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April 2020

Legal Update

Restructuring transactions in response to the COVID-19 crisis – Key UK tax considerations

The COVID-19 crisis is likely to impair the ability of certain UK borrower companies to make payments under their debt obligations. In response, borrower groups and their lenders may agree to restructure those obligations, perhaps by means of interest deferral or cancellation, a swapping of debt for equity in the borrower group or the borrower group's entry into new, potentially more subordinated debt. As part of this type of debt restructuring, a borrower group may also undertake an internal reorganisation of its assets and liabilities, possibly in conjunction with a sale of particular business operations to an external purchaser. This Legal Update explains some key UK tax considerations that apply in this area. It is based on an article that the authors have recently contributed to the *Tax Journal* magazine, which can be accessed at https://www.taxjournal.com/articles/how-to-handle-the-taxation-of-restructuring-transactions.

DEBT RESTRUCTURINGS

Debt releases

The release of interest or principal under debt obligations is generally a taxable event for a UK corporate borrower. The UK corporate borrower may have sufficient losses to reduce or extinguish any resultant UK corporation tax charge. However, that would generally prevent the use of those losses against other taxable profits of the borrower group. Thankfully, therefore, distressed UK borrowers will often be able to shelter releases of debt from UK corporation tax under the UK's corporate rescue exemption. The exemption applies if it can be reasonably assumed that, but for the release and surrounding arrangements, there would be a material risk of the borrower being unable to pay its debts within the next 12 months (CTA 2009 s322(5B)). Unable to pay its debts for these purposes can include both an insufficiency of cash to pay those debts and a state of balance sheet insolvency (CTA 2009 s323(A1)). Consequently, the exemption does not require the borrower to be in an insolvency procedure such as an administration or even, necessarily, on the verge of that procedure.

However, as HM Revenue & Customs in the UK ("**HMRC**") make clear in their published guidance, the exemption will not be available for mere liability management exercises. The borrower in question must be in "significant financial distress" with a "real prospect" (absent the restructuring) of going into insolvency within the next 12 months (HMRC's Corporate Finance Manual ("**CFM**") 33192 and 33194).

Consequently, if reliance is placed on this exemption, relevant directors should carefully consider and document why they consider the exemption's requirements are satisfied. Depending upon the context, reliance might also be placed on other exemptions. For example, if lenders agree to release some of their debt in return for ordinary share capital in the borrower under a debt for equity swap, that release would generally be eligible for a bespoke exemption from UK corporation tax in CTA 2009 s322(4) even if the corporate rescue exemption were not available. Separate exemptions will also usually be available for UK corporate borrowers whose debt is released as part of a scheme of arrangement, a company voluntary arrangement, an administration or a liquidation (CTA 2009 s322).

Debt modifications

The modification of the terms of existing debt (for example, a reduction in or postponement of interest payments) can also result in a UK corporation tax charge for a UK corporate borrower. This will generally depend upon whether the UK borrower realises an accounting profit in these circumstances since, under the UK's loan relationship rules, that accounting profit would usually translate into a taxable profit.

The accounting treatment in this area can be complicated and will usually require accounting input. Nevertheless, some basic points can be noted.

Under both FRS 102 and IFRS 9, it is understood that "substantial" modifications of debt can result in an accounting profit or loss for a UK borrower (FRS 102.11.36-38 and IFRS 9.3.3), which, ordinarily, the UK borrower would be required to bring into account under the above loan relationship rules.

FRS 102 provides no real guidance as to the meaning of substantial in this context. In contrast, it is understood that, under IFRS 9, a modification will be substantial for these purposes if, broadly speaking, the discounted present value of the cash flows under the amended debt is different by at least 10 per cent when compared with the discounted present value of the remaining cash flows under the original debt (discounted in both cases by applying the original effective interest rate) (IFRS 9.B3.3.6).

It is also understood that in certain circumstances under FRS 102 and IFRS 9 *non-substantial* modifications of debt can result in the above accounting and, therefore, tax consequences for a UK borrower (see, for example, IFRS 9.B5.4.6).

However, for tax purposes, a UK borrower will not be required to bring an accounting profit into account as a result of the substantial modification of its debt if the corporate rescue exemption in CTA 2009 s323A applies. This exemption entails the same requirements as the previously mentioned corporate rescue exemption that applies to releases of debt, albeit with the focus on whether the modification (and surrounding arrangements) satisfies those requirements.

Interest deductibility

A borrower may enter into new debt under a debt restructuring and will generally want to obtain as much tax relief for interest it pays under the new debt as possible. It will also want to preserve as much of the tax relief to which it was previously entitled under its existing debt. However, interest deductibility for UK corporate borrowers is now one of the more complicated areas of UK tax law with numerous obstacles to its availability.

For example, a UK borrower group that has "aggregate net tax-interest expense" of more than £2 million per annum may be restricted in the tax relief it can claim for that expense under the UK's corporate interest restriction rules in TIOPA 2010 Part 10. Generally speaking, the rules restrict tax relief in this way to a proportion of the group's "aggregate tax-EBITDA", which, subject to certain caps and exemptions, will be 30 per cent of that EBITDA under the fixed ratio rule or such higher percentage as is permitted under the elective group ratio rule.

The impact of the corporate interest restriction rules for a restructured group may be complicated, depending, for example, upon potentially hard-to-predict fluctuations in the group's aggregate tax-EBITDA from one year to the next. However, two points about the rules can usefully be made in this context.

First, a debt for equity swap might cause a previously unconnected lender to become a "related party" of a UK borrower under the UK's corporate interest restriction rules, in which case, interest on any debt of the lender that remains after the swap will be excluded from the borrower group's "qualifying net group interest-expense" or "QNGIE" under the group ratio rule. This is potentially problematic since the lower a group's QNGIE, the lower the interest deductibility it can generally claim under that group ratio rule (TIOPA 2010 ss398-400). Admittedly, under an important exception, this treatment will not apply if the release of debt that causes the related party status (i.e. as a result of being in consideration for shares) is eligible for the corporate rescue exemption previously described (TIOPA 2010 s469). Nevertheless, that exception will not always be available.

Second, restructured groups can and should be pro-active in maximising interest deductibility under interest restriction rules such as the above UK rules and comparable overseas regimes. For example, under a debt restructuring, a UK borrower may have over borrowed in the UK as a proportion of the group's "aggregate tax-EBITDA" and be unable, as a result, to obtain tax relief for all its interest expense in the UK.

In contrast, an overseas subgroup may have sufficient headroom under the interest restriction rules that apply to it to obtain tax deductions for interest which are denied in the UK. In turn, a solution might be to novate debt from the UK into that sub-group so that it can make use of those tax deductions.

Change of control

As suggested above, a debt for equity swap might cause a lender to become a "related party" of the borrower under the UK's corporate interest restriction rules. It or other arrangements under which lenders acquire shares in the borrower group may also cause the group to undergo a change of control.

This type of change in the ownership structure of a UK borrower group can have numerous UK tax implications, including potential de-grouping charges and restrictions in interest deductibility under transfer pricing and anti hybrid rules.

Crucially, however, equitisations of debt may result in a "change in the ownership" of relevant companies under CTA 2010 Part 14 Chapter 7, in which case, those companies may forfeit valuable tax losses in certain circumstances, including where:

- they undergo a major change in the nature or conduct of their trade or business within the period of 3 years before the change in ownership and 5 years after it (CTA 2010 Part 14 Chapters 2, 2A and 3); or
- their share and loan capital increases by at least £1 million and 25 per cent. in the five years that follow the change in ownership (CTA 2010 Part 14 Chapter 3).

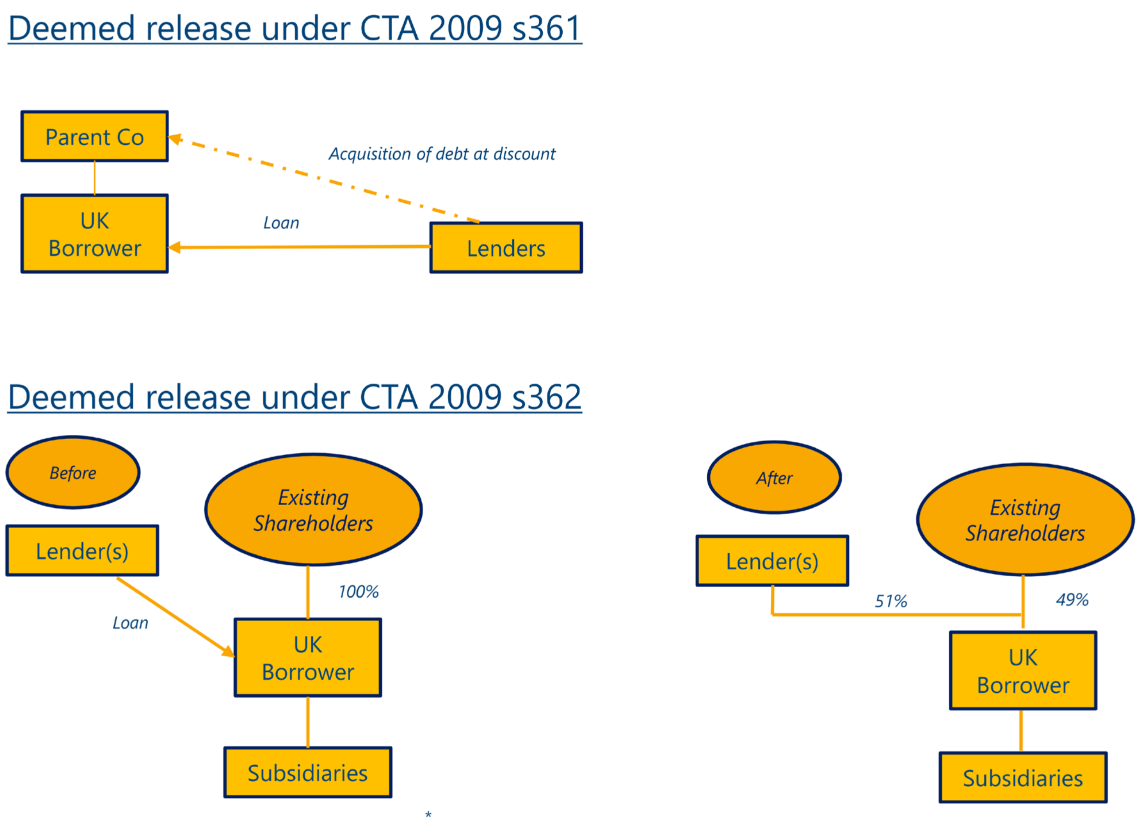
In this regard, the purpose of a restructuring will usually be to nurse the affected group back to financial health. In turn, it may be assumed that the group will be able to make use of carried-forward losses to shelter future expected profits from tax, so the potential for group companies to forfeit those losses as a result of, say, a debt for equity swap is worth noting. It is also worth noting that since 2017 there are structural limitations to a group's ability to carry forward and utilise losses in this way. In particular, above an annual £5 million allowance that they will usually share amongst themselves, UK group members will only generally be able to set off carried forward losses in this way up to a "relevant maximum", which, broadly speaking, will equate to 50 per cent of their taxable profit above that allowance.

Deemed release

An additional point is that a change in ownership or control of a UK borrower in favour of lenders may cause a deemed taxable release of the borrower's debt under CTA 2009 s362 and a potentially substantial taxable profit for it. It is sometimes thought that a deemed taxable release of a borrower's debt can only arise under CTA 2009 s362 if a lender or connected lenders obtain "control" of the borrower so as to become "connected" with it for relevant tax purposes. In contrast, HMRC consider that this deemed release can also arise where unconnected lenders that do not individually control the borrower nevertheless obtain collective control over it and agree to act together in particular ways (CFM 35120). In all such cases, however, the borrower should not be subject to UK corporation tax as a result of the deemed release provided, broadly speaking, that the conditions of the previously discussed corporate rescue exemption are satisfied and the debt in question is actually released within 60 days of its deemed release (CTA 2009 s362A).

A deemed taxable release will also generally arise for a UK corporate borrower if a company connected with it such as its parent company buys in the borrower's debt at a discount (CTA 2009 s361). However, again, the UK corporate borrower will generally be eligible for the corporate rescue exemption from any resultant UK corporation tax charge if the conditions of the exemption are satisfied and the debt is actually released within 60 days of the deemed release (CTA 2009 s361D). The borrower will be eligible for another exemption from that tax charge if the company buying in the debt issues ordinary share capital to the lenders as consideration for the acquisition or arranges for companies connected with it to issue ordinary share capital as that consideration (CTA 2009 s361C). Both possibilities of this deemed taxable release of a UK borrower's debt (i.e. under CTA 2009 ss 361 and 362, respectively) are illustrated in Figure 1 below.

Figure 1: Deemed release



INTRA-GROUP RESTRUCTURINGS

As part of, or in connection with, a debt restructuring, a UK group may undertake an internal reorganisation of its assets and liabilities, perhaps to facilitate a sale of particular operations to an external purchaser.

If intragroup debt is released as part of that reorganisation, the release will generally have no UK tax consequences for either lender or borrower (CTA 2009 s358). UK tax rules will also generally allow the intra-group transfer of assets and liabilities within the UK to be undertaken on a tax neutral basis.

However, for this tax neutral treatment to apply, the transferor and transferee must form part of the same group under the applicable tax regime – which may not be the case as regards chargeable gains groups, for example, if a relevant group company has entered into non "normal commercial loans" with its creditors (TCGA 1992 s170(8)). In addition, despite the initial tax neutrality, there may be de-grouping charges or a clawback of reliefs previously claimed if the group relationship relied upon is subsequently broken within a certain period of time.

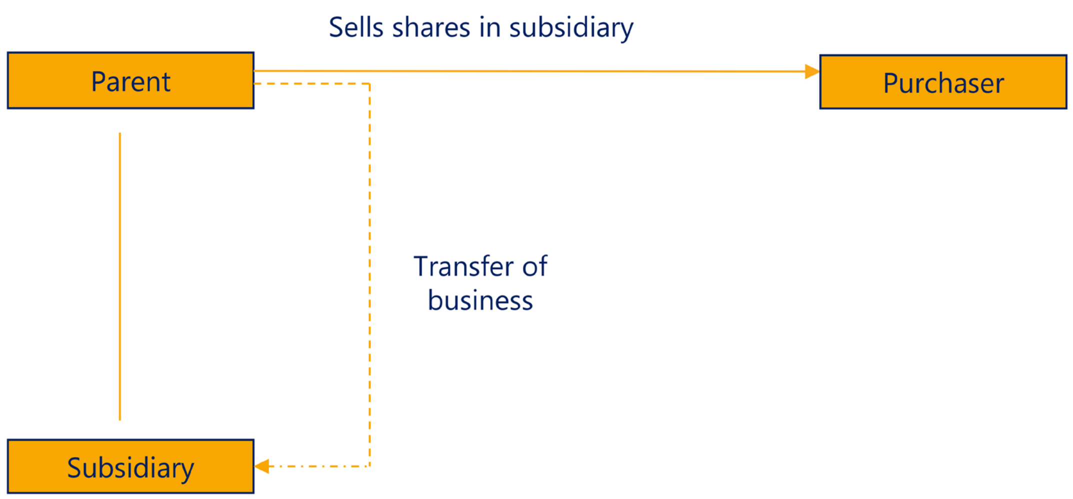
As an illustration of this, assets can generally be transferred between members of a chargeable gains group on a "no gain no loss" basis (TCGA 1992 s171), but a de-grouping charge (calculated on the assumption that the relevant assets were disposed of and immediately reacquired for market value immediately after acquisition of the asset) may be triggered where the transferee ceases to be a member of the relevant group within six years of the date of transfer (TCGA 1992 s 179). Likewise, the intra-group transfer of intangible fixed assets within the intangibles regime is treated as tax neutral (CTA 2009 s775) but a de-grouping charge may be triggered if the transferee ceases to be a member of the relevant group within six years of the date of transfer (CTA 2009 s780).

Hive downs

These de-grouping charges generally arise in the transferee entity, but it is possible to elect for the charge to be treated as realised in another group company (TCGA 1992 s171A and CTA 2009 s792), which can be advantageous if another group company has losses available to shelter the de-grouping gain. Moreover, if the de-grouping of a relevant company results from the sale of its shares, then, in certain cases, any de-grouping gain under the chargeable gains regime will be treated as forming part of the consideration for the sale of the target company that accrues to the vendor company – including, ordinarily, where the vendor company is a UK tax resident company (TCGA 1992 s179(3D)). This exception can be helpful in the type of hive down structure that is illustrated in Figure 2 below. In particular, it will often be possible for a UK group to hive down trading assets into a new subsidiary and sell it free of UK corporation tax (including de-grouping charges under the chargeable gains regime) under the substantial shareholding exemption from chargeable gains in TCGA 1992 Sch 7AC (see also para 15A of that Schedule and CTA 2009 s782A in this particular regard).

It may also be possible for corporation tax losses to be hived down into a new subsidiary along with the relevant trade (CTA 2010 Part 22). However, anti-avoidance rules will often restrict this where the transferor has liabilities in excess of its assets after the transfer (CTA 2010 s945). In addition, the subsequent sale of the subsidiary's shares to an external purchaser will constitute a "change in [its] ownership" under CTA 2010 Part 14 Chapter 7. Consequently, the subsidiary may be prevented from retaining those losses under the type of restriction that is described under "Change of control" above.

Figure 2: hive down structure



Other taxes

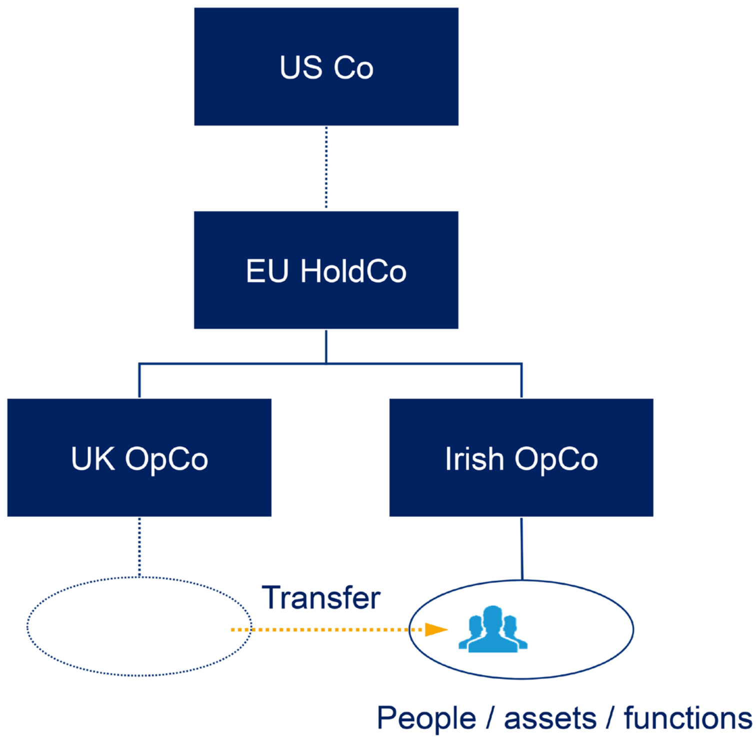
Of further relevance to an intragroup reorganisation, group companies will generally be permitted to transfer shares and property to each other free of UK stamp duty and stamp duty land tax ("SDLT") (FA 1930 s42 for stamp duty; FA 2003 Sch 7 para 1 for SDLT). However, the SDLT regime has a clawback mechanism if the transferee leaves the group within three years of the date of transfer (FA 2003 Sch 7 para 3). In contrast, the stamp duty regime does not impose this clawback, but does have a forward looking test assessed at the time of the relevant transfer (stamp duty group relief will not apply if arrangements are in existence by virtue of which a person could obtain control of the transferee but not the transferor – FA 1930 s42(2)).

It is also worth noting that intra-group transfers of assets and liabilities will be outside the scope of VAT where either (i) the transferor and transferee are members of a VAT group (VATA s43) or (ii) the transfer qualifies as a transfer of a going concern and certain conditions are met (Value Added Tax (Special Provisions) Order 1995, article 5).

DAC 6

A final topical point relating to intra-group restructurings is that an intragroup reorganisation of assets and liabilities may trigger reporting obligations under the new DAC 6 tax reporting regime regardless of its commercial rationale; for example, if it otherwise concerns the UK or an EU Member State and a third country and entails (under the DAC 6 E(3) hallmark): ' *… the intragroup cross-border transfer of functions and/or risks and/or assets, if the projected annual earnings before interest and taxes (EBIT), during the three-year period after the transfer, of the transferor or transferors, are less than 50% of the projected annual EBIT of such transferor or transferors if the transfer had not been made …*' (see also Figure 3).

Figure 3: potential application of DAC 6 E(3) hallmark



INSOLVENCY

The previous paragraphs have considered so-called consensual, out-of-court restructurings. It is nevertheless possible that the restructuring will fail and the affected company or group be placed in administration or liquidation. Pending that, the company might also undertake other forms of business rescue, including a scheme of arrangement or, potentially, under recent government proposals relating to the COVID-19 virus, a "restructuring plan" and related debt moratorium. The detail of these recent proposals is yet to be elaborated (and it remains unclear whether companies/groups that are already insolvent will be eligible for the moratorium), but we understand they are designed to give companies a breathing space from creditors while seeking a restructuring or rescue, protect access to essential supplies to facilitate continued trading during the moratorium period, and provide a new form of restructuring plan which will bind classes of creditors who vote against it. It is not clear whether these new proposals will carry any entitlement to tax exemptions or other special tax treatment.

Generally, however, the precise tax implications of rescue and insolvency procedures for a UK borrower group and its lenders will depend upon the type of procedure, the group's tax profile and related considerations. Where otherwise feasible, therefore, such implications should be considered in advance of that rescue or procedure. One overarching point to note in this context is that HMRC will usually rank as an unsecured creditor in respect of the affected company's UK tax debts that arise prior to an administration or liquidation. In contrast, UK taxes that the company incurs after entering that procedure will usually constitute expenses of the procedure, in which case they will rank above both floating charge holders and unsecured creditors in the relevant distribution waterfalls.

This distinction is important and can even invite the suggestion of triggering tax liabilities of an affected company (e.g. on the sale of valuable asset) before the relevant procedure begins. However, there are some crucial points to note in this area, as follows.

First, in certain circumstances, other group companies, which may themselves be solvent and outside an insolvency procedure, can be assessed for taxes that are primarily incurred by a company that is subject to such a procedure. As an illustration of this, if a UK company disposed of real estate, realising a large taxable gain, the "principal company" of its group could be assessed for the resultant tax charge if the company failed to pay it (TCGA 1992 s 190).

Second, a tax liability owed by a UK company may be set off against an amount that HMRC owes to it with the effect that the UK company effectively funds some or all of the liability. For example, provided the amounts in question represent "pre-insolvency" credits and debits, HMRC will generally have the power under FA 2008 s 130 to set off, say, a UK corporation tax liability of an insolvent company against a repayment of VAT to which the company is otherwise entitled.

Finally, whilst the general position as regards pre-insolvency tax debts is as set out above, the government has proposed legislation in this year's Finance Bill under which, for relevant insolvency procedures that begin on or after 1st December 2020, HMRC would become a secondary preferential creditor in respect of a company's pre-insolvency PAYE income tax, VAT, employee NIC and construction industry scheme deductions. The government has also proposed other legislation in that Finance Bill under which directors and others could be made jointly and severally liable for the pre-insolvency tax debts of their company in certain cases of insolvency-related tax abuse (e.g. phoenixism).

SUMMARY

As the preceding paragraphs have hopefully demonstrated, restructuring transactions can generate numerous tax issues in the UK (and, where relevant, in overseas jurisdictions). The key, as always, is to obtain tax advice at an early stage of the proceedings (whether the restructuring is expected to relate to solvent or insolvent companies) and to implement that advice carefully thereafter.

If you have any questions about the issues raised in this legal update, please get in touch with your usual Mayer Brown contact or:

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