CLIFFORD CHANCE

Briefing note 11 December 2014

New tax rules for restructuring and amending UK corporate debt

In this year's Autumn Statement, the Government announced new tax rules for restructuring and amending UK corporate debt. This is likely to have wide implications for debt restructurings, as well as distressed amendments and refinancings (such as "amend and extends"). We look at the new rules, and ask what practical impact they will have on lenders and borrowers.

Key issues

- New exemption for releases of debt where there would otherwise be a material risk a borrower would be unable to pay its debts within 12 months
- Existing exemptions for releases of debt are unaffected
- New risk that amending/refinancing distressed debt gives rise to an accounting profit. The only defence to this will be the new exemption.

The position today

Restructurings and releases

Where a UK corporate borrower's debt is released or capitalised the resulting accounting credit is subject to tax at 20%. And, because the credit will generally reflect the principal released, the resultant tax can be very significant indeed.

On the face of it, that would adversely affect many debt restructurings, with any attempt to release debt and preserve a company's solvency triggering a tax bill that the company might well not have the resources to pay.

Limited reliefs exist, including a debt-for-equity exception. In practice most lenders and borrowers have been able to carefully structure transactions to fall within the existing reliefs. This is, however, not straightforward and often requires an HMRC clearance (which introduces delay and uncertainty). It has, in addition, become more difficult to use the debt-for-equity exemption in recent years following the release of some unhelpful HMRC guidance.

There are, in addition, rules that deem debt to be released if it is acquired by a connected company; these rules need to be navigated with care when using standard LMA intercreditor provisions to transfer debt as part of a wider restructuring.

We therefore view the existing rules as a potentially significant impediment to UK debt restructurings.

Amendments/refinancings

The amendment or refinancing of a UK borrower's debt will in most cases not give rise to any accounting credits, even if the new financing has a material benefit for the borrower.

This means that the large number of "amend and extend" amendments the market has seen in recent years have mostly been achieved without the need for complex tax advice and structuring.

Unfortunately that is about to change.

Under the new accounting standards (IFRS9/FRS102) a "substantial modification" of the terms of debt (by amendment or refinancing) can give rise to an accounting credit representing the difference between the carrying value of the "old debt" and the fair value of the "new debt".

Typically the credit/profit will represent the relaxation of the conditions of the debt and the deterioration in the creditworthiness of the debtor.

As tax follows the accounts, this credit would also give rise to a tax charge. There is at present no exemption, and so as things stand this could be a serious problem for many amendments and refinancing of distressed borrowers.

The new accounting rules apply for all accounting periods starting on or after 1 January 2015.

The new exemptions

We and others have been involved in lengthy discussions with HMRC and the Treasury around creating a new and more flexible exemption, to cover both debt releases and amendments/ refinancings.

These discussions have led to draft legislation containing a new exemption for "corporate rescues", published on 10 December 2014 as part of the draft Finance Bill consultation.

In summary, the new exemption will apply:

- to releases of a borrower's debt which take effect on or after 1 January 2015; or
- to credits that arise on amendments/refinancings on or after 1 January 2015, (which may arise as a result of the new accounting treatment); and in either case,
- only where immediately before the release (or amendment/refinancing) it is reasonable to assume that, without the release (and other related arrangements), there would be a material risk that at sometime within the next 12 months the company would be unable to pay its debts.

The existing debt-for-equity exemption will stay on the statute book as a parallel exemption.

The good news

The new exemptions are welcome. They will provide additional flexibility in how restructurings are structured, particularly where lenders do not wish to hold equity.

It will also, importantly, enable distressed borrowers and their lenders to amend/modify debt without triggering potentially ruinous tax consequences.

The bad news

The new exemptions are less flexible than we would have hoped.

The 12 month window will be restrictive in some cases, but note that this is tested at the time of actual release, not when the debt restructuring commences.

The stated reason for the strict time limit is that HM Treasury and HMRC do not want the new exemptions to be used for what they describe as "liability management" exercises. In other words, if a solvent company buys-back its own debt that's currently trading at a discount then HMRC expect the profit (the discount) to be taxed.

Directors of borrowers may be concerned about potential legal and commercial consequences if they conclude the exemption applies, i.e. because they would be saying there is a material risk the company cannot repay its debts within 12 months. HMRC's intention is that this test is different from the wrongful trading "no reasonable prospect test" – so in their view directors could properly continue to trade at a point when they intend to rely on the new exemption.

Generally speaking, restructurings are designed to avert any formal insolvency, so as long as it is reasonable for the directors to assume that the restructuring would achieve this purpose and they take all necessary steps to protect the interests of the creditors, the risk of liability for wrongful trading should be relatively low. It should however be noted that if the company subsequently does become insolvent, then the fact that the company has relied upon this exemption, may make it easier (from an evidential perspective) for the liquidator to bring a claim, albeit the directors may still be able to rely upon the defence that in pursuing the restructuring they were doing everything they could to minimise exposures to creditors by facilitating a continuation of the business.

We therefore regard the requirement there is a material risk of being unable to pay debts within 12 months as unduly limiting. It would be preferable to have a generous definition of financial distress, and safeguard the taxman's position with an anti-avoidance rule.

We expect HMRC will publish draft guidance illustrating the cases where they will accept the exemption is available. We understand HMRC does not anticipate providing individual clearances for the new exemption.

We'd also note that it is slightly disappointing that the new exemption only applies to actual releases of debt, and not deemed releases where a connected party acquires debt (even though whether there is an actual release or a deemed release is in many cases a result of how a restructuring is sequenced, and doesn't reflect a different economic result).

What this means in practice

For all distressed amendments/ refinancings of UK companies from 1 January 2015 it will be important to confirm either that no accounting credit arises, or that the new exemption is available.

Distressed UK companies will have to carefully plan the restructuring if they want to take advantage of this new exemption, especially where they are considering a release of debt which is more than 12 months out from its maturity date.

For all releases of debt from 1 January 2015, the position will be in principle the same as it is today, save that the new exemption will be available as an alternative to the existing debt-for-equity exemption. In practice we anticipate many lenders and borrowers may chose to rely on both in the alternative.

In other words, qualifying for the new exemption is likely to be a "nice to have" for restructurings/releases, but a "must have" for amendments.

Finally, note that the clauses are draft only and there will now be short a consultation period before the law is enacted in Finance Act 2015, so there could be further changes.

Further information

If you would like further details on any aspect of the proposed new rules, please speak to your usual Clifford Chance contact or any of those listed overleaf.

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