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TAX IMPLICATIONS OF CONTINGENT CONVERTIBLE SECURITIES

Facts

In response to the financial crisis, the banking and financial authorities in Host Country may be requiring bank holding companies and banks to hold a much higher level of capital than was previously the case. One form of such capital that might qualify is a new type of contingent convertible securities ("CoCos"). Although the Basel Committee announced in July 2011 that global systemically important financial institutions cannot use CoCos to meet the Basel III requirements, CoCos may still be relevant to meet national capital requirements supplementing the Basel III requirements.

A Host Country bank is considering issuing CoCos. The CoCos would be labelled as debt and would be direct, unsecured and subordinated obligations of the issuer. They may have no fixed maturity date, or alternatively, they may have relatively long maturities in the range of 30 to 50 years. If the CoCos have a fixed maturity date, payment at maturity would likely be subject to the condition that the issuer's core capital is sufficient at that time and also subject to the consent of the issuer's regulator.

The CoCos would pay a regular coupon, although this might be deferrable in certain circumstances. The interest rate on the CoCos would parallel the rate on similar bonds issued publicly by an unrelated bank holding company.

The CoCos would be mandatorily convertible into the common equity of the issuer in the event the issuer's regulatory capital dips below a certain prescribed level on its quarterly audited financial statements. The conversion price would be set at a ratio fixed on the date of issuance (generally at a level which would result in some loss of the principal amount of the CoCos upon conversion). Neither the holder nor the issuer would have an option to convert the CoCos.

It is likely that, at the time of the issuance of the CoCos, the Host Country bank has a debt-to-equity ratio in line with other financial institutions, and the Host Country bank would be able to obtain independent loans outside of the CoCos.

The holders of the CoCos are not shareholders of the issuer.

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Tax implications of contingent convertible securities

FACTS

In response to the financial crisis, the banking and financial authorities in Host Country may be requiring bank holding companies and banks to hold a much higher level of capital than was previously the case. One form of such capital that might qualify is a new type of contingent convertible securities ("CoCos"). Although the Basel Committee announced in July 2011 that global systemically important financial institutions cannot use CoCos to meet the Basel III requirements,[1] CoCos may still be relevant to meet national capital requirements supplementing the Basel III requirements.

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It is likely that, at the time of the issuance of the CoCos, the Host Country bank has a debt-to-equity ratio in line with other financial institutions, and the Host Country bank would be able to obtain independent loans outside of the CoCos.

The holders of the CoCos are not shareholders of the issuer.

QUESTIONS

I. With respect to the CoCos:
   a. Would the CoCos be treated as debt instruments in Host Country for income tax purposes?
   b. Are there any changes to the conversion feature that might be made to insure their treatment as debt?

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   b. Interest payments, if the holder of the CoCos is a Foreign Country entity?
   c. A conversion upon which the holder receives stock in exchange for the CoCos?

NOTES

[1] The Basel Committee on Banking Supervision provides a forum for regular co-operation on banking supervisory matters. All countries covered by the *Tax Management International Forum*, except for Denmark and Ireland, have representatives on the committee.

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Host Country FRANCE

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I. Background

On December 16, 2010, the Basel Committee published "Basel III: a global regulatory framework for more resilient banks and banking systems". The objective of the reforms is "to improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy."

In particular, Basel III will: impose higher capital ratios, including a new ratio focusing on common equity; increase the capital charges for many activities, particularly those involving counterparty credit risk; and narrow the scope of what constitutes Tier 1 and Tier 2 capital, among other things, by disqualifying many types of "hybrid" securities from Tier 1 capital treatment. As a result, most existing hybrid and subordinated debt instruments will not qualify as capital under Basel III.

Tier 1 capital will need to be equal to at least six percent of a bank's risk-weighted assets, of which 4.5 percent must be Common Equity Tier 1 and 1.5 percent may take the form of Additional Tier 1 Capital. Moreover, "Global Systematically Important Banks" (G-SIBs) must also have higher loss absorbency capacity to reflect the higher risk these institutions pose to the financial system.

On January 13, 2011, the Basel Committee issued comments on "minimum requirements to ensure loss absorbency at the point of non-viability" that indicate the conditions that instruments issued by "international active banks" should meet to be included in Additional Tier 1 or Tier 2 capital. Following a consultation period, in November 2011, the Basel Committee published its final comments on "assessment methodology and the additional loss absorbency requirements" for G-SIBs. G-SIBs are required to meet their additional loss absorbency requirement with Common Equity Tier 1 only, so would not be permitted to use contingent convertibles bonds (CoCos) to meet additional capital requirements. However, the Basel Committee has expressly announced that it will continue to review and support the use of contingent capital to meet national loss absorbency requirements set at a higher level than the global requirement.

On July 20, 2011, in response to Basel III, the EU Commission adopted the CRD4 legislative package to strengthen the regulation of the banking sector, which implements the international Basel accord on banking supervision. The proposal replaces the current Capital Requirements Directives (2006/48 and 2006/49) with a Directive and a Regulation.

In contrast to Basel III, the EU proposal recognises contingent convertibles as eligible to form part of Additional Tier 1 capital to the extent they are written down or converted into Common Equity Tier 1 instruments, when the Common Equity Tier 1 capital ratio of the institution falls below 5.125 percent or any higher level specified for the instruments. The draft CRD4 package is still subject to discussion and is not yet in its final form.

Since the first issuance by Lloyds Banking Group in November 2009, the few CoCos that have been issued – notably by Rabobank, Credit Suisse and Bank of Cyprus – were linked to capital ratio. For example, Rabobank (which was AAA-rated) issued CoCos in 2011 for an amount of US$2 billion at 8.4 percent, the trigger point for conversion being eight percent Tier 1. The issue was oversubscribed, confirming the market appetite for such instruments.

In that context, as part of its general efforts to increase market confidence in European banks, the European Banking Authority (EBA) published a new Recommendation[1] on December 8, 2011. The EBA recommends that European banks should create, by June 30, 2012, a temporary capital buffer by attaining a Core Tier 1 capital ratio of at least nine percent. Core Tier 1 capital comprises ordinary shares or similar instruments, and newly-issued contingent convertible instruments called "Buffer Convertible Capital Securities" (BCCSs) if their terms comply with a new "Common Term Sheet" for such instruments set out by the EBA in Annex III to the Recommendation.

The "Common Term Sheet" consists mainly of provisions that are intended to be agreed by the relevant national supervisor (who may ask for stricter requirements than the minimum requirements or for specific requirements when none are mentioned in this term sheet):

- *Status and subordination*: BCCSs constitute direct, unsecured, undated and subordinated securities. They are fully issued and paid-in. Before conversion, BCCSs have priority over the ordinary shareholders of the bank. In the event of conversion, the holders become shareholders and rank *pari passu* with other shareholders.
- *Maturity date*: unless previously called and redeemed or converted in limited cases, BCCSs are perpetual and have no maturity date.
- *Coupon*: BCCSs will bear interest (to be determined on a case-by-case basis). No incentive to redeem can be included and the issuer would have full discretion at all times to cancel interest payments on the BCCSs. The issuer would be required to cancel interest payments in the event of there being insufficient profit.

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- *Conversion*: BCCSs will be mandatorily converted into ordinary shares upon the occurrence of a "Contingency Event" or a "Viability Event."

Two "Contingency Events" are specified: (1) where the bank gives notice that its Core Tier 1 capital ratio has fallen below seven percent; and (2) where the bank gives notice, after January 1, 2013 (the date by which the CRD 4 legislation is intended to become effective), that its Common Equity Tier 1 capital ratio has fallen below 5.125 percent (or such higher percentage as may be specified by the bank for purposes of the particular BCCS).

A "Viability Event" is either: (1) a decision of the national supervisor that a conversion of the BCCSs is necessary to prevent the bank becoming non-viable; or (2) a decision to make a public sector capital injection, or similar support, without which the bank would become non-viable in the determination of the national supervisor.

A discussion of the qualification of CoCos from a French tax perspective (see II., below) will be followed by an analysis of the tax treatment for the issuer (see III., below) and the holder (see IV., below).

II. French tax treatment of Contingent Convertible Bonds

A. Qualification of CoCos

As a general principle, the legal qualification and the accounting treatment of a transaction under French GAAP (*Plan Comptable Général* or PCG) determines its tax treatment,[2] except when the tax law provides for a different treatment. In the absence of a specific definition of debt or equity in French tax law, the legal qualification and accounting treatment should prevail for purposes of determining the tax treatment of instruments such as CoCos. From a French statutory accounting standpoint, the issuance of bonds convertible into equity is treated in a similar way to the issuance of conventional bonds, i.e. they are booked as debts and interest paid by the issuer is considered a financial expense.

The French Tax Authorities must normally rely on the legal and accounting qualification of a transaction but can challenge such qualification by reference to the legal and economic characteristics of the transaction. No single element is decisive. Only a comprehensive analysis of a transaction can lead to a potential reclassification, based on either the misqualification of a transaction with respect to its legal analysis, or because the transaction is abusive or fraudulent. Situations in which a financial instrument that is classified as debt for French commercial law purposes can be re-characterised as equity for tax purposes should remain rare.

The French Tax Authorities have not provided a precise analytical grid for qualifying an instrument as debt or equity and have stated that a case-by-case analysis should be conducted based on the characteristics of each instrument. It is, however, worth referring to some of the comments made by the Administration on this subject in the past.

The French Tax Authorities' guidance on the thin capitalisation rules,[3] for example, acknowledges the existence of hybrid instruments that share features of both debt and equity. The administration indicates that equity features would, in particular, be the absence of a predefined reimbursement date and the ability of the issuer to suspend the remuneration in the case of insufficient profit, and that debt features would be the existence of predefined fixed or variable remuneration and the absence of voting rights and the right to liquidation surplus. The Administration concludes in this Statement of Practice that once the analysis of an instrument is made leading to its qualification as debt, then the interest paid on the instrument is subject to the thin capitalisation rules commented on in the guidance.

The fact that a security does not have a predetermined duration does not, however, seem to disqualify it as a bond. For a decade now, most hybrid Tier 1 capital of banks has been issued in the form of undated subordinated bonds (*titres subordonnés à durée indeterminée* or TSDIs) whose features are close to those of CoCos.

TSDIs are subordinated instruments without a stated maturity and reimbursable upon the judicial liquidation of the issuer. Regulation N° 90-02 of the French Minister of Finance indicates that the following criteria need to be met for TSDIs to qualify as Hybrid Tier 1:

- they must have no scheduled maturity or a maturity date of at least 30 years;
- they may only be subject to repayment at the initiative of the issuer at the earliest after five years from the date of issuance and in any event subject to the authorisation of the French Banking Regulator (*Autorité de Contrôle Prudentielle* or ACP);
- the underwriting agreement must contemplate that the issuer has the option to defer interest payments (without any cumulative rights for the holder);
- the claim of the lender against the credit institution must be subordinated to the claims of other creditors; and
- the underwriting agreement or loan agreement must contemplate that the debt and unpaid interest must be able to absorb losses, the credit institution being in a position to continue its operations.

From an accounting standpoint,[4] TSDIs are classified as debt instruments and the French tax authorities also equate TDSIs with debt for tax purposes.[5]

The French Tax Authorities also had to comment on these questions in their guidance[6] on Islamic Finance and Sharia-compliant instruments. The Authorities indicated that such instruments should be treated in a manner similar to debts, to the extent that certain requirements are met. In particular, the Authorities indicated that Sukuks should be equated with debt instruments provided:

- The Sukuk holders have priority over shareholders whatever the nature of the equity stakes.
- The Sukuk holders do not have rights that are specific to shareholders, namely voting rights and rights to share liquidation surplus (unless the Sukuks have been converted into shares).
- The remuneration on the Sukuks is based on the performance of the collaterised assets but it must include an expected rate of return that must be capped at an admitted market rate (EURIBOR, LIBOR) increased by a margin consistent with market practice in relation to debt instruments. The remuneration could be zero in the case of an issuer in a loss-making position.
- The reimbursement of the Sukuks may be at below par value (in particular, because of the index-linking mentioned in the Sukuk agreement).

B. Features of BCCSs in the EBA's "Common Term Sheet"

The characteristics of BCCSs (CoCos) as set out in the last version of the EBA's "Common Term Sheet" do not seem to cast much doubt on the proposition that BCCSs should be treated in a way similar to TSDIs.

1. Maturity

BCCSs are perpetual and have no maturity date. French law does not require an instrument to have a

fix maturity for it to be recognised as a debt. On contrary, as mentioned before, the French tax authorities already equate instruments such as TSDIs with debt for tax purposes.

2. Coupons

BCCSs allow the issuer to suspend the payment of interest in certain pre-defined circumstances. CoCos' "Common Term Sheet" requires the setting of an interest rate that will in fact be capped to the issuer's result. The suggestion by the EBA in the proposed term sheet that the issuer potentially has full discretion regarding the payment of the coupon (without any deferral of unpaid interest) is an equity feature and could raise questions as to whether interest that the issuer can freely decide not to pay is still an expense (assuming such an instrument was effectively implemented and investors could be found to subscribe for it). However, as previously noted, the French tax Authorities have expressly accepted that Sharia-compliant instruments should be equated with debt instruments even if the remuneration on the instruments is linked to the performance of the underlying assets held by the issuer (to the extent that such contingent remuneration is capped) or even cancelled if the issuer finds itself in a loss-making situation.

3. Loss absorption requirement

Creditors generally do not participate in business risks and the loss absorption requirement could be regarded as an equity-linked feature. However, the French tax authorities' guidance relating to Sukuks also states that these instruments can be repaid at below par value and still be treated as debt.

By way of a general remark, except where the legal and accounting analysis would lead to a different conclusion, BCCSs and CoCos are likely to be treated in a manner similar to conventional convertible bonds (with the difference that conventional bonds do not convert automatically) and be considered as debt instruments from a tax standpoint, since they do not include the core characteristics of equity, i.e. voting rights, the right to receive dividends and the right to liquidation surplus.

However, as pointed out by the Basel Committee in its November 2011 release, contingent capital is still a "largely untested instrument that could come in many forms." Hence, legal classification as debt should be further confirmed once the CRD IV legislative proposal is enacted in French domestic legislation.

III. Tax treatment of the issuer

A. Interest deduction for issuer

1. Principles

Interest is normally fully deductible from taxable income.

French law does not currently provide for a general debt to equity ratio (although this may change, in view of discussions on convergence with other countries, like Germany, that do have such a rule). A limitation on the deductibility of financial expenses occurs mainly in situations involving debt taken out with (or secured by) related parties. However, French banks are outside the scope of the French thin capitalisation rules pursuant to Article 212 II 2 of the French Tax Code.

Accordingly, to the extent CoCos qualify as debt instruments, the deduction of interest accrued on CoCos should generally be allowed, subject to the same conditions as apply with respect to other debt instruments issued by banks.

2. Interest paid in a non-co-operative state or territory

With effect from January 1, 2011, interest paid to companies established in non-co-operative states or territories, as defined in Article 238-0 A of the French Tax Code, is not tax-deductible unless the taxpayer provides evidence of: (1) the reality of the operation in question; and (2) the fact that the main purpose of the operation is not to locate expenses in a non-co-operative state or territory.

The French government's list of non-co-operative jurisdictions was last updated in April 2012 and remains limited in scope. The list comprises: Brunei, Botswana, Guatemala, the Marshall Islands, Montserrat, Nauru, Niue and the Philippines. The list is updated annually by the French Ministry of Finance. Jurisdictions are included in the list of non-co-operative jurisdictions effective January 1 of the year following that in which they were designated as such.

Ruling 2010/11 of the French Tax Authorities, published on February 22, 2010, provides that, subject to certain conditions, three categories of listed debt instruments are deemed not to have as their main purpose and effect the location of income in a non-co-operative state or territory. This exemption applies to instruments meeting any of the following criteria:

- They are offered by means of a public offer within the meaning of Article L411-1 of the Monetary and Financial Code (*Code Monétaire et Financier)* or pursuant to an equivalent offer other than in a non-co-operative state or territory (an equivalent offer means any offer requiring the registration or submission of an offer document by or with a foreign securities market authority).
- They are admitted to trading on a French or foreign regulated market or on a multilateral securities trading system, provided such market or system is not located in a non-co-operative state or territory, and the operation of such market/system is carried out by a market operator or an investment services provider, or by another such similar foreign entity, provided the market operator, investment services provider or entity is not located in a non-co-operative state or territory.
- They are admitted, at the time of their issue, to the clearing operations of a central depositary or of a securities clearing and delivery and payments systems operator within the meaning of Article L561-2 of the Monetary and Financial Code, or of one or more similar foreign depositaries or operators, provided such depositary or operator is not located in a non-co-operative state or territory.

As CoCos are typically instruments listed on regulated markets, they should benefit from these exemptions and interest paid to subscribers located in a non-co-operative state or territory should in principle remain deductible, subject to the normal rules on *bona fide* loans.

B. Tax treatment on conversion

From an accounting standpoint, the conversion of bonds into equity results in a debit in the "bond" account and a credit in the "share capital" account and possibly a "share issuance premium" account.

If the nominal value of the bonds is higher than the value of the shares issued further to the conversion (which is likely), the difference will be booked in a "conversion of bonds into shares premium" account. Accordingly, the conversion should not lead to any adverse corporate income tax consequences for the issuer.

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As regards zero-coupon convertible bonds, the position of the administration is that the zero coupon, which is converted into capital, does not constitute an expense and cannot be deducted by the issuer. This position remains subject to discussion. In the case of CoCos, the treatment of accrued interest at the time of their conversion will have to be reviewed.

IV. Tax treatment of the holder

A. Interest payments to French holder

As long as CoCos are treated as debt instruments from a legal standpoint, a French holder of CoCos will be considered to receive interest income from the issuer that is subject to the standard corporate income tax rate on an accrual basis.[7]

Should part of the accrued interest due on the CoCos be cancelled because of insufficient profit of the issuer, the holder should not be taxable on such interest until the conditions defined in the agreement allow it to be concluded that such interest is due.

B. Payments to Foreign Country holder

As a general principle, with effect from March 1, 2010, no withholding tax is due in France on interest payments made abroad.

By way of exception, interest paid on a bank account held in a non-co-operative jurisdiction (see III.A.2., above) is subject to a 55 percent withholding tax, unless grandfathering rules apply (the withholding tax also applies if the interest is paid in cash or by check to a resident of a non-co-operative jurisdiction). The exemptions provided for by Ruling 2010/11 of the French Tax Authorities concerning listed securities (see also III.A.2., above) should, however, apply.

C. Tax treatment on conversion

Capital gains or losses realised on the conversion of bonds by French companies are deferred for tax purposes under Article 38-7 of the French Tax Code until the financial year during which the shares received as a result of the conversion are disposed of.

Such deferral (which is in principle favourable but may become an issue in the case of CoCos) is compulsory for French bonds, as defined by the law. It also potentially applies to bonds issued by non-French EU issuers,[8] but not to bonds issued by non-EU issuers.

The deferred loss (or gain) must be reported on the annual return. A five percent penalty may apply in the case of failure to declare deferred income.

The conversion of CoCos is likely to create a loss, the deduction of which will be deferred until the disposal of the shares. On subsequent transfer, the capital loss (or gain) will be calculated on the basis of the value of the bonds (acquisition price). The deferred loss is deductible at the time of disposal, unless the shares qualify as long-term investment portfolio shares and are held for at least two years (the two-year holding period being computed, to be exact, from the conversion date).[9] Any gain on such portfolio shares would be 90 percent exempt.

NOTES

[1] EBA "Recommendation on the creation and supervisory oversight of temporary capital buffers to restore market confidence" (EBA/REC/2011/1).

[2] French Tax Code (*Code Général des Impôts* or CGI), Art. 38 *quater* of Appendix III.

[3] Tax instruction 4 H-8-07 dated Dec. 31, 2007.

[4] Mémento comptable 2012 n°2130-4.

[5] In this context: tax instruction 4 C-3-95 n° 3 dated April 25, 1995, and administrative doctrine 4 C-2342 n° 3 dated Oct. 30, 1997.

[6] Tax instruction 4 FE/S2/10 dated July 23, 2010.

[7] Interest accrued on bonds over the year is included in taxable income and subject to tax at the rate of 33.1/3 %. A social contribution of 3.3% of corporate income tax (CGI, Art. 235 *ter* ZC) applies. This is added to the amount of corporate income tax, with an allowance of €763,000 for each 12-month period. However, entities that have a turnover before tax of less than €7,630,000 and whose share capital is fully paid-up and held continuously as to at least 75% by individuals (or by entities satisfying these conditions) are exempt from this contribution.
Moreover, a 5% corporate income tax surcharge is effective for fiscal years ending between Dec. 31, 2011, and Dec. 30, 2013. In practice, for calendar year companies (whose fiscal year ends on Dec. 31), the 5% surcharge would apply to both FY 2011 and FY 2012. It is applicable to large corporate taxpayers with an annual sales turnover of more than €250 million. The €250 million threshold is computed on a cumulated basis for French tax consolidated groups. The 5% surcharge is based on the amount of corporate income tax due at the standard rate (33.1/3%) or at reduced rates.

[8] *Réponse « de Roux » Assemblée Nationale*, Oct. 20, 2003 p. 8007 n°4267.

[9] Tax instruction 4 B-1-96 dated Jan. 31, 1996 and administrative doctrine 4 B-3121 dated June 7, 1999.

Host Country GERMANY

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I. Introduction

To date, contingent convertible securities seem not to have been used in the context of the German banking system. Although the Deutsche Bank has issued such securities, it apparently did so not in Germany but in London. According to information informally provided by the *Bundesanstalt für Finanzdiesnstleistungsaufsicht* (BaFin – the Federal Regulatory Agency for Financial Services), the use of such securities is being discussed at the European Union (EU) level, where an ordinance is being prepared that may enter into force as of January 1, 2013. At the same time, an amendment to the German Corporations Act (*Aktiengesetz* – AktG) is being discussed. Under the act currently in force, the holder of convertible bonds may request that the bonds be converted into shares,[1] but an automatic conversion dependent on the fulfilment of a condition or a conversion at the option of the issuer is not yet explicitly provided for. Notwithstanding this observation, mandatory convertible securities do exist in Germany and are considered to be legally admissible, although there is some discussion as to their admissibility under the constitution and the general law. Under German banking law, 50 percent of a bank's core capital may consist of hybrid instruments, which are converted into core capital in a financially difficult situation.[2]

The issuing of convertible bonds requires a three quarters majority of the votes of the corporation's general meeting.[3] This rule would also apply to contingent convertible securities.

The tax treatment of contingent convertible securities is not likely to differ from the tax treatment of traditional convertible bonds or mandatorily convertible securities. CoCos differ from traditional and mandatorily convertible bonds in that the conversion depends not on a declaration of the holder or an optional request of the issuer that the conversion be accepted, but rather on an uncertain event (a pending condition) that may or may not occur, namely the decrease of the bank's equity capital. In practical terms, the holder agrees to accept shares in the bank, when the condition eventuates. Like traditional convertible bonds, contingent convertible securities give the holder a claim on interest until the conversion, and the conditional right and duty to acquire shares.

II. Qualification of convertible bonds as debt instruments

A. Would the CoCos be treated as debt instruments in Germany for income tax purposes?

Although, economically speaking, convertible bonds are hybrid instruments, they are legally treated as debt instruments. Until the moment at which the condition for its conversion is fulfilled, a CoCo is a bond that bears interest. For the issuer, the debt value corresponds to the repayment amount.[4] If the issue price is lower (which will normally be the case) the difference between the issue price and the repayment amount must be shown on the asset side of the balance sheet as a conditional option right.

If the holder is a business, CoCos must be shown on the balance sheet as long term securities.[5]

B. Are there any changes to the conversion feature that might be made to insure the treatment of the CoCos as debt?

As long as the condition for the conversion has not been fulfilled, the securities qualify as debt instruments. Of course, after the conversion into shares, the remuneration paid by the issuer is a dividend.

III. Income tax treatment of the German issuer

A. Would the interest on the CoCos be deductible in Germany?

The interest paid to the holders of CoCos is a deductible business expense, unless it is excessive. Under the interest barrier rule,[6] excessive interest is not deductible.

On the balance sheet of the issuer, the CoCos must be shown as debt items.[7] The conditional capital increase, which is necessary in connection with the issuance of the CoCos[8] and which must be decided upon by a majority of at least three quarters of the votes of the general meeting,[9] must be mentioned in the notes to the annual report.[10]

In the event that the issuer's regulatory capital dips below the prescribed level and the conversion is made,

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