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Clients&FriendsMemo

Debt buy-backs - UK taxation Change as of 14 October 2009

2 November 2009

On 14 October 2009, the UK government announced a major change to the UK tax legislation covering the buy-back of debts. This change is effective from 14 October 2009, and could therefore affect transactions which are currently being arranged or undertaken. A full ministerial statement was issued by the Financial Secretary to the Treasury on 14 October 2009, which has now been amplified by further guidance published on 21 October 2009 regarding the intended legislative changes.

Old position: Legislation on debt buy-backs before 14 October 2009

Before 14 October 2009, where a company was party as a debtor to an impaired third party loan, and the corresponding creditor company transferred the loan to a company within the debtor's group for consideration which was less than the face value of the loan, an immediate tax charge could arise.

This corporation tax charge on a debtor company, introduced in Finance Act 2005 ("**FA 2005**"), arises where a company acquires a debt from an unconnected creditor and immediately after that acquisition the creditor is 'connected' with the debtor company (whether such connection arises by virtue of acquiring shares at the same time as the debt, or whether the debtor and creditor were previously connected in a corporation tax group) and the pre-acquisition carrying value of the debt (being the original amount of the liability in the accounts of the debtor due less any release by the unconnected creditor) exceeds the consideration which the connected creditor has paid for the debt. In such circumstances, there is a deemed release of the debt in the amount of the excess, so that the difference between the face value of, and the amount actually paid for, the debt is treated as released and therefore constitutes a credit taxable on the debtor (see Corporation Tax Act 2009 ("**CTA 2009**") s.361). The legislation does not impose a tax charge on the debtor company if the loan is transferred between group companies or if the exception described below applies. This rule has now been subject to the changes announced on 14 October 2009.

The original reasoning behind the introduction of the legislation in FA 2005 was that in certain circumstances the general rule relating to connected party debt (that the release of debt between connected persons does not result in the debtor company bringing into account a

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taxable credit) could have lead to a permanent tax asymmetry. In circumstances where a third party creditor had assigned an impaired debt representing a loan relationship to a connected creditor company, a release of the loan by the transferee connected creditor would, absent specific provisions, not have resulted in a tax charge on the connected debtor company. By contrast, any debtor company repurchasing a loan at a discount to par value would have realised an accounting profit on which it would be taxed. To address this tax asymmetry, the legislation introduced in FA 2005 ensured that any release of the impaired loan relationship is deemed to take place when the impaired loan is acquired by a transferee connected creditor (CTA 2009, s.361). Additional legislation applies where a creditor company becomes connected with the debtor company (CTA 2009, s.362), but these provisions are not subject to any amendment in the 14 October 2009 announcement.

Example: Hayward Ltd, Sussex Bank plc and Grinstead Group plc (Old rules prior to Government announcement on 14 October 2009)

Hayward Ltd owes £500,000 to Sussex Bank plc, an unconnected third party bank. Hayward Ltd is a distressed credit risk, and accordingly Sussex Bank has treated the loan as badly impaired, writing it down in its books to only £350,000 on 31 January 2009. Grinstead Group plc, the parent company of Hayward Ltd, decides in February 2009 to restructure Hayward Ltd's debts and offers to purchase the loan for £300,000 from Sussex Bank. The directors of Sussex Bank agree to the sale on 31 March 2009. Accordingly, the loan is sold later that day and Sussex Bank claims a further impairment loss of £50,000. Under the provisions of CTA 2009, s.361(3), Grinstead Group plc is deemed to have released the loan on 31 March 2009. The amount which Grinstead Group plc is treated as releasing is £200,000, but no relief is allowed in respect of that deemed release in Grinstead Group plc's loan relationships computation owing to Grinstead Group plc's connection with Hayward Ltd. Under CTA 2009, s.361(3), Hayward Ltd is required to recognise a credit in respect of £200,000 in respect of the deemed release. Relief is therefore only given once in respect of the impairment of the loan.

The exception from the CTA 2009, s.361 charge and application to restructuring transactions

There is an exception to the deemed charge in CTA 2009, s.361 described above (and illustrated by the Example) where:

(1) the impaired debt was acquired at arm's length (CTA 2009, s.361(2)(a));

(2) there was no connection between the creditor company and the person from whom it acquired the debt for the accounting period in which the creditor company acquired the debt (CTA 2009, s.361(2)(b)); and

(3) there was also no connection between the creditor company and the debtor company at any time in the three-year period beginning four years before the date on which the debt was acquired and ending twelve months before that date (also CTA 2009, s.361(2)(b)).

This exception was intended to provide relief for corporate rescue situations. The provisions of CTA 2009, ss.361 and 362 are particularly relevant to transactions involving the restructuring and reorganisation of loan relationships. In such transactions, impaired debt may be transferred to a company which is connected to the borrower of the debt. One example of this would be where a number of lenders are paid out some part of the creditor loan relationship owed to them, such payment being made under a restructuring agreement in consideration of the transfer of the remaining balance of the outstanding creditor loan relationship to a company within the borrower's group. The drafting of CTA 2009, s.361(2)(b), provides an exemption from the corporation tax charge in CTA 2009, s.361, thereby allowing some corporate borrowers suffering financial difficulties to restructure their loan portfolio without that corporation tax charge arising. The restructuring was not infrequently achieved through establishing a new company within the debtor company's group specifically for the purposes of acquiring the impaired debt.

New rule for debt buy-backs, effective from and including 14 October 2009

In the market existing in late 2009, many banks and other businesses have issued debt which is trading at a discount to the amount borrowed. A number of banks and businesses have considered buying debt back from market investors, and some, according to the UK government, have allegedly "taken advantage" of the rules to avoid taxation on the profit made when the debt is cancelled for less than the amount borrowed.

As noted above, the arrangement which has frequently been discussed and used to circumvent the tax charge under CTA 2009, s.361 involves establishing a new company to buy the impaired debt. The UK government now apparently views this arrangement as abusive in the context of the arrangement being used by otherwise healthy groups to buy back debt at a discount without paying UK corporation tax on the debt buy-back in accordance with the provisions of CTA 2009, s.361.

On 14 October 2009, the Financial Secretary to the Treasury announced an anti-avoidance provision to be introduced in Finance Bill 2010 in circumstances where corporate taxpayers have allegedly taken advantage of the legislation in CTA 2009, s.361(2)(b) to avoid taxation on the profit realised when debt is cancelled for less than the amount borrowed. The Government's concerns appear to be that the rationale for the exemption of the CTA 2009, s.361 tax charge under the circumstances of CTA 2009, s.361(2)(b) was to 'help genuine company rescues'; and that exemption now appears to have been used outside of that particular context, raising concerns within the Government. Accordingly, the Government has stated its intention to change the exemption condition in CTA 2009, s.361(2)(b) to require that:

- there must have been a 'change of ownership' of the debtor in the period 12 months before the debt purchase;
- the debt purchase must have been 'intrinsic' to the change of ownership; and
- before the change of ownership the debtor must have been suffering 'severe financial problems'.

This proposed change, which is stated in the announcement by the Financial Secretary to the Treasury to be effective from 14 October 2009, may adversely impact on any transaction that involves debt being bought back by a UK borrower group.

Importantly, even if the amended conditions of the exception are satisfied, thus providing relief from any immediate taxation at the time of the buy back on the discount in the borrower, any subsequent waiver of the debt by the new creditor will crystallise a tax charge on the previously untaxed discount.

Clarification by HMRC Guidance: 21 October 2009

On 21 October 2009, HMRC published on their website in more detail how the terms 'change in ownership', 'intrinsic' and 'severe financial problems' would be defined.

(a) 'Change of ownership' will take its meaning from ICTA 1988, s.769, which, broadly, entails:

(1) a single person acquiring more than half the ordinary share capital of the debtor company;

(2) two or more persons each acquiring more than 5 per cent. of ordinary share capital of the debtor company with the result that they hold more than half of the ordinary share capital of the debtor company as a result; and

(3) two or more persons each acquire a share of the ordinary share capital of the debtor company with the result that they hold more than half the ordinary share capital (disregarding shareholders with less than a 5 per cent. holding).

The comparison can be made over a three year period and holdings of persons connected (within the meaning of ICTA 1988, s.839) are treated as holdings of the same person for these purposes. (Change of ownership of mutuals such as building societies, will occur where the Building Societies Act 1986, ss.93, 94 or 97 apply.)

(b) A debt purchase will be 'intrinsic' to the change in ownership where 'it is reasonable to assume that the debt purchase would not have taken place but for that change of ownership, and arises from that change in ownership'.

(c) The debtor company will have been suffering 'severe financial difficulties' where 'without the change in ownership, it would be reasonable to assume that the company would have become insolvent'.

Even where the new exemption applies, if the connected creditor company subsequently releases the debt which has been bought-back, the connected debtor company will have to recognise a taxable loan relationship credit equal to the amount of the discount (and the creditor company will recognise an equivalent loan relationship allowable debit). This represents a departure from the usual rule that debits and credits in respect of releases of loan relationships between connected companies are generally left out of account.

Exemption from the new change in the debt buy-back rule

There will be an exemption from the new rule where new debt is issued in consideration of the release of the existing debt and there is no economic profit in the transaction. It is unclear how 'economic profit' will be measured.

Additionally, HMRC say that they are considering excluding arrangements from the ambit of the new rule where the consideration for the debt buy-back is an issue of shares in the new creditor company and the arrangement would have otherwise fallen within the exemption for debt to equity swaps (at CTA 2009, s.322) had the shares been issued by the debtor company.

Transitional rules

Transitional rules are expected to have effect so that new rules will not apply where:

(1) the offer (by way of direct approach to the creditors) to acquire the debt was made on or before 14 October 2009; and

(2) a discount arises in future upon a cancellation of debt by a new creditor where the buy-back was completed on or prior to 14 October 2009 (or is covered by the grandfathering provisions).

Example: Hayward Ltd, Sussex Bank plc and Grinstead Group plc (Proposed rules following the Government announcement of 14 October 2009)

To return to the Example given above, where Hayward Ltd owes £500,000 to Sussex Bank plc, an unconnected third party bank. Hayward Ltd is a distressed credit risk, and accordingly Sussex Bank has treated the loan as badly impaired, writing it down in its books to only £350,000 on 31 January 2009. Grinstead Group plc, the parent company of Hayward Ltd, decides in September 2009 to restructure Hayward Ltd's debts and incorporates a new subsidiary, Forest Row

Ltd, which offers to purchase the loan for £300,000 from Sussex Bank. The directors of Sussex Bank agree to the sale on 14 October 2009, the loan is sold later that day and Sussex Bank claims a further impairment loss of £50,000.

CTA 2009, s.361(3) does not deem Forest Row Ltd to have released the loan on 14 October 2009 as the debt was bought back in an arm's length transaction and Forest Row Ltd was not connected to Hayward Ltd in the three year period beginning four years before the date of the buy-back. Hayward Ltd does not, therefore, recognise any taxable credit in respect of the discount. Equally, any future release of the debt by Forest Row Ltd does not result in a credit being recognised by Hayward Ltd as the general rule, under CTA 2009, s.358 (that no credits are to be recognised as a result of releases of connected party debt) applies.

However, if the offer by Forest Row Ltd had been made on 15 October 2009 (and, say, accepted on that date), it is anticipated that (under the proposed rules following the Government announcement of 14 October 2009) Hayward Ltd would have to recognise a credit equal to the discount on the debt buy-back.

Assuming that no such release has taken place, Grinstead Group plc later sells Hayward Ltd to Bluebell Group plc for £1 on 1 November 2009. Hayward Ltd would otherwise have been put into insolvent liquidation. Bluebell Group plc incorporates another subsidiary, Lewes Ltd, to buy-back a £500,000 loan owed by Hayward Ltd to Brighton Bank for £400,000. Under the new rule, Hayward Ltd would not have to recognise a credit in respect of the discount of £100,000. However, if Lewes Ltd later released the debt, an amount equal to the discount of £100,000 would become taxable as a loan relationship credit of Hayward Ltd.

Conclusion

The proposed change may impact significantly on any transaction that involves debt being bought back by a UK borrower group.

Even if the amended conditions of the exemption in CTA 2009, s.361(2)(b) are satisfied, thus providing relief from any immediate taxation on the discount in the borrower, any subsequent waiver of the debt will crystallise a tax charge on the previously untaxed discount.

Whilst the details of the proposed legislation will not be clear until Finance Bill 2010 is presented to Parliament next Spring, it appears at this stage that other restructuring techniques (e.g. debt for equity swaps) should not be affected.

If you have any questions about the foregoing, please contact any of the following attorneys:

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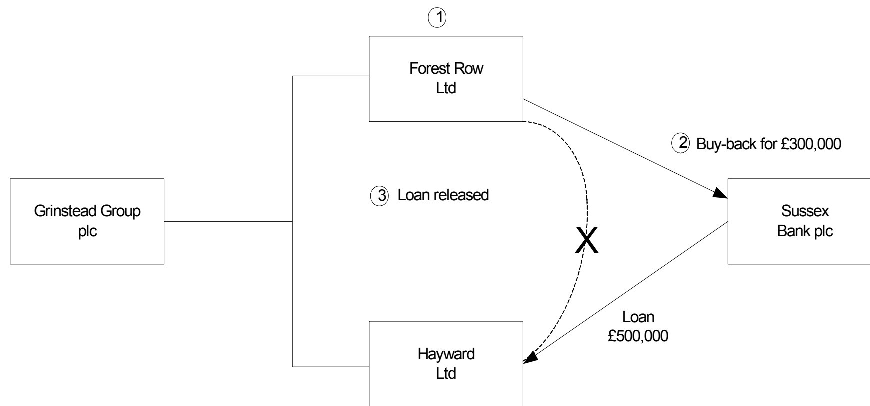
Pre - 14 October 2009

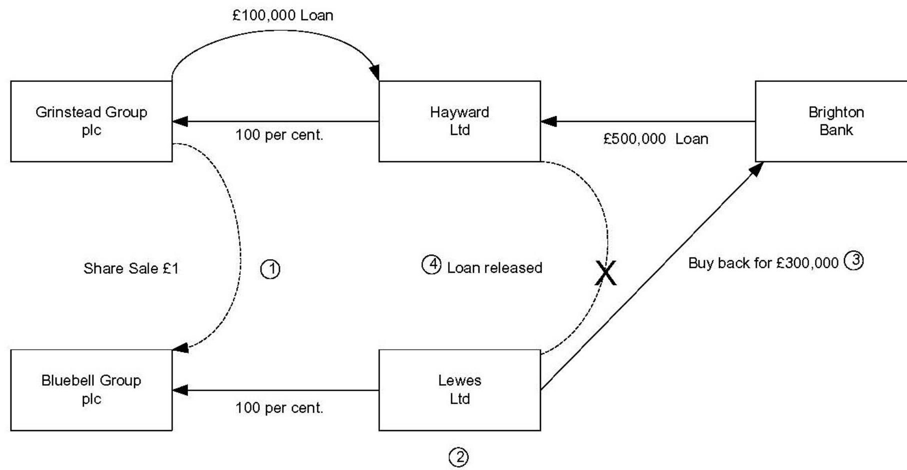


1. Forest Row Ltd is incorporated.
2. Existing loan of £500,000 is bought back for £300,000 in an arm's length sale. No credit is recognised by Hayward Ltd. Impairment loss of £200,000 recognised by Sussex Bank as loan relationship debit.
3. Loan is released. No credit is recognised by Hayward Ltd. No debit is recognised by Forest Row Ltd.

Post - 14 October 2009 (same example as above)

2. Existing loan of £500,000 is bought back for £300,000 in an arm's length sale. A loan relationship credit is recognised by Hayward Ltd in the sum of the discount (£250,000).

Post - 14 October 2009



1. Shares in Hayward Ltd are sold by Grinstead Group plc to Bluebell Group plc for £1. Hayward Ltd would otherwise have become insolvent.
2. Bluebell Group plc incorporates Lewes Ltd.
3. Lewes Ltd buys the loan to Hayward Ltd from Brighton Bank for £300,000.
4. If Lewes Ltd releases the £500,000 loan, Hayward Ltd would have to recognise loan relationship of £200,000 and Lewes Ltd would recognise a loan relationship debit of £200,000.

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