Practice guide

Guarantees revisited

Speed read

Although guarantees are common, the tax treatment of guarantee arrangements can be complex. However, before jumping to the tax analysis, it is first important to understand the nature of the guarantee arrangements and their legal effect. Once the legal nature of the various guarantee relationships are understood, the tax analysis can be applied. However, even then difficulties can emerge in determining the tax effect of guarantee arrangements given the lack of case law, guidance and legislative provisions specific to guarantees.

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It is common for lenders to require another group company to guarantee a borrower's obligations under a loan. All parties, of course, will hope and expect that the guarantee will never be 'called'. However, the current economic dip has unfortunately resulted in lenders and borrowers looking at guarantees more closely. This article revisits some of the key UK corporation and withholding tax considerations to consider on guarantees of financial obligations. Except where otherwise discussed, we have assumed that the borrower and guarantor are UK companies and the lender is a UK bank lender.

Nature of a guarantee

To analyse how a guarantee is taxed, it is important to understand the nature of the arrangements. Put simply, in a financing context, under a guarantee the guarantor promises the lender that the borrower will perform its obligations under the financing arrangements (see Figure 1 overleaf). In addition, the guarantee will typically include indemnification obligations requiring the guarantor to pay amounts owed to, and make good any loss suffered by, the lender following borrower default. A guarantor is not typically under any obligation to pay under a guarantee until a call has been made by the lender.

The UK tax treatment of the amount advanced by the lender to the borrower is clear: it is a loan relationship (being a 'money debt' arising 'from a transaction for the lending of money' (CTA 2009 s 302)).

Unfortunately, the nature of a guarantee and the source of guarantee payments for UK tax purposes are much less clear.

Corporation tax

From a corporation tax perspective, there is no 'money debt' on day one; no amount is owed by the guarantor to the lender under the guarantee – just a contingent contractual promise.

Although there may be a 'money debt' for the purposes of CTA 2009 s 303, where a guarantee is called following borrower default, HMRC takes the view that such 'money debt' does not arise 'from a transaction for the lending of money' and so not a loan relationship under CTA 2009 s 302 (see HMRC's *Corporate Finance Manual* at CFM31100). This is not, however, a universally accepted view. An alternative view is that the guarantor becomes a party to the original loan relationship with the original creditor when the guarantee is called.

HMRC considers that, once called, the guarantee would 'likely' be a relevant non-lending loan relationship under CTA 2009 Part 6 Chapter 2 (CFM31100). This will turn on satisfaction of the prescribed conditions. However, even if it were, HMRC's position (based on *IRC v Holder & Holder* (1930) 16 TC 540) is that any payment (including payments in respect of interest) made by a guarantor to the lender under the guarantee 'has lost the character of interest in the guarantor's hands'.

Looking at whether payments under a guarantee are of a revenue or capital nature, it is apparent that, in most cases, a guarantor would not have provided the guarantee in the course of its trade. Consequently, guarantees are generally regarded as capital liabilities with resultant impact on deductibility (explored below).

In terms of the borrower/guarantor relationship, generally following satisfaction of the guarantee, the guarantor acquires the lender's rights against the borrower by way of subrogation. That is, the guarantor effectively replaces the lender as the creditor on the original lending (see Figure 2 overleaf). Subrogation may occur by operation of law or under a subrogation clause in the guarantee.

HMRC's view is that, following subrogation, the borrower owes a 'money debt' to the guarantor, such 'money debt' being either a loan relationship or a relevant non-lending relationship (CFM31100).

Withholding tax

From a withholding tax perspective, there is no settled view on whether guarantee payments take the same nature and source as the obligation being discharged. Broadly, there are two schools of thought:

- The first is that the guarantee payment retains the characteristic of the underlying obligation (*IRC v Holder & Holder; Re Hawkins* [1972] 3 All ER 386) so that, if the payment is in respect of UK source interest, the guarantee payment should be treated in the same way.
- The second is that the guarantee is a separate money debt from the underlying obligation so the withholding analysis is separate from the analysis in respect of the underlying obligation.

The practical implications of these are discussed below.

Entry into guarantee

No UK corporation tax should generally be triggered upon entering into a guarantee. However, borrowers should be conscious of whether a guarantee affects interest deductibility under the transfer pricing rules in TIOPA 2010 Part 4. Where there is a UK guarantor, then an adjusting claim can be made (TIOPA 2010 s 192).

Fees and imputed fees

Guarantee fees will routinely be paid by the borrower to the guarantor for the provision of the guarantee.

From the borrower's perspective, guarantee fees are generally deductible under the loan relationship rules, HMRC viewing such expenses as payments required to bring the financing into existence (CFM31110; CFM33060).

From the guarantor's perspective, receipt of the guarantee fee is more complex. As an uncalled guarantee is generally a tax 'nothing' (and certainly not a loan relationship) then the guarantor is not required to recognise the fee as a credit under the loan relationship rules. However, generally guarantee fees will be regarded as income and so taxable as such.

An important factor on intra-group guarantee fees is transfer pricing. Transfer pricing will look at the guarantee arrangements to determine the appropriate amount of fee (if any) payable by the borrower to the guarantor for the provision of the guarantee. Where a fee is payable it may be adjusted for tax purposes to reflect arm's length arrangements; where no fee is payable an arm's length fee may be imputed. The application of transfer pricing to guarantee fees depends on the precise circumstances of the arrangement in question, including what benefits (other than the fees) a guarantor obtains from providing the guarantee. Where the guarantor and borrower are both UK tax resident, the impact of transfer pricing will likely be limited because of the symmetry resulting from any corresponding adjustments.

Default

Corporation tax

For the guarantor the tax treatment of a cash payment upon default is complex. As noted above, HMRC's view is that there is no loan relationship and, even though the guarantee is a relevant non-lending relationship after being called, amounts payable are not interest payments. On that view, no deduction is available to the guarantor on payments made under the guarantee under the loan relationship code.

Equally, applying general principles, a payment under a guarantee will likely be treated as a capital payment for which the guarantor will be unable to claim a deduction (and, in any event, it is unlikely that the payment would have been made by the guarantor wholly and exclusively for the purposes of its trade).

Even under the alternative view mentioned above where the guarantor becomes party to the loan relationship following call, generally the guarantor may not obtain any effective relief for the guarantee payment where the accounting treatment does not reflect any debits.

If possible, the guarantor may look for relief under CTA 2009 ss 479 or 481, (for interest payments only, but not for principal repayments), or as a capital loss under TCGA 1992 s 253(4) (although claiming a capital loss under s 253(4) is available in limited circumstances). HMRC takes the view that the payment of amounts under a guarantee will not give rise to an acquisition cost in the debt (CG53501).

The position is not improved by subrogation. Following subrogation, HMRC's view is that the amount owed by the borrower to the guarantor is a loan relationship (with resultant tax consequences), although again this is not a straightforward analysis. Most guarantees will be provided

Figure 1: Typical guarantee

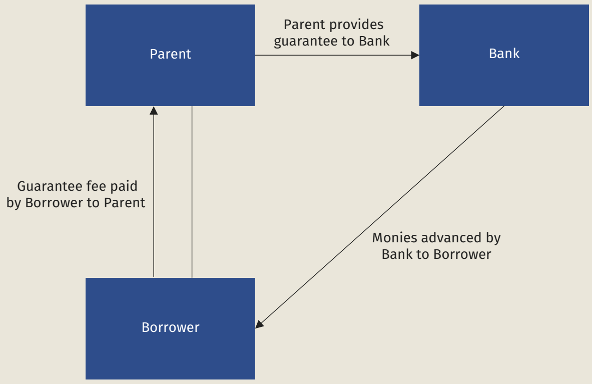
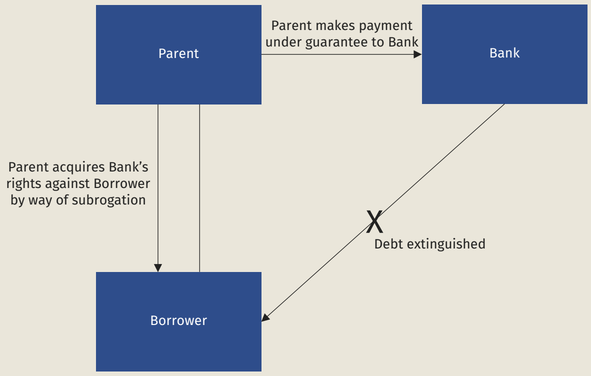


Figure 2: Subrogation



by 'connected' companies for the purposes of the loan relationship rules. Were the guarantor to impair or release the debt owed by the borrower it would not be able to claim a debit under the loan relationship rules (CTA 2009 s 354) and so is unable to claim (indirectly) relief for the guarantee payment through impairment or release. Accordingly, where there is the risk of borrower default and the guarantee being called, it may be preferable for the guarantor to pre-fund the borrower so that it can avoid default.

From the borrower's perspective, one initial question is whether CTA 2009 s 361 is triggered (which, where applicable, gives rise to a deemed release of a liability on impaired debt becoming held by a company connected with the borrower). Going forward, any subsequent impairment or release of the amount owed by the borrower to the connected guarantor following subrogation should not result in any UK tax cost for the borrower (CTA 2009 s 358).

From the lender's perspective, receipt of the guarantee payment should be treated in the same way as receipt of the equivalent payment from the borrower:

- if the guarantor makes a payment in respect of interest that should be treated as interest on a loan relationship for the lender;
- if the guarantor repays the principal outstanding, that should be treated as a 'related transaction' under the loan relationship code: repayment of principal would not normally result in a tax cost for the lender, but will depend on the circumstances (for instance, if the lender impaired the debt) and accounting treatment.

Finally, where satisfaction in cash is not possible, a lender may accept satisfaction (or part satisfaction) of the guarantee call through an issuance of shares. This presents additional complications, including whether this leads to a connection between the guarantor group and the lender and whether any tax grouping is broken.

Withholding tax

As mentioned above, there are broadly two views as to how guarantee payments can be analysed.

Under the first approach where the guarantee payment assumes the nature of the debt obligation, withholding tax would be due if the guaranteed payment is in respect of annual interest and paid from a UK source. This may also allow the guarantor to benefit from any exemption applicable to the underlying obligation – perhaps most notably, the quoted Eurobond exemption. However, the difficulty with this approach is that it is not the analysis that HMRC applies to guarantee arrangements generally (as explained above, HMRC regard the guarantee as being a separate money debt to the underlying obligation).

Under the second approach where the guarantee is regarded as a separate obligation, the guarantor should only be required to withhold UK tax to the extent that the payment is treated as an 'annual payment' for UK tax purposes (as noted above, on this view the payments should not be 'interest').

As with the corporation tax position, it may often be possible to avoid this uncertain withholding tax analysis through the guarantor putting the borrower in funds, rather than making guarantee payments itself.

If a guarantor does make payments and a withholding tax obligation arises in relation to which no domestic exemption applies, it may be possible for the parties to mitigate withholding tax leakage through a claim under a double tax treaty. This may be through the 'interest' article (noting here that 'interest' in a treaty may have a wider meaning than under UK domestic law) or under the 'other income' article. The procedures to enable a payer company to pay without deduction may be different depending on the characterisation of the payment.

In its double taxation treaty passport scheme guidance, HMRC confirms that it regards the date from which the guarantee is called upon (and the guarantor assumes liability for payments) as the beginning of a new loan relationship amenable to the use of a passport (DTTP30180). We are also aware of HMRC accepting 'one-off' treaty clearance applications, as well as DTTP applications, in respect of guarantee payments where there is a concern that a UK withholding obligation would arise in respect of that payment. It thus seems that HMRC adopts a pragmatic approach, regardless of whether the withholding arises through the payment being 'interest' or an 'annual payment'.

Given that most commercial loan agreements include a 'gross up' for withholding tax on guarantee payments, this is an important practical point.

Release

Sometimes a guarantor may make a payment to the lender to be released from its obligations under the guarantee. A guarantor may make such a payment either before borrower default (e.g. if the guarantor is being wound down or sold), or after borrower default (e.g. as part of a compromise arrangement between the guarantor and the lender). Tax points to consider include the following:

- Where the borrower has not defaulted, in most cases the guarantor will not be able to claim a deduction for UK tax purposes in respect of the payment (because it is a capital payment and/or not incurred wholly and exclusively for the purposes of its trade). Further, because no money debt has crystallised, there should be no adverse UK corporation tax consequences for the guarantor on the release of the guarantee (which remains a contingent liability).
- Where the borrower has defaulted and the guarantee called, the position is more complex. In this scenario, the obligation to make the payment under the guarantee would have crystallised (a current liability) and so, on HMRC's analysis, a 'money debt' is owed. Subject to the accounting treatment, although the guarantor may not be able to claim a deduction in respect of the amount paid, in some cases, the guarantor may be required to recognise any shortfall between the amount it pays and the amount released as taxable income (although symmetrical (neutral) tax treatment should be possible).

Indirect taxes

Although not addressed in this article, the indirect tax treatment of guarantee arrangements should not be overlooked. It should not be assumed that guarantee arrangements do not attract indirect tax consequences. This is a complex area with limited guidance.

Non-UK considerations

This article focuses on UK issues but, as borrowings in multinational groups frequently include parent company guarantees and cross-guarantees, non-UK issues should always be checked and are not always intuitive. For example:

- Depending on how a particular jurisdiction views guarantees, a UK borrower or UK guarantor could have non-UK withholding tax obligations (in addition to its UK obligations).
- Some jurisdictions impose stamp or registration taxes on companies entering into guarantees (even where those guarantees are not called).
- Profit attribution rules (for example CFC rules) may apply where a subsidiary of that shareholder guarantees its debt (for example, in the US before a change in law in 2017 a guarantor which was a CFC of a US debtor could lead to a deemed distribution of CFC earnings for US tax purposes).

Questions to pose in practice

Bringing together some of the points mentioned above, key questions to consider to determine the UK tax analysis are as follows:

- What is the legal nature of the guarantee? For instance, does the guarantee include an indemnity?
- Does the guarantee allow subrogation? If so, how does the subrogation mechanic work: is there an explicit mechanic or does it apply through operation of law? In a case where the guarantee has not been fully satisfied, has any subrogation right actually been activated?
- If there is a risk of borrower default, are there alternative steps which might be considered instead of the guarantee being called? For example, is an agreement or 'standstill' with the lender feasible? Could the guarantor fund the borrower rather than make payments directly?
- What is the withholding tax gross-up position on guarantee payments in the finance documentation? Does it differ from the position for the borrower?
- How are the guarantee arrangements treated for accounting purposes? Where there are different restructuring options, do those present a different accounting treatment? What is the tax analysis of those options? ■