DEBT RELEASES: TAXING TIMES FOR A CORPORATE DEBTOR

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1. Introduction

In this article, I will address the tax treatment of corporate debtors who find themselves in financial difficulty resulting in a restructuring of their outstanding borrowing obligations. This has unfortunately become a market malaise in recent times, with numerous companies unable to make payments under their borrowing commitments. Creative techniques have evolved between debtors and creditors to enable the debtors to carry on trading while keeping creditors interested. Unsurprisingly, tax has been a key consideration in the development of these techniques.

Where the restructuring results in release or replacement of debt, the rules are set out in the loan relationship regime now contained in Part 5 of the Corporation Tax Act, 2009 ("CTA"). I am going to concentrate on release of principal, as that has been an important factor in keeping a borrower afloat; but not all the ways in which tax relief for release of principal has been factored into restructurings have found favour with the Government, so much so that the statutory rules have been changed recently to limit relief to more clearly defined restructuring scenarios.

Prior to the introduction of the loan relationship rules in 1996, the rules on debt release of this type were not clear: they were pretty much unwritten and depended on advisers applying first principles and case-law which was not directly relevant. I remember cases such as *IRC v. Falkirk Ice Rink Ltd*[1] being used to support the notion that the release of principal in favour of a trading borrower was a taxable trading receipt, if the effect of the release was that the borrower could carry on trading. That was the case of the ice rink operator receiving a one-off voluntary payment from one of its users, a curling club, which enabled it to keep the rink open. The Court of Session in Scotland held that the receipt was a trading receipt. So, in the context of a trading company where the creditor had released its loan, the argument was that the release, like the payment in *Falkirk Ice Rink*, gave rise to a taxable trading receipt. This argument was not convincing and in, particular, presupposed that the "receipt" on a release of principal was of an income, not capital nature. This was debatable.

Releases of trade debts were (and are) dealt with separately in the legislation. Where a trader has claimed a tax deduction for a trade debt which is released in a later accounting period, that release is expressly taxable[2].

The pre-loan relationships position for a holding company or other investment company borrower was even less clear. It was hard to see how the release could give rise to a Schedule D Case VI charge. Further, it did not create a capital gain arising on a disposal of an asset or a capital sum derived from an asset of the debtor, since the debt was a liability in its hands, not an asset.

Finally, while advisers looked at what was Section 786 of the Income and Corporation Taxes Act 1988 (transactions associated with loans or credit), they could get comfortable quite quickly that no charge arose under that section on a release.

All of those doubts were swept aside by the loan relationship rules. These now have a self-contained code for dealing with debt releases and restructurings for corporate borrowers, irrespective of whether they are traders or not.

This area of corporate tax law is not something which is looked at much in good times. You might think that it would be pretty straightforward and would not give rise to too many planning opportunities. But recent experience in bad times has shown that not to be the case. Necessity really is the mother of invention. Where the child is too active, however, the Government may not like all of its behaviour, as has proved to be the case with recent trends.

In the rest of this article, I am going to look at the basic rule for tax treatment of debt releases, exceptions to that tax treatment and, in particular, equity-for-debt swaps, and finally where we are today on debt buybacks or, more accurately, buy-ins, where a company other than the debtor buys the debt into the debtor group at a discount reflecting its current market value.

2. The Basic Rule

The basic rule for release of principal is that the profit arising from the release is taxable in the debtor's hands as an income receipt. This is because the loan relationship rules apply to profits and losses from loan relationships including profits or losses from related transactions[3]. A related transaction means the acquisition and disposal of rights or liabilities under a loan relationship and expressly includes the extinguishment of a liability by way of release[4]. The "profit" is essentially the amount that is released: if the whole of the debt is released, the whole amount is taxable. But if there is part payment, the profit is the difference between the original debt and what has been paid back.

So, in the absence of any exemptions, this is a severe consequence for a borrower in financial difficulty to add to its other problems. Some, but not all, borrowers may have sufficient losses to absorb the taxable income. The charge affects the decision of banking lenders as to whether it is worth reaching a compromise with a struggling borrower, in the hope that its financial position will improve. Corporate knights looking to come to the rescue of such borrowers will also think hard if borrowers have to face this tax charge. Further, there is no point in levying the charge where the borrower's financial plight is such that it cannot continue to do business. There are, therefore, a number of exceptions to the charge.

3. The Insolvency Exceptions

The first exception applies where the release is part of a statutory insolvency arrangement[5]. A statutory insolvency arrangement is defined as a voluntary arrangement under the Insolvency Act 1986, a compromise or arrangement under Part 26 of the Companies Act 2006 or equivalent procedures under foreign law[6]. The second insolvency exception is one where the debtor company meets one of several insolvency conditions and is not connected with the creditor[7]. I do not propose to deal further with these exceptions as they have not been affected by recent changes to the law.

4. Equity for debt

The most topical exceptions are the exception where debt is swapped for equity and the exception where the release takes place between connected companies. I will deal with the connected companies' exception later. The equity-for-debt exception is contained in

Condition B in Section 322(4). It has been commonly used in third party bank debt restructurings and in particular in restructurings of companies which have private equity investors and a high level of gearing. This condition is satisfied where the release is not one of "relevant rights"(I will come back to what this expression means when looking at the connected companies exception, as it derives its meaning from several concepts used there), and is:

- in consideration of shares forming part of the ordinary share capital of the debtor; or

- in consideration of any entitlement to such shares.

At first sight, this looks like a pretty straightforward condition to meet, and indeed, those of us who have been involved in debt restructurings in recent years thought as much initially. "In consideration of shares" meant little more than getting the drafting right, so that it was clear that there was the right nexus between the release and the shares. If you can draft a consideration clause in a share purchase agreement, you should be able to get this right. If you are really troubled by this, you simply replicate the statutory wording. The consideration has to be ordinary share capital (so the shares can have very flexible rights) or an entitlement to receive ordinary share capital. HMRC consider "entitlement to such shares" to include a binding agreement at the time of the release that shares will be issued in the future by the company. They go further and say that options to acquire shares are also included provided it is likely that the options will be exercised[8]. This seems to be a somewhat pragmatic way of construing the statutory wording, since there is nothing in the word "entitlement" which permits degrees of likelihood.

The exception gives creditors and borrowers the flexibility to replace debt with an equity interest carrying deferred rights, thereby allowing the borrower to stay in business but giving the creditor some prospect of recouping committed funds in the future. But it is not meant to provide a coach and horses through the debt release charge.

In a recent update of their Corporate Finance Manual ("CFM") at para. 33202, HMRC warn that it would be imprudent to view the condition for the exception too formalistically. In particular, they say that the condition will not be satisfied "if, on the facts, the creditor has no interest in being a shareholder in the debtor company and is releasing the debt gratuitously, with shares being issued merely to obtain a tax advantage for the debtor company". They do, however, recognise and accept that there is almost inevitably going to be a wide disparity between the original face value of the debt and the market value of the new shares: that of its own will not mean the exception will not apply. Their seemingly purposive approach to what appears to be quite formal legislative wording is influenced by past situations where deferred valueless shares have been issued to bank creditors in exchange for once valuable debt, and there are arrangements in place whereby the bank in question is able to dispose of the shares quickly after the exchange. HMRC give two examples of unacceptable and acceptable situations. The first contains contractual pre-wiring at the time of the exchange, whereby the bank sells the worthless shares later to the original shareholders for a nominal amount of £500. HMRC there take the view that this is in reality a release of the debt for £500 so that practically the full amount of the debt (£80m in their example) released is taxable. In their second example, the facts are the same, but there is no contractual pre-wiring to sell the shares. The bank accepts the shares in good faith, thinking that their value will increase as the company's situation improves. But six months later, the bank believes it has been overoptimistic about the company's turnaround prospects and decides then to sell the shares to an existing shareholder. In this scenario, the exception will not be denied because the original bargain was an equity-for-debt exchange.

So where we are today is that the issue of shares with a very small value would not of its own mean the exception is unavailable. What is more important is looking at all the surrounding circumstances and identifying a real commercial desire at the time of the exchange that the shares issued should be held by the bank indefinitely. That does not mean that one can simply ignore the share rights (other than to ensure that they are ordinary share capital of course). If the shares are so deeply deferred to other classes of capital in the company that they cannot have any realistic prospect of going up in value, that could be relevant in ascertaining what the real intention of the bank is. But against that, if the bank actually holds onto the shares, no matter how worthless, it is hard to see why the exception wording would not be satisfied.

It should not be forgotten that the issue of a share warrant is the grant of an option by the debtor company for the purposes of corporation tax on chargeable gains. The consideration for the grant is the attributable amount of the debt released. In most cases, there may be little value or the option will be exercised so that the disposal on grant is unwound and merges into the issue of shares under the rules in Section 144 of the Taxation of Chargeable Gains Act 1992. If the option is never exercised, and the main purpose of its grant was simply to avoid the charge on release, the capital gains charge on the grant of the option could crystallise in the hands of the debtor company as grantor. This gives rise to an interesting question, as to whether there could be both a loan relationship charge by virtue of the release and a capital gains charge by virtue of the grant. The sensible answer to this should be no on the basis that the exception from the capital gains computation for consideration taxable as income[9] would apply, but it is not entirely clear. In practice, the expectation is that options granted in this context would be exercised, so the issue should not arise. Certainly, HMRC expect them to be exercised as mentioned above.

5. Transactions Between Connected Companies

Basic Exception

The exception for debtor releases where the debtor is connected with the creditor is contained in Section 358. This says that a connected debtor is only required to bring a credit into account on a release, if it is a deemed release or it is a release of "relevant rights"[10]. There is no taxable release other than in those situations. A deemed release can arise either under Section 361 or under Section 362. The Section 362 deemed release has not been affected by recent changes, so I intend to say nothing more about that. I will deal first with the Section 361 deemed release, which has been significantly altered by the Finance Act 2010, and then look at an actual release of "relevant rights" – a new concept also introduced by the same Finance Act.

Section 361 Deemed Release: Former Law

Prior to the recent changes, a Section 361 deemed release occurred in the following situation. D has borrowed 100 from a third party lender, X. The debt has decreased in value because of D's deteriorating financial situation. C buys the debt from X on non-arm's length terms for 60 – i.e. at a discount to face value. D and C are connected companies and were so connected at some point in time in the period of three years beginning four years before C bought in the debt. In this situation the discount of 40 was treated as a taxable deemed release by D. This was to discourage another company in D's group – like C – buying in D's debt cheaply and then releasing D subsequently from the debt obligation: because C and D were connected, the release would have been tax-free. On the other hand, if D had bought back the debt from X directly, the discount of 40 would have been taxable under the basic rule for taxing debt releases where the creditor and borrower are unconnected. It was not intended that a group could circumvent this basic charge by another group company buying in the debt and then releasing it.

Note, however, that the time for ascertaining the connection was in a period of three years beginning four years before the debt was bought in. This meant that a connection which only came into existence for the first time in the immediate twelve months before the acquisition, was ignored. In effect, that period of twelve months was a grace period. The reason for this grace period was to give positive encouragement to third party groups who might be interested in rescuing the D group from its financial predicament. So, if the corporate rescuer took control of the D group and within twelve months bought in third party debt, that would not have given rise to a deemed release. The grace period was deliberately there to permit corporate rescues. The only point a corporate rescuer had to watch was that the debt buy-in occurred within twelve months of the connection arising. This needed watching if there was significant debt out in the market and a complicated programme of buying in the debt had to be drawn up. But there was nothing else in the grace period let-out which said anything about how the connection arose. In particular, there was no link to a potential corporate rescuer. The provision was completely silent. This made it possible for the D group to set up a new company, which could buy in third party debt cheaply and then release it on a tax-free basis. This was very attractive for borrower groups whose debt was worth materially less than face value. The connection between the new company and the D group came into being during the grace period. Since the new company did not exist before the grace period, any question of a connection in the three years beginning four years before the buy-in was academic.

Not only was the deemed release avoided, but a subsequent release of the debt after it was held intra-group, would not give rise to a tax charge: by that stage the release would be a connected company transaction. So, this technique of using a new company achieved not just a deferral, but a complete avoidance of the debtor tax charge on a release.

Section 361: New Law

The Government realised that the grace period let-out was being exploited in this way outside corporate rescue situations and decided that this had to be stopped. On 14th October 2009, they published a Ministerial Statement in which the then Financial Secretary announced measures to deal with this perceived abuse. While the mischief the Government was trying to cure was clear, there was a lot of uncertainty about the proposed medication. Of particular concern was the interaction between the new proposals and equity-for-debt swaps. This resulted in HMRC clarification published just over a week later and a further Ministerial Statement on 9th November 2009 announcing more changes to the legislation. HMRC published draft guidance on the new rules in April last year. Most recently, HMRC have updated the CFM to reflect the draft guidance, and new text has been inserted to deal with all the relevant Finance Act 2010 changes to debt releases. The new rules came into force on 14th October 2009 and contain a number of transitional provisions which are outside the scope of this article.

Section 361 has been amended and now provides that the (taxable) deemed release on a connected company buy-in of debt arises unless one of three exceptions applies. These are:

- The corporate rescue exception;
- The debt-for-debt exception and
- The equity-for-debt exception

Corporate Rescue Exception: Section 361A

The new corporate rescue exception is available if:

- there is a buy-in of D's third party debt at arm's length by C (again, a connected company);
- there has been a change of ownership of D at some point in time in the period beginning one year before and ending 60 days after the buy-in;
- it is reasonable to assume that, without the change of ownership, D would have met one of the insolvency conditions within one year of the change; and
- it is reasonable to assume that the debt buy-in would not have occurred without the change of ownership.

The change in ownership is determined by the rules in Section 769 ICTA. The new exception does away with the "no connection" requirement in the three years beginning four years before the buy-in. What was the grace period has been transmuted into a slightly longer period, during which there needs to be a change of ownership of D, in circumstances where D might otherwise go into administration or satisfy one of the other insolvency conditions. This is designed to apply in situations where a group is in difficulty and another corporate group steps in with a view to baling it out. Once the corporate rescuer acquires control of the D group, a connection will clearly be established. If a company in the rescuer's original group – or a new company, for that matter – buys in D's debt, there will be no deemed release.

It is not clear why it was still felt necessary to retain the slightly modified grace period. If a corporate rescue situation exists, so that the other three requirements including the "reasonable" assumptions are all met, there does not seem to be any logic to putting a time limit around those requirements. While most debt buy-ins by corporate rescuers would fall within the time period, there may be instances where – for unavoidable reasons – it takes longer for the debt to be bought in. There appears to be no flexibility in this situation in the legislation, which is a little unfortunate.

The "reasonable" assumptions are likely to give rise to issues as to whether they have been satisfied in particular scenarios. In the CFM, HMRC clarify that they would regard it as reasonable to assume that the insolvency conditions have been met where:

- insolvency is avoided not only by the change of ownership but also by steps taken following the change of ownership: this would presumably include the step of buying in the debt and getting third party lenders out of the picture;

- under a guarantee of D’s borrowing, the creditor could take enforcement action against a group company other than D; this recognises that if D is in default on its debt and the guarantor is sued by the creditor, that is sufficient to recognise that an insolvency condition exists for D (irrespective of whether the guarantor enforces its rights of subrogation);

- there is evidence that insolvency conditions exist, but D has not publicly acknowledged its potential insolvency because of the need to engage in sensitive discussions with lenders and auditors over banking covenants and its going-concern status; this is a very helpful clarification, as it recognises the practical need for debtors to negotiate in complete confidence with their lenders to arrive at a compromise and to dissuade lenders and other creditors from taking pre-emptive action to enforce their debts.

These are, however, only three instances of doubtful areas which have been clarified in the taxpayer’s favour in relation to the insolvency conditions assumption. There are inevitably bound to be others, including those affecting the buy-in assumption. Suppose D has almost concluded negotiations for a buyback of debt, when a corporate rescuer comes on the scene, and subsequently the debt is bought in by a connected company. In those circumstances, would it be reasonable to assume the buy-in would not have occurred without the change in ownership? Literally, the answer is still yes, since a buyback of debt is different to a buy-in, but in substance the commercial effect is the same. It is clearly arguable that the change in ownership did not affect the outcome, so the exception would not apply. But that would be a harsh result.

In practice, the “reasonable” assumptions are likely to generate uncertainties which can only be resolved by getting HMRC’s agreement that they would not be prejudicial on the relevant facts.

The debt-for-debt exception: Section 361B

The debt-for-debt exception applies to arm’s length debt exchanges, where C debt is exchanged for D debt. There can be no other consideration. If the debt is in the form of a security, the consideration debt must also take the same form. Similarly, if the debt is an unsecured loan, it can only be replaced with an unsecured loan. It is not possible to mix and match loans and securities. The C debt must be in the same nominal amount as the D debt and must have substantially the same market value. In the CFM, HMRC clarify that while the question of market value is one of fact, they will ignore minor differences in interest, repayment and other terms and conditions[11].

The requirement for the consideration being “only” securities or loans as the case may be, is alleviated by further commentary in the CFM. If the issuer of the new securities agrees to pay off any accrued but unpaid interest on the old security, the payment of that interest will not fall foul of the “only” requirement. It is worth considering what would happen if that payment were by way of issue of a payment-in-kind or “PIK” note. Such a note would be a different security to the replacement debt, so – technically – the exception could not apply. However, there appears to be no reason to treat the PIK note as any different to a cash payment of interest, so one would expect HMRC to ignore the PIK note in considering the “only” requirement. But it would clearly be prudent to get written confirmation of this if it arises in a real situation.

Finally, HMRC have clarified that if debt is exchanged for a mixture of equity and debt, the debt-for-debt proportion can qualify for this exception.

The equity-for-debt exception: Section 361C

The final exception relates to equity-for-debt swaps. The exception is broadly on the same terms as the equity-for-debt exception in Section 322(4) discussed in Section 4 above. The consideration shares must constitute ordinary share capital. Share warrants may also be used as consideration. The one big difference is that the consideration shares or warrants may be issued either by the company acquiring the debt or a company connected with the acquirer. This is intended to facilitate debt restructurings in private equity structures, where there are a number of companies in a vertical corporate chain leading down to the investee company. So, for example, a Bidco company may own the investee company and may have borrowed from third party banks to fund the acquisition. Above Bidco there would be another company, Topco, whose investors would include the private equity investors. This type of vertical structure provides structural subordination, so that the interests of senior banking lenders who lend at the lower Bidco level rank in priority, both in the normal course as creditors and also because the ultimate equity investors own their interests in a company, Topco, which is at least one corporate tier removed from the investee company. Under the new exception, Topco (or any other connected company in the chain) may purchase the debt and issue the shares. Bidco's debt cannot, however, be bought back by Bidco in consideration for Topco shares being issued to the original lenders. The new exception is an exception to Section 361 which contemplates the debt being bought in by a company connected with the borrower, not bought back by the borrower itself. In such a situation, it would be prudent to have a tripartite agreement between Topco, Bidco and the lenders, whereby Topco buys in the debt for its shares and then immediately releases Bidco. If the debt is in the investee company below Bidco, then either Topco or Bidco could buy in the debt for its shares.

The comments made by HMRC in the CFM at paragraph 33202 (see under Section 4 above) regarding equity-for-debt swaps and the attempted use of the exception in Section 322(4) to get a tax advantage, where there is no intention on the part of the lender to hold onto the shares, should be taken as applying equally to swaps under Section 361C, although the new CFM commentary on Section 361C at paragraph 35560 is silent on this point.

The tax charge on the release of relevant rights under Section 358

As stated at the beginning of this section, the second type of situation where the connected company exception is unavailable is where the transaction between connected companies involves the release of "relevant rights". These are defined as rights acquired by C from a third party lender, in circumstances where a deemed release would have arisen were it not for the applicability of either the corporate rescue exception or the debt-for-debt exception. Put another way, the tax charge on such a release confirms that the exceptions to the deemed release charge on a corporate rescue or a debt-for-debt exchange are intended to provide a tax deferral, not a complete exemption, if the debt is subsequently released. So, no tax charge arises on the acquisition by C, but if the debt is released later – when C and D are parties to the relevant loan relationship, D is then taxable, as C's "relevant rights" have been released.

Where the deemed release has not occurred, because the debt acquisition was in consideration of shares under Section 361C, the exception provides full protection. On a subsequent release of the debt, when C and D are parties to it, there is no release of "relevant rights", so the normal exception for connected companies under Section 358 still applies. This is simply intended to replicate the tax treatment of an equity-for-debt swap under Section 322(4), where the debtor itself issues the shares. On the swap, the debt disappears, so it cannot be subsequently released. Therefore, there is no tax charge on the swap itself and no subsequent tax charge on the debtor, since there is no subsequent taxable event. The fact that debt remains in place on an equity-for-debt buy-in and is subsequently released should not give rise to a worse tax treatment for the debtor than if it had entered into the swap itself. This is achieved by excluding a Section 361C equity-for-debt scenario from the definition of "relevant rights".

6. Conclusion

So where does all this leave corporate debtors today, when debt is released? If one ignores the exceptions for insolvency, the only way of avoiding a tax charge on release (other than by using available losses) is by using equity-for-debt swaps. These have to be real transactions, in the sense that the exchange should not simply be a device to get the exemption, while enabling the lenders acquiring the equity to get rid of that equity. The swap can still involve a buyback of debt by the debtor, or the buy-in of debt by a connected company, and full protection from tax on a deemed or actual release is available in both situations. A cash buy-in by a connected company, followed by a release, is no longer capable of providing a full exemption from the charge. If the buy-in falls under the corporate rescue or debt-for-debt exceptions, it can provide a tax deferral at that point in time. But if the debt is subsequently released, a tax charge will arise.

One can reasonably expect HMRC to keep equity-for-debt swaps under review. But there is no need to be unduly defensive in structuring these and, in particular, in writing the share rights for the consideration shares. If shares have little value, that on its own should not be prejudicial, other than perhaps to indicate in aggressive situations that they were never meant to be a meaningful asset for the lender. Despite what HMRC say at para. 33202 of the CFM, it remains important not to confuse the sufficiency of the equity consideration with the nature of the consideration – i.e was the consideration really equity or an intermediate step to cashing in at a huge discount? Sufficiency of consideration, or lack of it, is of itself irrelevant.

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[1] [1975] STC 434.

[2] Section 94 CTA 2009 (formerly Section 94 Income and Corporation Taxes Act 1988 ("ICTA")). The original version of this provision was brought in to negate the House of Lords decision in *The British Mexican Petroleum Company Limited v. Jackson* (1932) 16 T.C. 570, where the House of Lords upheld the taxpayer's contention that the release of liabilities it had incurred in a prior tax year, and which arose from the unpaid purchase price of oil for onsale in its trade, did not give rise to taxable income.

[3] Section 293(1) CTA 2009.

[4] Section 304(2) *ibid.*

[5] Section 322(2) *ibid.*

[6] Section 834(1) ICTA.

[7] These are set out in Section 322(6) and cover insolvent liquidation, insolvent administration, insolvent administrative receivership, the appointment of a provisional liquidator and comparable scenarios under foreign law.

[8] Corporate Finance Manual at para. 33200.

[9] Section 37 TCGA.

[10] Companies are connected if either one controls the other or both are under common control: Section 466 CTA 2009. "Control" is ascertained by reference to a person's power to secure that the affairs of a company are conducted in accordance with that person's wishes through the ownership of shares, voting power or other rights conferred by corporate constitutional documents: Section 472.

[11] Para. 35550.