Cleary Gottlieb Alert Memo
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UK Pre-Budget Report: Focus on the Banking Sector

As part of today's UK Pre-Budget Report, the Chancellor of the Exchequer, Alistair Darling, announced two important measures targeting the banking sector. The first is the introduction of the much-heralded bank bonus tax, which will apply with immediate effect until April 5, 2010, to bonuses over £25,000. The second is the introduction of the Code of Practice on Taxation for Banks, which was originally published in draft form in June of this year.

This memorandum summarizes some of the key elements of these measures.

1. Bank Payroll Tax

Summary

Legislation in the Finance Bill 2010 will introduce a new "bank payroll tax" set at a rate of 50%. It will be payable by a bank, on the amount of a bonus to which an employee engaged in banking business is entitled, to the extent that the bonus exceeds £25,000. The tax will apply to bonuses awarded to the employee after the time of today's announcement up to April 5, 2010. It is intended that in the longer term the remuneration practices of banking businesses will be changed as a result of corporate governance and regulatory reforms.

The bank payroll tax will be payable on all discretionary and contractual bonus awards comprising money, money's worth, benefits and loans (excluding contractual bonus entitlements where the payer has no discretion as to the amount of the bonus as a result of a contractual obligation existing as at the time of the Chancellor's announcement). Where the bonus includes money's worth or a benefit, the amount of remuneration for the purposes of the bank payroll tax is the higher of the market value or the cost of providing it.

The new bank payroll tax is payable on August 31, 2010 and will not be deductible for UK corporation tax purposes. The tax is imposed on the bank and not the relevant employee and it will not affect the employee's income tax or National Insurance liabilities.

In introducing this measure, the Chancellor claimed that all banks had benefitted from taxpayer support and, accordingly, he was giving them a choice: "They can use their profits to build up their capital base. But if they insist on paying substantial rewards, I am determined to claw money back for the taxpayer." The UK Treasury estimates that 20,000 bankers will be affected.

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Overview of draft legislation

The bank payroll tax is payable by taxable companies on the aggregate of the amounts of chargeable relevant remuneration awarded to or in respect of relevant banking employees of the taxable company by reason of their employment as relevant banking employees. Relevant remuneration is only "chargeable" relevant remuneration to the extent that it exceeds £25,000.

We have outlined the meaning of some of the key terms used in the draft legislation below. Please note that the draft legislation (and the technical note and explanatory notes published with it) contain more detailed definitions and provisions which we have not discussed for the purposes of this alert.

"Taxable Company"

For the purposes of the bank payroll tax, a "taxable company" is:

- a UK bank or building society;
- a UK resident investment company or UK resident financial trading company in a banking or building society group; or
- a UK branch of a foreign bank or UK branch of a foreign financial trading company in a banking group.

Non-UK banks with a UK presence will therefore need to consider the payroll tax.

Banks include companies that are authorized persons for the purposes of the Financial Services and Markets Act 2000 that carry out certain regulated activities, and financial trading companies include companies that are authorized persons and companies that carry on a trade consisting wholly or partly in dealing in securities. However, certain other entities (such as insurance companies, investment trusts, OEICs, friendly societies and credit unions) are excluded.

"Relevant Banking Employee"

An individual will be a "relevant banking employee" of a taxable company if that individual is employed by the taxable company in a "banking employment" and either the individual is resident in the United Kingdom in the tax year 2009/10 or performs duties of the banking employment at any time in that year wholly or partly in the United Kingdom.

For this purpose, "banking employment" means an employment which wholly or mainly involves duties that relate either directly or indirectly to activities that are "relevant regulated activities" (i.e., accepting deposits, dealing in investments as either principal or agent, arranging deals in investments, safeguarding and administering investments on behalf of clients and carrying out retail mortgage lending).

In certain circumstances where an individual is not employed by a taxable company but provides services for a taxable company through an intermediary, that individual may still be regarded as a relevant banking employee.

"Relevant Remuneration"

"Relevant remuneration" is defined in the draft legislation as anything that is either within the general meaning of "earnings" for UK employment taxation purposes in relation to the employee's employment or is a benefit provided by reason of that employment. This may include employment-related securities.

There is an exception for "excluded remuneration" being, in essence:

- Regular salary or wages or a regular benefit: In this context, "regular" means that the amount of salary, wages or benefits does not vary according to (i) the performance of the business of the taxable company (or a person connected with it), (ii) the contribution to that performance made by the employee, (iii) the performance by the employee of any of the duties of the employment or (iv) any similar considerations.

- Anything in respect of which a contractual obligation to pay or provide it arose before the Chancellor's announcement: For this purpose, a contractual obligation to pay or provide something will, in summary, not arise until amounts to be paid or provided are fixed or are capable of becoming fixed without the exercise of discretion by any person.

- Certain approved share-related awards.

"Award" of relevant remuneration

The bank payroll tax charge applies to aggregate amounts of chargeable relevant remuneration awarded during the period commencing with the Chancellor's announcement today and ending on April 5, 2010.

Relevant remuneration is considered to be awarded when a contractual obligation to pay or provide the relevant remuneration arises. Otherwise, relevant remuneration will be considered to be awarded when it is paid or provided during the relevant period without such an obligation having arisen.

Anti-avoidance measures

The bank payroll tax has a targeted anti-avoidance rule and certain other provisions intended to ensure that awards that in substance are bonuses will be chargeable.

2. The Code of Practice on Taxation for Banks

On June 29, 2009 HM Revenue & Customs ("**HMRC**") published a draft Code of Practice on Taxation for Banks (the "**Code**") to encourage banks to comply with the spirit as well as the letter of the law. After a period of consultation the Government has today introduced an updated and amended Code. The Government expects all banks operating in the United Kingdom to adopt the Code and whilst it understands that banks may require time to consider the implications for them of the Chancellor's announcement that the Code has been introduced, adoption and implementation should take place soon after.

A consultation response document and supplementary guidance note (set out in Q&A format) to address additional questions which arose during the consultation period have also been published.

<u>What is the purpose of the Code?</u>

The Code asks banks to procure that they:

- maintain proper governance around tax;
- integrate tax into business decision-making processes;
- establish an appropriate relationship with HMRC following certain principles set out in a Review of Links with Large Businesses; and
- undertake tax planning only to support their business operations, not to achieve unintended and unexpected tax advantages (i.e., tax results that are contrary to the "intentions of Parliament").

<u>Which banks does the Code apply to?</u>

The Code is intended for all banks operating in the United Kingdom and for any other organizations undertaking banking activities in the United Kingdom. UK subsidiaries of overseas banking groups and UK branches of overseas banks are capable of falling within the scope of the Code.

<u>What changes have been made to the draft Code?</u>

While the main tenets and policy rationale of the Code remain unchanged, HMRC has agreed to change some of the wording of the Code to clarify the responsibilities and behaviours expected.

The two substantive changes to the wording of the Code are:

- Banks are no longer required to initiate dialogue with HMRC if they are in any doubt as to whether the tax result of a proposed transaction is contrary to the "intentions of Parliament". Instead the bank may simply choose to do so.

- The Government's expectations with regard to approaches to tax planning are set out more clearly. The Code will only apply to schemes banks enter into themselves and schemes they design for and plan to sell to their customers. HMRC accepts that it would be operationally impossible for banks, when they are involved in someone else's transaction, to identify whether the tax consequences of that transaction are, or may be, contrary to the "intentions of Parliament".

<u>What other important points have been addressed in the consultation response document?</u>

HMRC confirmed that they agree with one very important concern that the Code should not confer a quasi-legislative and judicial function on them. The response document confirms that banks will continue to be taxed in accordance with the law; the Code does not give HMRC the right to tax a bank in respect of a transaction in accordance with its own view of the spirit or intention rather than the letter of the law. If a bank enters into a transaction and in due course makes a return on the basis of that transaction, HMRC will still need to decide how to respond. It may risk-assess the transaction and decide to open an enquiry, but the objective of that enquiry, as is currently the case, will be to establish the correct tax treatment of the transaction in accordance with the law; the Code does not change this, nor will it affect the bank's right to appeal the findings of any enquiry to the tax tribunals and the courts.

With regard to the meaning of a transaction giving rise to a tax result which is "contrary to the intentions of Parliament", HMRC will be publishing a technical note in which it will suggest that banks answer this question in practice by asking whether the tax consequences of a transaction are "too good to be true, so that the tax consequences would be a surprise to HMRC".

As for timing issues surrounding consultation with HMRC on a particular transaction, HMRC confirms that it will commit to work with the bank within a reasonable timeframe that recognises commercial pressures but banks should make reasonable efforts to give HMRC sufficient time to comment. It is clear, however, that a bank does not have to wait for HMRC to respond to its approach before determining whether to enter into any given transaction.

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Please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under Tax under the "Practices" section of our website (http://www.clearygottlieb.com) if you have any questions.

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