MODERNISING THE TAXATION OF CORPORATE DEBT AND DERIVATIVE CONTRACTS

DRAFT GUIDANCE FOR THE CORPORATE FINANCE MANUAL ON THE CORPORATE RESCUE EXEMPTION

On 10 December 2014 the Government published draft legislation to be included in Finance Bill 2015, together with explanatory notes. These include a schedule of amendments to the corporation tax rules on loan relationships in Part 5 of the Corporation Tax Act 2009 (CTA 2009).

New sections 322(5B) and 323A of CTA 2009 will remove the obligation to bring into account a loan relationships credit arising on a release, modification or replacement of debt in certain circumstances where a company is unable to pay its debts. The new sections will apply to the release, modification or replacement of a debtor relationship of a company on or after 1 January 2015.

The following pages set out draft guidance on this new legislation for inclusion in HMRC's Corporate Finance Manual (CFM).

This provisional guidance explains HMRC's interpretation of the proposed legislation as published on 10 December 2014. It is published here to help companies and their advisers consider the application of the new legislation until the CFM is amended following the enactment of the legislation. Comment is invited on this draft guidance and the final text incorporated into the CFM will take account of comments received and any amendments to the draft clauses.

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CFM33xxx: Loan relationships: computational rules: credits not brought into account: debt releases: corporate rescue exemption: overview

CTA09/S322(5B) provides an exemption for a credit arising on the release of a debt where the release takes place on or after 1 January 2015 as part of what are commonly referred to as 'corporate rescues'. The exemption applies where it is reasonable to assume that but for a release of a debt, there would be a material risk that at some time in the 12 months following the release the company would be unable to pay its debts.

Where this is the case, the company is not required to bring into account a credit in respect of the release.

There is a similar exemption in CTA09/S323A for a credit that arises on the replacement or modification of a debt on or after 1 January 2015, where this is part of a corporate rescue. In this case, where no credit has been brought into account, no debit may subsequently be brought into account where there is a later reversal of the exempted credit.

CFM33xxx explains the policy intention behind the exemption in CTA09/S322(5B).

CFM33xxx to CFM33xxx explains the conditions required for the exemption to apply.

CFM33xxx explains the CTA09/S323A exemption.

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CFM33xxx: Loan relationships: computational rules: credits not brought into account: debt releases: corporate rescue exemption: policy intention

The CTA09/S322(5B) exemption is aimed at companies in significant financial distress (as is the CTA09/S323A exemption) – companies for which there is a real and foreseeable prospect that they will be unable to pay their debts.

A creditor may agree to a debt restructuring where a debtor is experiencing financial difficulties and is unable to repay the interest and/or principal on a debt. In the case of lending between third parties at arm's length, a creditor will normally only agree to such a restructuring as a last resort, where there is a genuine prospect of non-payment.

In many cases, the creditor and debtor will enter into a debt-for-equity swap under which the creditor will take an equity interest in the debtor in exchange for the release of the debt. CTA09/S322(4) exempts the credit that appears in the debtor's accounts and which would otherwise be taxable as a loan relationship credit. CFM33200+ explains the exemption for debt-for-equity swaps.

Where a company is already in insolvency a credit on a release will be exempt where one of the insolvency conditions applies – see CFM33190. However, insolvency practitioners often work with creditors and debtors to achieve a consensual restructuring of debt to prevent actual insolvency. CTA09/S322(5B) may provide an exemption in such cases (as does S323A where the debt is modified or replaced rather than released).

In such cases a lender may be unable or unwilling, for regulatory or commercial reasons, to take equity in the debtor company and take advantage of the exemption in CTA09/S322(4). The exemption in CTA09/S322(5B) is targeted differently to that in S322(4); the former is aimed broadly at cases of corporate distress, and the latter specifically at debt-for-equity swaps. Although the conditions in S322(4) and S322(5B) are not the same it is possible that a credit on release may qualify for exemption under both provisions. In such a case the effect will be the same.

A creditor and a debtor may agree a package of measures under which debt is restructured. In these cases, the exemption for a credit arising under the arrangements may fall partly under CTA09/S322(5B) and partly under CTA09/S323A (CFM33xxx).

Arrangements

The trigger for the exemption in CTA09/S322(5B) is that it is reasonable to assume that without the release and the arrangements of which it forms part, the company would be unable to meet its debts at some time in the next 12 months. The term 'arrangements' is not defined and takes its common meaning. Its use here recognises that the release of a debt is often part of a wider set of negotiations and actions aimed at ensuring the company is able to continue operating. It is not necessary to consider the impact of the release in isolation on the company's survival.

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CFM33xxx: Loan relationships: computational rules: credits not brought into account: debt releases: corporate rescue exemption: reasonable to assume a company is unable to pay its debts

CTA09/S322(5B) applies where it is reasonable to assume that but for a release of a debt, and any arrangements of which the release forms part, there would be a material risk that within 12 months from the release the company would be unable to pay its debts.

Unable to pay its debts

'Unable to pay its debts' is defined in CTA09/S323(A1) as meaning that the company is unable to pay its debts as they fall due, or that the company's assets will be worth less than its liabilities, contingent and prospective. These terms are based on sections 123(1)(e) and (2) of the Insolvency Act 1986.

Material risk

The exemption requires that, in the absence of the restructuring, there would be a 'material risk' that the company would be unable to pay its debts. This requires a significant risk of insolvency that is of real concern to the directors.

However, the test for the exemption to apply is not the same as the condition in section 214((2)(b) of the Insolvency Act of there being 'no reasonable prospect' that the company will be able to avoid insolvency. Importantly, it does not imply that the directors are in breach of their company law obligations by continuing to trade. It is also based on the hypothetical position of what would have happened had the debt not been released. CFM33xxx has more on this.

Reasonable to assume

The evidence for such a 'reasonable assumption' in the context of this provision will normally be the sort of circumstances that may result in insolvency practitioners being called in, and/or statutory or voluntary arrangements being considered, for example:

- likely breaches of financial covenants, negotiations with third party creditors over release or restructuring of debt;
- enforcement actions taken by creditors;
- adverse trading conditions with no prospect of recovery, failure of a material customer or supplier, redundancies, business disasters, litigation that the company may be unable to meet;
- management accounts, reports and forecasts showing material cash flow shortfalls;
- an insolvent balance sheet;
- qualified audit reports, accounts prepared on a break up basis.

An insolvent balance sheet is likely to be the strongest evidence of a reasonable assumption that the company would be in the position of being unable to pay its debts within the next 12 months, although no single factor will necessarily be determinative, and such evidence will usually comprise a number of factors taken together.

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CFM33xxx: Loan relationships: computational rules: credits not brought into account: debt releases: corporate rescue exemption: material risk

Material risk of the company being unable to pay its debts

The terms ‘reasonable to assume’ and ‘material risk’ of being unable to pay debts, taken together mean that there must be a realistic likelihood of the company going into insolvency if remedial action is not taken.

As explained in CFM33xxx, the phrase ‘unable to pay its debts’ is based on section 123 of the Insolvency Act 1986. The Insolvency Act definition is based on the evidence a creditor would need to present to a court to begin winding up proceedings. It is not necessary for such proceedings to have begun in order for the exemption in CTA09/S322(5B) to apply. Nor does it mean that a debtor can merely claim the exemption just because any creditor could at any time commence court proceedings.

Case law on insolvency (for example, Colt Telecom [2002] EWHC 2815, and BNY Corporate Trustee Services Ltd [2013] UKSC 28) emphasises that a court will require more than a ‘modest threshold of probability’ before agreeing to insolvency proceedings.

In BNY, Lord Neuberger said: ‘In practical terms it would be rather extraordinary if section 123(2) was satisfied every time a company’s liabilities exceeded the value of its assets. Many companies which are solvent and successful, and many companies early on in their lives, would be deemed unable to pay their debts if this was the meaning of section 123(2)… Essentially, section 123(2) requires the court to make a judgment whether it has been established that, looking at the company’s assets and making proper allowance for its prospective and contingent liabilities, it cannot reasonably be expected to meet those liabilities. If so, it will be deemed insolvent although it is currently able to pay its debts as they fall due. The more distant the liabilities, the harder this will be to establish.’

For the exemption to apply, then, there must be a ‘real prospect of insolvency’ as an insolvency court would understand it, within the next 12 months. It will not be enough for a company to claim the benefit of the exemption on the basis of temporary cash flow difficulties for which it is seeking bridging finance or which it meets by selling assets. Nor is it sufficient that there is a mere possibility that the company may (like any business) run into problems in some years’ time.

See CFM33xxx for more on the 12 month period.

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CFM33xxx: Loan relationships: computational rules: credits not brought into account: debt releases: corporate rescue exemption: the 12 month period

The exemption in CTA09/S322(5B) applies where it is reasonable to assume when the release was made, that the company will be unable to pay its debts (CFM33xxx) in the following 12 months.

Insolvency practitioners emphasise the importance of a company taking pre-emptive action to avoid future problems. A company may therefore be in discussions with insolvency advisers for some time before the final rescue package is agreed. The key test is whether within the 12 month period there would have been a real prospect of the company being unable to pay its debts. This question is independent of the existence of discussions with insolvency practitioners or creditors, or the state of any such process.

The 12 month time limit is intended to differentiate between the immediate urgency of a corporate recue, which will qualify for the exemption, and more general or strategic liability management exercises, which will not. It does not mean that all necessary action as part of the arrangements of which the release forms part has to take place within the next 12 months.

In a case where the reasonable assumption of a company being unable to pay its debts in the 12 month period cannot be met, a credit arising on a release may still be exempt where the company undertakes a debt-for-equity swap within CTA09/S322(4).

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CFM33xxx: Loan relationships: computational rules: credits not brought into account: debt releases: corporate rescue exemption: modification or replacement

Where a debtor relationship of a company is modified or replaced on or after 1 January 2015, CTA09/S323A provides an exemption for a credit arising. In the context of corporate rescues theses are sometimes referred to as ‘amend and extend’ exercises. The exemption applies where it is reasonable to assume that, but for that modification or replacement, there would be a material risk that a company would be unable to pay its debts at some point in the following 12 months.

The meaning of the phrases ‘unable to pay its debts’, ‘material risk’ and ‘reasonable to assume’ for the purposes of CTA09/S323A is the same as that which applies for the exemption in CTA09/S322(5B). See CFM33xxx – CFM33xxx.

The terms ‘modification’ and ‘replacement’ refer to the accountancy treatment of a ‘substantial modification’ of the terms of the debt which gives rise to a credit. There is no definition of a ‘substantial’ modification in IFRS9 or FRS102, other than meaning ‘more than insignificant’. Examples of cases where credits may be recognised in the accounts are:

- where the debtor’s contractual terms are eased – in effect an accounting profit from having a less onerous obligation to meet;

- where the modification is substantial, as explained further below.

The accounting treatment is to derecognise the existing debt and recognise a new debt instrument based on the new terms. Even though the instrument is accounted for on an amortised cost basis of accounting, the ‘new’ instrument is measured on initial recognition at its fair value.

The difference between the carrying value of the ‘old’ instrument and the fair value of the ‘new’ instrument will be recognised as an item in profit or loss. Typically, in the case of distressed debt, this will be a profit of the debtor company comprising

- the relaxation of conditions under the instrument; and
- the deterioration in the creditworthiness of the company.

This means that the fair value of the instrument in the books of the creditor is worth less than it was originally. In other words, a larger discount factor is used to calculate the present value of the future obligations under the revised instrument.

It should be noted that CTA09/S323A prohibits any debit being brought into account where a credit previously exempted under S323A is reversed. No such prohibition applies to CTA09/S322(4) on the basis that it is not possible to reverse a debt release.

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