THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2024

MODULE 3.05 – BANKING OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

In computing business profits for accounting and tax purposes, interest is a deductible cost of earning profits, while distributions are a non-deductible application of profits.

Securities which pay interest and have a legal right to repayment are debt; securities which pay dividends and are irredeemable are equity.

Preference shares are simply shares which a right to a fixed rate of dividends, payable in priority to dividends to ordinary shareholders.

Redeemable preference shares are economically equivalent to a fixed term loan, because the holder has a contractual claim to be repaid his capital after the expiry of a fixed period. They will therefore command a lower rate of return than non-redeemable preference shares, because they carry less risk.

The preferred participating bonds are called bonds, but other than the right to interest, carry rights similar to ordinary shares.

Under IAS 32, redeemable preference shares are classified as debt, and the dividends are classified as interest. However, for company law and tax purposes, the shares remain shares and the dividends remain dividends.

All payments by a company to its shareholders are distributions for tax purposes unless (i) a return of capital, or (ii) equal in value to new consideration received by a company, e.g. the proceeds of a new share issue made for the purpose or retiring existing shares: CTA 2010, s 1000(1)B.

An issue of redeemable share capital is a distribution: CTA 2010, s 1000(1)C.

Where securities issue equity-like returns, the returns will be classified as distributions, on the basis that the securities are either non-commercial securities (CTA 2010, s 1005) or special securities (s 1015).

Profits available for distribution are defined in the Companies Act 2006, s 830, as accumulated realised profits less accumulated realised losses. Profits available for distribution are justified by reference to the relevant accounts: s 836.

As preference shares remain shares for company law purposes, they can only be redeemed out of profits available for distribution or the issue of new shares made for the purpose.

For the accounting period ended 31/03/2024, profits available for distribution will be £2,500,000. The dividends on preference shares are no deductible for this purpose, nor distributions in respect of non-commercial securities or special securities.

The distribution of profits will be:

Profits for distribution	2,500,000	
Preferred bonds		100,000
Preference shares		500,000
Redeemable preference shares		300,000
Redemption of preference shares		1,600,000
	2,500,000	2,500,000

Question 2

Contingent convertibles (co-cos) are debt until conversion, when they become shares. They constitute Additional Tier 1 equity for capital adequacy purposes. For tax purposes they are classified as debt until conversion, so that interest is deductible in computing the bank's taxable profits.

When the bank fails to satisfy a solvency test, in this case its solvency ratios, the co-cos automatically convert into Tier 1 equity. The effect of conversion will normally be to devalue the existing ordinary shares, because they may be swamped by the new shares and will often rank behind the new class of shares on a winding up.

On the other hand, if when the bank is in difficulties, a rescue is undertaken backed by public sector guarantees, the new class of ordinary shares may themselves be devalued.

Such a rescue is proposed in this case. The banking regulator is keen for it go ahead, because if the Gamma Bank becomes insolvent, the deposit protection scheme may be called upon to compensate the depositors of the bank. In those circumstances the public interest may override the interests of the Z shareholders.

Accordingly, the Z shareholders are denied a vote on the takeover, because they would be likely to oppose it. The existing ordinary shareholders, by contrast, may be able to save some value for their shares by supporting the takeover.
The Z shareholders may be able to seek a legal order to prevent the takeover. On the other hand, the public interest in the takeover may be regarded as paramount to the interests of the Z shareholders, the court would have to choose between the interests of the ordinary shareholders and the Z shareholders, and the Z shareholders have chosen to invest in a high-risk investment.

Much the same issues occurred in relation to the takeover of SBC by the Union Bank of Switzerland. The result in that case was the holders of the co-cos lost the whole value of their investments.

PART B

Question 3

In a repo transaction the holder of securities, usually gilts, sells his securities to an interim holder, to raise funds for a short-term loan.

Gilts are a low-yielding but low risk investment. They produce a reward pattern which matches the liabilities of a final salary scheme. Pension scheme trustees have therefore used their securities to raise funds for investment in higher yielding assets, without making a permanent disposal of the securities, which they need to retain.

The form of transaction used for this purpose is repo.

From one point of view, repos constitute an investment transaction. From another, they constitute a borrowing transaction. Trustees normally have a wide power of investment, but their power to borrow is restricted and only exercisable with the consent of the sponsoring employer, who bears the ultimate risks of the pension scheme, should the pension scheme ever be insufficient to pay pension benefits.

Normally, repos are a low risk transaction. However, in September 2022 they became high risk because of a liquidity crisis in pension schemes, caused by the combination of over-leverage through an investment strategy known as liability driven investment, and a sharp fall in gilt prices, caused by government economic policy.

In these circumstances, leveraged transactions by trustees, such as repos, caused major losses to pension schemes. This naturally concerned the employer who sponsored the pension scheme, and in this case the employer proposes to sue the trustees for engaging in unauthorised borrowing transactions, under the guise of using their investment power.

Whether the trustees have gone outside their powers will depend on a decision as to whether they have been exercising their investment or their borrowing power.

Question 4

The OECD/G20's Pillar 2 rules go beyond and outside the original 15 BEPS Actions. They are set out in the Global Anti-Base Erosion Model Rules. These have been implemented in the UK in Finance (No 2) Act 2023. The broad aim is to impose a minimum global corporation tax rate of 15% in all jurisdictions in which MNEs operate.

Like the corporation interest restriction rules (BEPS Action 4) and the UK's loss carry forward rules, these operate at a group level, not an entity level.

The rules only apply to multinational groups with annual turnover of more than €750 million.

The UK rules introduce both a multinational top-up tax (MTT) and a domestic top-up tax. Th domestic top-up tax is designed as a back stop to the MTT.

As the UK's main rate of corporation tax is 25%, it is unlikely that the new measures will increase the tax charge on UK-resident companies. However, the new measures will greatly increase the compliance burdens for groups. Moreover, the UK rules for granting tax credits on taxed overseas income seek to bring the rate of tax on foreign income up to the UK main rate.

Working out the tax base, i.e. the profits by reference to which the rate of tax paid by a country in a particular jurisdiction is taxed, is a considerable challenge in the international sphere. Most jurisdictions strike a balance in their tax systems between (i) having a higher general rate of tax, subject to special allowances, such as investment allowances, and (ii) having a lower general rate with fewer special allowances.

PART C

Question 5

Cryptocurrency is an asset because value is attached to it, and it acts as a store of wealth. Whether it fits into conventional definitions of assets is another matter.

As regards the possible classifications:

1) Cryptocurrency is not cash, and equity instrument or contractual right to receive cash. It is simply a speculative instrument.
2) A currency is a medium of exchange with a territorial basis and linked to a national authority;
3) It does not function as a medium of exchange;
4) It does not provide income or personal enjoyment;
5) Intangible fixed assets are intended to produce future economic benefits on a predictable basis. Cryptocurrency It does not produce income on an ongoing basis, as require by the definition of fixed asset in IAS 38/FRS 102, Section 18;
6) It does not meet the definition of a derivative in IAS 32 or FRS 102. It is probably correct to regard it as an asset sui generis.

Question 6

Profit-shifting between connected enterprises may be achieved by means of lending money into high taxation countries to reduce the profits chargeable to tax there. This produces thin capitalisation. Thin capitalisation has been traditionally addressed by arm's length principle (ALP) transfer pricing rules.

These have fallen out of favour on the grounds that (i) they are too subjective; (ii) they are unpredictable in their impact; and (iii) they involve long and complex negotiations which absorb considerable resources and diminish the tax take. The CIR seeks to remedy perceived shortcomings in traditional ALP-based thin capitalisation. Hence the BEPS project simply ignores ALP-based transfer pricing.

Instead, Action 4 mandates participating states to introduce the corporation interest restriction (CIR) rules.

These operate at the group level. They are accounts-based, thought the commercial accounts require considerable modification for CIR purposes. The aim is that, once the consolidated accounts have been satisfactorily modified, the accounts figures can simply be fed into the computer and will automatically produce the correct tax charge.

The CIR rules do not impose a tax charge as such. Unlike the transfer pricing rules they cannot increase or decrease the rate of finance charge payable for tax purposes. What the CIR rules do is to seek to limit the percentage of external finance cost which groups pay to 30% of overall finance costs for tax purposes. The basic interest allowance (allowable finance cost) is established for a worldwide group on the basis of the fixed ratio rule or group ratio rule. The disallowed element is then attributed to the UK members of the group.

The transfer pricing rules take precedence over the CIR. If the transfer pricing rules produce a similar or greater disallowance of tax deductible finance cost than the CIR, then the CIR rules have no application. However, in practice it is likely that the CIR rules will produce a larger restriction and so higher tax charge. That was, after all, the main reason for their introduction.

Accordingly, in practice cursory consideration will be given to ALP-based thin capitalisation, before proceeding straight to the CIR analysis.

Question 7

A DTA between two high taxation states will normally provide that interest is only taxable in the residence state of the person beneficially entitled to the interest, so that no withholding tax is charged on cross-border interest payments. This is fundamental to international finance, because international lenders invariably require that interest should be paid gross.

The meaning of ‘beneficial entitlement’ is disputed. Indofood International Finance Ltd v JO Morgan put forward an ‘international’ meaning, whereby if the payee was bound to pay on the interest which he received, he did not have beneficial entitlement to the interest. On the other hand the ‘domestic’ meaning of the term means that if the recipient has any measure of free disposition over the payment which he receives, that is sufficient to constitute beneficial ownership.

Where interest is paid from a high taxation jurisdiction (here the UK) to a low tax jurisdiction (here Guernsey) withholding tax on UK source interest paid to a Guernsey lender will still be due.

The source of interest is determined by reviewing all the connecting factors: location of the payer, where the debt is enforceable, governing law etc. See National Bank of Greece v Westminster Bank.

The common means of avoiding withholding tax in these circumstances is for the loan to take the form of a zero coupon bond. The bond is issued at a discount and repayable on its expiry at its face value.

Interest remains interest even if paid in a lump sum at the end of the term.

15,000,000 x 1.084 = 20,407,334 so the lender will receive exactly the same payment from Hazelnut, as he would have received from Almond.

The question is, whether Hazelnut can be said to have beneficial ownership of the money paid to it by Almond, or is simply a pass on vehicle.

The recent Hargreaves Property Holdings Ltd case explores these issues.

Question 8

Banks have a key systemic function in the economy. Banks have a key role as financial intermediaries. They have custody of customers' deposits. Loss of these deposits would produce an unpredictable and uncontrollable chain reaction nationally and internationally.

Deposit protection schemes reduce the risk to small depositors but transfer it to the community generally.

Moreover, it is essential that banks should finance their lending activities from deposits, rather than by inter-bank lending, because the collapse of one bank will cause others to fail.

It is therefore essential that banks should be run responsibly, should retain sufficient liquid resources and with a limit on risk-taking.

The financial stability of banks is primarily maintained by the requirement that banks should maintain a prescribed ratio between capital and risk-weighted assets (RWA).

Ratios are set by the Bank of International Settlements (BISS) and then implemented and adapted by national regulators.

The minimum capital ratio is 8% of RWA.

6% must be Tier 1.

4.50% must be Minimum Common Equity Tier 1, i.e. ordinary shares.

A countercyclical capital buffer can be imposed for 0% to 2.5%.

The balance can be made up of Tier 2 capital, i.e. long-term debt.