afme/

11 February 2011

Aidan Reilly
HMRC
100 Parliament Street
London SW1A 2BQ

Dear Aidan

Comments on the bank levy: draft legislation and guidance

Further to our meeting last week, we set out below our comments on the draft legislation and guidance on the bank levy. For ease of reference we have enclosed a copy of the notes used as the agenda for our meeting.

1. **Liquid assets, collateralised lending (e.g. reverse repo), collateralised borrowing (eg repo)**

   Collateralised borrowing

   We believe that where a person ("A") transfers high quality securities to another person ("B") under a stock lending arrangement and receives a sum of money or other asset from B, the liability recognised in A's financial statements should be treated in the same way as a repo liability for the purposes of the levy. However, as the draft legislation requires there to be a 'sale' of the securities to satisfy paragraph 31, we are not sure that the current legislation achieves this.

   We understand from our meeting that it would be consistent with the policy intention to treat stock lending liabilities in the same way as repo liabilities, and it would be helpful for the point to be clarified in the legislation and guidance.

   Collateralising derivatives transactions with cash or with securities

   We have provided some worked examples showing the accounting treatment under International Accounting Standards and the bank levy analysis of various derivatives transactions:

   - derivatives collateralised with cash;
   - derivatives collateralised with securities;
   - derivatives collateralised with securities which are transferred out pursuant to a repo agreement;
   - derivatives collateralised with securities which have been transferred in pursuant to a reverse repo agreement.

   We believe that the analysis in examples five and six (which consider repos in respect of high quality collateral) should be the same if, in those examples, the repo transactions were replaced by stock lending/borrowing transactions.

We would welcome your thoughts on all the examples and we would be pleased to consider other examples if that would be helpful.

2. Netting

GAAP adjustments

We understand that the second paragraph of BLM 322 312 is intended to apply to trade date payables and receivables (rather than to CUSIP netting) and we would ask that the guidance be clarified.

Multilateral netting agreements

We understand that the intention is to allow multilateral netting in cases where this is consistent with the legal analysis.

We understand that HMRC has looked into the legal analysis of certain multilateral agreements, and that the conclusion in those cases is that the agreements allow netting between entities M and N_1, and, separately, between M and N_2 (see example in the notes). We would suggest that it would be useful to set out in guidance both the intention of the provision and a summary of the legal analysis.

We believe that if the terms of a multilateral netting agreement were such as to allow netting between M and the two entities N_1 and N_2 (taken together), then netting should also be allowed for bank levy purposes, in accordance with the policy intent, and we would be grateful for your comments on this.

Drafting changes

We understand that the drafting changes in paragraph 16(1) were intended to clarify rather than to change the meaning of that paragraph.

Our concern was the extent to which it may be necessary for a taxpayer to consider the position of the counterparty. For example, where the taxpayer has a derivative liability to a counterparty, it might be reasonable to assume that the counterparty has an asset corresponding to that liability, but the taxpayer would not generally know the amount of that asset.

We understand that there is no requirement either that the amount of the asset in the counterparty's books be equal to the amount of the liability in the taxpayer's books, or that the taxpayer should make enquiries as to the counterparty's position, and we would be grateful if you could confirm that in guidance.

3. Long term liabilities

Option to repay early

We understand that where a borrower has the <u>option</u> to repay a term loan early

(and the lender has no right to repayment), then the liability would be a long term liability. This is consistent with the policy intent, that the borrower should have access to liquidity in a crisis.

In contrast, where a lender has the option to require early repayment within the 12 month period, we understand that the liability would be a short term liability.

Conditional obligation to repay early

The position is less clear in cases where a borrower has a conditional obligation to repay a term loan early, on the occurrence of a trigger event, (e.g., that a stock index reaches a certain level) and the trigger event has not occurred by the end of the chargeable period (and the lender has no right to require early repayment).

In such cases, the accounting classification as long term or short term generally depends on the likelihood of the trigger event occurring within twelve months of the end of the period of account.

We would suggest that a practical approach might be to follow the accounting classification. We would be pleased to provide examples if this would be helpful.

Prorating

We understand that where a firm is not able to trace an intra-group liability to a particular external source of funding, then a pro-rating approach will be applied, and that the applicable method (or choice of methods) of pro-rating will be set out in guidance.

We note that the pro-rating approach is not explicitly included in the legislation itself and we would ask whether it would be sensible to include some form of "just and reasonable" language so as to provide a link between legislation and guidance.

It would also be helpful if detailed numerical examples would be provided in guidance.

The example we discussed at the meeting was as follows:

- UK subsidiary has 100 of debt funding from a non-UK group company
- Assume that none of the debt has a contractual term of less than one year, and that none of the debt can be traced to the group's external funding
- The consolidated group has 300 of external debt funding, of which 40% is long term and 60% is short term
- In this case, for bank levy purposes the UK subsidiary should have 40 of long term liabilities and 60 of short term liabilities.

Developing this example:

- UK subsidiary has 100 of debt funding from a non-UK group company
- Assume that 45 of the debt has a contractual term of more than one year and 55 of the debt has a contractual term of less than one year
- The consolidated group has 300 of external debt funding, of which 40% is long term and 60% is short term.
- For bank levy purposes, the UK subsidiary should have long term liabilities of:-
    - 45 if the long term debt is treated as Tier 2 by FSA; otherwise
    - 45 if the long term debt can be traced to the consolidated group's long term funding; and otherwise
    - 40, being the lower of 45 and the long term percentage (ie 40%) of the consolidated group's total external debt funding applied to the total debt funding of the UK subsidiary (ie 100).

We would be pleased to provide further examples which might help with developing guidance on how to approach the calculations.

4. Anti-avoidance

BLM 610 000 states that

"The Bank Levy legislation seeks to encourage banks to adopt lower risk funding strategies. It is not intended the anti-avoidance rule will apply to arrangements so far as their effects reflect compliance with this policy aim. The legislation therefore includes exemptions for arrangements to [the] extent they have specified effects".

We would agree that it makes sense to disapply the anti-avoidance rules in such cases.

In order for the legislation to give full effect to that intention, we consider that it would be appropriate to clarify in paragraph 46 that where the exemption applies, the effect (i.e., reduction in bank levy) should not fall within the definition of tax advantage. Such clarification would not preclude HMRC from seeking to apply anti-avoidance provisions to arrangements which provide other tax advantages, but would provide welcome certainty to the taxpayer that the effect in question (i.e. reduction in bank levy) would not be inadvertently caught.

5. Double tax relief

We note the double tax relief provisions and look forward to developments in bilateral agreements with other jurisdictions.

6. Other points

6.1 <u>BLM 170 000 and paragraph 44 (recharges)</u>

We understand that where an amount in respect of the bank levy is recharged intra-group as a component of a transfer pricing calculation, the amount recharged will not be taken into account for corporate tax

purposes.

6.2 BLM 245 000 and 261 000 (definitions of bank)

There would appear to be drafting errors in the definitions of bank and relevant foreign bank. We would suggest that paragraphs 78(2)(b) and 76(2)(b) be amended so as to include a reference to the capital resources condition.

6.3 BLM 331 350 and paragraph 34 (deferred tax liabilities)

We understand that where deferred tax assets and deferred tax liabilities are offset in the accounts, it will be the net deferred tax liability that is excluded by virtue of paragraph 34.

6.4 BLM 331 500 and paragraph 37 (client monies)

The FSA handbook states at CASS 7.4.1R that

"A firm, on receiving any client money, must promptly place this money into one or more accounts opened with any of the following: (1) a central bank; (2) a Banking Coordination Directive credit institution; (3) a bank authorised in a third country; (4) a qualifying money market fund".

We would be grateful for confirmation that where firms place client money into one or more accounts as set out above, then the client monies should be excluded from the levy base.

6.5 BLM 378 700 and paragraph 25(5) (netting)

We note that the method requires firms to identify assets before netting, and that this may not be straightforward to identify this figure. It is expected that this may arise as a practical point in bilateral discussions with CRMs.

6.6 BLM 361 000 and paragraph 15(2)(c) (interaction of assets and netting)

We understand that the intention is to avoid double counting. Accordingly, if an amount of assets has not been used in netting down liabilities, such amount should be available for relief under the assets provisions of paragraph 15(2)(c).

6.7 Federal Deposit Insurance Corporation

We understand that the Federal Deposit Insurance Corporation would be comparable to the Financial Services Compensation Scheme for the purposes of paragraph 29(3)(b).

It would be helpful if the Bank Levy Manual provides a full list of schemes which are comparable "protected" schemes.

6.8 Netting event

The definition of netting event (for example in paragraph 16(2)) refers to cases where the insolvency or bankruptcy of one or more entities gives rise to the termination of any arrangements under which any of the liabilities arise (the liabilities being those for which there is a provision for net settlement).

In the particular case of derivative liabilities, the termination of the arrangements may be caused by an “Insolvency Event” as defined in the relevant master agreement. We understand that the definition would typically include a variety of insolvency or bankruptcy or other similar events. Accordingly it would appear to be consistent with the policy intention for such events to fall within paragraph 16(2). We would welcome your thoughts on this and would be pleased to discuss further.

We would also note other developments in the legal framework since the financial crisis, for example the developments in relation to special resolution schemes for banks. Such schemes may provide that the instruments of transfer which are used to give effect to resolution are to be disregarded for the purposes of determining whether a default event provision applies. Accordingly, in such cases, depending on the terms of the instrument of transfer, there may or may not be a termination event. We would suggest that developments in law be kept under review to ensure that the bank levy legislation achieves its intended effect in resolution cases.

6.9 Intra-entity assets

We understand that intra-entity assets should be excluded by virtue of paragraph 26(2) and 26(3), which in turn refer to the relevant provisions of Corporation Tax Act 2009. Those provisions are given effect by the Capital Attribution Tax Adjustment methodology, which in turn is interpreted by reference to the OECD commentary.

We would ask whether it is possible to include a statement in the guidance to the effect that intra-entity assets should not be treated as assets for the purposes of the branch calculation as assets cannot arise between branches of the same entity.

We consider that it would also be helpful to include a paragraph in the guidance which draws out how the legislation delivers this result, and for this purpose we consider that it would be useful to include some relevant background on HMRC’s interpretation of the OECD commentary.

6.10 Chargeable periods

Paragraph 39 applies where an entity does not prepare financial statements for a period.

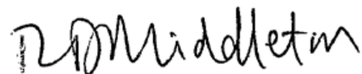
It is not entirely clear at what stage the test should be made, and it would be helpful if clarification could be provided on the guidance.

6.11 Administration

We understand that draft regulations in the administration of the bank levy should be available by 23 March. We look forward to reviewing the draft regulations.

We trust that this letter is helpful and we would be pleased to engage further on any of the points raised.

Yours sincerely,



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