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UK Tax Alert

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Proposed New UK Tax Rules for Debt Restructuring

1. Executive Summary

The U.K. corporate tax landscape has been undergoing reform for a number of years. A significant part of the changes involves the ongoing modernization of the U.K.'s complex tax regime for corporate debt, a project that has included proposals to provide new tax exemptions for consensual debt restructurings. The changes have not been limited to legislation, since the U.K. tax treatment of loans has been materially impacted by recent developments in U.K. generally accepted accounting practices (GAAP).

This article aims to highlight the following concepts in the context of the restructuring of debt.

First, where the debt obligations of a U.K. corporate borrower are released or otherwise forgiven, any resulting income or gain that the borrower is required to recognize in its accounts will generally be treated for U.K. tax purposes as taxable income.

Second, for accounting periods starting on or after January 1, 2015, a far greater number of U.K. companies will be required to recognize accounting (and therefore potentially taxable) income when their distressed financial liabilities are amended or refinanced.

Third, the risk of U.K. taxation in these situations may be counterbalanced by new "corporate rescue" exemptions, which were introduced in draft legislation published as part of Finance Bill 2015 and are intended to remove the requirement for a borrower to bring into account taxable income where a debt is released, or the terms of a debt are substantially modified (or replaced), in situations where the borrower is in significant financial distress.

2. Background

The U.K. taxation of corporate debt generally follows the accounting treatment. Credits (and debits) that are recognized in the accounts of the debtor and creditor are therefore usually brought into account as taxable income (or tax deductible expenses).

However, accounting principles do not always produce an appropriate tax result, and so this basic rule of tax following the accounts is subject to a number of statutory overrides that adjust the accounting entries for the purposes of computing a company's taxable profit or loss. In the context of a debt workout, statutory tax exemptions play a key role in relieving a financially distressed corporate borrower from tax charges on its accounting profits that may arise as a result of the alleviation of its debt burden.

Debt releases

If a creditor releases a debtor company from an obligation to repay some or all of a loan, the liabilities on the debtor company's balance sheet are reduced, and a corresponding credit (income) is recognized in the debtor company's profit and loss account. That accounting credit will generally be brought into account by the borrower as taxable income, unless an exemption or relief applies.

However, in certain prescribed circumstances, a borrower will be exempt from U.K. tax on the income or profit that may appear in its accounts as a result of a release. Those circumstances include where:

- the debt is released as part of a statutory arrangement (such as a scheme of arrangement under the Companies Act 2006)
- the debtor company meets one of a number of specified insolvency conditions (e.g., where the debtor is in insolvent liquidation, administration or receivership)
- the debt is released in consideration for an issue of ordinary shares in the debtor (a debt for equity swap).

The policy intention behind these tax exemptions is to ensure that U.K. companies in financial difficulties do not incur additional exposure to tax as a result of efforts to reduce their debt obligations. The exemptions are, however, limited. In situations where a borrower is in financial distress but not yet in formal insolvency proceedings, efforts to restructure its debt and preserve the business as a going concern can give rise to material tax uncertainties, in particular, where the lenders do not necessarily want to receive shares in the borrower.

Tax losses are not always available to offset taxable release income, in part due to the U.K.'s rules and limitations on the utilization of losses by a company or within a group.

Debt modifications

Of course, not all financial restructurings of a company or group will necessarily involve a reduction in principal amounts owed under a loan. Prior to (and often in an attempt to avoid) the event of a debt release, a lender and borrower may agree to modify the terms of the existing debt through an "amend and extend" arrangement or a refinancing.

Under previous U.K. GAAP, a modification to the terms of the debt, or a replacement of the debt, of a borrower would not normally result in the borrower recognizing profits or losses for accounting purposes, even where the modification materially benefited the borrower.

This position has now changed. For accounting periods commencing on or after January 1, 2015, U.K. companies will not be permitted to prepare their accounts in accordance with "old" U.K. GAAP. Instead, entities that applied old U.K. GAAP[1] must transition to an alternative accounting standard. It is expected that many U.K. companies will transition to Financial Reporting Standard (FRS) 102.

[1] Prior to the comprehensive introduction of FRS 102, U.K. companies were permitted to prepare their accounts using either old U.K. GAAP or the International Financial Reporting Standards (IFRS), although, for accounting periods commencing January 1, 2005 onwards, publicly traded entities (among others) have been required to

Under that accounting standard, where the terms of a financial liability of a company are substantially modified, the company must account for the modification as the cancellation of the original financial liability (i.e., the original liability is derecognized in the borrower's accounts) and the recognition of a new financial liability. The new financial liability is initially recognized in the accounts at its fair value. Where the carrying value of the original liability exceeds the fair value of the new liability, the difference is recorded as profit in the borrower company's accounts. In the case of a modification of distressed debt, this will typically result in accounting profit being realized by the debtor company, reflecting a relaxation of the terms of the debt (e.g., a change in interest rate, an extension of the maturity date, a softening of covenants) and/or a deterioration in the borrower company's creditworthiness.

To take a basic example, assume that a U.K. company is the borrower under a loan of 100. The liability is recorded in its accounts at 100. The company agrees with its lender to amend the terms of the loan, such as extending the repayment date and making certain other changes. The principal amount due under the loan remains at 100 (i.e., there is no release of any part of the debt). The changes to the debt amount to a "substantial modification" for accounting purposes, and so the company derecognizes the 100 liability under the "old" loan in its accounts and recognizes a "new" loan at its fair value. As a result of the changes made to the loan and the current creditworthiness of the company, the fair value of the "new" loan is only 80. The company therefore recognizes a credit of 20 in its profit and loss account in the accounting period in which the changes to the debt take place. The company would then subsequently recognize total accounting debits of 20 from that period to maturity of the loan as the debt is written up to its face value of 100 in its accounts.

On basic U.K. tax principles, the accounting credit of 20 would be taxable in full in the period in which it arises. The accounting debits of 20 should be relievable for tax purposes over the remaining life of the loan; however, there will be a tax mismatch, since those debits may not be carried back to offset the one-off taxable credit of 20 at the outset.

3. The Corporate Rescue Exemptions

In 2013, HM Treasury announced wide-ranging proposals on the modernization of the U.K. tax treatment of corporate debt and derivatives. Those proposals included suggestions for changing how the U.K. tax legislation should address the restructurings of the debt of companies that are in financial distress.

Following a lengthy consultation period, draft legislation was published as part of the U.K.'s Finance Bill 2015, which, if enacted, would provide for new taxation exemptions in respect of releases, modifications or replacements of debt that take place as part of a genuine corporate rescue. The purpose of these exemptions is to promote early remedial action and facilitate the restructuring of debts of companies that are in danger of, but are not yet in, insolvency..

prepare their accounts using IFRS. As such, the introduction of FRS 102 will be mainly relevant for entities that have made the relatively recent transition to FRS 102 from old U.K. GAAP.

When would the exemptions apply?

As drafted, the proposed tax exemptions would apply in the following circumstances:

- **Release of debt**: A borrower would not be required to recognize taxable income in respect of a debt release if, immediately before the debt is released, it is reasonable to assume that, without the release and any arrangements of which the release forms part, there would be a material risk that, at some time within the next 12 months, the borrower would be unable to pay its debts.
- **Modification or replacement of debt**: A borrower would not be required to recognize taxable income in respect of a modification or replacement of an existing debt if, immediately before the modification or replacement, it is reasonable to assume that, without the modification or replacement and any arrangements of which the modification or replacement forms part, there would be a material risk that, at some time within the next 12 months, the borrower would be unable to pay its debts.

The new tax exemptions are intended to apply to debt releases or modifications/replacements taking place on or after January 1, 2015. They would be in addition to, and not instead of, the existing exemptions from recognizing taxable release income (e.g., during formal insolvency processes or schemes of arrangement, or on debt-for-equity swaps).

There are some aspects of the exemptions that are worth noting.

Unable to pay its debts

The term “unable to pay its debts” is based on U.K. insolvency law concepts and means that the company is unable to pay its debts as they fall due or that the value of the company’s assets is less than the amount of its liabilities (taking into account liabilities that are contingent and prospective).[2]

Material risk

The corporate rescue exemptions are intended to help companies where there is a “material risk” of insolvency. The test for qualifying for tax exemptions is, however, intended to be set at a lower threshold than wrongful trading tests under U.K. insolvency law, which can apply where there is “no reasonable prospect” that the company concerned will be able to avoid an insolvency. Satisfying the tax test is not meant to imply that the directors are in breach of their company law obligations by continuing to trade.

The inclusion of a 12 month time limit in the draft legislation indicates that the corporate rescue exemptions are intended to apply only in circumstances where a company faces a tangible threat of insolvency. It is viewed as a “line in the sand” to prevent solvent companies from benefiting from the tax exemption in the context of liability management exercises.

Reasonable to assume

The tests are objective: it must be “reasonable to assume” that, but for the release/modification and related arrangements, there would be a material risk that, within 12 months, the company would be unable to pay its debts. It will therefore be important to have evidence, contemporaneous with the

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[2] See e.g., *BNY Corporate Trustee Services Ltd* [2013] UKSC 28.

release/modification, for such a reasonable assumption that can be made available to the U.K. tax authorities on any subsequent inquiry into the tax treatment of the debt restructuring. Such evidence will depend on the facts and circumstances, but might include enforcement actions taken by creditors, insolvent balance sheets, qualified audit reports and likely breaches of financial covenants.

4. Conclusion

The corporate rescue exemptions supplement and extend the existing U.K. tax provisions relating to companies in financial distress and reflect the policy objective that companies that are already facing financial difficulty should not be subject to tax charges that could either hinder their ability to stay in business or adversely affect the orderly sale or winding-up of their assets and activities. They are intended to assist companies in the timely restructuring of their debts to improve the balance sheet and cash flows, without resorting to statutory insolvency arrangements, or creating a debt for equity swap where that would otherwise not be commercially desirable.

The exemptions have largely been regarded as a welcome addition to the existing legislation dealing with the taxation of loan relationships in debt restructurings. However, it should be noted that, as currently drafted, the proposed legislation applies only to actual releases or modifications. They do not apply to a “deemed release” of debt[3], where the existing deemed release tax exemptions will need to continue to be relied upon unless and until new extended corporate rescue tax exemptions are enacted.

The draft legislation for the exemptions was published on December 10, 2014 as part of Finance Bill 2015. However, along with a number of other significant measures, it was not included in the pre-General Election Finance Act 2015 (which received Royal Assent on March 27, 2015). However, in the Budget Report HM, Treasury confirmed that “a new relief for companies in financial distress” (i.e., the corporate rescue exemption) is intended to be introduced in a future Finance Bill.

[3] A deemed release can occur for U.K. tax purposes where, broadly, debt is acquired at a discount by a company connected with the debtor, or where the debtor and lender to a distressed debt become connected.

Contact Information

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