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M&A Tax Matters

Spring 2015

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Welcome to the spring edition of M&A Tax Matters

Kicking things off in our spring edition of M&A Tax Matters, John Cox, Christine Hood and Anto Dudgeon give an overview of the new Diverted Profits Tax, which is expected to be passed in the Finance Bill this month and come into effect from 1 April 2015.

Naz Klendjian, Mikko Saressalo and Mythrayi Manickarajah then discuss the OECD's BEPS Action Point 4 regarding interest deductions and other financial payments, outlining the situations that are likely to be affected in the world of M&A and potential next steps for those who may be affected by the proposals.

Next, we hear from Sean Randall, Iain Kerr and Neil Whitworth on the amendments due to be made to the Companies Act 2006 to restrict companies reducing share capital by means of share cancellation schemes during a takeover.

Adrian Crouch and Saul Russo will then walk us through the unclear tax treatment of vendor and management transaction costs with a focus on corporate tax deductibility and VAT recovery of fees in relation to share sales. As the M&A market has shown signs of improvement, this is becoming ever more important.

With the welcome widening of rules around debt releases for distressed companies, Gavin Little and Stephen Hunt walk us through the new corporate rescue exemption and discuss the practical considerations for clients.

Next up, Asif Hussain discusses the tax treatment of bonus payments to key management personnel at the time of exit which has become common practice used by private equity houses.

Then, with warranty and indemnity insurance becoming more common in M&A transactions, Miles Bonsor takes us through the key practical issues and treatment of proceeds.

Pavan Singh talks us through the trends in the valuation of securities for tax purposes due to the changing policies of HMRC's Shares and Assets Valuation Division.

Finally, Peter Grant, Simon Chapman and Jeanette Cook shine a spot light on the issues surrounding non-financial entities being considered a financial entity for the purposes of FATCA and outline the next steps that clients may want to consider.

We hope you will enjoy our spring edition of M&A Tax Matters. If you would like further detail on the articles in this, or any previous issue, please call us, the authors, or your usual KPMG contact.

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Diverted Profits Tax: An overview

The DPT has given rise to much discussion since its announcement in the Autumn Statement, but in the current political climate it seems very likely that this will be passed in the Finance Bill in March and then come into effect from 1 April 2015.

Once the DPT comes into effect, it will apply immediately, with split accounting periods, so that a company with a 31 December accounting date that falls within the rules will be treated as having a deemed period from 1 April 2015 to 31 December 2015 within the tax.

Press coverage has focused on the charge on non-UK resident companies, which are considered to be diverting profits out of the UK by "avoiding" a UK permanent establishment, i.e. a taxable presence which would result in a UK corporation tax liability. However, there is a second type of charge to the tax under the proposed rules, which applies to UK companies. This has arisen from the perceived risk that fees paid by UK companies to group companies in low-tax countries can be overstated, particularly where the low-tax company does not have sufficient staff giving it substance. The new tax, at a rate of 25%, and with its own regime outside self-assessment, is a strong weapon to challenge contentious transfer pricing arrangements.

The legislation also goes further than this, giving a liability of 25% on the whole payment in certain cases. The most common of these are royalty arrangements to a group Intellectual Property ("IP") holding company, where the conditions are met, and where HMRC consider that it is reasonable to assume that but for the tax benefits, that IP would be held in the UK. This is particularly likely to be raised where the IP has been moved out of the UK in the past, but where the UK company which held it did not pay a full cash tax exit charge (for example because it claimed a statutory deferral relief). The liability on the payer can arise in addition to the tax liability of the recipient on its income.

The legislation includes a requirement to notify where a company meets certain conditions. In the current draft legislation, notification is required by reference only to the purely factual conditions which act as a threshold to the charge, and not on the more complex conditions which determine whether the arrangement is one for which a liability arises.

This means that currently, many groups whose arrangements are very straightforward would be required to notify, even though they do not have a liability when the further conditions are considered. We understand that HMRC are considering how the legislation can be amended to give a more practical result.

Groups will also be required to consider whether a provision for DPT is required at audit. The wording of the legislation is very broad, involving undefined terms such as "financial benefit" and "economic value". Given this broad wording, it could be very difficult to confirm that no liability

arises. The tests which are considered under DPT are broader than the points considered in respect of transfer pricing; currently, a company that has its transfer pricing considered and agreed by HMRC cannot assume that it will not have a liability to DPT.

This is likely then to cause difficulty in due diligence procedures going forward. We would expect the scope of information requests to be extended to ask whether a company has notified under the DPT rules, and whether it has made any provision for a potential DPT liability. DPT is regarded as anti-avoidance legislation and there will be no formal clearance procedure. A group which is intending to sell a subsidiary or a subgroup may find it difficult to demonstrate that there is a low risk of a DPT liability.

We understand that HMRC are considering how their processes and procedures should respond to DPT. It is clear that DPT will encourage more groups to discuss their transfer pricing with HMRC at an earlier stage. However, it is not clear what kind of comfort HMRC will be prepared to provide. There is also a potential question as to whether HMRC has enough skilled transfer pricing specialists to be able to deal with many more discussions and negotiations in a timely manner.

Thus, while it may be possible to obtain greater clarity for transactions which happen late this year, the position is likely to be difficult immediately after the 1 April 2015 commencement date. Some groups are reviewing their transfer pricing policies and documentation. Others are considering some of the more general conditions in the DPT legislation and putting together documentation to support a position that they are not met, based on the particular activities and history of the arrangement and the group business structure.

Other groups are beginning work on their documentation position, with a view to updating it when the legislation is passed, and when more detailed guidance is issued (we understand that such guidance may not be issued until the autumn.)

One area of particular uncertainty is whether DPT could apply where a UK company is making an interest payment. We understand that HMRC accept that there is already a number of anti-avoidance rules in this area, and that the current limited exclusion for loan relationships needs to be extended so that it is clearer that DPT should not apply generally to interest. Currently, a vanilla loan to a UK company could be within the scope, where that loan is made as part of a funding arrangement through a number of entities, and not all of that funding has been provided by way of loan; for example, where the funding includes a hybrid instrument, even where this is between two non-UK companies.

The BEPS process in general looks set to create many challenges for tax directors; unfortunately DPT seems to be both a particularly difficult issue, and because of its timing, a particularly urgent one.

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BEPS Action 4: Interest deductions and other financial payments

On 18 December 2012 the Organisation for Economic Co-operation and Development ("OECD") released a Discussion Draft on Action 4 (interest deductions and other financial payments) under the base erosion and profit shifting ("BEPS") Action Plan. This article outlines the key features of the recent Discussion Draft and proposed approaches to limit interest deductibility whilst highlighting a number of situations that are likely to be affected in the M&A market.

Overview

The aim of BEPS Action 4 is to address base erosion connected with interest and economically equivalent payments. The primary concern expressed in the BEPS Action 4 Discussion Draft is that multinational groups may be able to claim total interest deductions that significantly exceed their actual third-party interest expense. The Discussion Draft describes a consensus approach to:

- focus on related party and structured financing regimes;
- prescribe rules that are triggered based on interest expense, and not on an amount of debt; and
- limit those rules to net interest expense, and not gross interest expense.

In suggesting approaches to implement these principles, the Discussion Draft describes two main options to limit the deductibility of interest expense (and a third approach that is a combination of the first two), and solicits comments from stakeholders regarding those approaches.

Key features of the December 2014 Discussion Draft

Depending on how the proposals are taken forward, Action 4 could have some of the most far reaching implications of the BEPS project. The proposals potentially impact all entities that claim interest relief (including third party debt) and appear to go much further than countering the perceived problem, as the premise is that all interest within a group in excess of net third party debt could be regarded as disallowable.

As described in the Discussion Draft, interest payments arising from wholly commercial third party arrangements would be denied tax relief in many situations, and represent a significant departure from the UK's interest relief regime which applies the arm's length concept as a 'primary' rule.

This is compounded by the fact that the proposals do not consider transitional arrangements. Depending on the outcomes, grandfathering of existing financing structures would be necessary to prevent potential default on existing higher geared capital-intensive (e.g. infrastructure) projects and manage investor confidence perceptions.

Principal focus and objectives of Action 4

The Discussion Draft stresses the need to address base erosion and profit shifting from interest deductions that relate to the debt funding of outbound and inbound investment by international groups. In particular, the focus is on the following:

a) outward investment – parent companies that are able to claim relief for their interest expense while the return on their equity holdings (e.g. dividends/capital gains) is taxed on a preferential basis (e.g. because of participation exemptions).

b) inward investment – subsidiaries which are heavily debt financed with a disproportionate share of the group's debt.

The objective of the work on Action 4 is to identify consistent solutions, to address BEPS using interest on related party and third party loans, through rules which encourage groups to adopt funding structures which more closely align the interest expense of individual entities with that of the overall group.

The rules are intended to apply to interest and financial payments economically equivalent to interest (current proposals suggest this could include foreign exchange and derivative payments, which could lead to significant complexity).

Proposed alternative approaches

1. Group interest allocation rule

The net interest expense of the group would be allocated to each entity in the worldwide group by reference to a measure of the economic activity of the entity, e.g. using either earnings or asset values. Interest above the amount allocated would be disallowed.

The group interest allocation rule is a very different concept to the UK's worldwide debt cap rule, as it seeks to allocate a portion of the group's total external expense to each country (rather than the debt cap rules which permit the UK to be geared up to a cap equal to all of the group's total external expense).

If a group allocation rule is adopted, significant practical issues arise e.g. each entity's interest deductibility position becomes 'intertwined' with all other entities in its global group (and potentially parties with as little as a 25% interest) and sensitive to changes outside of its control (e.g. acquisitions by its parent in other territories).

The allocation may lead to the total deductions claimed being less than the group's actual external net expense unless groups continually restructure their internal funding arrangements to match their actual interest expense up to the deductible allocation for each territory within the group. This could present a number of difficulties given the complexity of the process, possible tax and non-tax costs and interaction with local anti-abuse rules.

2. Fixed ratio rule

Under this rule, deductible interest expense for an entity would be limited by applying a fixed ratio to the entity's

earnings or assets e.g. X% of Earnings Before Interest, Taxes, Depreciation and Amortisation ("EBITDA").

The Discussion Draft observes (based on a sample of the top 100 non-financial groups) that current limitations applied by some countries (e.g. 25% - 30% x EBITDA limitations) appear to be much higher than their actual external interest (closer to 5% – 20% x EBITDA), suggesting that current fixed ratio rules do not address BEPS.

3. Combined approach

In addition to the above, the Discussion Draft also outlines a combined approach with a view to simplifying compliance:

a) by applying the group interest allocation rule with a carve-out for entities meeting a low fixed-ratio test (to exclude low risk entities); or

b) by applying a fixed-ratio rule with a carve-out permitting entities to apply the group interest allocation rule where this results in additional deductible interest.

Early indications are that the OECD/governments may favour the "combined approach", in particular option (b) above.

Situations likely to be affected in the M&A space

- Groups undertaking M&A transactions could lose relief for third party acquisition debt unless they can re-organise their investments after each new acquisition e.g., if a group undertakes a debt funded acquisition and pushes debt down, a second acquisition funded from cash reserves would allocate capacity away from the first investment requiring a second debt push down to the equity funded investment, and so on.
- Groups which have not pushed down or cannot push down debt to subsidiary entities due to corporate, legal or commercial barriers such as, exchange controls, minority interests, or other statutory/tax rules e.g. targeted anti-avoidance rules such as the unallowable purpose rule in the UK (OECD will consider specific examples of laws or commercial imperatives that prevent "self-help" debt push downs being achieved, before concluding on the group-wide tests).
- Long term Public-Private Partnership/regulated infrastructure projects, which attract entity-level third party debt (which is non-recourse and by definition not 'excessive', presenting little or no BEPS risk), will not be able to assume interest relief in their financing and investment decisions. This could push up the cost of infrastructure to governments/users and create unpredictability throughout its ownership cycle.
- Pension funds and sovereign funds with limited external debt but who hold/acquire debt alongside their equity investments for legitimate commercial reasons may become non-competitive when bidding with or against more highly leveraged bidders. This could drive behaviour towards higher third party leverage, whilst also discouraging the flow of capital from institutional investors, in conflict with the OECD's wider economic growth objectives.
- Businesses owned by PE, infrastructure and real estate funds which are often collective investment vehicles in the form of partnerships and trusts and not traditionally within the meaning of a 'group' could be impacted as a consequence of the proposed related/connected party concept applying to 25% or more interests. Listed groups with a 25% plus shareholder may have their interest relief position impacted.
- The rules may result in increased denials of interest deductions for UK companies which are not currently affected by the debt cap rules either because (i) they are less than 75% subsidiaries of the ultimate parent company (the scope of the proposals could include related parties with a 25% plus interest) or (ii) there is currently no restriction by reference to the external gross debt.
- Groups with minimal external leverage/cash rich, which finance subsidiaries with debt would be impacted.
- UK sub-holding companies which borrow intra-group to fund overseas investments, where dividends are exempt and the interest expense shelters UK operating profits would also be impacted.
- Certain sectors are particularly affected e.g. banking and insurance companies, and sectors taxed under special regimes such as oil and gas and real estate. The Discussion Draft suggests that separate rules might need to be applied for such sectors. However, sector specific rules must not represent State Aid.

What's next?

KPMG submitted comments on the Discussion Draft on 6 February 2015 and also assisted The Infrastructure Forum with its submission (for a copy, please click here). In addition, KPMG attended the Public consultation meeting with the OECD on 17 February 2015 (please click here). The period for formal consultation is now over, and we expect the OECD and country governments to finalise their proposals by around July 2015. The recommendations ultimately agreed upon with respect to Action 4 will be delivered to the G20 Leaders and Finance Ministers in late 2015, along with other 2015 BEPS deliverables.

In addition, recommendations regarding the design of domestic rules are expected by September 2015 and changes to the Transfer Pricing guidelines by December 2015.

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Takeover schemes of arrangement: Implications for private companies

Last year's Autumn Statement included an announcement that amendments are to be made to the Companies Act 2006 to restrict companies reducing their share capital by share cancellation schemes in a takeover situation. There were concerns initially that the proposed amendments would restrict a private company's ability to reduce its share capital by means of a special resolution supported by directors' solvency statements.

A new draft of the Companies Act 2006 (Amendment of Part 17) Regulations 2015 has been published that clarifies that the amendments will prevent takeovers of public companies effected by court approved cancellation schemes of arrangement.

Broadly, there are three ways in which a takeover can be achieved:

1. A contractual offer, where the acquiring company offers to buy the shares of the target company.
2. A 'transfer' scheme of arrangement, where shares in the target company are transferred under a court order to the acquiring company in return for consideration in the form of cash, loan notes or shares.
3. A 'cancellation' scheme of arrangement, where the court authorises the target company to cancel its share capital and issue new shares to the acquiring company, again in return for consideration.

A court approved scheme requires a smaller proportion of shareholder consents to be implemented, 75% as against 90% for an offer, and a cancellation scheme currently has the benefit of completely or partly mitigating a stamp duty charge as the target company's shares are cancelled and re-issued rather than transferred. The Government considers that treating transfer and cancellation schemes differently for stamp duty purposes is unfair and that stamp duty should be payable. However, rather than introduce a charging provision for cancellation schemes, the proposed change is to the Companies Act to restrict companies from reducing their share capital where that is part of arrangements for a takeover. The alternative of introducing a charging provision for cancellation schemes would have exposed the UK Government to claims that the charge contravened the EU Capital Duty Directive.

Although the specific legislative amendment is in reference to capital reductions effected by special resolution (supported by a solvency statement as well as by special resolution confirmed by the court), it only applies to a 'scheme' which is then defined as a compromise or arrangement sanctioned by the court under part 26 of the Companies Act (arrangements and reconstructions).

Consequently, private companies should be able to continue to effect capital reductions via special resolution supported by a solvency statement free from stamp duty.

For court approved schemes there are still some carve-outs:

- The restriction does not apply where a new parent undertaking is to be inserted above the existing company and all or substantially all of the members of the company become members of the parent undertaking in the same or substantially the same proportions as they held shares in the existing company. So, cancellation schemes of arrangement will still be possible for demergers.
- Whilst the regulations will come into force on the day they are made, there are transitional rules that mean that the rules will not apply where the acquiring company has made a public announcement of a firm intention to acquire the existing shares, or, where the Takeover Code is not in point, where the terms of an offer have been agreed with the existing company prior to the regulations coming into force.

As the amended regulations refer specifically to part 26, we understand that the change will not affect any capital reductions which may be undertaken in the context of mergers or divisions of public companies as set out in part 27.

The draft regulations must be approved by Parliament. At the time of writing, it is expected that they will come into force any time within the next few weeks.

Transfer schemes of arrangement are unaffected and so will continue to be possible for takeovers. The effective removal of the stamp duty saving for cancellation schemes means that transfer schemes will likely be used more often. Aside from the lower approval threshold noted above, they have many advantages over contractual offers.

Click here for the Companies Act 2006 (Amendment of Part 17) Regulations 2015.

Click here for the explanatory memorandum.

Click here for the draft information and impact note.

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Tax treatment of vendor and management transaction costs

The improving M&A market has increased the focus on the tax deductibility of transaction fees for bidder and target companies. Although the treatment is not clear-cut and is inevitably dependent on the particular facts and circumstances of each deal, there are a number of cases, HMRC opinions and experiences that can be drawn on to understand (at least broadly) what treatment and challenges should be expected.

Overview

The range of situations in which transaction fees arise, along with the numerous types of fees typically incurred, contributes to the uncertainty in their tax treatment. For instance, fees may be incurred by a company in relation to the sale of shares (either successful or abortive), a refinancing, an Initial Public Offering ("IPO") or a trade and asset sale.

This article focuses on the corporate tax deductibility and VAT recovery of fees in relation to a share sale and, in particular, what the tax effects of paying for management investment advice and seller costs are for the target entity.

Seller Costs

Often the seller's costs are borne by the target entity in a transaction. These may well be included as leakage or net debt items. However, to ensure the correct amount is adjusted the tax treatment needs to be understood.

Typically, such costs will include vendor due diligence costs, certain legal expenses and possibly M&A advice.

Corporate tax deductibility

On the sale of shares, the seller's deal fees incurred by the target can usually be identified as being:

- Costs relating to the return of capital to shareholders;
- Debt issue costs; or
- Other costs.

Costs incurred in relation to the return of capital to the shareholders/sale of shares are typically not allowable for tax purposes since they relate to shareholder issues and not the trade or business of the target. Broadly, expenses that are not severable from the purchase decision or the legal documents related to the sale of shares (such as the drafting of sale and purchase agreements) are non-deductible for corporation tax purposes. On the other hand, fees for services such as strategy consultancy costs and potentially vendor due diligence costs may be deductible.

Such costs may be deductible for corporation tax purposes if they are (i) charged to the profit and loss account and (ii) are for the benefit of the trade or business. For example, it could be argued that vendor due diligence costs, particularly any forward looking work or commercial or market diligence, will benefit the company going forward.

Additionally, if the costs can be accounted for as costs of raising loan finance (assuming incurred by the borrower, e.g. where the lending banks require reliance on the vendor due diligence report) a tax deduction may be available as the costs are amortised over the life of the loan. This is, however, dependent on the accounting treatment and expenses in the profit and loss account.

The target company may incur fees that it pays on behalf of other parties for instance, the company may pay the legal fees for bondholders/banks if changes are needed to banking group/security arrangements, or for advice

in relation to a Management Investment Plan ("MIP") on behalf of managers. Where fees are incurred on behalf of other parties, no corporation tax deduction will typically be available for these costs, subject to any duality of purpose that can be argued.

Duality of purpose

Inevitably, some deal fees incurred, such as MIP advice, may have a dual purpose – although the advice is for the benefit of the managers, it can be argued that it is a cost incurred by the bidding company or target to incentivise management, has a business purpose and is therefore deductible. We typically see that only a percentage of deal fees may need to be disallowed for corporation tax purposes where there is duality of purpose.

VAT recoverability

HMRC are continuing to aggressively challenge the recoverability of VAT incurred on transaction costs and there are a number of court cases in this area. Broadly, VAT is only recoverable where there is a direct and immediate link to taxable supplies made by the beneficiary of the services and where the beneficiary of the services should also be the party which bears the cost and associated VAT hence, the recovery of VAT on deal fees cannot be guaranteed.

However, to maximise the chances of securing VAT recovery, the fees incurred should relate to the beneficiary's economic activities and/or the making of taxable supplies of services to group companies or third parties. It is also essential that the true recipient of the supply is identifiable, that this is documented accurately and consistently, and the engagement letters are with the recipient of the service.

Practical aspects

Given the treatment of deal fees is a grey area both from a VAT and corporation tax perspective, this will inevitably cause tension between sellers and purchasers where the tax benefit is expected to be included in the leakage amount.

It is important for both the purchaser and seller to understand exactly what each advisor did and obtain copies of engagement letters/invoices ensuring they are addressed to the right entity to be able to correctly assess the impact of the target bearing the costs. The seller will need to be proactive early in the process in the respect to ensure the position is optimised where possible.

Management advice and employment taxes

The target company or bidding company may typically pay for advice given to management in relation to their investment in the business post-transaction. These fees can often be material and, on top of the difficulty in obtaining a corporate tax deduction and VAT recovery, there may also be an employment tax charge and, depending on how the advice is paid for, a charge to either Class 1 or Class 1A NIC.

The most difficult problem to deal with is calculating the taxable "cash equivalent" of the benefit in question. If specific advice is provided to a single member of the management team and is separately identified in the scope of the engagement (and in the corresponding fee note), then the cash equivalent of that benefit is simply the cost incurred (inclusive of VAT) in the provision of the advice.

However, life is seldom that simple. Consider instead advice provided to a management team; is the cost to be attributed to each member in an equal proportion, or would a degree of weighting need to be applied taking into account the relative benefit that each member derived? The answer is deceptively straight-forward – HMRC would allow the cost to be apportioned on "any reasonable basis", so either a straight-line or weighted apportionment may be appropriate given the particular services provided.

Taxable benefits are further complicated when there is little clarity in the letter of engagement about for whose benefit the advice provided, or where there is a dual purpose. General tax advice for the benefit of the company is clearly not a taxable benefit in the hands of a particular employee or director however, advice will often deal with the post transaction effects on groups of employees.

We have seen HMRC seek to apply a tax charge in these cases and the result can be confusing. The best plan is to identify where professional advice may benefit an employee or groups of employees and "ring fence" that advice by asking an adviser to set it out separately on the fee schedule for the purposes of quantifying any resulting benefit in kind.

If the engagement letter is with the individual rather than the company, then the amount is subject to PAYE and NIC rather than treated as a benefit in kind. Also, if the company simply bears the tax on behalf of the employee a gross up is likely to be required.

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The new Corporate Rescue Exemption: Practical considerations for taxpayers

A welcome widening of the rules on debt releases for distressed companies has been drafted by HMRC, meaning that financial rescues of companies involving a release, modification or replacement of underperforming debt are more likely to be undertaken without crystallising a significant tax liability. The new reliefs apply to a release, modification or replacement taking place on or after 1 January 2015.

As part of HMRC's ongoing consultation document on 'Modernising the taxation of corporate debt and derivative contracts', the Government published draft legislation on 10 December 2014 to incorporate the new 'Corporate Rescue Exemption'. Draft guidance on the Corporate Rescue Exemption was also published on 12 January 2015.

The purpose of the corporate rescue exemption is to extend the currently available reliefs for releasing third party debt on a tax free basis to situations where the borrower is in financial distress. The new exemption is intended to differentiate between "the immediate urgency of a corporate rescue" where tax relief should apply and "more general or strategic liability management exercises" where tax relief is not intended to apply.

Whilst the legislation is still in draft, it is expected that the current draft will change very little between the time of writing and Royal Assent, although consideration is still being given as to how these rules may interact with other aspects of the loan relationship legislation. Consequently, for simple debt releases and simple fact patterns, a reasonable level of comfort can be achieved from the draft legislation. For more complex situations, more caution may be needed.

How has the legislation acted in the past?

Before the exemption came into force, companies in financial distress had two options for releasing debt without triggering a tax charge:

1. release in consideration for the borrower issuing ordinary shares to the lender; or
2. undertake the release when the borrower is already in an insolvency procedure.

It is not always commercially feasible for a lender (or syndicate of lenders) to hold ordinary shares in the borrower (under method 1). Additionally, entering an insolvency procedure can often be detrimental to a company's trading operations such that it would not facilitate a rescue of the company. Therefore, a key aim of a financial rescue is often to prevent a company from entering into an insolvency process.

Against this background, financial rescues often required very complex structures in order to achieve the commercials aims of the rescue and fit in with the limited tax exemptions which prevented the rescue from triggering a substantial tax charge.

In addition to straightforward releases of debt, some corporate rescues involve amending the terms of existing debt, for example converting cash-pay interest into PIK interest and rescheduling capital payments. In some cases the accounting in the borrower requires the amended loan to be treated as a new loan at the fair value of the amended debt and the old loan liability is derecognised. Such cases are referred to as a "substantial modification" of the loan. Historically, under UK GAAP no accounting profits typically arose on a substantial modification, however, for accounting periods beginning on or after 1 January 2015 a substantial modification under UK GAAP (FRS 101 or FRS 102) is more likely to create an accounting profit. In particular under FRS 101, FRS 102 and IFRS the fair value of the amended loan will take into account the borrower's ability to settle that liability. So, as a simplified example, if a loan of 100 is refinanced but the borrower's business and assets (and therefore the fair value of the refinanced loan) have a fair value of 80, an accounting profit of 20 may arise on the loan amendment.

The new rules are therefore also looking to exempt any profits arising from substantial modifications where the borrower is in financial distress, including profits that arise on transitioning to new UK GAAP (FRS 101 and FRS102) accounting frameworks.

How and when will the new exemption apply?

Two new sections (s322(5B) and s323A) have been inserted into the Corporation Tax Act 2009 which remove the obligation to bring into account a loan relationship credit arising on the release, modification or replacement of debt in circumstances where the borrower is unable to settle its debts. The new reliefs apply to a release, modification or replacement taking place on or after 1 January 2015.

Section 322(5B) and 323A broadly apply where immediately before the release, modification or replacement, it is reasonable to assume that, without the release and any arrangements of which the release, modification or replacement forms part, there would be a material risk that at some time within the next 12 months the company would be unable to pay its debts.

Unable to pay one's debts is defined as either:

i) unable to pay its debts as they fall due; or

ii) the value of its assets are worth less than the amount of its liabilities, taking into account its contingent and prospective liabilities (i.e. balance sheet insolvent).

In s323A, where a modification credit is exempt, any subsequent reversal of that credit, for example by the borrower settling the full face value of the loan at a future time, will not give rise to a tax deduction.

Regulation 3C paragraph 2 (g) in SI 2004/3271 also extends the corporate rescue exemption to profits that arise on transitioning to new GAAP (FRS 101 and FRS 102) where there is a change in the fair value of a liability on transition that has arisen from a substantial modification of a loan in an earlier accounting period and at a time where the borrower was in financial distress. These regulations apply for accounting periods beginning on or after 1 January 2015.

HMRC state in the draft guidance that an insolvent balance sheet will usually be the best indicator of a company being unable to pay its debts within the next 12 months, however consideration should be given to other factors, such as expected breaches of financial covenants.

In practice, it is often these other factors, in particular financial covenant breaches, that would lead to an insolvency of the company and which trigger a financial rescue process.

HMRC's guidance also discusses whether a court would allow winding up proceedings to commence, simply because a company is balance sheet insolvent. In particular, it states that "the more distant the liabilities the harder this [insolvency] will be to establish", further adding "for the exemption to apply, then, there must be a 'real prospect of insolvency' as an insolvency court would understand it, within the next 12 months".

Based purely on a literal reading of the draft legislation, if the value of a company's assets and business are less than its liabilities the exemption would be expected to apply. However, based on the draft HMRC guidance, if the company is meeting its current cash flow obligations and the maturity of its liabilities is not imminent, there may be some doubt as to whether HMRC would regard the exemption as applying to a balance sheet insolvent company.

This complication is more likely to apply in a "covenant light" financing, where a business is currently servicing its debts but has an enterprise value significantly lower than its liabilities.

Conclusion

The introduction of the corporate rescue exemption is certainly a welcome change in this area. However, whilst the legislation and guidance are still in draft form, great care must be taken when seeking to rely on the exemption, in particular if the facts and circumstances are not straightforward.

Whilst still not certain, the new legislation is envisaged to be enacted in the pre-election Finance Bill. Given the size of the potential tax liabilities arising from debt elimination and modification, it is important to ensure timely tax advice is taken at the commencement of any financial rescue process.

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Deductibility of bonus payments paid on exit

Bonus payments to key management personnel at the time of exit has become more of a common practice used by private equity houses of late. This article sets out the tax position on those payments, and whether they are, and in what conditions they may be, deductible for corporation tax purposes.

Deductibility of bonus payments linked to exit

The deduction of compensation damages, or other lump sum payments is based primarily on whether such a payment was made "wholly and exclusively for trade purposes" (BIM42951).

Trade purpose test

Any ex-gratia payment must be made in connection with the trade that the company carries out, to be allowed. In the case of CIR v Anglo Brewing Co Ltd [1925] 12 TC 803, payments made to employees prior to the winding up of the company were disallowed, as the payments were made in connection to the cessation of the business trading, rather than its continuance. (BIM38310).

Further, the trade purpose test is unlikely to be met where "a payment in compensation for loss of office is connected with the purchase or sale of a business or a change of controlling interest by the transfer of shares" (BIM42955). This would be compounded where there is evidence in board minutes, share transfer/purchase agreements or, contracts of employment and any other such documents that the relevant payments were made for any reason other than the continuing trade of the company.

Taxpayer must show that the two events are unconnected

In order for lump sum payments made prior to, or shortly after a change of control of the company, to be deemed deductible, it is upon the taxpayer to show that the two events are unconnected (BIM38340). In the case of James Snook & Co Ltd v Blasdale [1952] 33 TC 244, an agreement for the sale of shares in a company provided for the buyer to pay compensation for the loss of office for a certain number of directors who were to resign as a result of the transaction. Though Donovan J stated that the mere fact that the compensation was paid on the occasion of the share sale did not make it inherently disallowable, he did affirm that the proximity of the two events was such that the company had to prove that they were unconnected. The onus lies on the company to prove that the payments are not connected to the share sale.

Payments must be considered independent of any deal struck with the purchase of shares

For any payments made to employees by a company on or around a sale of the shares of that company, the company must show that the payments were made independently of "any bargains struck by the shareholders with the respective purchasers of the shares" [BIM38385]. In the case of George Peters & Co Ltd v Smith [1963] 41 TC 264 the purchasers of

the shares in the company agreed with the outgoing shareholders the amount of compensation to pay two employees being made redundant as a result of the transaction. The commissioners found that the payments made to the employees comprised an integral part of the bargain between the outgoing shareholders and the incoming purchaser. It was also held that it was not enough for the transaction to be "good for the company's trade"; the "company has to show that the compensation was paid wholly and exclusively for the purposes of the trade".

Change of control

It will usually be difficult for a company to claim that any payments made to directors when there is a change of control, are deductible (BIM38380). The case of George J Smith & Co Ltd v CIR [1968] 45 TC 384 established that "it is not enough for the company to show that the amount paid [...] reflects a bargain at arm's length between the parties [...] the company must establish that the issue of compensation has been considered entirely separate from the share transaction." Though many of the examples given above relate to compensatory payments made to parting directors, it is emphasised in this case, and in the Snook case that notwithstanding any commercial rationale behind the payments, the connection between the payments and the share sale of the company is what makes them disallowed. Hence, the same can be said to hold true for bonus payments for continuing directors, even if such payments serve a commercial purpose – if those payments are linked in any way to a change of control, they will not be deductible. On the other hand, retention bonuses or pure reward for achieving certain trading results should be deductible.

Conclusion

Bonus payments to management triggered by the sale of the company, may be non-deductible. The onus lies squarely with the company to show that the two events are unconnected, which will require the tax implications of the bonus payments to be contemplated when first drafting the documents setting them out. As noted above, bonuses that clearly relate to rewarding loyalty (retention) or achieving trading results should be deductible.

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Practical issues of warranty and indemnity insurance and treatment of proceeds

Warranty and indemnity insurance is becoming more common in transactions. This article highlights some of the key practical issues that arise.

Differences between a tax warranty and tax indemnity

It is important for sellers and buyers to be aware of the distinction between a tax warranty and tax indemnity.

A tax warranty is a contractual statement made by a seller in relation to the state of the tax affairs of the target company or business. If any warranty provided is untrue (and therefore the value of the target company or buinsess is less than the buyer pays for it) the seller may be liable to damages to the buyer under a breach of warranty claim.

A tax indemnity (or deed/covenant) is an agreement to reimburse a buyer against specific tax liabilities arising as a result of a transaction. An indemnity allocates specific tax risks between each party and provides the buyer with a clear basis for securing a recovery of relevant liabilities.

What is tax warranty and indemnity insurance and why is it used?

Tax warranty and indemnity insurance covers losses incurred as a result of a breach of the warranties and/or claim under the tax deed in specific transactions. The insurance intends to provide coverage to "match" the tax warranties and indemnities in the Share Purchase Agreement ("SPA"). In doing so the seller is able to access the sale proceeds immediately as opposed, for example, to placing them in escrow. Meanwhile, the buyer is not disadvantaged as it can recover any unforeseen loss incurred from the transaction directly from the insurer.

It is becoming increasingly common in acquisitions for a buyer (e.g. to reduce the retained liability of a seller in a competitive auction process) or seller (e.g. to achieve a clean exit) to consider the use of tax warranty and indemnity insurance and there are relative merits of each.

Sell-side policy

A seller will take out a sell-side policy where it has provided tax indemnities but wants coverage from the insurance company in the event that it is required to make a payment under these indemnities. Sellers may often wish to do this if they are exiting from the business and want a clean break or if they are not prepared to give an escrow in respect of tax liabilities.

Escrow arrangements for tax matters can be commercially unappealing due to the length of time (e.g. the statute of limitations) for which the funds must be placed in escrow. In a sale by a Private Equity Fund that could prevent the fund from distributing sale proceeds; alternatively it may cause the buyer concern that the fund will not exist to meet a future tax claim if it is reaching the end of its life.

Advantages of a sell-side policy

- Quicker to negotiate than a buyer policy as sellers will be aware of key issues to cover and will be able to provide full information; and
- Generally cheaper than a buyer policy due to commercial factors and the exclusion of fraud (see later).

Buy-side policy

A buyer will often take out insurance to satisfy its lenders. Insurance may also be taken out where the seller has not provided tax indemnities or where the tax indemnities have a very low financial cap. The insurers often want the seller to have some liability under the tax deed (even if this is capped at a low level) to provide comfort that a proper exercise has been undertaken in relation to the negotiation of the form of the warranties and indemnities.

Advantages of a buy-side policy

- The buyer has a direct contractual relationship with the insurer. A buyer policy enables the insurers to assess the adequacy of disclosure and the scope of warranty exposure through the buyer's due diligence exercise; and
- A buyer may be able to insure against loss arising by reason of fraud by the seller or the target company's management. By contrast the seller will not be able to insure against loss arising because of its own fraud or other criminal actions.

What are the main differences between a tax indemnity and tax insurance?

An insurance policy does not work in the same way as a tax deed. If the buyer obtains a tax deed it would expect a pound for pound indemnity in respect of any pre-completion tax liabilities arising in the target company (subject to certain exclusions) whereas a buyer (or seller) will have to comply with stringent conditions in order to rely on the tax insurance. Typically an insurer will not insure against any known or potential tax liabilities in the target company. The insured party will be required to make full disclosure to the insurer about any known tax liabilities (and potential liabilities in some instances) of the target company.

The insurers may also decline to give cover for specific areas e.g. some insurers will not insure against environmental risks, pensions risks, criminal or fraudulent risks (as this is against public policy) and sometimes they will not offer insurance against forward looking warranties or indemnities.

When should insurance be taken out and how long will the policy last?

Policies can be purchased at any point in the deal process and they can even be put in place after completion. Typically they are taken out in conjunction with completion and run concurrently with the limitation period(s) in the underlying SPA. In addition warranty and indemnity insurance can be used to bridge a timing gap if, for example, a seller has reduced its period of risk in the SPA to less than the market norm. In this case warranty and indemnity insurance coverage can be negotiated to extend beyond the period agreed under the SPA and give the buyer an additional period of protection.

What can be recovered?

The amount that the buyer or seller will be able to claim under the insurance policy will depend on the amount insured and the amount of the 'excess' or 'retention' under the policy. This excess will often equate to the amount of the agreed minimum claims threshold in the SPA. Once the minimum claims threshold has been reached on a buy-side policy the buyer can typically pursue claims against the seller for amounts up to the threshold and the insurer for the remainder (up to the insurance policy limit). On a sell-side policy the seller is liable to the buyer for the whole amount (up to the negotiated maximum limit in the SPA) and will then seek recovery for amounts over the excess against the insurer.

Is it possible to have no risk under the policy?

Although it is theoretically possible to obtain an insurance policy which covers all risks and which provides either the seller with no exposure at all under the warranties/the buyer with no obligation to pursue the seller for the agreed threshold amount (with the associated risk of non-payment) most insurance companies are unwilling to offer cover on this basis (or at least at a reasonable premium). Insurance companies generally require the seller to be exposed to a degree of risk to ensure reliability of the disclosure process against the warranties and that the negotiation of the warranties takes place on a commercial and arm's length basis.

What won't the policy cover?

In addition to any excess provisions, typical exclusions to standard cover include (i) liabilities arising from information disclosed or otherwise within the knowledge of the insured party, (ii) fines and penalties which are uninsurable by law, (iii) forward-looking warranties, (iv) product liability and environmental issues (these can be covered by separate policies), (v) pension underfunding and (vi) anything arising as a result of fraud or dishonesty.

How much will the policy cost?

Pricing can depend upon a number of factors but typically tax warranty and indemnity insurance costs between 4% and 8% of the amount covered (both buy-side and sell-side policies tend to be priced on the same basis). However, each policy is bespoke for each specific transaction and firm pricing can only be obtained once specific details of the deal have been submitted to the underwriters.

The factors taken into account when pricing these policies include:

- the complexity of the transaction;
- the limit of liability in comparison to the sale consideration;
- the scope of the cover agreed;
- the identity and nationality of the parties to the deal and their financial stability;
- the type of business being sold;
- the amount of any excess;
- the identity of the professional advisers to the parties to the sale (where they are deemed to be well respected the insurers will generally have greater comfort that a thorough due diligence exercise will have been carried out and therefore more liabilities will have been disclosed); and
- the nature of the warranties and indemnities (the more specific they are, the lower the premium).

Tax treatment of receipts in respect of claims under warranty and indemnity insurance

There is little guidance available on how proceeds of such insurance policies should be treated for tax purposes. In the absence of any guidance the tax treatment of a receipt under an insurance claim (more generally) will depend on the nature of the receipt and whether it is deemed to be revenue or capital in nature. However, we would expect the net tax effect to be nil in either case i.e. the receipt under an insurance claim makes good a loss/restores an asset's value.

Whilst some receipts (such as those to compensate for loss of trade) can be revenue in nature many will be capital as they relate to an asset. Where capital sums are derived from an asset Section 22 TCGA 1992 states that there is a disposal by the recipient notwithstanding that no asset is acquired by the person paying the capital sum. However, and subject to a claim by the taxpayer, Section 23 may apply to ensure that the receipt of insurance money is not treated as a disposal provided:

- the capital sum is wholly applied in restoring the asset;
- the capital sum is applied in restoring the asset except for a part of the capital sum which is not reasonably required for the purpose and which is small as compared with the whole capital sum; or
- the amount of the capital sum is small, as compared with the value of the asset.

On the basis that the claim would generally relate to a tax liability of a target company and the target company will need to be put in funds to pay the liability, the expectation is that the proceeds would not be taxable.

In any event, provided that the insured entity (whether it is the seller or buyer) is paid an amount not exceeding the tax arising in the target company then there should be no tax consequences for the receipt of the insurance money. This is the same result as a payment under a tax deed by the seller to the buyer as a result of a successful claim under the tax deed.

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Valuation trends for issuing shares to employees

The issuing of shares to employees is becoming increasingly popular for quoted, Private Equity ("PE") backed and family run companies as a form of retention and incentive. However, valuing these securities for tax purposes is becoming more challenging as HMRC's Shares and Assets Valuation ("SAV") Division changing policies, particularly with regard to expected information available to a minority shareholders and related discounts.

As the M&A sector continues to pick up, tax due diligence is uncovering that a number of historic employee share issues have not had contemporaneous professional valuations carried out. This in itself can mean a potential indemnity required from the purchaser or price chip to account for any inherent tax charge (especially where joint elections were not entered into at the time of acquisition).

Methods of valuation for minority shareholdings

Since the inception of the Income Tax (Earnings and Pensions) Act 2003 ("ITEPA") and the introduction of SAV's discretionary Post Transaction (Pre Filing) Valuation Check ("PTVC") procedure, employee share incentives and subsequent dialogue with SAV in relation to agreeing values is on the increase. The shares issued are, in general, minority interests i.e. sub 25% holdings.

The main areas of interest in tax valuations for minority shareholdings are:

- Information standards; and
- Minority discounts.

When valuing sub 25% holdings in the hypothetical vendor/purchaser scenario case law states that if the value of the investment is small then only information within the public domain would be available and any other information that would be "reasonably required" based on the size of shareholding. This has been interpreted to exclude forecasts, details of sales or other confidential information held by board members.

Such information standards have previously been accepted by SAV.

Additionally, traditional ordinary equity was often issued in family run companies with no exit prospects. As such a minority shareholding based on the hypothetical scenario, in the absence of dividends, voting control on exit could have attracted discounts of up to 80% to the pro-rata value of the shares.

The impact of modern day share issues

As transactions, particularly within the PE/M&A sphere become increasingly complex with regard to the debt/share structuring, traditional case law and methods of valuation with regard to the application of discounts and

the information available to a minority shareholder have needed to be addressed.

Advisors have sought to apply case law to suit the facts in modern transactions. There have been reductions in minority discounts applicable when valuing sub 25% holdings to take into account the fact that PE houses will have some expected exit period (versus a traditional family run business where no exit was in prospect) and following the introduction of growth shares, Advisors have sought to value shares by assessing the extent to which the premium to current value can be achieved. This has been based on what information the hypothetical minority shareholder would be entitled to i.e. a view of historic performance of the company and industry outlook.

SAV's view

The above methodology adopted by advisors had in the round been accepted by SAV historically; however, the three recent key departures have been:

1. Requiring full disclosure of a potential sale;
2. Stating in correspondence that it is their "policy" to now ask for forecasts in order to value growth shares; and
3. Challenging the level of minority discount due to the "intention" to exit, in particular by PE houses.

With regard to full disclosure of a potential sale SAV have said that they will disregard such sale intentions if there is sufficient evidence to support its remoteness.

There are, however, challenges to the changes of approach:

- A "policy" of seeing forecasts now means that the holder of a growth share which has no intrinsic value, will potentially have a greater level of access to information than a minority ordinary shareholder (where such shares have intrinsic value), such standard being set in case law.
- Suggestions that previously accepted discounts should now be reduced due to the "intention" to exit by PE houses misunderstands the nature of an "intention" to exit. An intention to exit is always dependent on market conditions and as a result of the recession we have seen that exits can be a seven to ten year period or more.

Summary

Tax valuations are becoming increasingly complex. Advice should therefore be sought from professional tax valuers when valuing employee shares to help ensure that current valuation thinking and approach is taken in order to provide protection going forward from challenges not only from SAV but also on an ultimate sale of the business.

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FATCA: Is your non-financial entity actually a Financial Institution?

The Foreign Account Tax Compliance Act ("FATCA") is in-force U.S. tax legislation that is designed to identify U.S citizens who have failed to declare taxable income and assets on their tax returns. The U.K., along with a large number of other countries, has entered into an 'Intergovernmental Agreement' ("IGA") with the U.S. to introduce FATCA-like rules into local law. M&A transactions involving Financial Institutions generally now include as a standard procedure FATCA considerations as a key part of the due diligence process. However, many non-financial entities may not be aware of the potential risk of being considered a Financial Institution. This article considers the situations where this could be likely and what actions clients may want to take going forward.

As a result of the many information sharing agreements between tax authorities, you may receive a request from your bank, custodian or other financial institution which you deal with asking for your status under one of these information sharing agreements.

Therefore all entities, regardless of whether they have any U.S. connections or not, need to consider how these agreements apply to them.

When do I have to think about this?

Banks and other Financial Institutions will request this information when a new account or financing arrangement is entered into. In fact, they may not provide the financing if you cannot answer their questions.

For accounts and financing arrangements already held, the requests are likely to be received on a more ad hoc basis until the financial institutions complete the due diligence required under the legislation.

How many sharing agreements are there?

There are a number of agreements currently in force or about to be introduced:

- An agreement with the U.S. that began on 1 July 2014;
- An agreement with the U.K. Crown Dependencies and Gibraltar that began on 1 July 2014; and
- An Organisation for Economic Co-operation and Development ("OECD") initiative that commences on 1 January 2016, currently with over 50 countries committed to taking part from that date.

Unexpected financial institutions

What is catching a number of non-financial groups by surprise is certain holding companies, even of non-financial groups, could be considered Financial Institutions under the rules.

This is particularly relevant where a private equity house has used a holding company to acquire all or part of a non-financial company.

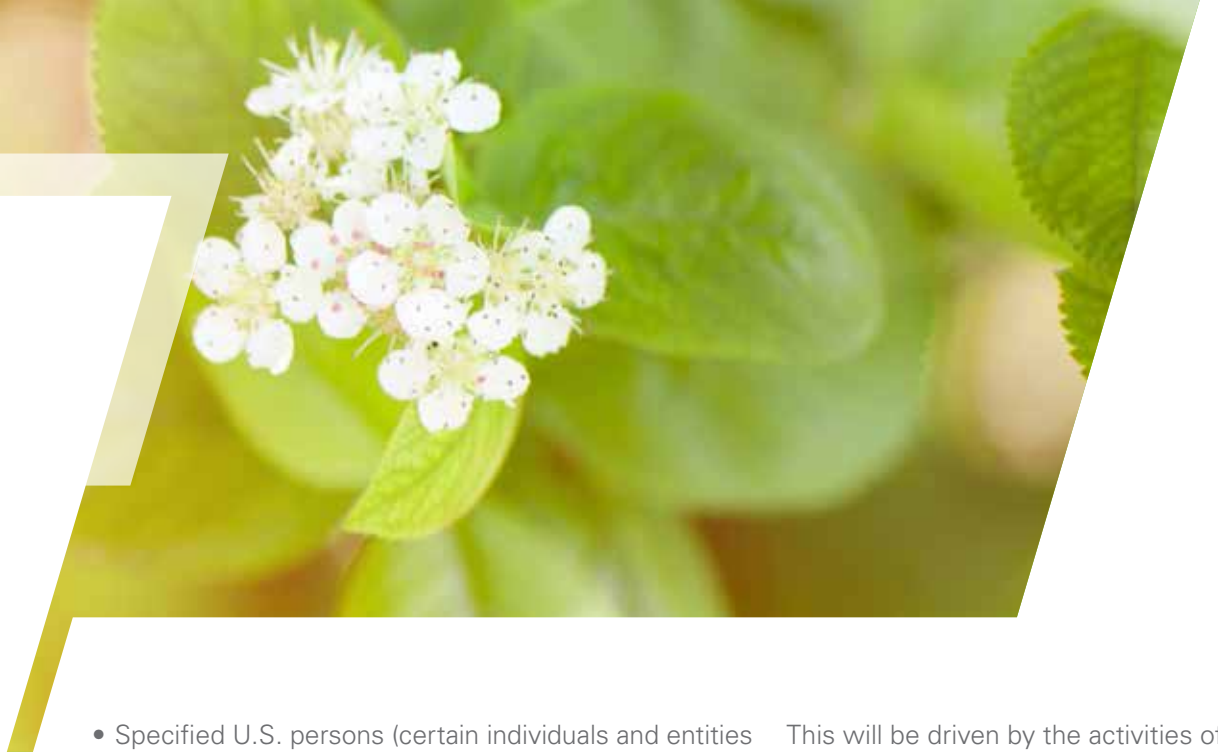
As always, each scenario requires analysis in its own right, however, it is likely that many portfolio investments of private equity funds will be classified as Financial Institutions along with certain employee benefit trusts and certain pension arrangements.

If you have any of these arrangements in the group, be aware that there could be a number of obligations should these prove to be Financial Institutions:

- Registration with the Internal Revenue Service ("IRS") and with Her Majesty's Revenue and Customs ("HMRC") as a Financial Institution;
- Due diligence on all Account Holders (i.e. investors); and
- Reporting on any identified reportable persons by the relevant deadline which is annually on 31 May from 2015 in the U.K.

What information is passed to HMRC for sharing?

Information is shared on accounts held at U.K. Financial Institutions by:



- Specified U.S. persons (certain individuals and entities that have an obligation to file an income tax return in the U.S.);
- Residents of the Crown Dependencies and Gibraltar;
- Residents of E.U. Countries; and
- Residents of other non-E.U. jurisdictions that have agreed to participate in the OECD regime.

The information shared includes details on the account holder (e.g. name, address and tax identification number) and the account (e.g. balance and payments from the account).

Non-Financial Entities

If none of the entities in the group are Financial Institutions, then they will be Non-Financial Entities ("NFEs") and will need to certify if they are an active or passive NFE, either when a new account is opened or in the next 12 – 18 months as the financial institutions complete their due diligence exercise.

This will be driven by the activities of the company and the HMRC guidance on the Implementation of the International Tax Compliance under the different regimes provides comprehensive information on this. However, it is worth noting that, the answer may differ under the different regimes.

Next steps

Clients might want to consider the following actions:

- Complete an entity classification exercise for all entities in the group especially if there are holding companies, unapproved share options, vested share options held in a nominee arrangement or unapproved or unregistered pension arrangements. Further action will be required should these entities meet the definition of a Financial Institution.
- Confirm with third party trustees of any employee benefit arrangement that they are aware of these agreements and know what the consequences are for the trust.

Whether you do something now or later will be driven by the type of entity in your group, your plans for financing and when your bank contacts you.

There is guidance from HMRC, last published in August 2014, which is updated regularly that may help you classify the entities in the group (which will include any trusts and pension arrangements).

Please let us, or your usual KPMG contact, know if you would like us to assist you in either completing an entity classification exercise, assessing whether you fully compliant for IGA purposes, or if you would like more detailed advice on the implications of being compliant and the ongoing reporting.

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Additional KPMG publications you may find of interest are listed below

Weekly Tax Matters

KPMG's weekly newsletter which covers the latest issues in taxation and government announcements relating to tax matters.

Taxation of Cross-Border Mergers and Acquisitions

Taxation of Cross-Border Mergers and Acquisitions features information from 60 countries on their current laws and regulations and the possible implications for tax-efficient structuring and financing of a merger or acquisition.

High-growth Markets Magazine

KPMG's High Growth Markets magazine brings you insight and perspective on today's global economic hot spots.

Previous issues of M&A Tax Matters

Past editions of this publication.

Create Graphics I CRT034083 I February 2015

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