

Practice guide

Debt restructuring: releases

Speed read

The impact of the pandemic may necessitate a financial restructuring of a company's liabilities. Debt release exemptions may be required to avoid adverse tax consequences. Releases of loan relationships which existed before 1 January 2016 must qualify for an exemption to avoid taxable profits, but for newer debts an exemption is necessary only if the release results in an accounting profit. Where creditors undertake a 'debt for equity' swap, then the accounting treatment, the terms attaching to the shares and when the debt came into existence need to be considered. Releases of trade or property business debts follow the loan relationship exemptions, but unpaid management expenses may result in a clawback.



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 or easing the debt burden through changes to terms of borrowings.

This article is the first in a series discussing tax issues of restructuring corporate debt. It discusses debt releases and debt for equity swaps. Deemed releases and modifications shall be covered in later articles. All statutory references are to CTA 2009 unless otherwise stated.

Which provisions apply to taxing a debt?

Where a debt arises from the lending of money then it is a loan relationship. Where an instrument has been issued to represent the creditors' rights (for example, a promissory note) then the debt is also a loan relationship. Loan relationships are dealt with by the rules in Part 5.

Debts which are money debts but are not from the lending of money may be dealt with by the relevant non-lending relationships rules in Part 6. These apply the loan relationship rules for specific matters including releases of such debts.

Debts within Part 6 are those where a deduction has been allowed in computing the profits of a trade or property business. Releases of amounts owed to trade suppliers are caught by Part 6.

If a debt is not covered by the loan relationship rules in either Parts 5 or 6, then the question is whether other provisions apply. This is important as the management expense rules in Part 16 include a clawback provision if the management expense is never paid. However, it is

common practice for an unknown debt to be documented into a loan relationship (by issuing a unilateral instrument) to ensure the loan relationship rules take priority over any other applicable taxing provision. This helps provide certainty on the tax treatment of a release and so releases of management expenses can be mitigated.

In releasing a debt subject to the loan relationship rules, the debtor company will want to ensure the release does not result in taxable income. Whilst the exemptions in the loan relationship rules are widely known, this article discusses the detailed requirements which need to be met for the exemptions to apply in certain situations.

What is a release?

A release of a liability to pay an amount owed under a debt means a release in the legal sense. HMRC's view in the *Corporate Finance Manual* (at CFM41060) indicates release means either a formal release which the creditor executes by deed or a legally binding agreement between the debtor and creditor that cancels the debt.

The High Court considered the meaning of 'release' in *Collins v Addies* [1991] STC 445 (reaffirmed by the Court of Appeal; see [1992] STC 746), where a debt subject to the loan to participator rules was novated. As a matter of law, a novation constitutes a release and it was held that the word release should bear its plain and ordinary meaning.

The meaning of release is important as case law indicates a legal release is a release and it is a condition in the loan relationship exemptions that the debt is released.

A release of a liability to pay an amount owed under a debt means a release in the legal sense

Exemptions for debt releases

The general rule in s 307 indicates credits and debits to be brought into account for loan relationship purposes are only those recognised in determining the company's profit or loss for period in accordance with generally accepted accounting practice. Whether a credit or debit is recognised in determining a company's profit or loss is defined by s 308 (which is discussed later).

Exemptions for releases are provided in s 322 and s 358. The exemptions provide that the credit in respect of the release of a liability is not required to be brought into account. Both sections require an amortised cost basis of accounting is used in respect of the debt. This means a basis of accounting where the debt is carried on the balance sheet at amortised cost using the effective interest rate.

Section 322 includes exemptions for releases in the following circumstances:

- condition A: statutory insolvency arrangement;
- condition B: release in consideration for an issue of ordinary shares (i.e. a debt for equity swap);
- condition C: the debtor company is in an insolvent process and the liability is not a connected companies relationship;
- condition D: mandatory release or release under bank stabilisation powers (applicable to banks and not discussed in this article); and
- condition E: the release is part of a corporate rescue arrangement.

Section 358 provides for releases of loan relationships between connected companies. For loans between connected companies, the requirement for an amortised cost basis of accounting will be satisfied as this is automatically required for tax purposes. It should be checked whether the release is of relevant rights (or a deemed release) as s 358 cannot apply to those releases.

Changes in accounting standards may mean that bifurcation of a loan into a loan plus the conversion or equity feature is less common. Therefore, it is possible that a loan relationship liability may be accounted for at fair value through profit or loss (FVTPL) rather than using an amortised cost basis of accounting.

One example is a convertible loan where bifurcation of the loan into a liability and embedded derivative is not permitted under FRS 102 and so the loan is accounted for as FVTPL. This is discussed in more detail in HMRC's *Corporate Finance Manual* (at CFM37780). The exemptions in s 322, including the corporate rescue exemption, would not be available. Whether this ultimately represents a problem for a creditor company will depend on whether the release gives rise to an accounting credit included in the company's profit or loss (or a credit in equity which is taxable).

Amounts recognised in profit or loss

In most situations, a loan relationship liability released by an unconnected creditor tends to result in a credit in the debtor company's income statement and is included in the accounting profit and so can be brought into account under ss 307 and 308.

For accounting periods beginning on or after 1 January 2016, the taxable amounts under the loan relationship rules have been determined under s 308 by reference to what constitutes an 'item of profit or loss' including an 'item of other comprehensive income' that is transferred to become an 'item of profit or loss'. The legislation states the terms 'item of profit or loss' and 'item of other comprehensive income' take their accounting meaning.

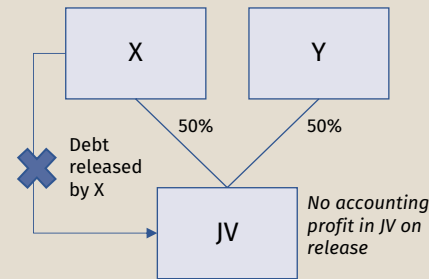
The latter is defined in both UK GAAP (i.e. FRS 102) and IFRS whereas readers, particularly those who are not accountants, will be a little surprised to read that the term 'item of profit or loss' is not explicitly stated in accounting standards! Accounting frameworks are based on key definitions. Below are the relevant definitions stated in FRS 102 (and similar definitions exist in IFRS, see the *Conceptual Framework for Financial Reporting*):

- **Profit and loss:** The total of *income less expenses*, excluding the components of *other comprehensive income*.
- **Income:** Increases in economic benefits during the reporting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity investors.
- **Expenses:** Decreases in economic benefits during the reporting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity investors.
- **Other comprehensive income:** Items of *income and expense* (including reclassification adjustments) that are not recognised in *profit or loss* as required or permitted by this FRS or by law.

From a policy perspective, the rewrite of the loan relationship rules by F(No.2)A 2015 Sch 7 is to base

Example 1

Companies X and Y each hold 50% of the share capital of JV. X has made a shareholder loan to JV and releases JV of the liability outstanding. JV accounts for the release as a contribution to equity and no accounting profit arises.



taxable loan relationship profits on the accounting profit and loss entries (see para 743 of the explanatory notes to that Act). For accounting purposes, profit or loss is simply the arithmetic sum of all *income less all expenses*, excluding certain amounts. For loan relationship purposes, the better view is that an 'item of profit or loss' refers to the *components* which are either items of accounting *income* or *expense*.

The approach outlined above leads to the conclusion that to identify the profits and losses to tax under the loan relationship rules, then credits and debits which are accounting items of *income* and *expense* need to be identified.

In the context of a debt release by a non-controlling shareholder (for example, a joint venture situation as shown in example 1 above), if the credit taken directly to equity is regarded as a contribution from equity investors for accounting purposes then it cannot be income (see definitions above) and so no taxable profit can arise for loan relationship purposes. This is the case for debt which came into existence in an accounting period beginning on or after 1 January 2016, as s 321 is not in point for new debts (F(No.2)A 2015 Sch 7 paras 15 and 106). For pre-2016 debts, the old s 321 remains applicable, and so a credit in equity (or shareholders' funds) which is not an item of profit or loss or an item of other comprehensive income may still be taxed in the absence of an exemption.

Which exemption?

Once the accounting treatment of the release (i.e. credit to equity or included in profit or loss) and when the debt came into existence have been established, then it can be determined whether a release exemption is required for the proposed release.

Practitioners may directly identify an applicable exemption therefore no further tax analysis is required. If no exemption is available (as noted in the examples elsewhere in this article), the accounting treatment and when the debt came into existence need to be considered further.

Where the financial restructuring is to avert a formal insolvency of the debtor, then releases may fall into conditions A, B, D or E of s 322.

Condition A covers statutory insolvency arrangements. This includes releases under a creditors' voluntary arrangement (CVA) and a Part 26 scheme or arrangement under Companies Act 2006. The definition was extended by the Corporate Insolvency and Governance Act 2020

to include the new restructuring plan under Part 26A of Companies Act. Condition C is relevant where the debtor is not connected to the debtor and is in insolvent liquidation, insolvent administration or insolvent administrative receivership. In an insolvent process, the control relationship between the companies may be broken and so the connected companies release exemption in s 358 may not be available.

Corporate rescue exemption

The exemption in condition E was introduced to provide relief for releases of loan relationship liabilities to companies in impending financial distress. The condition is met where it is reasonable to assume that, without the release and the arrangements it forms part of, there would be a material risk that at some time in the next 12 months the company would be unable to pay its debts.

The relief is targeted at companies in significant distress and is helpful, for example, in situations where a formal insolvency process has other adverse effects on the business.

There is extensive guidance in HMRC’s *Corporate Finance Manual* on this exemption (see CFM33191 onwards). As the availability of the exemption is a question of fact rather than a technical interpretation,

seeking non-statutory clearance from HMRC is generally not possible. The availability of the exemption is based on the directors of the company self-assessing the solvency position of the company.

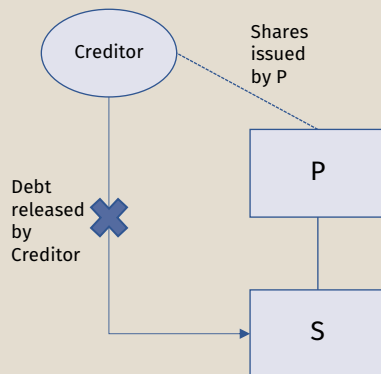
HMRC’s guidance (at CFM33193) indicates examples of where there is a reasonable assumption and these include:

- 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.

Directors should seek support on assessing the solvency position from insolvency practitioners if a company’s inability to pay its debts in the next 12 months is in doubt. For example, servicing interest on a ‘pay as you can basis’.

Examples 2 and 3 illustrate debt for equity swap arrangements where the corporate rescue exemption would also apply. Whilst just one exemption needs to apply to prevent any credit from being brought into account, the availability of the debt for equity swap exemption in condition B depends on whether the debtor company itself issues shares or not.

Example 2



Here, company S has borrowed money from the creditor and is unable to repay its debts. The creditor decides to undertake a debt for equity swap and agrees company P will issue shares for S being released. S does not issue shares and so cannot qualify for condition B but is able to exempt any release credit by claiming the corporate rescue exemption in condition E.

Debt for equity swap exemption

The debt for equity swap exemption in condition B applies where shares are issued in consideration of the release of a liability where an amortised cost basis is used in respect of the relationship by the debtor company. Condition B does not apply to releases of relevant rights but this is not relevant in the context of a debt for equity swap with an unconnected creditor.

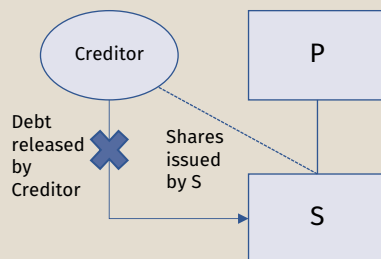
For loan relationships which existed before 1 January 2016, release credits in equity may still be taxed

Background to condition B

The exemption in condition B of s 322 was originally introduced by FA 2005. Before then, the loan relationship rules included a provision that excluded amounts taken to the share premium account from being taxed. FA 2005 repealed this exclusion and introduced a new rule to tax debits and credits taken directly to equity (at FA 1996 Sch 9 para 14A, subsequently rewritten as s 321). The related explanatory notes (to what was Finance (No. 2) Bill 2005 Sch 4) indicated there *may* be circumstances where s 321 would charge a release of debt in a debt for equity swap, and so the condition B exemption overrides this.

For loan relationships which existed before 1 January 2016, release credits in equity may still be taxed in addition to the accounting profit. Where reliance on condition B is necessary (i.e. no other exemption applies) then debtor companies shall need to exert due care to ensure the conditions, discussed below, are met.

Example 3



The creditor agrees to a debt for equity swap and company S issues shares in consideration for the release. S may claim the corporate rescue exemption in condition E but can also exempt the credit under condition B if qualifying shares are issued.

Shares issued as consideration

Whilst the number of shares issued is not specified, so one share would suffice, the terms of the shares are critical to condition B being met. Here, a share must meet the definition in s 476 which is a share in any company under which an entitlement to distributions arises. Furthermore, the shares issued by the debtor company must form part of the *ordinary share capital* of the company. This takes its general meaning from CTA 2020 s 1119. Shares therefore need to form part of the company's issued share capital other than shares which have a right to a dividend at a fixed rate but no other right to share in the company's profits.

Whilst an entitlement to distributions should be obvious to check, closer inspection of the company's articles is required to confirm the shares carry the requisite rights to profits other than at a fixed rate. The meaning of 'ordinary share capital' has been covered in recent cases (for example, see *HMRC v Warsaw* [2020] UKUT 366 (TCC)) and there is HMRC guidance on its view (at HMRC's *Company Taxation Manual* CTM00514). If the debtor company is not a UK-incorporated company, then inspection of the articles and the non-UK company law is required to check the company does have a legal share capital otherwise the debt for equity exemption cannot apply.

Entitlement to warrants

Instead of issuing shares, s 322 condition B also permits an entitlement to shares, and this may be met by issuing warrants in consideration for the release. Warrants are options and so care is needed to manage any chargeable gains consequences or implications under the derivative contract rules. Whilst any release credit should be exempted for issuing warrants, it is considered that the priority rule in section 464 overrides the chargeable gains rules such that the amount released cannot be consideration for the grant of the options, as this is a disposal event under the chargeable gains rules.

Options over shares, including warrants, are within the derivative contracts regime in Part 7, which takes priority over the chargeable gains regime. There is an escape route in s 589 and s 591 if the shares delivered would constitute a substantial shareholding under TCGA 1992 Sch 7AC para 8 otherwise warrants accounted for as derivative contracts may have subsequent tax consequences.

Readers should note that, in certain circumstances, accounting rules require an instrument which can be settled in an entity's own equity to be accounted for as a derivative. Consideration of the subsequent accounting consequences of warrants is recommended if the derivative contract rules apply as the debtor company could be subject to volatility in its future tax position.

Whilst the requirements for amortised cost accounting and shares constituting ordinary share capital should result in the debt for equity swap applying to a release, there may be instances where non-ordinary shares are commercially desired.

For example, fixed rate preference shares issued to a third-party lender should not qualify for the condition B exemption. If the debt released existed before 2016 then the credit in equity shall be taxable in addition to any credit included in accounting profit. Where the debt existed from 2016, then only the accounting profit on the release should be taxable.

The guidance at CFM33203 states HMRC's view, with examples, on the availability of the debt for equity swap exemption where the creditor enters into arrangements

Accounting treatment of a debt for equity swap

The accounting treatment of a debt for equity swap under FRS102 is summarised in the ICAEW Financial Reporting Faculty's *Debt for equity swaps FRS 102 factsheet* (see bit.ly/33iGaXl) upon which the comments below are based.

Under a debt for equity swap, where a financial liability is extinguished then the debt liability is derecognised whilst the issuance of equity is recognised. However, where the lender is a third party (and there is no common control) then the difference between the liability extinguished and the consideration paid is recognised in profit or loss.

The issuance of equity is recognised as the fair value of the cash or other resource received, net of transaction costs. In a debt for equity swap there is no cash paid between the parties. FRS 102 does not specify whether to measure the transaction based on the fair value of the equity instruments issued or the fair value of the debt extinguished. In an arm's length transaction, it indicates the fair value of the equity instrument and the fair value of the financial liability should be the same.

Issuing of equity instruments to extinguish a financial liability can be considered as two separate transactions. The entity could first issue equity instruments to the creditor for cash consideration. The creditor could then agree to accept the same amount of cash as settlement of the full amount of the liability. The accounting treatment should be the same whether the financial liability is exchanged for equity instruments or equity instruments are issued for cash, which is then used to extinguish the liability.

Consider the situation where a company has borrowed £100 from a bank and seeks to enter into a debt for equity swap. It is considered the shares to be issued to the bank will have a fair value of £30. The accounting entries will be:

- Dr Bank liability: £100
- Cr Profit or loss: £70
- Cr Share capital/share premium: £30

For company law purposes, when there is a release of a liability then the amount of the consideration for the share issue is the amount of the liquidated sum. Accordingly, a further accounting entry is required to record the correct share capital/share premium amounts.

- Dr Retained earnings: £70
- Cr Share capital/share premium: £70

to transfer the shares received on a debt for equity swap. This should be consulted if share transfers are intended to occur.

Corporate interest restriction

Where part of a debt is released, the creditor company and debtor may become related parties under the corporate interest restriction regime. By way of example, this could arise where there is a debt for equity swap with the result the creditor holds a 25% investment in the debtor company.

As such, this may restrict the creditor company's ability to deduct interest at times on or after financial distress. This is because interest on related party debt is excluded if electing to use the group ratio method.

TIOPA 2010 s 469 provides that the debtor and creditor are not related parties where there is a relevant release of a debt. A relevant release of debt occurs where a liability is released under arrangements and immediately before the release it is reasonable to conclude that without the release and any arrangements it forms part of that there would be a material risk at some time in the next 12 months that the company would be unable to pay its debts. This is similar to the corporate rescue relief in condition E.

Other considerations

On a debt for equity swap, whether UK income tax may need to be deducted on accrued interest payments that are treated as paid as part of the swap should be considered (ITTOIA 2005 s 380). In some situations, the creditor releasing the debtor company may be a UK bank or a treaty cleared lender such that no withholding tax liability arises. If the lender has changed, for example because the debt has been traded, then withholding tax may now be applicable. The amount of interest paid is the market value of the shares issued in respect of the liability to interest.

The debt for equity swap may also result in a change in ownership of the debtor company and the wider group. The implications for utilising tax losses may need to be considered.

The hybrid mismatch provisions exclude deduction/non-inclusion mismatches for debt releases (see TIOPA 2010 ss 259CB(3) and 259CC(3)), including s 322 and s 358). Finance Bill 2021 proposes to amend the release exclusions and so the hybrid provisions are not further discussed here.

An additional tax liability may undermine the objectives of the wider restructuring plan

Closing comment

Where a company is in financial distress, releases of debt liabilities to restructure the company's finances may be necessary. Whilst there is a generous set of debt release exemptions in the loan relationship rules, the availability of such exemptions requires closer inspection of the accounting treatment of the release, establishing whether the debt existed before 2016 and remains subject to the credits in equity rule in s 321, and whether the release exemption requirements are met need to be considered.

Generally, the amounts involved in a debt release are significant therefore detailed analysis should be undertaken to confirm an exemption should be available. This is because, it may not be possible to fully cover a taxable release with losses carried forward from a previous period. An additional tax liability may undermine the objectives of the wider restructuring plan.

It is worth noting that other relevant loan relationship aspects to facilitate a financial restructuring include the deemed release rules (i.e. situations involving impaired debt where there is a connection between the debtor and creditor) and group continuity (such as novation of debts between group companies). Changes in terms of debt may result in accounting profits due to modification accounting. These additional aspects will be considered in future articles. ■

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