

[UK government actively encouraging offshoring of all financial services](#)

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Summary

Plans announced in the UK Pre-Budget Report ("PBR") provide encouragement to offshore financial services not provided to UK clients. The "super-levy" follows earlier discouragements to financial services firms: taxation of non-UK domiciled individuals, increases in income tax rates generally etc.

There is a risk that this proposal will, when considered with the other recent tax changes, provide a tipping point that causes banks to restructure operations so as to take them outside UK taxation.

Analysis

Alistair Darling, UK Chancellor of the Exchequer (Finance Minister), has today announced a one-off levy on discretionary bonuses paid in the banking sector. The levy will affect all bonuses over £25,000 paid between today and April 2010. The levy will be 50% on the excess of each individual bonus over £25,000 but the tax will be levied on the bank(s), not individuals. Individuals will continue to be liable to income tax on the bonus actually received. There is a clear encouragement to place non-UK business totally outside the scope of UK accounts and Revenue scrutiny, so as to minimise the exposure of UK-based personnel whose work on non-UK business may give rise to some or all of their bonus being subject to the Darling levy. Banks looking to mitigate this exposure might as well undertake a more fundamental review in order to shelter their business from other arbitrary taxes that may be levied in future.

Why has Darling done this?

Ostensibly, it is because he is concerned that, whilst still being dependent on UK taxpayer support, banks are planning to distribute large bonuses. This gives Darling two problems. The first is that Royal Bank of Scotland ("RBS"), which is 70%+ owned by the UK government now, wants to pay about £1.5 billion in bonuses. The UK government has already vetoed this. However, that simply makes RBS' top talent easy targets for cherry picking by less constrained banks. In particular Barclays has no UK government shareholding, is expanding aggressively in certain areas post-Lehman acquisition, and may quite like some of RBS' talent. Politically, Darling cannot sanction large bonuses to RBS staff to retain them. Therefore, he has to make it deeply unattractive to other banks, over which he has no direct control, to pay discretionary amounts to staff.

The second problem for Darling is that there has to be an election in the UK by end-May 2010. Stories of big bonuses to bankers, even as unemployment continues to rise, will make Labour's already hopeless-looking position even worse. Conversely, a bit of populism might just save a few Labour MPs' jobs in six months' time as well as strengthening Darling personally in a future Labour leadership election.

How will the banks react?

The first thing to keep in mind here is that this measure covers a wide range of institutions, ranging from pure UK retail banking through to the London-based operations of large international investment banks. Clearly the latter will be more affected than the former.

This makes generalising on bank reactions somewhat difficult. However, there are a number of possible reactions. The first is that banks accept this is a one-off, accept it, do not pay bonuses, and simply move on. As noted above, the levy sets a level playing field, at least within the UK, making it unlikely that some institutions will poach from others based simply on a willingness to pay bonuses. It makes it easier for non-UK based institutions to poach talent in UK-based organisations, of course. However, even if banks do decide to accept the levy, I think they will still have some quiet (non-contractual) words with key staff to make clear that they will add the bonus they would have been paid for 2009 to 2010's award. By making this non-contractual, the banks avoid having formally to provide for it in this year's financials, and hence avoid the levy. The only cost to the employee is the cash flow deferral, which is far less than the 50% levy would be.

What if, however, banks see this as just one more attack on them, and a further discouragement to basing operations in the UK? What is to prevent them restructuring operations such that bonus provisions can be booked outside the UK and avoided? What if banks perceive this as being part of a wider attack on their activities and take pre-emptive steps to avoid any further attack? We have already seen quite significant loss of Hedge Fund activity in the UK, with firms either relocating fully or partly to Switzerland. This has arisen due to a combination of UK tax changes plus the impact of proposed EU regulation. It is easy to foresee banks taking similar steps to protect not just their right to pay bonuses, but also to route non-UK income to more business-friendly and tax-attractive jurisdictions.

We already have evidence of this happening in other industries as a result of changes to UK corporate taxation on non-UK generated income. Many companies in industries ranging from engineering to marketing have relocated their ultimate holding company to Ireland, which has a tax regime specifically geared to attract headquarters' functions. Will banks now do the same? Well why not? Ireland has low corporate tax rates, no withholding taxes, and a desire to attract headquarters functions. Significant tax benefits can be gained without the need to redeploy large scale operations.

Alternatively, the banks may seek to adjust employee contracts in order to avoid the levy. This could range from splitting employment across a number of group companies so as not to pay over £25,000 per person from any one legal entity, through to ceasing to employ key talent at all, but rather contract with them on a service provider (effectively self-employed) basis. The latter is a structure often used in creative sectors, such as entertainers, footballers etc. The banks can then negotiate success fees rather than bonuses. The result in the pocket of the recipient is very similar!

It is not clear how the Treasury intends to monitor and charge the levy, and so it is hard to say how the banks are most likely to try and avoid it. The simplest way for the Treasury to make the levy is to look at banks' consolidated bonus pools. However, these will include bonuses payable to non-UK resident individuals for work done in non-UK companies. It is hard to see a basis on which to charge UK tax on these. However, if the Treasury looks at bonuses paid by every legal entity in a group separately, then it is easy to avoid by splitting bonuses as noted above.

My view

My view is that certain banks will now undertake a structural review, and will consider moving their HQ out of the UK. This is because of the combined impact of tax changes over the last 2-3 years. Also, there is no longer the business-friendly consensus across the political spectrum that we have seen over almost 20 years in the UK. Add to that the UK's somewhat strained relationship with the EU, in particular the growing influence of nationalist parties such as BNP and UKIP, and the UK no longer appears to be quite the "no brainer" choice for a pan-European business to locate itself.

Despite its problems, Ireland appears to be a much more attractive locale in which to locate. Businesses taxes are lower, it encourages the immigration of talented individuals, corporate tax encourages new economy-type industries, it has a large pool of suitably experienced professional services personnel (accountants, lawyers etc). Crucially, language and law are the same as the UK. Furthermore, it has greater currency stability as a Eurozone member (though with a poor fiscal position right now).