Weil

Weil, Gotshal & Manges
With approximately 1,100 lawyers in offices on three continents around the world, Weil operates according to the 'one firm' principle, allowing us to bring the right mix of firm-wide skill and local-market presence to deliver the coordinated legal advice necessary to help our clients achieve their sophisticated goals and objectives.
Weil's tax team is a global practice, advising clients on a broad range of domestic and cross-border tax issues, advising on restructurings, private equity and general corporate M&A transactions, leveraged and structured financings, fund formation, tax-efficient incentive arrangements and tax litigation.

Authors David Irvine and Nathan Langford

Debt waivers in cross-border restructuring: problems with the UK's anti-hybrid legislation

KEY POINTS

- Recent changes to UK tax law appear to have resulted in a stealth increase to the number of situations in which a release of loans in cross-border restructuring scenarios can be taxable in the UK.
- The date on which a loan was entered into or drawn down now appears to have a material effect on the UK tax treatment on its release (potentially making the difference between that release giving rise to taxable income or not in the UK).
- It is not clear whether these changes were deliberate, or are simply a by-product of oversight and several otherwise unrelated changes to UK tax law.
- Absent a change in law, the likelihood of cross-border debt releases giving rise to UK tax charges will increase with the passage of time.

Group restructurings, particularly those arising in the context of a corporate rescue, commonly involve a reworking of the group's borrowing arrangements. This can often involve the formal release of outstanding debts, whether those debts are owed to third parties, or are intra-group.

Restructuring practitioners often start from a working assumption that even where a UK company is party to a loan as debtor, the release of that loan should not give rise to any adverse UK tax consequences.

Approaching this assumption from a technical standpoint, the basic position under the relevant UK tax legislation (the 'loan relationship rules', as set out in Parts 5 and 6 of the Corporation Tax Act 2009 (CTA 2009)) is actually that the release of a debt owed by a UK company will give rise to taxable income in that debtor company. However, the loan relationship rules contain a number of exceptions to this position, some of which are drafted specifically to prevent releases of: (i) intra-group debt; or (ii) releases made in a corporate rescue situation, from giving rise to a UK tax charge. As a result, the restructuring professionals' working assumption described above is not an unreasonable starting position.

BEAR TRAPS FOR THE UNWARY

Unfortunately (and as is so often the case with UK tax law), there are some particularly nasty bear traps for the unwary. Our recent experience suggests that another such bear trap may have found its way onto the statute books, with the potential to affect loans (or in certain cases, new tranches of existing loans) entered into in an accounting period beginning on or after 1 January 2016.

The bear trap leading to the potential charge arises out of the UK's anti-hybrid legislation (the 'anti-hybrid rules', as set out in Part 6A of the Taxation (International and Other Provisions) Act 2010 (TIOPA 2010)). The anti-hybrid rules are mechanistic, and seek to counter mismatches in the tax treatment of an instrument, circumstance, or entity, under non-UK tax laws, as compared to the treatment arising under UK tax law. By way of simple example, the anti-hybrid rules seek to deal with certain situations where one party to an 'instrument' obtains a tax deduction for payments relating to that instrument, but the counterparty does not recognise a corresponding amount of taxable income.

Chapter 3 of the anti-hybrid rules ('Chapter 3') contains rules designed to counter mismatches arising from 'financial instruments' – the definition of which explicitly includes arrangements, broadly, which fall to be taxed under the loan relationship rules. A debt will usually constitute a loan relationship, so will also usually constitute a 'financial instrument' – and, as a result will usually fall within the scope of Chapter 3.

The rules set out in Chapter 3 will result in a UK tax charge where the following four conditions are satisfied:

a. a payment or quasi-payment is made under or in connection with a financial instrument;
b. the payer or the payee is within the charge to [UK] corporation tax for the payment period (or, for the payee, an accounting period some or all of which falls within the payment period);
c. absent the UK's anti-hybrid legislation (and any overseas equivalent), there would be a hybrid or otherwise impermissible deduction/non-inclusion mismatch in relation to the payment or quasi-payment; and
d. (amongst other things) the payer and payee are related at any time in the period beginning with the day on which any arrangement is made by the payer or a payee in connection with the financial instrument, and ending with the last day of the payment period.

Applying these tests to a simple example should help to understand these conditions. Suppose that a UK debtor company ('UK Debtor') owes money under a loan relationship (the 'Loan') to a US sister company ('US Creditor') which sits in the same group as UK Debtor.

Feature

Biog box

David Irvine, Partner, Weil, Gotshal & Manges (London) LLP. Email: david.irvine@weil.com. David advises on the UK and international tax implications of complex refinancing and restructuring transactions. He also advises companies and multi-asset managers (sponsors and management teams) on the tax aspects issues associated with their investment programmes, on fund structuring and on incentivisation arrangements and advises institutional investors on their investments with and into private funds.

Without getting too involved in the detail, it is relatively easy to see that, as one of the companies which is party to the loan is a UK entity, condition (b) above is likely to be met. In addition, as UK Debtor and US Creditor are sister companies within the same group, condition (d) is also likely to be met.

Looking at condition (a), it may not be immediately obvious that the release of the Loan might constitute a 'payment'. However, the argument becomes more understandable if one considers that, in releasing the Loan, the US Creditor is effectively telling the UK Debtor 'that money which, until now, you had to repay to me is now yours to do with as you please'. Even if the mind still rebels: (i) the relevant definition of 'payment' includes any (indirect) transfer of money's worth – and any argument that a release of a debt is not a 'transfer of money's worth' seems more difficult to sustain than an argument that a release of a debt is not a payment; and (ii) in any event, HMRC's guidance makes clear (at INTM551300 for those interested) their view that a debt release can constitute a 'payment' for these purposes. As a result, it is difficult to argue that a debt release does not satisfy condition (a).

So, with no obvious out from the anti-hybrid rules under conditions (a), (b) or (d), it is necessary to look in more detail at condition (c). Section 259CB TIOPA 2010 defines 'hybrid or otherwise impermissible deduction/non-inclusion mismatch', by reference to two cases. Only one of those cases ('Case 1') is relevant to our example, and covers a situation where:

I. the relevant deduction exceeds the sum of the amounts of ordinary income that, by reason of the payment or quasi-payment, arise to each payee for a permitted taxable period; and
II. all or part of that excess arises by reason of the terms, or any other feature, of the financial instrument.

Where an overseas lender (for example, the US Creditor in the scenario above) obtains, under relevant domestic law, a deduction as a result of the release of a UK debtor company, and the UK debtor company is not subject to tax in the UK in respect of that release (ie there is a mismatch), (I) here will be in point.

It is worth noting that (I) takes no account of the reason for such a mismatch. As a result, the rules are wide in scope (and much wider than the scope of the *Base Erosion and Profit Shifting Action 2* report from which the UK's anti-hybrid rules drew their inspiration – which sought to address only mismatches arising from arrangements actually involving some form of 'hybrid').

The result of this wide ambit is that, in order to fall outside Chapter 3 (and the UK tax consequences that arise as a result), it is necessary for (II) not to be met. The problem with this is that HMRC takes an inclusive view of the phrase 'by reason of the terms, or any other feature, of the financial instrument'. In fact, HMRC explicitly states (at INTM551130), that:

> The addition of the phrase 'or any other feature' to s 259CB(2) widens the scope of Case 1, bringing within it, for example, mismatches that arise by reason of the financial instrument being treated in a more beneficial manner because of the relationship between the relevant parties…

So, in HMRC's view, the fact that a loan is a 'connected companies relationship' will be a 'feature' of the loan. And, as a UK debtor party to a connected companies relationship (ie an intra-group loan) can be treated more beneficially in certain situations where its debt is released than it would be if the relationship was not a 'connected companies relationship' (II) is arguably (and is, in HMRC's view) met. As a result, any such release, where an overseas lender also obtains a deduction in respect of the release, is potentially within the hybrid mismatch rules.

However, helpfully the legislation seems to address this exact point: s 259CB(3) makes clear that (II) above will not be fulfilled where the 'excess arises by reason of a relevant debt relief provision'. The definition of 'relevant debt relief provision' (which is set out in s 259CC), includes UK legislative provisions which provide for income to be excluded for a debtor company which has its debt released (for those interested, these are ss 322, 357, 358, 359, 361C, 361D and 362A CTA 2009).

That the provision in s 259CB(3) exists seems to imply that the legislators:

- were clearly of the view that the above-mentioned sections of the loan relationship rules could result in a mismatch under the hybrid mismatch rules; and
- in order to prevent this being the case, included s 259CB(3).

So, no problem, right? In our example, the release of the Loan should still not give rise to UK tax, as the legislation includes a 'fix' for the potential issue? Well, if the loan (and each tranche thereof) was entered into prior to 1 January 2016, then yes, feel free to stop reading. However, for any loan relationship entered into by a company in an accounting period beginning or after 1 January 2016, s 321 CTA 2009 was repealed, and this repeal leads to a potential issue here. For ease, s 321 reads/read as follows:

> 321 Credits and debits recognised in equity
> (1) This section applies if in accordance with generally accepted accounting practice a credit or debit for a period in respect of a company's loan relationship –
> (a) is recognised in equity or shareholders' funds, and
> (b) is not recognised in any of the statements mentioned in section 308(1).
> (2) The credit or debit is to be brought into account for the period for the purposes of this Part in the same way as a credit or debit which is brought into account in determining the company's profit or loss for the period in accordance with generally accepted accounting practice.

Section 308(1) CTA 2009 makes clear that, for the purposes of the loan relationship rules, amounts recognised in determining a company's profit or loss for a period are references to an amount that is recognised in the company's accounts for the period as an item of profit or loss.

In brief then, the effect of s 321 CTA 2009 (at least for loans to which it applies) is to force companies to treat amounts which would otherwise never have touched their profit and loss account

Biog box

Nathan Langford, Associate, Tax, Weil, Gotshal & Manges (London) LLP. Email: nathan.langford@weil.com. Nathan advises on UK tax issues arising across a wide range of transaction types, with particular focus on high-value restructuring matters and complex financing arrangements. Nathan also advises private equity clients on UK tax issues arising throughout the life cycle of a private equity fund, from fund formation through to the acquisition and disposal of fund assets.

(being recognised instead directly on the balance sheet) as items of profit or loss (as applicable) for the purposes of the tax (loan relationship) rules.

Why does this matter? Well, the 'general rule is that the amounts to be brought into account by a company as credits [taxable income] and debits for any period for the purposes of [UK tax] … are those that are recognised in determining the company's profits or loss for the period in accordance with generally accepted accounting practice' (s 307 CTA 2009).

As a result (taken broadly) the loan relationship legislation charges to tax amounts which are brought into account by a company as credits and debits relating to those loan relationships. Those credits and debits are, broadly, the amounts which relate to that company's loan relationships, and are featured in its profit and loss account.

However, in the absence of s 321 CTA 2009 (which, as noted above, does not apply to loans entered into in an accounting period beginning on or after 1 January 2016), there is nothing that forces credits and debits to form part of a company's profits or losses from a (tax) accounting perspective where the 'ordinary' accounting rules would not result in the relevant amounts being taken through the company's profit and loss accounts. So, it is necessary to look to what the actual accounting position is.

Input from a number of the 'Big 4' accounting firms indicates (perhaps unsurprisingly) that credits and debits relating to the release of a debt owed under a connected company loan relationship will not (in most circumstances) go via a company's profit and loss account at all. Instead, the accounting credit or debit will simply be reflected directly in the relevant company's balance sheet.

As a result, these release amounts never come within the scope of the loan relationship legislation (since they are not recognised in determining the company's profit or loss for the period in accordance with generally accepted accounting practice).

This has a number of effects. Under the loan relationship rules, the key effect is that the relieving provisions in the loan relationship rules (the 'relevant debt release provisions', as the anti-hybrid rules refer to them) are not engaged, as there are no credits arising on the connected company debt waiver which fall to be charged under the loan relationship rules in the first place, so there is nothing for the 'relevant debt release provisions' to relieve from charge.

WHAT IS THE TAX EFFECT OF THIS?

At least under the loan relationship rules, it should be UK tax neutral. This is because, prior to the repeal of s 321 CTA 2009, connected company debt releases were brought into the scope of the loan relationship rules by virtue of s 321 CTA 2009, but were then relieved from charge under the relevant legislation by specific exemptions. Post the repeal of s 321 CTA 2009, such releases are never brought into charge in the first place, so require no relieving provision. In both cases, therefore, no UK tax arises.

But now let's look at the legislative position under the anti-hybrid rules. The exclusion in (II) (which, as set out above, we are relying on to avoid engaging the anti-hybrid rules) relies on the use of the 'relevant debt release provisions', as defined. But as we have just seen, for loans entered into in accounting periods beginning on or after 1 January 2016, these provisions cannot be engaged. As a result, there seems to be no 'get out' from the UK anti-hybrid rules on such a release. This is a somewhat bizarre outcome for two reasons:

- The release of two otherwise identical loans may suffer materially different UK tax consequences – with one being taxable, and the other relieved from tax – purely because one loan was entered into on 31 December 2015, and one was entered into on 2 January 2016, in an accounting period which began the day before. Turning back to our example, does it seem right that the date on which the Loan was entered into has such a significant effect on the UK tax treatment on its release – notwithstanding that the tax position under the primary legislation dealing with the release effectively remains the same?
- The release of a connected company loan is now, in certain circumstances, effectively a taxable transaction, notwithstanding that there are provisions within UK statute (both in the loan relationship rules and in the anti-hybrid rules themselves) which appear aimed at relieving such a charge.

Where does that leave us? On the one hand, the inclusion of s 259CB(3) TIOPA 2010 seems to indicate that the legislators did not intend for debt releases which are exempted from UK tax under the circumstances addressed by the loan relationship rules to fall within the scope of the anti-hybrid rules. However, on the other hand, the anti-hybrid rules are mechanistic, do not contain any kind of purposive test, and for loans entered into after 1 January 2016, the legislators appear not to have succeeded in excluding such debt releases from the scope of the anti-hybrid rules.

It is difficult to believe this is anything other than an oversight – but absent an amendment to the legislation (and attempts to engage with HMRC on this have, to date, met with limited success) reaching a conclusion that the anti-hybrid rules do not apply is likely to prove very difficult.

At the moment, this issue is likely to affect a relatively narrow group of taxpayers as it only arises on certain releases of loans entered into in accounting periods which have begun in the last two and a half years. However, as we move further away from 1 January 2016, and more post 1 January 2016 debt falls into restructurings, the opportunities for this issue to arise can only increase. ■

Further reading

- LexisPSL Restructuring and Insolvency: Practice Note: Restructuring: Restructuring Tools: Restructuring process
- LexisPSL Restructuring and Insolvency: Practice Note: Debt waivers, extending maturity and debt rescheduling
- LexisPSL Restructuring and Insolvency: Practice Note: Tax and Insolvency: Debt restructurings – points to consider when dealing with distressed debt