge on income.

The tax treatment as outlined above shall not apply to an AT1 or equivalent instrument which forms part of any arrangement or scheme of which the main purpose, or one of the main purposes, is to avoid liability to tax.

2 Additional Tier 1 capital instruments

2.1 What are AT1 instruments?

AT1 instruments are a specific type of contingent convertible bond ('CoCo')[1], a form of loss-absorbing capital issued by regulated financial institutions such as banks. In order to be considered an AT1 instrument for the purposes of section 845C the instruments must meet the regulatory capital requirements imposed by the CRD IV and be issued by the regulated financial institutions as specified under Article 4 of the CRR.

2.2 Features of AT1 instruments

To comply with the requirements of the CRD IV, AT1 securities, must be CoCos, meaning that they must be convertible to equity or written down if a pre-specified trigger event occurs and must have a number of features which are designed to aid loss absorbency in the event of a financial crisis. They are hybrid instruments, sharing features of both debt and equity, i.e. they are similar in nature to debt instruments but convert to equity or can be written down under certain circumstances. These features include, that:

- the AT1 instruments must be issued by an 'institution' within the meaning of Article 4 of the CRR;
- AT1 securities are perpetual in term with no incentive to redeem;
- AT1 securities are ranked below Tier 2 instruments, senior creditors and depositors;
- distributions on the AT1 securities can be paid only out of distributable profits;
- distributions can be cancelled at the bank's discretion and are non-cumulative;
- AT1 securities convert into Common Equity Tier 1 (CET1) capital or are written down if a bank's CET1 ratio falls below a certain threshold; and
- the purchase is not funded directly or indirectly by the institution.

The prescribed list of features is set out in Article 52 'Additional Tier 1', Chapter 3, Title 1, Part 2 of the CRR.[2]

[1] All AT1 instruments are CoCos but not all CoCos are AT1 instruments.

[2] https://eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/-/interactive-single-rulebook/toc/504/article-id/746

2.3 Tax treatment

Debt and equity have different tax treatments. Dividends paid on equity investments are generally not deductible expenses for tax purposes, whereas interest payments on debt instruments are generally deductible. Due to the hybrid nature of AT1 instruments, clarity around how they were to be treated from a tax perspective was required. Section 845C was introduced by Finance Act 2015 to confirm that an AT1 instrument should be regarded as a debt instrument.

3 Finance Act 2019 – ‘equivalent’ instruments to AT1s

As above, section 845C confirms that AT1 instruments are to be regarded as debt instruments for tax purposes. Finance Act 2019 amended section 845C to ensure that the treatment afforded to AT1 instruments under the section was extended to instruments with **equivalent** characteristics to AT1s. It does this by amending the definition of ‘Additional Tier 1 instrument’ to include other comparable instruments, notwithstanding that they have not been issued by institutions as specified under the CRR.

This amendment provides parity of treatment to financial instruments issued by non-financial institutions that are substantially similar to AT1 instruments. This levels the playing field between financial and non-financial institutions. For the purposes of the section, references to ‘Additional Tier 1 instruments’ now include those equivalent instruments issued by non-financial institutions.

To determine whether the instrument is an AT1-equivalent instrument, it should be compared against each of the criteria specified under Article 52 of the CRR. Where a criterion, as specified under Article 52, cannot be easily applied in a non-financial institutional context, for example, where a condition prescribed in respect of AT1 instruments in accordance with Article 52 of the CRR derives from the fact that AT1 instruments are issued by financial institutions, the Article 52 criterion should be adapted or modified as necessary so that a corresponding criterion may be applied to the instrument in a non-financial institutional context. Ultimately, however, in order to be an AT1-equivalent instrument, the instrument in question should possess characteristics that align with the essential characteristics of an AT1 instrument (see section 4 of this manual).

4 How will equivalence be assessed?

As explained above, the treatment prescribed for AT1 instruments under section 845C has now been extended to equivalent instruments that are issued by non-financial institutions. It would be expected that an 'equivalent' instrument would be one that shares the essential characteristics associated with AT1 instruments, including, but not limited to the fact that:

a) they possess the convertible capability associated with AT1 instruments as CoCos, i.e. that the instruments can be written down or converted into equity upon a pre-specified trigger event;

b) they are loss-absorbing;

c) they are subordinate (where this occurs in a non-financial institutional context, the instrument is subordinate in a manner equivalent to that specified under Article 52);

d) they are perpetual in nature with no incentive to redeem;

e) the coupons are fully discretionary and non-cumulative;

f) the distributions can be paid only out of distributable profits; and

g) the purchase is not funded directly or indirectly by the issuer.

Article 52 of the CRR defines what an AT1 instrument is and details its attaching features. In determining **equivalence**, where a condition prescribed in respect of AT1 instruments derives from the fact that AT1 instruments are issued by financial institutions, the condition should be modified or adjusted accordingly to ensure that a corresponding condition applies to the instrument issued by a non-financial institution.

As already outlined, AT1s in accordance with Article 52 of the CRR are issued by financial institutions only. Although section 845C now allows for AT1 'equivalent' instruments to arise outside of a financial institution context, these would be regarded as somewhat rare and unlikely to arise with any frequency. Also, section 845C(5) contains an anti-avoidance provision that provides that the tax treatment shall not apply where the AT1 instrument forms part of any arrangement or scheme of which the main purpose, or one of the main purposes, is to avoid liability to tax.

In light of an anticipation of relatively few instances of AT1-equivalent instruments arising, the anti-avoidance subsection (5) of section 845C, the lack of published precedents, and complexities associated with determining what an AT1 'equivalent' instrument is, Revenue considers it prudent for taxpayers, to either:

a) seek a Revenue opinion (an 'opinion') regarding whether the tax treatment under section 845C applies to their AT1-equivalent instruments in advance of any issuance; or

b) following the issuance of possible AT1-equivalent instruments, to include an Expression of Doubt when filing their corporation tax returns.

For those seeking an opinion, the request for such an opinion should be sought, in writing, from the Revenue district dealing with the company's affairs in advance of the possible AT1-equivalent instrument issuance. Any request for an opinion or an Expression of Doubt should outline the basis upon which section 845C tax treatment should apply, including:

a) relevant details regarding the instrument, e.g. the name of the instrument, the nature of the instrument, details regarding the relevant body issuing it and the purpose behind the issuance;

b) the taxpayer's assessment of an instrument's equivalence to the characteristics of AT1 instruments as prescribed by Article 52 of the CRR[3]; and

c) any other details the taxpayer considers to be relevant.

In relation to the requirement set out at b), any request for a Revenue opinion or Expression of Doubt should include a comparison of the instrument against all the criteria as specified by Article 52 of the CRR.

Where a condition, as specified under Article 52, cannot easily be applied in a non-financial institutional context, the request for an opinion or Expression of Doubt should, in accordance with section 845C(1)(b), outline what **'necessary modification'** of the condition is considered to be required so that a corresponding condition applies in the context of the instrument. Ultimately, however, in order to be an AT1-equivalent instrument, the instrument in question should possess characteristics that align with the essential characteristics of an AT1 instrument.

[3] https://eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/-/interactive-single-rulebook/toc/504/article-id/746