



*cutting through complexity*

# M&A Tax Matters

Autumn 2014

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## Introduction

# Welcome to the autumn edition of M&A Tax Matters

Starting this edition of M&A Tax Matters, Sean Randall and Jo Joyce walk us through the new land and buildings transaction tax for land transactions in Scotland. Moving further abroad, Vipul Patel considers the proposed changes to the Swedish corporate tax regime which could apply from 1 January 2016. In particular he focuses on those changes impacting the funding of a Swedish business.

To continue our series of articles on the BEPS Action Plan, Anna Roberts and James Andrews look at BEPS Actions 7, 8 and 11 and consider the merits of including these in tax due diligence scopes and structuring discussions.

Next up, Peter Honeywell and Anna Roberts consider the implications for due diligence processes with the advent of Follower Notices and Accelerated Payments, introduced through the 2014 Budget. Moving on to technology normally associated with sunnier climes, Harinder Soor, Naz Klendjian, Michael Everett and Philip Sullivan look at key considerations for solar power infrastructure assets investments.

To conclude our two part series on IPOs, Steven Heath and David Mortimore address some of the practical issues arising as a result of an IPO.

Gavin Little and Lee Tucker then share with us their recent practical experience on the applicability of the loan relationship group continuity rules in the context of novated secured debt liabilities. Finally, as the economic upturn may incentivise lenders to provide continued financial support to distressed borrowers, Gavin Little and Anna Roberts provide an overview of the UK tax exemption for debt for equity swaps.

We hope you'll enjoy this Autumn edition of our publication. If you would like further detail on the articles in this issue, please call us, the authors, or your usual KPMG contact.



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# Replacing stamp duty in Scotland – are you ready for the change?

With less than seven months to go until stamp duty land tax ('SDLT') is replaced by land and buildings transaction tax ('LBTT') for land transactions in Scotland, have you considered how this could affect your business?

From April 2015 SDLT will be abolished in Scotland and replaced with a new tax, LBTT. This change is being accompanied by another devolved tax (being landfill tax). The LBTT legislation was passed last year, however the rates are not yet known. Statutory instruments are expected to amend the rules in certain areas (e.g. commercial leases, partnerships and trusts), although guidance has yet to be released.

While LBTT is heavily based on SDLT there are a number of key differences, including:

- LBTT will be a 'progressive tax', rather than a 'slab tax' like SDLT. There will be a nil rate band and at least two other rate bands, with the applicable rate of tax applying only to so much of the consideration as falls within each band, rather than a single rate applying to the price paid;
- As with SDLT on leases, there will be a charge to LBTT based on the net present value ('NPV') of rent payable over the life of the lease. Like SDLT, the

NPV will be calculated initially on an estimate of the rent payable with an obligation to 'true up' the NPV calculation when the actual rent is known. However, whereas for SDLT that adjustment is required to be made once after the fifth year of the term of the lease, for LBTT that adjustment will need to be made every three years. This is likely to represent an increase in the compliance burden for occupiers;

- While licences are exempt from SDLT, a licence to occupy a 'retail shop' in Scotland will be taxed in the same way as a lease; and

- In contrast to SDLT, there is no relief from LBTT for assignments of rights and sub-sales. Consultation is currently underway as to whether relief should be provided for such transactions where there is a reasonable prospect of significant development of the land within five years, and that development in fact takes place.

## Anti avoidance

There is no general anti-avoidance provision included within the LBTT legislation, as there is with SDLT. Rather, a new general anti-avoidance rule will apply to all devolved taxes. This Scottish GAAR is wider drafted than the existing UK GAAR, applying to tax avoidance arrangements that are 'artificial', rather than those that are 'abusive'. In addition while the UK GAAR is overseen by an independent GAAR advisory panel, no such panel will exist in Scotland. Guidance will therefore be key in establishing how this Scottish GAAR will be applied in practice.

## What should you do now?

If you are contemplating entering into a land transaction in Scotland, your negotiations should reflect the risk of the costs of the transaction increasing (or, conversely, the benefit of the cost decreasing) if it completes after 1 April 2015.

Changes to internal controls may be required to address the additional compliance requirement to file LBTT returns for rental leases every three years.

You may also wish to review any licence arrangements over Scottish property to establish whether they are likely to be taxed under LBTT.



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# Funding a Swedish business: Proposed changes to Swedish corporate tax regime

The Swedish tax environment for mergers and acquisitions has changed fundamentally in recent years. The Swedish government has introduced various tax laws and proposals to minimise possibilities for avoiding tax by using tax havens and to comply with the EU law development.

## Recent changes to interest deductibility

Historically, investments in Sweden that were financed by equity were taxed more heavily than investments financed by debt. The government has however on two previous occasions (2009 and 2013), limited the right to deduct interest costs. The limitations introduced were designed to prevent tax planning by means of interest deductions for loans between associated companies. In both cases, the limitation of the right to deduct interest was accompanied by a reduction in the corporate tax rate.

As of 1 January 2013, interest payments on all loans from affiliated companies are not tax deductible except where, in general:

- the beneficial owner of the interest income is taxed on the interest at a rate of at least 10% in its state of residence (and the primary reason was not to obtain a substantial tax benefit for the unity of interest); or
- the debt relationship is primarily based on sound business reasons and the beneficial owner of the interest income is resident in an EEA or treaty country.

An affiliated company is a company that, directly or indirectly, has a significant influence over the company through ownership or otherwise. The rules also apply to certain back-to-back loans (i.e. where the loan is routed through a third party, related or unrelated).

## Further proposed changes to the tax regime

In 2011 the Swedish government appointed a Committee to deliver proposals on an improved corporate tax system. The Committee's main task was to propose a corporate tax system that leads to greater neutrality between the taxation of equity and debt, and that would prevent tax planning through the use of the interest deduction rules.

On 12 June 2014, the Committee on corporate taxation proposed a new corporate tax system which consists of two parts. According to the Committee, the proposed changes should apply as from 1 January 2016.

## Main proposal

Firstly, deductions for interest expenditure and other ‘financial costs’ will be limited by only allowing deductions for financial costs for which there is corresponding financial income; no other financial costs will be deductible. This proposal means deductions for excess net financial costs will no longer be available, whilst excess net financial income will be taxable. In other words, on a company by company basis, where financial costs exceeds the financial income, a (non-deductible) ‘net financial cost’ would arise, whilst where the financial income exceeds financial costs, taxable ‘net financial income’ would arise. In addition, it will not be possible to carry forward/backwards the financial costs to obtain relief against financial income of different periods.

The Committee has proposed that the term ‘financial cost’ will have a special meaning for tax purposes, and will include interest, exchange rate effects, taxable profits and losses on financial instruments, taxable dividends and the interest component of some forms of rental arrangements. This may lead to interpretation issues. For simplicity, certain types of interest payments, such as imputed interest in accounts payable and accounts receivable, will normally not be included within ‘financial costs’.

One important principle in the Swedish corporate tax system is that activities conducted by a group and activities conducted by a single company are to be taxed equally. To uphold this principle, companies with net financial income will be allowed to set this off against net financial costs reported by companies in the same Swedish tax consolidation group.

Thus depending on the facts and circumstances, the proposed off-set may apply to a foreign company’s permanent establishments in Sweden.

Secondly, a standard deduction will be introduced for all financing costs (a ‘financing allowance’) at a rate of 25% of the company’s taxable profit. This financing allowance will be allowed regardless of whether or not the company has financial costs and, in terms of the financial effects for companies, will be equivalent to reducing the corporate tax rate from 22% to 16.5%.

Given the majority of companies that conduct non-financial activities have net financial costs, prohibiting deductions for net financial costs will result in equity and debt being treated in the same way for tax purposes in companies that have net financial costs.

Removing the deduction for net financial costs removes the tax incentive to report large interest costs in Sweden. This makes it possible to abolish the rules to prevent tax planning by means of intragroup loans between associated entities that were introduced in 2009 and 2013.

## Other proposed changes

Since any losses carried forward as at the date of enactment (i.e. 1 January 2016) would have been incurred during a period when it was possible to create losses by utilising interest deductions, the Committee has proposed that such losses carried forward should not be fully deductible for tax purposes. Their proposal is that any losses remaining as of 1 January 2016 would be reduced by 50%. Following the enactment, the rules governing losses carried forward would be applied as normal.

## Next steps

The Committee’s report is the first step in the legislative process. The report will be referred for consideration to relevant bodies whose feedback will allow the government to gauge the level of support for the proposals. The process is complicated by the fact that there will be an election in September 2014. It is uncertain how (and if) any of the proposals will be accepted by the government and ultimately presented to parliament for adoption. It is, however, expected that there will be some changes to the tax legislation concerning interest deductions with effect from 1 January 2016. As such, taxpayers with operations in Sweden should monitor the progress of the Committee’s proposals. In particular, careful consideration should be given to multinational groups with Swedish subsidiaries that are currently the recipient of intra-group debt. If the debt is provided cross-border, the potential implications are that the credit may be subject to tax whilst relief for the debit is prevented. This will need to be addressed as part of the consultation process.



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# BEPS Actions 7, 8 and 11: Intangibles, Permanent Establishments and Country-by-Country reporting

Following our first article on the summer edition of M&A Tax Matters, this is the second in a series of articles focussed on the latest thinking around the impact of the BEPS proposals on M&A transactions.

The BEPS proposals are intended to ensure fairness and preserve the integrity of tax systems globally; it seeks to introduce specific changes to tax rules and guidance over an implementation period between September 2014 and January 2016. Whilst the actions are yet to be implemented, some of the proposals embody the current interpretation of existing legislation and guidance and in particular in areas surrounding transfer pricing. This focus on international tax issues has directed tax authorities and other stakeholders (such as the media) to place greater scrutiny on the tax affairs of businesses. As such, a BEPS readiness review should be at the forefront of discussions when considering the scope of diligence work and wider issues when structuring for M&A transactions.

The 15 actions published by the OECD are anticipated to take prospective effect, with current discussions and output beginning to impact on tax authorities' approaches to existing law and guidance. For example the guidance on the discussion draft on the transfer pricing aspects of intangibles, released as Action 8 of the Action Plan, is likely to be interpreted by the tax authorities in a manner which gives it a degree of retrospective effect. Therefore, it is worth understanding the proposed changes now and considering these as part of due diligence work.



could be higher tax locations.

With the additional transfer pricing documentation requirements by virtue of the master file and country-by-country reporting requirements detailed below, there will be a greater transparency for the tax authorities to examine the position.

In terms of understanding current structures and whether there is a robust transfer pricing methodology in place, we would suggest due diligence procedures to include a focus on the following:

- what are the key value drivers;
- where are key individuals located;
- where are the key functions performed or controlled; and
- is the transfer pricing policy an accurate reflection of plus aligned with value creation.

There has historically been an 'all or nothing' approach adopted in due diligence procedures in relation to value chain and transfer pricing. In light of BEPS and the increasing focus on transfer pricing there is certainly merit in addressing this work during the course of

a transaction. In addition, with more transparency over the transfer pricing value chain, the allocation of purchase price across assets in global acquisitions is an area which could see increasing focus, particularly as it drives the allocation of debt (and potentially the wider valuation of assets). Tax authorities have historically been known to challenge allocations, despite these ostensibly being determined at arm's length between the parties.

Whilst focussing on the review of existing arrangements, it is also worth noting that a transaction represents a catalyst for change in a business, thereby creating an opportune time to review and update a group's transfer pricing policy, so that it is in line with BEPS (but also optimal for the business).

#### **Documentation and Country-by-Country Reporting**

In light of the increasing focus on the value chain in transfer pricing analysis, there is a corresponding increase in focus on transfer pricing documentation rules. In particular, there is a review of the existing documentation requirements and the development of a template for country-by-country reporting of income, taxes and economic activity for tax administrations.

## **Transfer pricing**

### **Intangibles**

The discussion draft on intangibles seeks to provide further guidance to that previously given in the OECD Transfer Pricing Guidelines for Multinationals and Tax Administrations on how transfer pricing principles apply in the case of intangibles. As with other supplementary guidance issued previously, it provides further detail on what the transfer pricing position for intangibles is now and has been in the past. It is not to be interpreted as a change of view which will only impact transfer pricing arrangements on a go forward basis when the final report is issued. This means that existing structures may be challenged and, as such, it is imperative that more focus is given to transfer pricing on due diligence.

The key shift of emphasis in the discussion draft is to reduce the significance of legal ownership. Instead, the emphasis shifts to the location of the people managing, controlling and monitoring the functions which create value in the intangibles. Regardless of which companies' accounts show the profits from intangibles, transfer pricing could apply to tax the profits in the countries where key functions are exercised, which

The overarching objectives of the action plan to re-examine transfer pricing documentation requirements are for multinational groups to prepare and retain transfer pricing documentation which:

- provides tax authorities with the information necessary to conduct an informed transfer pricing risk assessment;
- ensures that taxpayers give appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises, and in reporting the income derived from such transactions in their tax returns; and
- provides tax administrations with the information that they require in order to conduct an appropriately thorough audit of the transfer pricing practices of entities subject to tax in their jurisdiction.

To achieve these objectives, it is proposed that a global standardised methodology for transfer pricing documentation be adopted, which includes the requirement to document the entire value chain of the group. The guidance suggests that a master file be produced containing standardised information for group entities which conveys a reasonably complete picture of the global business, financial reporting,

debt structure, tax situation and the allocation of the multinational group's income, economic activity and tax payments, so as to assist tax authorities in evaluating the presence of significant transfer pricing risk. The guidance suggests that taxpayers should be able to prepare the master file either for the multinational group as a whole, or by line of business, depending on which would provide the most relevant transfer pricing information to the particular tax authority.

Given the sizeable additional compliance burden, there need to be, as part of a due diligence exercise, discussions around whether a multinational target group has the controls/processes and indeed resources in place to be able to collate the data required for the master file and country-by-country reporting template and, if not, what actions will be put in place to facilitate compliance in the future. In due course reviews of the masterfile itself should become commonplace in due diligence exercises.

#### **Permanent establishments**

BEPS Action 7 deals with strategies regarding permanent establishments ('PEs') that raise BEPS concerns (including the artificial avoidance of PE status). The aim of this action is to develop changes to the definition of PEs to prevent the artificial avoidance of PE status in relation to BEPS, including through the use of commissionaire arrangements and exploitation of the specific activity exemptions.

The OECD has determined that the definition of PEs in treaties must be updated in the light of developments in the business world, in particular around the digital economy, and to prevent abuses. The OECD has raised concerns that in many countries the interpretation of the treaty rules on agency-PE allows contracts for the sale of goods belonging to a foreign enterprise to be negotiated and concluded in a country by the sales force of a local subsidiary of that foreign enterprise without the profits from these sales being taxable to the same extent as they would be if the sales were made by a local distributor. As a consequence the OECD has observed that, in many instances, enterprises have replaced arrangements whereby the local subsidiary traditionally acted as a distributor, with 'commissionaire arrangements' resulting in a shift of profits out of the country where the sales take place but without a substantive change in the functions performed in that country. Similarly, there is a concern that multinational groups may artificially fragment their operations among multiple group entities to qualify for the exceptions to PE status for preparatory and ancillary activities.

This action plan has prompted tax authorities around the world to pay increasing attention to the PE issue under existing rules and there has certainly been additional public/media focus on this area. It will therefore be key to understand the group's operations and how PE risks are identified and managed when considering an acquisition.

## **Due diligence of existing structures and transaction structures**

### **Hybrid mismatch arrangements and treaty abuse**

Action 2 of the BEPS Action Plan addresses the requirement to neutralise the effect of hybrid mismatch arrangements. As discussed in the Spring 2014 edition of M&A Tax Matters, it is proposed that model treaty provisions should be developed (and domestic rules modified or introduced) to neutralise the effect of hybrid instruments and entities with aggressive tax intent (e.g. double non-taxation, double deductions, or long-term deferral of profits).

Action 6 of the BEPS Action Plan seeks to prevent the granting of treaty benefits in inappropriate circumstances and to address treaty shopping and the abuse of domestic law provisions through the use of treaties. As discussed in the previous edition of M&A Tax Matters, the two main proposals are to include a Limitation on Benefits clause and a General Anti-Abuse Rule into the OECD Model Treaty Provisions with the aim that these will be applied to existing treaties.

Whilst it is widely anticipated that the action plan to neutralise the effects of hybrid mismatch arrangements and to prevent treaty abuse is likely to have only a prospective application only, it is important to seek

comfort in a diligence process that current structures fully consider the impact of the BEPS proposals on the post- transaction structuring.

### **Conclusion**

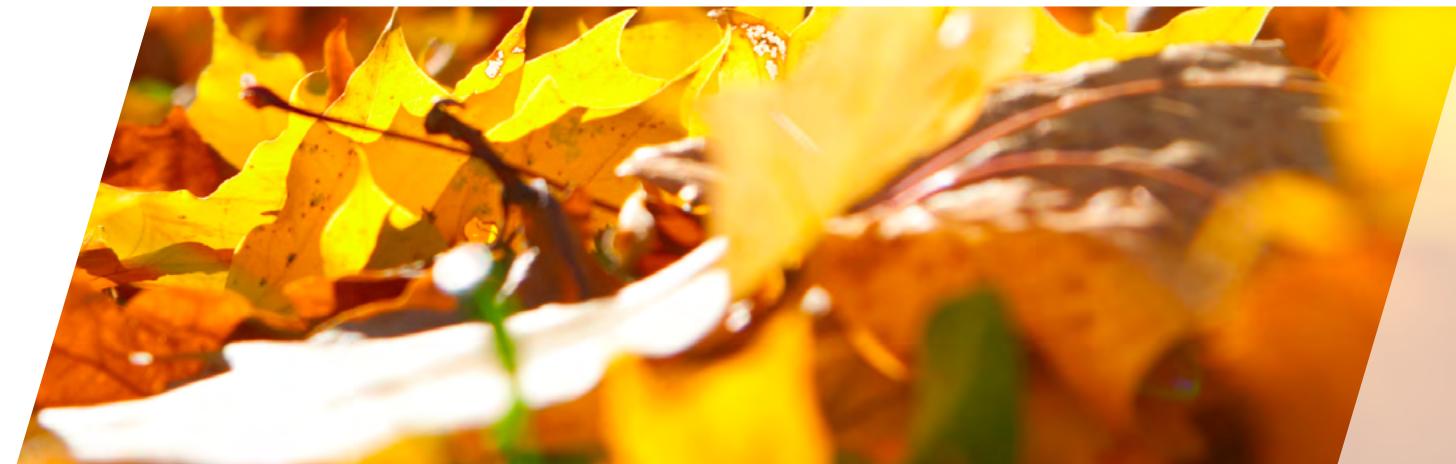
BEPS should be on the table for discussion now as the proposed dates for implementation of the action plans are fast approaching. Comfort should be obtained as part of the due diligence and structuring process of any transaction, to ensure multinational groups are not only ready for the additional compliance burden but also that they are not susceptible now to the shift in focus on transfer pricing and other key areas.



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# Follower notices and Accelerated payments: make sure you are protected

The 2014 Budget saw the introduction by the Government of two measures designed to change the economics of entering into tax avoidance schemes and, thereby, to change the behaviours of taxpayers and promoters in relation to tax avoidance. These followed the widely publicised consultations, 'Raising the Stakes on Tax Avoidance' (August 2013) and 'Tackling Marketed Tax Avoidance' (January 2014). The 'Follower Notice' and 'Accelerated Payment' rules were both introduced retrospectively and so they apply to existing enquiries that have not yet been settled as well as to future transactions.

## Follower Notices

The Follower Notice rules are designed to improve the rate at which tax avoidance cases are resolved where the point at issue has, in HMRC's view, already been decided in another taxpayer's case. They provide that HMRC can issue such a notice where:

- there is an open enquiry or appeal;
- obtaining a tax advantage was the main or one of the main objectives of the underlying arrangements; and
- a final decision has been given by the courts which denies all or part of the asserted advantage.

The notice requires the taxpayer to amend its return if the return is still under enquiry, or, where a closure notice or tax assessment is under appeal, to enter into an agreement with HMRC to settle the dispute. The taxpayer is also required to give HMRC a notice stating that it has taken the necessary corrective action and notifying HMRC of the amount of additional tax which becomes payable as a result. The taxpayer has 90 days in which to comply. There is no right of appeal against the notice although representations can be made.

There is a maximum penalty of 50% of the denied tax advantage for non compliance with the follower notice requirements. If the disputed tax has not been paid, then an Accelerated Payment Notice (see below) may be issued which specifies the amount of tax that needs to be paid.

### Accelerated Payments

An Accelerated Payment Notice can be issued by HMRC when:

- an avoidance case has been notified to HMRC through the Disclosure of Tax Avoidance Scheme rules;
- the arrangements are counteracted by the General Anti-Abuse Rule ('GAAR'); or
- a Follower Notice has been issued.

The notices will specify the amount of tax that must be paid within 90 days of the issue of the notice. There is no right of appeal against an Accelerated Payment Notice. A recipient has 90 days from receipt of the notice to send written representations objecting to the notice to HMRC, but only on the grounds that the conditions for the notice were not fulfilled or that the amount is not accurate.

It is key that as part of the due diligence process, the possibility that a target may be required to make accelerated payments is fully considered and adequate protection sought in the warranties and indemnities. In particular, regardless of whether the acquirer has custody or not over an enquiry into a historic issue, the SPA should include specific provisions to deal with the Accelerated Payment liability and Follower Notices. Without this, the acquirer is potentially exposed to the cash flow risk of the Accelerated Payment liability.



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# Key considerations when investing in solar power infrastructure assets

## Background

Over recent years, the UK Government has heavily incentivised investment in both small and large scale renewable electricity generation projects. In our experience, such schemes fall into two broad categories:

- solar farms – large arrays of solar panels, predominantly in southern/eastern England; and
- roof mounted solar panels – solar panels on the roof space of residential/commercial property.

Typically, such projects operate under Power Purchase Agreements ('PPA'). In a PPA, the solar asset owner contracts with a third party to supply all or part of the electricity generated for an agreed fee. The income is often referred to as being generated under the Feed-in Tariffs ('FITs') regime or the Renewable Obligation Certificates ('ROCs') regime.

In such projects, the PPA structure can add complexity to the capital allowances analysis as the PPA may be accounted for as a lease, in which case the complex long funding lease provisions will need to be considered. The key considerations below should therefore be considered when:

- constructing a solar farm or installing roof mounted solar panels; or
- acquiring a solar asset infrastructure – by way of an asset deal; or
- acquiring a solar asset infrastructure – by way of a share/corporate deal.

## Key considerations

### Fixtures versus chattels

It is critical to determine whether the solar assets are 'fixtures' or 'chattels' for capital allowances purposes:

- **Chattels** are items of tangible, moveable property which under property law have not become part of the land on which it resides.
- **Fixtures** are items that have become part of the land on which it resides, under property law. Capital allowances are only available if the legal owner of the fixture has a relevant 'interest in land' over the land on which the fixture is installed.

Whether an item is a fixture or chattel is a legal question and depends on the exact nature of the solar assets

installed, and specifically the method and purpose of their affixation to the land. The analysis is not straightforward.

The key point is if an asset (or part of an asset) is considered to be a fixture for capital allowances purposes, the solar asset owner must hold an interest in the relevant land prior to incurring expenditure to be able to make a valid capital allowances claim.

The capital allowances legislation defines 'interest in land' as including freehold, leasehold and a licence to occupy land. A common error, in respect of roof mounted solar panels, is mistaking a licence to occupy the airspace or a licence to install as an interest in land for capital allowances purposes.

### Long funding lease ('LFL') rules

Full consideration should be given to the specific terms of the PPA in question. This could result in the solar assets being recognised for accounting purposes as a leasing arrangement. If recognised in such a way it is important to determine, from a tax perspective, whether the LFL rules apply. If the PPA is accounted for as a lease and is a LFL, then capital allowances will not be available to the solar asset owner (lessor) but instead

will vest with the other party to the PPA in question (lessee).

The first LFL test is whether or not the lease is 'short', which legislation broadly defines as a period of less than five years. PPAs tend to have a minimum term of 15 or 20 years and so we would expect most PPAs to qualify as 'long' leases. The LFL rules will therefore apply if one or more of the following additional tests are satisfied:

- a. The 'finance lease test' – is the lease accounted for as a finance lease?
- b. The 'useful economic life test' – is the term of the lease more than 65% of the remaining useful economic life of the leased plant or machinery?
- c. The 'lease payment tests' – Is the present value of the minimum lease payments equal to or more than 80% of the fair value of the leased plant or machinery?

In our experience, tests (b) and (c) above are normally based on a particular modelling calculation that should be undertaken. When planning on investing in such an infrastructure asset, the key issues to consider are: do the long funding lease rules apply; if so and if it is a problem, can you do anything to mitigate this?

#### **Connected party/sale and leaseback transactions - Anti-avoidance provisions**

To the extent that the assets are being transferred between connected parties or where there is a sale and leaseback arrangement, it is important to consider the tax and accounting treatment.

Specifically, in respect of the capital allowances treatment, the quantum and speed at which tax relief is received may be restricted by way of the anti-avoidance provisions within CAA2001 s.217 and s.218. Based on our experience, this is likely to be relevant in a deal context where a solar farm is developed by one group company and is then sold to another group company

(such as a new SPV) shortly before transfer to the purchaser. Pre-sale reorganisations should be considered with this in mind.

#### **Identifying and quantifying qualifying capital allowances**

On the basis that the technical entitlement rules discussed above have been covered off, the solar asset owner will need to prepare a detailed capital allowances claim to quantify the tax relief available. This will need to be fully supportable as it will accompany the tax return submitted to HMRC.

This exercise is very much a mix of a surveying and tax analysis. In preparing a claim, consideration will need to be given to the rate at which relief can be obtained on the infrastructure (18% main rate of WDA versus 8% special rate of WDA for solar panels, long life assets, integral features etc) and whether allowances can be claimed under the contribution allowances regime (e.g. payments to network operators)?

With regard to fixtures, it is now fundamental to consider the recent changes to the capital allowances fixtures rules, introduced in FA2012 and discussed in more detail in the summer 2014 edition of M&A Tax Matters. If the infrastructure is to be sold by way of an asset deal, the owner of the solar assets will need to identify the qualifying expenditure and 'pool' it in their tax return to pass the benefit on to the purchaser. Failure to do so, may lead to 'price chip' or delay a transaction. There may be exceptions to this rule and each case should be considered on its own merits.

#### **Summary**

The capital allowances position on solar asset transactions can be complex, specifically in instances where a PPA exists (or will be put in place post-acquisition) and the LFL rules apply.

Given that HMRC now commonly conducts risk based reviews and that this is an area which HMRC are scrutinising in more detail, it is important the position is covered off thoroughly as part of the due diligence process, including obtaining adequate SPA protection (where necessary), as well as considering the impact on any future taxable earnings model. This will not only help manage the risk, but also assists with the sign-off for SAO (where applicable), and the outcome may help shelter taxable income and maximise your return on any future sale of the solar infrastructure.



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# Initial Public Offerings ('IPOs'): Practical tax issues

In the summer 2014 edition of M&A Tax Matters, we considered some of the tax issues that need to be addressed during the planning/preparation phase of an IPO. This article addresses some of the practical tax issues that can arise as a result of the transaction itself.

The starting consideration is which entity will be floated. There are various requirements of a publicly listed company that can affect the choice of entity – can the existing holding company of the group be listed or should a new holding company be implemented prior to listing? One key consideration in this regard is the requirement for a listed company to have a single class of share capital. This can be undertaken through a reorganisation of the share capital of the existing parent company to consolidate all the classes of shares into a single class of share or by the interposition of a new holding company on top of the group. This latter choice will involve a share-for-share exchange between NewCo and the existing shareholders and should be subject to the usual tax clearances with HMRC. The use of a NewCo has been facilitated by a recent change in Finance Act 2014 ('FA 14') which provides that the interposition of a NewCo at the top of a group does not constitute a change in ownership for the purposes of the anti-avoidance rules for losses.

Further restructuring may be required to manage the group's debt position, particularly if the value of the company is 'underwater'. This could involve waiving or capitalising debt or novating loan balances within the group and again may require advance tax clearances from HMRC. The position regarding interest and withholding taxes must be monitored.

Another consideration is that the transaction may be structured to facilitate shareholders tax objectives. This can be the case for the exit of an existing shareholder who is using the float to divest (for example the timing of the disposal may affect the timing of any tax arising) or for new shareholders investing in the business. Many smaller AIM floats take advantage of shareholding incentives such as Venture Capital Trust ('VCT') and Enterprise Investment Scheme ('EIS') status. There are specific rules concerning the eligibility of shares to qualify for VCT or EIS advantages and so care must be exercised when considering these opportunities.

For example, the issue of new shares may be staggered over different days to different classes of shareholders to ensure that those that are able to and wish to take advantage of the investment incentives are able to do so.

The position regarding stamp taxes must also be considered. Ordinarily the issue of shares in the UK is not subject to stamp duty, whereas the sale of shares is subject to stamp duty. Consequently, where there is an IPO that involves both the sale of existing shares (by an exiting shareholder) and the issue of new shares, an investor may or may not be required to account for stamp duty on his acquisition of shares (depending on whether he is acquiring existing shares or new shares). As a result, the issuing company often agrees to settle the stamp duty liability arising on connection with a float. Furthermore, FA 2014 includes provisions to abolish any stamp duty charge on share transactions in respect of shares on certain growth markets such as AIM.



Funds generated to repay funding may crystallise interest deductions where interest is subject to the late payment rules and only deductible when paid. There are two aspects that need to be considered. Firstly, where interest is accrued at the time of the IPO but has not been deducted for corporation tax purposes, it could be subject to the change in ownership anti-avoidance rules. The position requires careful monitoring as the analysis may be complex – there may be no change in ownership (for corporation tax purposes). Secondly, the payment of interest and consequent crystallisation of a deduction needs management to ensure that full relief can be obtained for the interest and that the group is not left with stranded tax losses that can only be carried forward. The withholding tax position regarding interest payments should not be overlooked; an assessment of whether any exemptions may apply should be considered in advance.

Management equity incentivisation plans should also be managed, both in terms of existing plans and future plans. If the listing is a trigger event for the exercise of existing options, clarity is required to determine the position for management shareholders and any corporation tax deduction arising from the exercise should be factored into the cash tax forecasts. Furthermore, a new Management Incentive Plan ('MIP') will often be introduced for management of the new public entity. However, given the restrictions on the share capital of the listed company (i.e. only one class of share can be issued), the new MIP may need to be introduced at a lower level in the group, especially if it is a reasonably complex scheme.

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An IPO can give rise to other consequences which are not always readily apparent. If the IPO takes the form of a shareholder exit, a sell-down of shares below 75% can cause a degrouping event for capital gains purposes. To the extent that the transferor and transferee leave the group together then the associated company exemption should apply. However, there may be instances where a transferor has been liquidated and therefore the associated company exemption cannot apply, and it should be remembered that the associated company exemption does not apply to loan relationships.

Finally, consideration needs to be given to the accounting and tax (corporation tax and VAT) treatment of fees incurred by the group in connection with the transaction.



# Equivalence and group continuity

The transfer of loan relationships between group companies has become increasingly common practice, especially in financial restructurings, and is often seen as a precursor to a subsequent capitalisation or refinancing of debt to leave the group on a more stable footing for the future.

A relevant scenario could arise where the market value of the property assets in a Group have dropped significantly below the level of secured lending on those properties, coupled with restructuring involving the transfer of properties and secured debt liabilities to a clean new group company ('Newco'). In these circumstances, an accounting profit would have arisen in the transferor on the novation of the debt liabilities (as the consideration given, i.e. the properties are lower in value than the debt obligations being assumed). Once novated to Newco, the debt obligations would then be restructured onto more sustainable terms.

In such a situation, it is critical that the loan relationship group continuity rules (s336 CTA 2009) applies to the novation of the secured debt liabilities. There is particular uncertainty whether it could be said that Newco's obligations under the loan liabilities are 'equivalent' to those of the transferor companies, and therefore it may be advisable to seek an opinion from Tax Counsel.

Whether the transferor's and transferee's obligations are 'equivalent' is defined in s338 CTA 2009 and considers whether the borrower has the same obligations to the same person with respect to capital, interest and dividends and that there are the same remedies to enforce those obligations.

The key area of concern is whether the novation of the loan liability (with no changes to the terms on novation) would fall within the group continuity rules if, prior to the novation, there was an agreement to change the terms of the novated loan liability at a future time.

There is a significant risk that the continuity rules would not apply if the intentions of the relevant parties were for the novated loan liabilities to ultimately be on different terms after the novation. Even if there would be a delay in any variation, this may not allow the equivalence conditions for continuity to be met at the time of novation.



There may also be a concern that if the financial circumstances of the transferee and transferor were ultimately different, then the continuity rules may not apply. For example, if the transferee's balance sheet was stronger, the Lender would obtain greater value from taking enforcement action on the loan. Although, it could be argued that the obligations (and remedies to enforce those obligations) of the transferee and transferor are the same regardless of their abilities to meet those obligations.

However, HMRC may be willing to accept that continuity applies despite the two concerns outlined above although, given the large numbers usually involved, it may be appropriate to consider applying for a non-statutory tax clearance if a transaction in similar circumstances is being considered.

It should also be noted that any changes to the terms of the novated loan in the transferee company should be carefully considered, in particular, whether the changes represent a substantial modification of the novated loan for accounting purposes, creating the potential for 'de-recognition credits'.

Given the complexity of both tax and accounting rules when novating or modifying distressed debt obligations, it is important to seek tax advice at the earliest opportunity. This enables sufficient time to develop a tax efficient structure and, to the extent any areas of material tax uncertainty are identified, obtain a non-statutory clearance from HMRC.

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# Underwater groups in distress and debt for equity swaps

Over the past few years, due to weak economic conditions, we have seen an increasing number of distressed companies that have faced difficulty in servicing their debts and, as a consequence, need to strengthen their balance sheets and reduce their interest payments in order to stay afloat.

On the other side, lenders have been faced with difficult decisions in how best to recover value from distressed loans; whether to 'cut losses' by selling the underlying loan to distressed debt investors, enforcement over the loan collateral or, where there is sufficient turnaround potential in the borrower, restructuring the debt facilities to allow continued financing support.

With an upturn in forecast economic growth, there may be a stronger commercial rationale for existing traditional lenders, or alternative distressed debt investors, to provide continued financial support in the hope of maximising future returns. With liquidity returning to their balance sheets and improving capital ratios, banks are also starting to see greater flexibility enabling continued financial support to distressed borrowers.

A common tool used by lenders in continuing to provide support to a distressed borrower is allowing a release of debt in exchange for an equity stake in the borrower

('a debt for equity swap'). This route might be used by either existing traditional lenders or alternative investor lenders who have acquired distressed debt with a view to supporting a turnaround of the borrower.

In addition, we are also seeing a significant growth in the volume of debt for equity swaps being implemented by highly leveraged groups that need to restructure their shareholder debt to facilitate a sale.

The UK tax legislation provides an exemption from the charge to corporation tax for credits that arise in borrowing companies on the release of loan relationship liabilities in consideration for the issue of ordinary share capital.

This article considers:

- back to basics and conditions for qualification;
- non statutory clearance process; and
- HMRC loan relationship consultation and potential changes coming out of this process.

## Back to basics and conditions for qualification

The legislation at section 322(4) CTA 2009 (referred to in this article as the ‘debt for equity exemption’) provides that no credit will be brought into the charge to corporation tax in the borrowing company as a consequence of a debt for equity swap provided the following conditions are met:

- i. a liability to pay an amount under a company’s debtor loan relationship is released;
- ii. the release takes place in an accounting period for which an amortised cost basis of accounting is used in respect of that relationship;
- iii. the release is not a release of relevant rights; and
- iv. the release is either in consideration of shares forming part of the ordinary share capital of the debtor company or in consideration of any entitlement to such shares.

There are other relieving provisions available for the release of loan relationship liabilities between connected companies and therefore this exemption will typically be most relevant for the release of loan relationship liabilities where the parties are not connected or the lender is not a company.

Whether conditions (ii) and (iii) are satisfied will be a question of fact relating to the current accounting policy of the borrower and how the loan between the current lender and borrower came into being. This article therefore focuses on conditions (i) and (iv) outlined above.

The key features are: a release of a loan relationship, shares (or an entitlement to shares) are issued in consideration for the release and that those shares are also ordinary share capital for tax purposes. It is critical that these features are consistent with the literal interpretation and policy intent of the tax legislation and appropriately drafted in the legal documents required to facilitate the transaction.

To be certain that the debt liability has been released, typically a deed of release would be required. However, other less formal mechanisms for releasing debt liabilities may be accepted by HMRC as a release of debt.

An ‘entitlement’ to shares enables the release to be extended to circumstances where shares are to be issued at a later time (under a binding agreement) or where the lender is given an option or warrant to subscribe for shares at a future time. However, in these circumstances it is important that under the terms of the option/warrant there is a genuine commercial expectation that the options/warrants will be exercised.

When considering whether shares are issued ‘in consideration’ for the release, HMRC guidance in the Corporate Finance Manual (CFM33202) states that:

*“it is not enough for a release of debt merely to be accompanied by an issue of shares in order to come within the exemption in CTA09/s322 (4). Whether or not a debt has been released ‘in consideration of shares’ will depend on whether on a realistic view of the transaction, CTA09/s322 (4), construed purposively, can be said to apply to it.”*

Each case will need to be considered based on the precise facts and circumstances of the debt for equity swap but, HMRC manuals (CFM33203) contain some helpful examples of what they consider would and would not constitute ‘in consideration’ for these purposes.

In particular, they confirm that there is no need for the issued shares to be held for a particular time and acknowledge that there may be commercial or regulatory reasons why a lender would need to sell on the shares it has received.

However, the manuals also note that such on-sale arrangements may not be within the scope of the rules if the onward sale of shares is to a company connected with the borrower.

The definition of a ‘share’ is to be found at section 476 CTA 2009 and requires an ‘entitlement to distributions’. The definition of ‘ordinary share capital’ is to be found at section 1119 CTA 2010. The legislation provides that shares will be ordinary shares so long as they are not fixed rate preference shares (with no other rights to shares in the borrower’s profits).

Shares issued in debt for equity swaps often have little value at the time of issue; this in itself should not prevent the application of the debt for equity exemption. This is supported by the Corporate Finance Manual (CFM 33201) which accepts that most debt/equity swaps in distressed company situations will represent a bargain at arm’s length, even where there is a mismatch between the amount of the debt released and the market value of the shares issued in exchange.



However, following the case of *The Collector of Stamp Revenue and Arrowtown Assets Limited*, it is also important that the rights attached to the shares do provide economic substance (i.e. have potential for future value) and have not just been issued to benefit from the exemption.

It is important to document and understand the commerciality of the deal/rights of the shares issued such that, on a realistic view of the facts, it can be demonstrated that the exemption can be said to apply to the release of the debt.

### **Non statutory clearance process and latest HMRC approach**

HMRC's non statutory clearance process is available to provide certainty to tax payers where there is material uncertainty over the interpretation of the tax legislation. Debt equity swaps often involve very large amounts of debt being written off – in some cases in excess of the enterprise value of the underlying business. Consequently, where there is uncertainty as to whether the debt for equity exemption applies, tax payers have typically sought clarity via the non statutory clearance process.

With a view to reducing the number of tax clearances, HMRC have updated their guidance on debt for equity swaps in recent years to cover some common areas of uncertainty. Whilst the size of the numbers involved

means that tax payers would likely require a clearance application should there be any potential uncertainty of the position, tax payers should be mindful of applying for clearance where the concern is solely down to the size of the transaction and quantum of debt release rather than any technical uncertainty. We have seen clearance applications refused by HMRC where they believe that there is not sufficient material uncertainty to warrant the clearance.

### **HMRC consultation process and the new rule to provide tax relief in cases of 'corporate rescue'**

In 2013, the Government announced consultation on a package of proposals to modernise the corporation tax rules governing the taxation of corporate debt and derivative contracts, with a view to legislating in Finance Bill 2014 and Finance Bill 2015. As part of this consultation, a new rule has been proposed which would provide tax relief in cases of 'corporate rescue'. This measure would facilitate restructuring of debt as part of arrangements to rescue companies in danger of insolvency.

If legislated, this new rule would provide alternative protection for borrowers from release credits in situations where the debt equity swap conditions could not be met or meeting the considerations would impose onerous restriction on the commercial terms of the transaction.

### **Conclusion**

Given the typically large numbers involved in debt for equity swaps combined with the prescriptive legislative requirements for the exemption to be met, it is key that the legal documents facilitating the transaction reflect the tax legislation. Early tax advice should be sought and HMRC clearance considered where there is material uncertainty.



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