HMRC - CFM97515 - Groups: Banking Companies And Banking Groups

CFM97515 Interest restriction: Banking and insurance groups: Banking companies and banking groups

TIOPA10/S450

The core business of a bank is to make loans funded by deposits and shortterm borrowing. This business model can be expected to give rise to net interest income for UK banking groups.

However, there may be little commercial difference to a bank between interest income and other fees charged in connection with the making of loans. For example, a bank may offer a product for a higher rate of interest, or for a oneoff arrangement fee and a lower rate of interest. In the context of banking, there is an argument that this sort of fee is equivalent to interest income given that it is a direct return on the lending.

Banks do not only deal in debt but also deal in the full range of financial instruments and do not see a particular distinction between lending of money and dealing in other types of financial instrument. In each case they will often look to minimise market risks in the products leaving a return. This is especially true for investment banking where interest is only one component of overall profit.

Nonetheless, this dealing in a wide range of financial instruments may still be supported by significant borrowing. In the light of this there is a risk that the main definition of tax-interest would introduce distortions into the UK banking market as it would provide a tax advantage for holding certain types of financial instrument over others and creates an uneven playing field between banks with a significant UK retail and lending operation and those without. Therefore, for a banking company there is a wider definition of tax-interest and group-interest for the fixed ratio method and group ratio method. This reflects the broader range of financial instruments in which they deal as part of their trading activity.

Modification of tax-interest

Under s450, tax-interest for a banking company will not be restricted to amounts brought into account in respect of loan relationships and some derivative contracts but is a more inclusive concept which will include all amounts brought into account from its dealing in financial instruments.

For this treatment to apply the dealing in financial instruments (which should be understood to include the origination and holding of financial instruments) must be part of the trade of the banking company and the amounts brought into account must be directly linked to that dealing. This treatment will apply to all profits and losses from the instrument, including amounts of interest, dividends and fees arising from the instrument. In circumstances where a bank has an offsetting position in derivatives and also ownership of the underlying commodity, then HMRC accepts that profits and losses from the underlying commodities can also be included.

Example

A bank may provide a mortgage to a customer and charge both interest and an arrangement fee for that product. Both these amounts should be recognised as tax-interest and brought into account because they arise directly from the transaction. On the other hand, general operating expenses of the company such as staff costs and pure advisory fee income are not sufficiently closely related to the dealing in financial instruments to fall within s450.

‘Dealing in’

To be included within s450 the banking company must be ‘dealing in’ the financial instruments. The reference here to ‘dealing in’ would include the orginination and termination of financial instruments. So for example, a banking trade consisting of writing derivative contracts would be included in s450.

‘Financial instruments’

The reference to dealing in ‘financial instruments’ includes loan relationships, derivative contracts, shares and other securities. In circumstances where a bank has a position in derivatives and also ownership of the underlying commodity offsetting that position, then profits and losses from the underlying commodities are also included in tax-interest.

Impairment losses

In line with the general definition of tax-interest, there is an exclusion for impairment losses (s450(2)) but not for credit or debt valuation adjustments. However, other exclusions contained in the general interest definition (e.g. relating to exchange gains or losses, derivative contracts entered into to hedge certain risks) do not apply.

Banking company

For these purposes a banking company is defined by CTA10/S269B.