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
Irish Tax and Customs

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Introduction

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 sets out 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. This was amended in Finance Act 2019 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.

1 Tax treatment of AT1 and AT1 'equivalent' instruments

As set out in section 2, AT1 instruments are hybrid instruments which share the characteristics of debt and equity. To provide certainty on the tax treatment of such instruments section 845C provides that AT1 (and equivalent instruments) are to be regarded as 'debt' instruments for the purposes of the Tax Acts. There are two main tax treatment consequences flowing from this, as follows:

a) a 'coupon', which is a distribution within the meaning of Article 4 of the CRR, is regarded as interest and, consequently, may qualify for tax deductibility where relevant criteria are met; and

b) section 64, which provides for an exemption from withholding tax on interest in respect of certain debt instruments, is applied to AT1 and equivalent instruments as it applies to quoted Eurobonds, with necessary modifications.

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[1], or one of the main purposes, is to avoid liability to tax.

2 AT1 instruments (instruments within paragraph (a) of the definition of AT1s in section 845C(1))

AT1 instruments are a specific type of contingent convertible bond ('CoCo')[2], a form of loss-absorbing capital issued by regulated financial institutions such as banks. In order to qualify for treatment under 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.

To comply with the requirements of the CRD IV, the AT1 instruments 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,

[1] Refer to TDM 33-01-01 for guidance on the application of main purpose tests.

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

- 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.[3]

3 Instruments equivalent to AT1s (instruments within paragraph (b) of the definition of AT1s in section 845C(1))

Finance Act 2019 amended section 845C to extend the treatment afforded to AT1 instruments under the section to instruments with equivalent characteristics to AT1s where they were issued other than by a financial institution. The instrument must meet all of the characteristics set out in Article 52 of CRR, other than those that it cannot meet by virtue of not being a financial institution. Where it cannot meet a condition, that condition must be suitably modified to take account of the fact that it is not being issued by a financial institution.

An instrument with equivalent characteristics might include CoCos issued by life companies to satisfy their capital requirements under Solvency II. It is considered unlikely that equivalent instruments that would be entitled to treatment under section 845C will arise outside of industries where there are capital adequacy requirements.

3.1 What "equivalence" means

For an instrument to be equivalent to an AT1 instrument, it is one that shares the essential characteristics associated with AT1 instruments. Those characteristics include, but are not limited to:

a) possessing 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) being loss-absorbing;

c) being 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) being perpetual in nature with no incentive to redeem;

[3] https://www.eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/16106

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.

3.2 Necessary modification of criteria

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.

To determine whether the instrument is an AT1 "equivalent" instrument, the following steps should be followed:

1. Compare the AT1 instrument against each of the criteria specified under Article 52 of the CRR.
2. Where a criterion, as specified under Article 52, cannot be easily applied in a non-financial institutional context, the Article 52 criterion should be adapted or modified as necessary. Modification does not include a complete disapplication of any criteria.

Appendix 1 sets out the criteria required by Article 52.

Where there is uncertainty in respect of how to modify any of the criteria which cannot easily be applied to a non-financial institution, Revenue may be contacted for an opinion[4].

[4] Refer to the following for the process to be followed in respect of submitting a technical query to Revenue: https://www.revenue.ie/en/tax-professionals/rts/index.aspx

Appendix 1: Article 52 criteria

Set out below are the criteria from Article 52 of the Capital Requirements Regulation ("CRR"). Where a taxpayer is seeking to treat an instrument as equivalent to an ATI, they should complete the right-hand column below to ensure that all criteria have been considered.

Conditions of AT1	**Application to Instrument**
(a) the instruments are directly issued by an institution and fully paid up;	
(b) the instruments are not owned by any of the following: (i) the institution or its subsidiaries. (ii) an undertaking in which the institution has a participation in the form of ownership, direct or by way of control, of 20% or more of the voting rights or capital of that undertaking;	
(c) the acquisition of ownership of the instruments is not funded directly or indirectly by the institution;	
(d) the instruments rank below Tier 2 instruments in the event of the insolvency of the institution;	
(e) the instruments are neither secured nor subject to a guarantee that enhances the seniority of the claims by any of the following: (i) the institution or its subsidiaries; (ii) the parent undertaking of the institution or its subsidiaries; (iii) the parent financial holding company or its subsidiaries;	

(iv) the mixed activity holding company or its subsidiaries; (v) the mixed financial holding company or its subsidiaries; (vi) any undertaking that has close links with entities referred to in points (i) to (v);	
(f) the instruments are not subject to any arrangement, contractual or otherwise, that enhances the seniority of the claim under the instruments in insolvency or liquidation;	
(g) the instruments are perpetual and the provisions governing them include no incentive for the institution to redeem them;	
(h) where the instruments include one or more early redemption options including call options, the options are exercisable at the sole discretion of the issuer;	
(i) the instruments may be called, redeemed or repurchased only where the conditions laid down in Article 77 are met, and not before five years after the date of issuance except where the conditions laid down in Article 78(4) are met;	
(j) the provisions governing the instruments do not indicate explicitly or implicitly that the instruments would be called, redeemed or repurchased, as applicable, by the institution other than in the case of the insolvency or liquidation of the institution and the institution does not otherwise provide such an indication;	
(k) the institution does not indicate explicitly or implicitly that the competent authority would consent to a request to call, redeem or repurchase the instruments;	

(l) distributions under the instruments meet the following conditions: (i) they are paid out of distributable items; (ii) the level of distributions made on the instruments will not be amended on the basis of the credit standing of the institution or its parent undertaking; (iii) the provisions governing the instruments give the institution full discretion at all times to cancel the distributions on the instruments for an unlimited period and on a non-cumulative basis, and the institution may use such cancelled payments without restriction to meet its obligations as they fall due; (iv) cancellation of distributions does not constitute an event of default of the institution; (v) the cancellation of distributions imposes no restrictions on the institution;	
(m) the instruments do not contribute to a determination that the liabilities of an institution exceed its assets, where such a determination constitutes a test of insolvency under applicable national law;	
(n) the provisions governing the instruments require that, upon the occurrence of a trigger event, the principal amount of the instruments be written down on a permanent or temporary basis or the instruments be converted to Common Equity Tier 1 instruments;	

(o) the provisions governing the instruments include no feature that could hinder the recapitalisation of the institution;	
(p) where the issuer is established in a third country and has been designated in accordance with Article 12 of Directive 2014/59/EU as part of a resolution group the resolution entity of which is established in the Union or where the issuer is established in a Member State, the law or contractual provisions governing the instruments require that, upon a decision by the resolution authority to exercise the write-down and conversion powers referred to in Article 59 of that Directive, the principal amount of the instruments is to be written down on a permanent basis or the instruments are to be converted to Common Equity Tier 1 instruments; where the issuer is established in a third country and has not been designated in accordance with Article 12 of Directive 2014/59/EU as part of a resolution group the resolution entity of which is established in the Union, the law or contractual provisions governing the instruments require that, upon a decision by the relevant third-country authority, the principal amount of the instruments is to be written down on a permanent basis or the instruments are to be converted into Common Equity Tier 1 instruments;	
(q) where the issuer is established in a third country and has been designated in accordance with Article 12 of Directive 2014/59/EU as part of a resolution group the resolution entity of which is established in the Union or where the issuer is established in a Member	

State, the instruments may only be issued under, or be otherwise subject to the laws of a third country where, under those laws, the exercise of the write-down and conversion powers referred to in Article 59 of that Directive is effective and enforceable on the basis of statutory provisions or legally enforceable contractual provisions that recognise resolution or other write-down or conversion actions;	
(r) the instruments are not subject to set-off or netting arrangements that would undermine their capacity to absorb losses.	