Avoiding the trap

Large Corporate OMB

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Mandipa Soni provides practical guidance on avoiding common pitfalls when dealing with debt restructuring

Key Points

What is the issue?

When undertaking a corporate transaction, debt restructuring can be a complex area with many pitfalls.

What does it mean to me?

Given the impact financing matters can have on a corporate tax profile, getting it wrong can be costly.

What can I take away?

Anyone advising on the restructuring of corporate debt should understand the full history of how the debt arose, and give thought to tax issues that might arise outside the loan relationship rules including distributions, withholding taxes, anti-hybrids and the impact on the corporate interest restriction, among other considerations.

For most tax advisers, when undertaking a corporate transaction, debt restructuring can be a complex area with many pitfalls. Really understanding the transaction and its constituent parts is key, and typically will involve terminology such as debt elimination, refinancing or buy-ins, novations and distressed debt, all of which come with their own tax implications. Given the impact financing matters can have on a corporate tax profile, getting it wrong can be costly.

More often than not, the decision to restructure debt is driven by the commercial reality facing the company or group. Some of the reasons for reorganising debt include:

- To facilitate repatriation of cash through the structure and to shareholders;
- Obtain better terms of lending from third party lenders (which will depend on the level of debt in a group);
- Improve or restore liquidity (e.g. where a company is in financial distress); or
- Enhance the value/credit worthiness of group debtor companies.

As a result, tax advisers play an important role when undertaking any kind of debt restructuring highlighting important tax issues for both the lender (creditor) and the borrower (debtor).

The loan relationships legislation in CTA 2009 provides a framework for the taxation of UK corporate debt. The default position is that companies are required to bring debits and credits into account for corporation tax purposes that are recognised in the P&L. However, there are many exceptions to this basic rule, and this article seeks to uncover some of the key issues in dealing with debt on a group reorganisation, and addresses some of the author’s views on best practice.

What is a loan relationship?

Before we start, a quick refresher on the key term – ‘loan relationship’.

Per s302 CTA 2009, a loan relationship is a money debt, which arises from a transaction for the lending (or borrowing) of money.

As defined in s303(1) CTA 2009, a money debt is any debt that falls, or has fallen, to be settled by the:

- Payment of money;

- Transfer of a right to settlement under a debt which is itself a money debt; or
- Issue or transfer of shares in a company.

The definition of a money debt also includes a transaction that has at any time been a debt that at the option of either party falls to be settled in any of the above ways.

The basic definition of a loan relationship is extended in s303(3), to include money debts arising where an instrument is issued representing security for the debt, or the rights of a creditor in respect of the debt.

The question as to what constitutes a 'debt' for these purposes, presents the first challenge here. Ultimately, this becomes a question of the legal substance of the transaction, i.e. the existence of a legal obligation to transfer cash, goods or services to another party. If the creditor has no legal right to the consideration, there can be no debt.

Debt restructuring options

The following sections consider some of the options available in relation to debt reorganisation, and the issues that might arise.

Formal release of debt

A formal release is a method of eliminating debt in a structure. A release of debt would typically result in a P&L debit and credit for the creditor and debtor companies, respectively. In the absence of specific tax legislation to the contrary, for UK tax purposes, it can be expected that credits arising from a formal release would be taxable, and debits tax-deductible.

However, the legislation provides for a different tax treatment, such that any credit would be non-taxable, and any debit non-deductible, providing certain conditions are met and the creditor and debtor companies are 'connected' under the loan relationship provisions. Companies are connected for these purposes if one company controls the other, or both are under the common control of a third company. Control is defined in s472 CTA 2009 and requires the power of a person to secure that the affairs of a company are conducted in accordance with his wishes.

There can be complications when seeking to apply the loan relationship provisions to the release of connected company debt.

The debt in question must fall within the loan relationship provisions. That is, it must have arisen through a transaction for the lending of money. The definition of a loan relationship is extended in s479 CTA 2009 to include 'relevant non-lending relationships' which are deemed to be loan relationships for tax purposes. However, the scope of the debits and credits to be brought into account under these rules is restricted to specific items such as impairment losses and foreign exchange.

A potential solution may be available under the extended definition of a loan relationship under s303(3), which allows a money debt (that has not arisen from the lending of money) to be deemed a loan relationship by the issue of a debt instrument, such as a company security or promissory note. Whilst any legal document can be an 'instrument', it is necessary to ensure that the purpose test is satisfied, i.e. that the instrument is issued for the purpose of representing:

a) Security for the debt; or
b) The rights of a creditor in respect of the debt.

Furthermore, the word 'issued' is not defined, but requires a unilateral act by the issuer. That is, it is unlikely to apply to a bilateral agreement entered into jointly by both parties.

Care must be taken where a promissory note has been issued in respect of a debt which includes accrued interest. Whilst the release of interest does not, in itself, constitute a payment of interest for UK withholding tax purposes, there is a risk that the issue of a security under s303(3) over accrued interest could give rise to a withholding tax obligation under the funding bond rules. Per s413(2) CTA 2009, the issue of a funding bond creates a payment of interest equal to the market value of the security that requires the issuer to tender to HMRC, bonds to the basic rate of tax on the deemed interest in discharge of the withholding tax liability (s939(2) ITA 2007). Although, if the interest is subsequently released by the creditor, there is an argument that the funding bonds become worthless.

In addition to withholding taxes, there may be other tax costs associated with the release of debt in an international group. For example, a cross-border release could result in a tax mismatch where the release debit is tax-deductible in one country, and the release credit non-taxable in another. The UK's anti-hybrids legislation seeks to obtain tax symmetry in situations of tax mismatch, and may result in the release credit being taxable in the UK. Clearly, it has become critical to understand the tax treatment in all territories in order to determine the UK tax position, and access to comprehensive international tax advice is necessary when advising in this area.

In addition to tax, there are also non-tax issues to consider. The tax analysis relies on the accounting treatment, and therefore clarity is required as to how the debt, and any release debits and credits may be accounted for. Furthermore, the legal considerations are critical and it will be important to ensure these are understood early in the process, ensuring Company law and legal agreements are not breached. Specific matters may include drafting documentation and modelling distributable reserves positions, which can head off potential dividend blocks in the structure that may prevent the commercial purpose of the transaction succeeding.

One common Company law matter where advice may need to be obtained is where one is releasing debt where the money has been lent by a subsidiary to a parent company, or between two sister companies, as the release may be considered an unlawful distribution under Company Law if the lender has insufficient distributable reserves at the point the balance is released (*Aveling Barford v Perion Ltd* [1989]).

Debt buy-ins

Care must be taken when a restructuring or refinancing involves impaired debt (i.e. one that is unlikely to be paid or recovered in full), as provisions exist which can result in a taxable profit where the relevant loan asset is impaired. In these cases, it is important to understand the detailed history of a particular balance, including how it arose, and how it has been measured.

Broadly, the general principle in s358 CTA 2009 that prevents a release credit being taxable for a connected company relationship can be overridden in one of the following cases:

i) A connected creditor company acquires an 'impaired debt' to which the debtor is party (s361 CTA 2009); or
ii) Two unconnected creditor and debtor companies which are party to an impaired debt, become connected (s362 CTA 2009).

In either of the above situations, the tax treatment is such that there is deemed to be a release of the impaired portion of the debt, giving rise to a taxable credit in the debtor company (effectively overriding s358 CTA 2009).

A taxable credit might also arise on the release of ‘relevant rights’. These are broadly rights that would have been taxable as a ‘deemed release’ (absent exclusions) prior to the introduction of F(No.2)A 2015, which introduced two new corporate rescue exceptions to enable companies in financial difficulty to be refinanced without a tax charge arising on impaired debt. There isn’t enough space on the page to also go into detail on the nuances for financial distress situations in detail (and the topic is deserving of an article in its own right), but broadly, these reliefs ensure that where the debt buy-in has been undertaken as part of a genuine corporate rescue, s358 CTA 2009 should still apply and prevent release credits being brought into account to tax.

Debt for equity

An alternative method for eliminating debt, would be to release debt in consideration for ordinary shares of the creditor company.

In this case, the general rule where debt is swapped for equity in an unconnected debtor, is that the debtor is not required to bring a release credit into account where the debtor company is using an amortised cost basis of accounting for a liability, and the conditions of s322(4) CTA 2009 are met:

> *‘…the release is:*
> *a) In consideration of shares forming part of the ordinary share capital of the debtor company; or*
> *b) In consideration of any entitlement to such shares.’*

Ordinary share capital is defined for these purposes in s1119 CTA 2010, as ‘all the company’s share capital (however described), other than the capital the holders of which have a right to a dividend at a fixed rate but have no other right to share in the company’s profits’.

However, it is worth noting that in their manuals (CFM33202), HMRC draw attention to the potential misuse of the exemption within s322(4) – ‘Whether or not a debt has been released ‘*in consideration for shares’ will depend on whether on a realistic view of the transaction, s322(4) CTA 2009, construed purposively, can be said to apply to it.*’ HMRC also acknowledge, however, that ‘*In the majority of cases, there will be no doubt that a debt/equity swap that forms part of a commercial debt restructuring, undertaken at arm’s length transaction, will fall within the exemption in CTA09/S322(4).*’

Whilst there are situations where the s322 CTA 2009 provisions might not apply (for example, where an amortised cost basis is not adopted), it is possible that the release credit falls outside of the scope to tax. An example might be where the creditor company agrees to subscribe for additional shares in the debtor company, and uses the subscription proceeds to repay the original debt. In this case, the cash need not transfer hands. This relies on the outcomes from the *Re Harmony and Montague Tin and Copper Mining Co Ltd (Spargo)* [1873] case which established the principle that a debt obligation owing from one company to another could be offset by the second company’s obligation to pay an equal amount to the first. Care, of course, should be taken to ensure the obligations have equal value.

Transfers of loan relationships between group companies

It may be the case that the debt may be transferred, by novation or otherwise, to other companies in the same group.

In the UK, the Group Continuity rules seek to ensure that tax neutral treatment applies where a transferee company replaces the transferor as a party to a loan relationship. In order to apply these rules, both companies must be within the charge to UK corporation tax and within the same capital gains group (s340 CTA 2009).

The impact of the Group Continuity provisions is that one company directly (or indirectly) replaces the other as a party to a loan relationship and as such, any debits or credits arising from the transfer are ignored. However other debits and credits (such as interest) are treated normally, and arise to the transferor or transferee company according to their periods of ownership.

However, if the transferee company leaves the group within six years of the transfer while still party to the loan relationship, a degrouping charge would arise to bring into account the taxable profits held-over at the time of the transfer of the loan relationship (s344–346 CTA 2009).

In effecting an intragroup transfer of debt, consideration should be given to any relevant legalities. For example, the novation of a liability can only be undertaken with the consent of all parties involved, and therefore, typically requires a tripartite agreement (or similar).

Final thoughts

My key tips and practical considerations for anyone advising on the restructuring of corporate debt would be:

- Understand the full history of how the debt arose – has the debt been previously impaired, or arisen from a previous intra-group transaction?
- Whilst tax is important, the best solution is obtained by being involved in the whole project and adopting a holistic approach, giving consideration to the accounting and legal implications as well. It is worthwhile having a step plan to ensure that you track the impact on reserves and identify the specific order in which steps should be undertaken.
- Use your international network – in today’s tax world, a complete answer will not be obtained by considering the UK in isolation. For all cross-border situations, ensure that you understand the tax treatment for any overseas territories.
- Give thought to tax issues that might arise outside the loan relationship rules including distributions, withholding taxes, anti-hybrids and the impact on the corporate interest restriction.