Practice guide

Debt restructuring: deemed releases

Speed read

The impact of the pandemic may necessitate a financial restructuring of a company's liabilities. As part of the plan, steps to restructure external debts could be caught by the deemed release rules. For example, a distressed group buys back its debt at a discount to the amount of the liability owed, or the creditor company acquires or otherwise becomes connected with the debtor company. To mitigate taxable deemed releases in significant corporate distress situations there must be an actual release within 60 days of the potential trigger. Awareness of the deemed release rules to take timely action to manage the risk is crucial. The corporate rescue relief disapplies the deemed release rule if the whole debt concerned is released. If there is a partial release, then the deemed release amount is reduced by the amount released. Care is needed when computing the deemed release amount to ensure sufficient debt is released to mitigate the deemed release amount. Deemed releases are relevant to loan relationships in CTA 2009 Part 5 and trading or property business debts in CTA 2009 Part 6.

Paul Pritchard
FTI Consulting
Paul Pritchard is a managing director in the European tax advisory practice at FTI Consulting LLP. He is a chartered accountant (2002) and chartered tax adviser (2004), and he has advised on tax aspects of complex debt restructurings over the last ten years. Email: paul.pritchard@fticonsulting.com; tel: 020 7269 7193.

The global pandemic has had an unprecedented impact on businesses. For some, the pandemic has stressed their financial position such that a restructuring is necessary. This may involve reducing debt liabilities through releases, equity injections to pay down debt and/or easing the debt burden through changes to terms of borrowings.

Other approaches may involve the rights to the debt and so this article discusses the deemed release rules.

All statutory references in this article are to CTA 2009 unless otherwise stated.

Deemed releases

The actual release of a debt liability is just one way to manage a debtor's indebtedness in financial distress. It is not uncommon that a creditor may have legal and commercial constraints such that it cannot undertake an actual release or a debt for equity swap. Alternative approaches may involve transferring the impaired debt rights into the debtor's group.

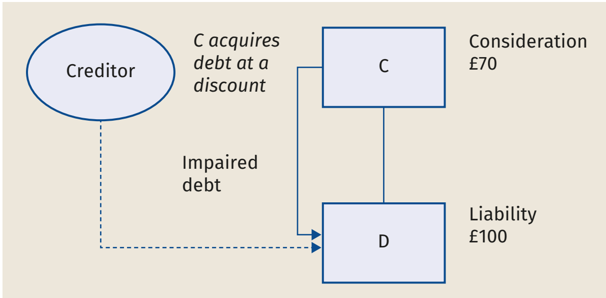
As there is no actual release, then a debtor should not be affected if the wider group takes ownership or control of the debt rights. The deemed release rules then become relevant and may result in a taxable release for the debtor company.

Like the corporate rescue relief for actual releases, a similar relief for deemed releases situations exists. It requires an actual release within 60 days of the deemed release being triggered to switch off the whole or part of the deemed release.

The deemed release rules apply to loan relationships, but since Part 6 applies to releases of relevant non-lending relationships then the deemed release rules also apply to debts where there has been a deduction in computing trading or property business profits. The application of deemed release rules does not extend to debts in respect of unpaid management expenses.

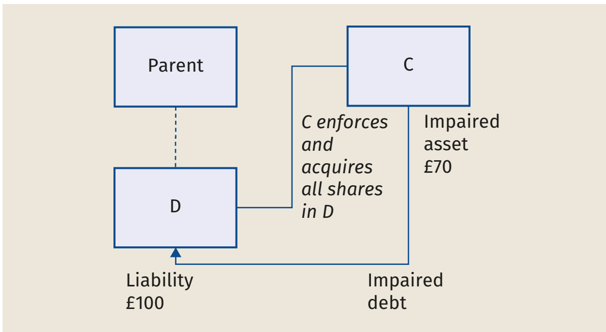
By way of overview, deemed releases may arise in two situations illustrated below.

Section 361: Acquisition of debt at a discount



Section 361 is relevant where a company connected with the debtor company acquires the debt rights for consideration which is less than the amount of the liability. In the example above, debtor (D) owes the creditor (C) £100 and C acquires the rights for £70. D is deemed to be released of the difference and has a taxable credit of £30.

Section 362: Debtor and creditor become connected



Section 362 is relevant where a company which is a creditor becomes connected with the debtor company, and in broad terms, the carrying value of the impaired debt asset is less than the liability. In the example above, D has defaulted on its loan owed. C enforces with the result that C acquires all of D's shares and so becomes connected with D. C has lent £100 to D and carries the asset at £70, due to impairment, while D carries a liability of £100. C is deemed to release D of the difference and has a taxable credit of £30.

The deemed release situations in ss 361 and 362 are discussed in more detail below.

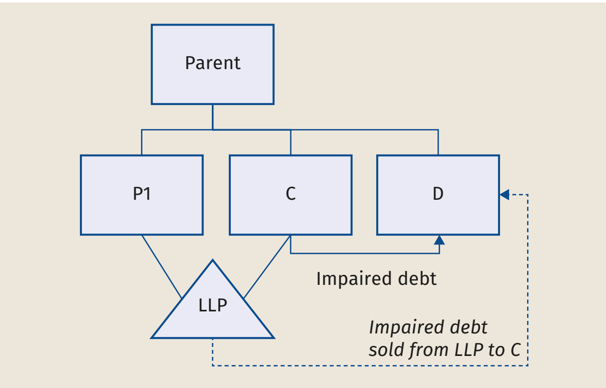
Section 361: acquiring impaired debt

Section 361(1) specifies the conditions to be met for s 361 to trigger a deemed release. Conditions (1)(a) to (c) are met where a company D is party to a loan as debtor and another company C becomes party to it as a creditor, and immediately after C and D are connected.

C and D may be immediately connected afterwards because they were already connected or because C acquired shares in D at the same time as acquiring the debt in D. This is common in corporate mergers and acquisitions (M&A), particularly private equity transactions.

If the person from whom C acquired the debt is a company, then condition (1)(d) requires in the period of account in which C acquires the debt that there is no connection between the two companies. This additional condition ensures there is no deemed release where the debt is transferred intra-group. However, as illustrated below, this may trigger a deemed release where a debt is transferred from a partnership to a corporate partner as the LLP does not satisfy the company requirement.

Condition (1)(d) example



Condition (1)(e) is met if the amount or value of any consideration given by C for the acquisition is less than the *pre-acquisition carrying value.*

Section 361 cannot apply if the consideration is shares (or an entitlement to shares) in C, or a company connected to C, such that the equity for debt exception in s 361C applies. If this exception applies, then condition (1)(f) is not met and therefore s 361 cannot apply. Section 361C is discussed in the examples further below.

Where conditions (1)(a) to (f) are met then C is treated as releasing its rights under the loan relationship when it acquires them. The amount treated as released is the difference between the consideration and the pre-acquisition carrying value ('PACV').

How is consideration and PACV determined?

To compute the difference under s 361(e), it is important to ensure the amounts of consideration and PACV compared are the *same* in nature.

Section 361(4) states that the amount of the deemed release is the difference of the amounts of the consideration and PACV referred to in condition (1)(e). The consideration must be less than the PACV.

Whilst s 361(6) indicates the PACV is to be determined taking no account of accrued amounts or amounts paid or received, such an adjustment appears to be one-sided when compared to the consideration. In the writer's view, the consideration amount to use for computing the difference should also exclude accrued amounts. The example in HMRC's *Corporate Finance Manual* at CFM35460 indicates the PACV and consideration both exclude accrued interest. This is an important point to note if computing a s 361 deemed release amount.

The adjustment for accrued amounts represents amounts which were taxable in both the creditor and debtor (if both were UK resident companies). The effect of adjusting out accruals is to compute a deemed release credit in the debtor which equates to the impairment loss deducted by the creditor.

To illustrate the point, consider a loan of £100 with accrued interest of £15 and carried as a total liability in the debtor's accounts of £115. A third party carries the loan receivable, including accrued interest of £15, after an impairment of £45 at an asset value of £70. The third party sells the loan to a creditor connected with the debtor for £70.

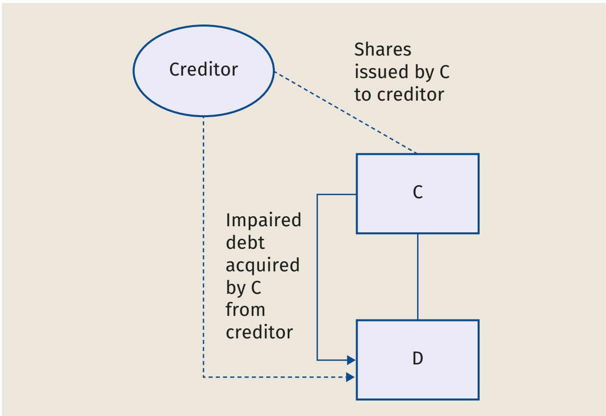
The section 361 deemed release credit is computed as follows:

- Consideration = £70 - £15 = £55
- PACV = £115 - £15 = £100
- Deemed release credit = £100 - £55 = £45

If there is a deemed release credit triggered, then CFM35460 indicates the debtor may claim a deductible debit when the debt is repaid, with a taxable credit in the creditor.

Section 361 examples

Equity for debt exception: s 361C



In a debt restructuring situation, a creditor could transfer the rights to the impaired debt into the debtor's group rather than release the debt under a debt for equity swap.

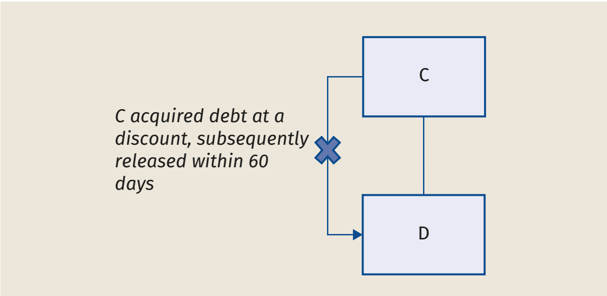
Where the acquisition of the impaired debt is an arm's length transaction, and the shares form part of the ordinary share capital of C, or a company connected with C, then the equity for debt exception in s 361C should apply. This has the effect of causing the condition in s 361(1)(f) to fail and so a s 361 deemed release cannot arise.

As the shares issued must form part of the ordinary share capital of C, or a company connected with C, then s 361C is not available if fixed rate preference shares are issued to the creditor. The corporate rescue relief in s 361D may be helpful in that situation.

The s 361C exception is a useful tool to overcome legal or commercial constraints associated with an actual debt release. A deemed payment of interest under the funding bond rules is also avoided, and this is helpful where the debt has been traded and treaty clearance is not available to the new creditor.

Whilst s 361C can apply where the creditor receives an entitlement to shares (e.g. warrants) instead of actual shares, care is needed here as the grant of options is a disposal event for chargeable gains purposes. So, where the debt rights transferred have any material value, a chargeable gain may arise in C or the derivative contract rules need to be considered. (Readers may wish to refer to the discussion on warrants and derivative contract rules in the author's previous article, 'Restructuring: debt releases', Tax *Journal*, 14 May 2021.)

Corporate rescue exemption: s 361D

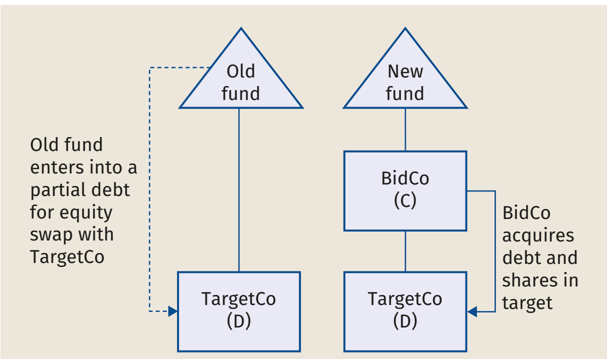


Similar to the debt release exemption in s 322, there is a *corporate rescue* relief available for s 361 deemed releases. It is similarly targeted at companies which are in significant financial distress. Section 361D applies where s 361 would otherwise apply, and within 60 days of C becoming connected to D, C releases D's liability to pay an amount and the corporate rescue conditions are met. A deemed release can be mitigated if there is an actual release.

The corporate rescue relief has two conditions to be met. Firstly, the debt rights are acquired in an arm's length transaction. Secondly, immediately before C became party to the debt rights it was reasonable to assume that, without the release and any arrangements of which the release forms part, there would be a material risk that at some time in the next 12 months the company would be unable to pay its debts.

If these conditions are met, and the whole debt is released, then s 361 does not apply to the acquisition of the rights by C. If part of the debt is released, then the deemed release amount is reduced by the actual release. If there is a release of part of the debt, the difference between the consideration and the PACV needs to be correctly determined otherwise a taxable credit may still arise. Continuing with the earlier illustration of computing the difference, using actual consideration of £70 and a PACV of £100 then the deemed release could be incorrectly determined as £30. As the correct deemed release is £45, an actual release of £30 would still leave a taxable credit of £15. Unless there is a compelling reason to undertake a partial release within 60 days, it is recommended to simply release the whole debt such that s 361 does not apply.

Pre-sale restructuring: corporate M&A example



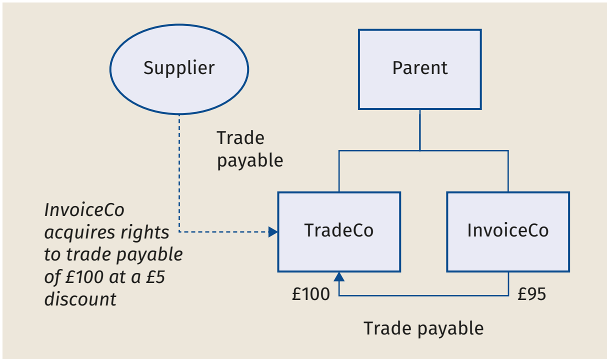
Suppose in an M&A situation the overall enterprise value of the target company is less than the value of the debt outstanding. BidCo's acquisition of all debt and shares would trigger a section 361 deemed release. To undertake a sale of TargetCo to BidCo a pre-sale release of debt to its recoverable amount is needed and so TargetCo avoids a deemed release when acquired by BidCo.

Furthermore, the seller Old Fund, is a partnership and the connected company release exemption in s 358 cannot apply. Therefore, an exempt debt for equity swap needs to be undertaken prior to the sale.

HMRC's guidance at CFM33202 indicates an on-sale of shares to an unconnected third party does not undermine HMRC's view of the availability of the debt for equity swap exemption. The guidance at CFM35590 indicates a release of a debt to its recoverable amount is not considered itself to trigger the application of the deemed release anti-avoidance rule in s 363A (discussed later).

These two aspects of HMRC's guidance are helpful in providing comfort that no adverse tax consequences arise in a corporate M&A situation where there is a sale of both shares and debt between third parties.

Trade debts: reverse factoring arrangements



In a non-restructuring situation, deemed releases can still arise. In the example above, InvoiceCo seeks to purchase a trade receivable of £100 owed to Supplier by TradeCo, a connected company. TradeCo has claimed a deduction in computing its trading profits. Supplier may achieve early payment of the trade receivable by selling the receivable to InvoiceCo at a discount of £5 to the amount owed and so receives £95. Such an arrangement is caught by s 361 and therefore TradeCo needs to ensure it includes the deemed release credit of £5 in its trading profits.

The relevant non-lending relationship rules in Part 6 apply to releases of debts where there has been a deduction in computing the profits of a trade or property business. For the purposes of s 481, a release includes deemed releases. This is noted in HMRC's guidance at CFM41070. This aspect tends to be overlooked, and so can result in significant and unexpected tax consequences.

Section 362: debtor and creditor *become* connected

Section 362 triggers a deemed release of a loan relationship liability where the debtor and creditor companies become connected. This may occur in a restructuring where a creditor acquires a controlling shareholding in the debtor, for example on a debt for equity swap.

Section 362(1) requires the creditor and debtor are not connected and then the companies *become* connected. The definition of connection takes it meaning from s 363 instead of s 348. Section 363 indicates there is a connection at *any* time if the control condition exists at *that* time. The control condition is met if A) one company has control of the other or B) both companies are under control of the same person. Section 363 also specifies there is a connection for the whole period of account if there is a connection at any time in the *period of account*; this differs from s 348 which deems connection for the whole of the *accounting period*.

Where the companies become connected then the pre-connection carrying value (PCCV) of the debt in the creditor's accounts and debtor's accounts is compared. To the extent the debtor's PCCV exceeds the creditor's PCCV then the excess is deemed to be released.

For the debtor's PCCV, it is the carrying value of the liability representing the debt in the debtor's accounts assuming that a period of account would have ended immediately before C and D become connected.

As this is an accounting test, the legislation does not appear to require adjustments if the debtor uses fair value accounting or has bifurcated the debt liability for accounting purposes. There is no explicit requirement to use an amortised cost basis of accounting to determine the debtor's PCCV.

For the creditor's PCCV it depends whether the creditor was party to the debt asset on the last day of the period of account ending immediately before connection arises. If the debt was held then the PCCV is the carrying value of the asset on that last day, using an amortised cost basis of accounting, and in any other case the creditor's PCCV is the amount or value of any consideration given to acquire the asset.

Like s 361, the PCCV of the debt asset and liability exclude accrued amounts, or amounts paid, or received in advance. Establishing the PCCV in both the debtor and creditor does require the accounting amounts and treatment to compute the necessary amounts. In the normal situation it is expected that the debtor and creditor use an amortised cost basis of accounting and so adjustments to accrued amounts are required.

Consider a company C with a loan asset of £70, after recognising accrued interest of £15 and an impairment of £45. The debt liability in company D is a liability with a carrying value of £115, including accrued interest of £15. In the context of s 362, assume C and D become connected instead of the creditor selling the debt rights for £70 to the debtor group.

The s 362 deemed release credit is computed as follows:

- C's PCCV = £115 - £15 = £100
- D's PCCV = £70 - £15 = £55
- Deemed release credit = £100 - £55 = £45

The amounts in the s 362 calculation are the same as the amounts in the earlier s 361 calculation. This is intended to demonstrate the adjustments for accrued amounts under either rule should produce the same deemed release amount.

Where the creditor and debtor companies are connected then s 349 requires an amortised cost basis of accounting to be used when applying the loan relationship rules for the period. When the creditor and debtor first become connected then the actual accounting in each company needs to be adjusted if it is not amortised cost basis of accounting for s 349 purposes.

HMRC's guidance at CFM35480 indicates that adjustments under s 316 arise on transitioning the carrying value of a debt from fair value accounting to amortised cost accounting. Those adjustments may arise in the creditor, and though unusual, they could arise in the debtor company. Any transitional adjustments in the creditor are taxable. Any transitional adjustments in the debtor company are not deemed release amounts and so cannot be prevented from arising under the corporate rescue exemption in s 362A (discussed further below).

What is amortised cost?

To recap, s 313(4) defines an 'amortised cost basis of accounting' as a basis of accounting under which an asset or liability representing a loan relationship is measured on the company's balance sheet at amortised cost. Amortised cost, per s 313(4A) takes its meaning as it has for accounting purposes. Its meaning under UK GAAP if FRS 102 is applied and stated below.

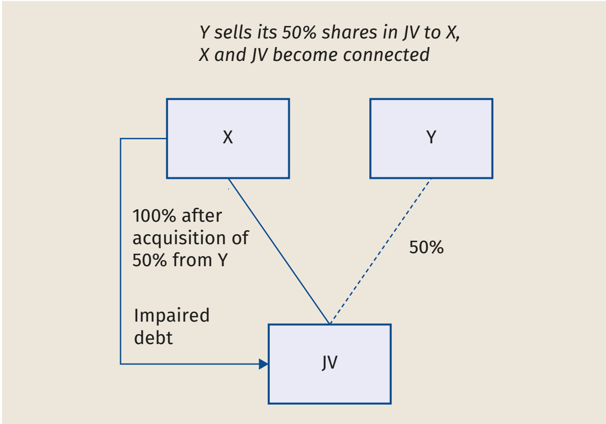
FRS 102 para 11.15 states:

> 'The amortised cost of a financial asset or financial liability at each reporting date is the net of the following amounts:
> '(a) the amount at which the financial asset or financial liability is measured at initial recognition;
> '(b) minus any repayments of the principal;
> '(c) plus or minus the cumulative amortisation using the effective interest method of any difference between the amount at initial recognition and the maturity amount;
> '(d) minus, in the case of a financial asset, any reduction (directly or through the use of an allowance account) for impairment or uncollectability.'

A similar definition is used in IFRS 9 for IFRS and FRS 101 purposes.

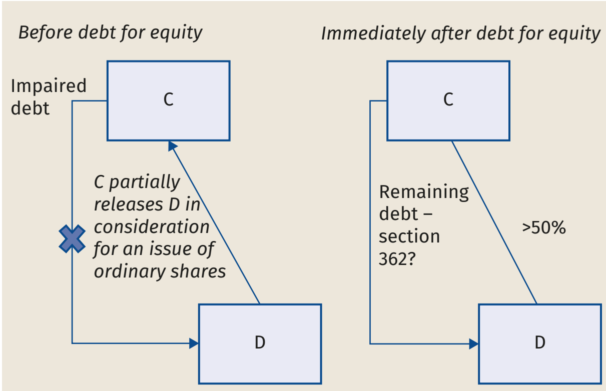
Section 362 examples

Exiting a joint venture arrangement



Companies X and Y are partners in JV, a joint venture company. Company X has already fully impaired its debt asset with JV. Company Y seeks to exit the arrangement and Company X proposes to acquire its 50% shareholding in JV. If this occurs, then X will become connected with JV and a s 362 deemed release shall occur.

Partial debt for equity swap



Debtor company D is in financial difficulties and creditor company C has impaired the debt already. As the business performance of D continues to deteriorate, C agrees to release D of an amount equal to the impaired portion of debt in consideration for an issue of shares. D issues shares on the partial release with the result that C and D are connected companies. C and D become connected in relation to the remaining debt. Following the partial release, to the extent D's PCCV exceeds C's PCCV then a s 362 deemed release shall arise.

Corporate rescue exemption

If in the examples above, the debtor company has become connected with its creditor company due to the debtor being in significant financial distress then s 362A provides a corporate rescue relief. It operates in a similar way to s 361D.

The corporate rescue relief has two conditions to be met. Firstly, the creditor and debtor companies must become connected as a result of an arm's length transaction. Secondly, immediately before the companies became connected it was reasonable to assume that, without the connection and any arrangements it forms part of, there would be a material risk that at some time within the next 12 months the debtor would have been unable to pay its debts.

The corporate rescue relief provides for s 362 to be disapplied if the whole debt is released. To the extent part of the debt is released then the deemed release amount is reduced accordingly (but not below nil). The actual release of a liability to pay an amount under the debt must occur within 60 days of the creditor and debtor companies becoming connected. Like section 361D, if it is not possible to determine the exact amount of the deemed release, then it is recommended to release the whole debt such that s 362 is simply disapplied.

> In a genuine situation to restructure a financially distressed company the anti-avoidance rule in s 363A should not be expected to be in point

Where a debtor group is restructured, and the creditors remain lenders and become shareholders then there remains a risk of a s 362 being triggered in the future. This will be the case if a corporate creditor becomes connected (i.e. subsequent trading in the debt and shares) or several corporate creditors 'act together' and so there is control under s 472. This is discussed in HMRC's guidance at CFM35120. Practically speaking, it can be difficult to safeguard from triggering s 362. Creditors should be made aware of the impact of s 362 because it may be difficult to mitigate the effects if it is triggered without the debtor company knowing. Furthermore, it may not be detected until after 60 days and so deny the corporate rescue relief if it were available.

Anti-avoidance: s 363A

The purpose of this article is to discuss deemed releases in the context of genuine corporate distress situations.

In a genuine situation to restructure a financially distressed company the anti-avoidance rule in s 363A should not be expected to be in point.

HMRC's guidance at CFM35590 states that s 363A should not override the exceptions in ss 361C, 361D and 362A.

Notwithstanding this, s 363A is a specific anti-avoidance rule targeted at arrangements which are entered into and the main purpose, or one of the main purposes, is to avoid or reduce a deemed release under ss 361 or 362. If this rule applies, then the arrangements do not achieve that effect.

Other points to note

In relation to actual releases of rights under ss 361D and 362A, these releases are between connected companies and so are not excluded from the release exemption in s 358 for debts between connected companies.

The deemed release rules when applicable, treat the creditor company as having released its rights under the loan relationship. However, for other aspects of the loan relationship rules, HMRC's guidance and examples indicate interest accruals and foreign exchange movements on the loan relationship are computed in the normal way. In other words, the amount deemed to be released is ignored for other parts of the loan relationship rules.

The hybrid mismatch provisions exclude deduction/non-inclusion mismatches for debt releases (for example, TIOPA 2010 ss 259CB(3) and 259CC(3)). Finance Bill 2021 has retroactively amended the release exclusions back to 1 January 2017. Readers may wish to refer to new TIOPA 2010 s 259CC (3A) for relevant debt relief circumstances in new TIOPA 2010 s 259NEB to s 259NEF.

Closing comment

Debt restructuring plans may include the acquisition of impaired debt by the distressed group, or the debtor and creditor companies becoming connected.
Whilst this may be because of legal and commercial constraints for the situation in hand, if a deemed release is triggered in a corporate rescue situation then there is 60 days to undertake an actual release and switch off the deemed release. It is recommended that the whole debt be released, unless the amount of the deemed release can be correctly computed and then actually released to ensure the corporate rescue relief applies. Otherwise there could be an unexpected tax liability. ■

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