Weil

Founded in 1931, Weil has provided legal services to the largest European, US and global public companies, private equity firms and financial institutions for more than 85 years. Widely recognised by those covering the legal profession, Weil's lawyers regularly advise clients globally on their most complex Litigation, Corporate, Restructuring, and Tax and Benefits matters. Weil has been a pioneer in establishing a geographic footprint that has allowed the Firm to partner with clients wherever they do business, providing clients with legal expertise at the highest level across all our practices. Weil's London office is a leader in the UK legal market, and is the hub of our European practice. Established in 1996, we are the largest of our European offices, and consistently regarded as one of the most successful London offices of a US-based law firm.

Authors Jenny Doak and Stuart Pibworth

UK companies in distress: a tax refresher

KEY POINTS

- Although immediate liquidity and cash management are currently at the forefront of minds, creditors and debtors are also being required to assess their debt positions and consider whether any debt needs to be restructured, which can be done in various ways.
- It is important that the tax impact of debt restructurings is not overlooked both by creditors and debtors otherwise there could be adverse tax implications, including tax leakage, the loss of tax assets or 'secondary tax liabilities'.

The COVID-19 pandemic and measures taken by national governments to restrict its spread have given rise to a whole host of issues. Although tax may not be at the forefront of the minds of creditors and debtors, the pandemic and national measures have thrown up a number of tax considerations. In terms of immediate liquidity and cash management, the UK government has introduced a number of tax specific measures for business including:

- Automatic deferral of VAT payments due between 20 March and 30 June 2020 to the end of the current tax year (ie 31 March 2021);
- Extended 'time to pay' arrangements giving breathing space on settling tax liabilities (including corporation tax and payroll taxes) while continuing to process refunds owed to taxpayers on a timely basis;
- Introduction of the Coronavirus Job Retention Scheme whereby, as well as the relevant capped salary amounts, employers are eligible to be reimbursed for the employer national insurance contribution (NIC) and minimum auto enrolment employer pension contributions in respect of the pay covered by the scheme.

In addition to immediate liquidity and cash management, more generally both creditors and debtors are also being required to assess their debt positions and consider whether any debt needs to be restructured. What follows is a refresher of some key UK tax considerations to bear in mind when looking to restructure debt:

1. **Impairments:** Where a UK creditor is required under applicable accounting principles to impair a debt, that creditor is generally able to claim a deduction for UK corporation tax purposes to the extent of such impairment, unless, subject to two exceptions, that creditor is connected with the debtor. Under accounting principles, it is not usually possible for a UK debtor to impair the value of its liabilities and so, from a UK tax perspective, impairments are usually a creditor only issue and so should not result in any adverse UK tax consequences for a UK debtor. It is further understood that HMRC does not consider that a deduction arising in respect of an impairment should give rise to a counteraction under the UK anti-hybrid rules.
2. **Debt releases:**
   - Subject to certain exceptions, when non-connected debt is released this will give rise to a taxable credit (for a UK debtor) and deductible debit (for a UK creditor) to the extent of the amount released in accordance with the accounting position. However, importantly, a UK debtor will not be required to recognise a taxable credit on a debt release where that debtor meets one of the prescribed insolvency-related conditions or the release falls within the scope of either the 'corporate rescue' or 'debt-for-equity' exemption. In the event that no exemption applies, regard should be had to whether the UK debtor has any losses (whether current or carried forward) which may be used to shelter any UK tax leakage arising on the debt release.
   - Where the debt in question is between connected parties, *prima facie*, such releases should not give rise to a taxable credit for a UK debtor and, subject to very limited exceptions, no deductible debit for a UK creditor. However, where a non-UK connected creditor is able to claim a deduction in respect of the debt release (eg some US connected creditors) then a counteraction may be required under the UK anti-hybrid rules which, effectively, would require the UK debtor to recognise the amount released as taxable income for UK corporation tax purposes.
3. **Deemed debt releases:** In addition to 'actual' debt releases, often overlooked is the fact the UK tax code 'deems' debt to be released in two circumstances. The first is where a company acquires creditor rights under an impaired debt of a connected debtor company at an undervalue; the second is where an unconnected creditor and debtor are party to an impaired debt and then become connected. In both cases, there is deemed to be a release of the impaired portion of the debt giving rise to a taxable credit for the UK debtor unless one of either (in both cases) the 'corporate rescue' or (in the first case only) 'equity-for-debt' exemption apply. There is a far-reaching targeted anti-avoidance rule which counters arrangements that seek to avoid a charge arising under the deemed release rules. These rules often fall to be considered when looking at debt buy-backs where a company connected to the debtor acquires the debt from the third party creditor at a discount – in those circumstances, subject to the availability of an exception, a UK tax charge may arise to the UK debtor to the extent of the discount.
4. **Debt-for-equity:** As opposed to a debt release, creditors may prefer to 'swap'

Feature

Biog box

Jenny Doak is a tax partner at Weil, Gotshal & Manges. Her experience includes restructurings, M&A transactions, joint ventures, financings, debt and equity capital markets, and special situations. She advises across all sectors, with particular specialism in energy and TMT. Email: jenny.doak@weil.com. Stuart Pibworth is an associate in the London team of Weil's European Tax practice. He advises on a broad range of complex UK and international matters, including corporate and private equity transactions, group restructurings, insolvencies, finance matters and tax litigation. Email: stuart.pibworth@weil.com.

their debt for equity in the debtor company. Any taxable credit otherwise arising to a UK debtor on a debt release in those circumstances will be exempt from UK tax where the release is in consideration for the issue of shares forming part of the ordinary share capital of the UK debtor (or any entitlement to such shares). Although that may seem straightforward there are a number of pitfalls, including whether (1) the shares issued constitute 'ordinary share capital', (2) the shares are given in consideration for the debt release, and (3) there is a difference between the value of the debt released and the shares. Further, where shares are issued to a creditor, depending on the circumstances, this may have the effect of breaking tax groups or tax 'connections', which may trigger tax charges and/or the availability of tax reliefs, including deductions and losses. Creditors who are issued shares in those circumstances should also be mindful of any secondary tax liabilities (ie taxes of the debtor company or its affiliates) for which they may become liable on a change in control.

5. **Debt renegotiation:** Where the terms of existing debt are amended (including agreements to subordinate debt or impose a moratorium), it is important to consider the accounting treatment of such amendments. In particular, where such amendments give rise to accounting adjustments these will result in a taxable credit for a UK debtor, unless, but for that amendment, there would be a material risk the company would be unable to pay its debts at some point in the following 12 months. In addition, UK debtors may need to (re) assess the deductibility of interest payments on the amended debt (for instance, whether there are any concerns on deductibility under the UK transfer pricing regime or re-characterisation of interest as a non-deductible distribution).
6. **Debt novation:** Where debt is novated intra-group between UK companies the 'group continuity' rules allow the debt to be novated for its notional carrying value (on a tax neutral basis). However, HMRC takes the view that those rules only apply where the whole debt in question is novated; consequently, any partial debt novation will not benefit from these rules. It may be possible to manage this by 're-tranching' existing debts prior to novating. Equally where debt is novated to non-UK companies, these rules will not apply.
7. **Debt refinancing:** UK debtors may look to refinance existing debts rather than restructure those debts as envisaged above. As is the case with any financing, the withholding tax position on interest payments (and the contractual allocation of risk) as well as the deductibility of interest payments will be important considerations. It should be remembered that PIK debt does not mitigate any UK withholding exposure; rather than withholding and accounting a cash amount to HMRC, in those circumstances the UK debtor is required to withhold and account for the relevant amount of PIK notes to HMRC (which can create practical challenges). In certain cases, where discounted debt is issued (as an alternative to interest-bearing debt to mitigate cashflow disruption), the UK debtor will be unable to claim a deduction in respect of the discount until such time as the debt is redeemed.
8. **Guarantees:** The UK taxation of guarantee payments is complex. HMRC's position is that where a guarantor makes a payment under a guarantee the guarantor does not become a party to the original debt with the original creditor (ie HMRC does not consider that the guarantor 'stands in the shoes' of the debtor). Instead, HMRC's view is that by making a guarantee payment, the guarantor acquires a debt by way of subrogation with the debtor. There is an alternative view that the guarantor simply becomes a party to the original debt when the guarantee is called. In either case, the UK tax analysis for the debtor and guarantor is complex. Further, difficult questions also arise as to whether guarantee payments give rise to UK withholding obligations (even where interest payments under the original debt may not have done so). Guarantee payments can often be tax inefficient so where there is the risk of borrower default and the guarantee being called, it may be preferable (if possible) for the guarantor to fund the borrower so that it can avoid defaulting on the debt.
9. **Debt enforcement:** The UK tax position where security is enforced by creditors will turn on the precise mechanism used to enforce that security. However, there will often be both direct and indirect UK tax consequences to consider on enforcement from both the creditor and debtor perspective.
10. **Debt acquisition:** When acquiring debt, the purchaser will need to consider the appropriate acquisition structure to be used to purchase that debt which, in turn, will depend on a number of considerations (such as legal, regulatory and accounting requirements). From the purchaser's perspective, key tax considerations will include whether (1) there are any indirect taxes (stamp or transfer tax, or VAT) on the acquisition of the debt, (2) there will be any withholding tax on interest payments by the debtor to it, (3) it will be subject to tax in respect of interest payments (and whether it will be taxed on a 'paid' or 'accruals' basis), and (4) there is any tax leakage on payments out by the purchaser to its own creditors / investors.

Of course, when it comes to restructuring debt, tax (understandably) will not be the driving factor. However, the implementation of a debt restructuring can often be managed in a more tax efficient way and therefore it is important that tax is not overlooked when considering the options. ■

Further reading

- *Practice Note: Debt restructurings – tax issues on debt restructurings;* Lexis PSL Banking & Finance; Lending; Tax issues for banking lawyers
- Howard and Hedger: *Restructuring Law and Practice*; Chapter 6 Restructuring Exits and Solutions
- *Practice Note: Taxation in corporate insolvency – the principal issues in outline;* Lexis PSL Restructuring & Insolvency; Tax and Insolvency