Tax Alert

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Tax 2020: Developments Affecting Financial Restructurings

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Executive Summary

During the course of 2020, the U.K. government has pushed ahead with introducing new measures that are likely to be of material relevance to financial restructurings and corporate reorganizations. There have also been other international developments this year that may have some bearing on international restructurings, which we discuss below.

Joint and Several Liability Notices for Directors of Insolvent Companies

The Finance Act 2020 provides Her Majesty's Revenue and Customs (HMRC) with new powers to issue notices to directors, shadow directors and certain other individuals connected to an entity (a 'relevant person') making them personally liable—alongside the entity—for its unpaid tax liabilities. These rules are targeted at arrangements that abuse insolvency procedures but are drafted very broadly and potentially catch a number of commercial transactions.

HMRC can issue such notices in 'repeated insolvency and non-payment' cases. These will be situations where a relevant person is involved with multiple entities over a five-year period that have been subject to insolvency procedures and where the business of these entities has been transferred to another entity with which the relevant person is also concerned. The rules relating to repeated insolvency cases are particularly notable as they potentially encompass the use of pre-packaged administrations and situations involving repeat financial restructurings of insolvent companies.

HMRC can also issue these notices in 'tax avoidance/evasion' cases and 'facilitation of tax avoidance/evasion cases'. These cases deal with circumstances involving tax avoidance/evasion arrangements or situations where certain penalties have been imposed on an entity and there is a serious possibility tax liabilities will not be paid.

HMRC Preferred Creditor Status

The Finance Act 2020 and subsequent regulations have promoted HMRC to secondary preferential creditor status for certain tax debts. These new rules apply to any insolvency procedure commenced on or after December 1, 2020.

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HMRC's secondary preferential creditor status only applies to taxes collected by a company on HMRC's behalf, such as value-added tax (VAT), pay as you earn (PAYE) and employee National Insurance Contributions (NICs). This status means that HMRC will rank behind preferential creditors but ahead of prescribed part creditors. However, this status will not apply to corporation tax and employer NICs in respect of which HMRC will remain an unsecured creditor.

DAC6

Businesses are preparing themselves for the introduction of the European Union's mandatory 'DAC6' disclosure regime, requiring intermediaries and (in some cases) relevant taxpayers to report cross-border arrangements they have been involved with.

Intermediaries include anyone who designs, markets, organizes, makes available or implements a reportable arrangement or anyone who aids or assists with these activities and knows, or could reasonably be expected to know, they are doing so. This will cover not only advisers on a particular matter, but potentially fund managers who are managing a fund's portfolio of investments.

Arrangements will be 'cross border' where they concern (a) the U.K. or an EU member state and (b) any other jurisdiction (including another EU member state).

Cross-border arrangements will be reportable where they feature any one or more 'hallmarks'. Some of the hallmarks require a tax motivation; however, others potentially capture many normal commercial transactions.

A transaction may be more likely to feature one of these hallmarks where there are intra-group transfers of assets, transfers of intangible property, conversion of income into capital (or other lower-taxed income) and certain cross-border payments between related entities. As such, DAC6 will need to be considered in the context of many debt restructurings.

The deadlines for first reports were deferred until the following dates:

- Arrangements where the first step was implemented between June 25, 2018, and 3 June 30, 2020, must be reported by February 28, 2021.
- Arrangements where the first step in implementation takes place between July 1, 2020, and December 31, 2020, must be reported by January 30, 2021.
- Arrangements that become reportable on or after January 1, 2021, must be reported within the 30 day period prescribed in the legislation.

Updates to HMRC Guidance Relating to Company Residence and Permanent Establishments in Response to COVID-19

Earlier in 2020, HMRC updated its manuals to provide guidance on dealing with determining company residence and permanent establishments during the COVID-19 pandemic.

HMRC states that the pandemic has not necessitated legislative changes but will be factored into HMRC's consideration of where a company is 'centrally managed and controlled' for the purposes of determining whether it is U.K. tax resident. The guidance restates HMRC's position that the location of board meetings alone is not determinative and that a company does not become U.K. tax resident due to decisions being taken in the U.K. over a short period. However, if decisions are more frequently taken in the U.K. and a majority of directors continue to join board meetings and pass resolutions in the U.K. over a prolonged period of time, it would be difficult to argue the company is not U.K. resident.

HMRC has taken a similar line with permanent establishments and concluded current provisions are flexible enough to deal with issues posed by the pandemic. The new guidance notes there must be a degree of permanence for there to be a permanent establishment and HMRC does not consider a non-resident company to have a taxable presence in the U.K. just because of actions conducted within the U.K. over a short period. The guidance further notes lockdown restrictions will also be taken into consideration when HMRC assesses whether a business 'habitually' concludes contracts in the U.K.

Other jurisdictions have taken different approaches to the impact that the COVID-19 pandemic has had on international travel and its effect on taxable presence issues of foreign companies.

Updates to U.K. Anti-hybrid Rules

In November 2020 the government published responses to a consultation that requested public comment on the U.K. anti-hybrid regime, which is intended to counteract tax mismatches arising from hybrid entities and hybrid instruments.

A welcome change that is of particular relevance to financial restructuring is a proposed amendment to the anti-hybrid rules to ensure that changes to applicable accounting rules in 2016 do not have the unintended consequence of effectively disallowing the U.K.'s tax relief for releases of debt between connected companies.

Brexit and the U.K. as a Holding Company Jurisdiction

There are a number of consequences of Brexit that will impact post-Brexit structuring regardless of whether a deal can be struck. One consequence is that the U.K. can no longer benefit from EU directives that eliminate certain withholding taxes. This means that structures using U.K. holding companies may need to rely on double taxation treaties to which the U.K. is party to avoid withholding tax leakage. Helpfully, the U.K. has a wide treaty network, but not every treaty will reduce withholding tax to nil. One notable example is the U.K./Germany tax treaty, which only reduces the rate of withholding to five percent.

A further consequence arises from the fact that a number of U.S. tax treaties include a reference to the EU in their limitation of benefits provisions, which operate to deny treaty relief. By way of an example, the U.S./Ireland treaty allows an Irish company to enjoy treaty benefits where it is substantially owned by persons resident in an EU member state. Therefore, treaty benefits may be lost when payments are made from a U.S. source to an Irish company, which is a wholly owned subsidiary of a U.K. parent.

HMRC have also confirmed that the 1.5 percent stamp charge on the issues of U.K. shares into clearing/depositary receipt systems (which is not currently imposed as it is contrary to EU law) will not be re-introduced once the Brexit transition period ends on December 31, 2020.

Increasing Emphasis on Economic Substance

It has become clear over recent years that both tax authorities and taxpayers are increasingly focused on ‘substance’ when considering potential structures. A key driver behind this has been the introduction of the ‘principle purpose test’ in tax treaties as a result of the Base Erosion and Profit Shifting (BEPS) Project. This test may deny treaty benefits if, having regard to all relevant facts and circumstances, it is reasonable to conclude that obtaining the treaty benefit was one of the principal purposes of an arrangement that directly/indirectly resulted in that benefit. This consequence has encouraged taxpayers to ensure newly introduced entities have economic substance and a commercial function justifying their presence in a jurisdiction so that treaty benefits will not be denied.

Removal of the Cayman Islands from EU Blacklist

On October 6, 2020, the European Council removed the Cayman Islands from Annex I: the EU list of non-cooperative jurisdictions for tax purposes (the European ‘blacklist’) (after it was added in February of this year). This is particularly pertinent given that a number of jurisdictions (including Luxembourg) are introducing rules, with effect from January 2021, that will deny deductions on payments to certain entities based in a blacklisted jurisdiction. The jurisdictions remaining on the blacklist are as follows: American Samoa, Anguilla, Barbados, Fiji, Guam, Palau, Panama, Samoa, Seychelles, Trinidad and Tobago, the U.S. Virgin Islands and Vanuatu.

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