KPMG

M&A Matters

Spring 2017

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Welcome to the spring edition of M&A Matters

M&A Matters incorporates the latest topical tax updates with a broader review of M&A insights.

Note to the reader: Some articles in this edition of M&A Matters examine several reforms that have been removed from Finance Bill 2017. We understand that the Financial Secretariat to the Treasury has notified the House of Commons that these delayed measures are intended to be reintroduced at the earliest opportunity post-election. The expectation is that if the measures are reintroduced, this would occur in a summer Finance Bill soon after the election, and the start dates of these measures are likely to remain at 1 April 2017.

We begin the spring issue with Iain Kerr providing an update on the reform of the substantial shareholdings exemption, providing an overall simplification to the trading conditions.

Martin Walker and Iain Kerr then take us through the expanded provisions regarding group relief and consortium relief for carried forward losses, as well as the basic rules for group relief for carried forward losses arising after 1 April 2017.

Important changes to corporate interest deductibility are then outlined by Rob Norris and Mark Eaton.

Then, Chris Barnes, Pavan Singh and Ann Sharpe from KPMG's Rewards team give an update on securities valuations, in particular management incentive share issues.

Jonathan Galin and Gabriel Ewing from KPMG in the US then run through the finalised 385 Treasury Regulations released in October 2016, introducing a series of rules that apply to potentially recharacterise certain US company issued debt to certain related parties as equity.

Then, Rob Norris and Mark Eaton return for their view on HMRC's consultation process covering an interest withholding tax exemption for debt traded on a multilateral trading facility.

BEPS 4 has given rise to unusual situations in an M&A context that would otherwise not be expected. Luckily we have Rob Norris, Mark Eaton and Greg Smythe to guide us through their worked examples.

Then, Martin Walker delves into a more technical look at the new corporate tax loss relief rules and group relief.

Finally, Mythrayi Manickarajah and Mikko Saressalo provide guidance on whether debt from a 24.9% shareholder is related party debt for the new corporate interest restrictions rules.

We hope you will enjoy our spring edition of M&A 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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The Substantial Shareholding Exemption: An overdue simplification?

Note to the reader: The measures examined in this article have been removed from Finance Bill 2017. We understand that the Financial Secretariat to the Treasury has notified the House of Commons that these delayed measures are intended to be reintroduced at the earliest opportunity post-election. The expectation is that if the measures are reintroduced, this would occur in a summer Finance Bill soon after the election, and the start dates of these measures are likely to remain at 1 April 2017.

The reform of the substantial shareholdings exemption ("SSE") is expected to bring about a simplification. This reform accounted for only six pages of the draft Finance Bill 2017, most of which were devoted to the new exemption for qualifying institutional investors, and would apply to disposals on or after 1 April 2017.

Removal of the trading group requirement

Turning to the changes to the historical exemption first, the requirement that the company making the disposal be a trading company or member of a trading group is to be removed. The removal of this requirement will provide increased certainty in the application of the rules. It will no longer be necessary to determine whether the worldwide group is trading in order to conclude whether the SSE applies. Once the substantial shareholding requirement is met, that determination will turn solely upon the character of the company being sold. This should mean that the sale of a trading subsidiary by an investment group can qualify, and that an investment which would qualify for the exemption cannot subsequently cease to do so because of changes elsewhere in the group.

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Whilst notice of this change was given in the Autumn Statement, the change to the requirements relating to the company being disposed of came as a pleasant surprise. The company being disposed of will no longer need to satisfy the trading test immediately after disposal where the disposal is to an unconnected party unless the disposal is of a new company to which a trade has been hived down. This is helpful as immediately after disposal here means immediately after the time of the conveyance or transfer i.e. completion. At this time, the vendor will no longer control the company being disposed of and the purchaser may want to hive-up the business, giving rise to concerns that the requirement would not be met.

Extension of the group transfer provision

The period for which a company has held shares will now be treated as extended by any earlier period during which the shares were held by a non-UK tax resident group company. Consequently it will no longer be necessary for 12 months to have elapsed before shares acquired from an overseas group company can become eligible for the SSE.

Relaxation of the holding requirement

The final change to the historical exemption is to extend by 4 years the period for which shares can be sold with the benefit of SSE once the shareholding has fallen below 10%. This enables the sale of shares standing at a gain in tranches and serves as a deterrent for tax planning in relation to companies sold at a loss.

Institutional investors

Where the new exemption for qualifying institutional investors ("QIIs") applies, neither the company making the disposal nor the company being disposed of will need to satisfy a trading test so the sale of property investment companies and IP holding companies will be able to benefit from the SSE. Under this new exemption, the substantial shareholding requirement may also be met if the company making the disposal owns less than 10% of the shares in the company being disposed of provided that the cost of those shares on acquisition was at least £20 million. This will allow large investments in items such as infrastructure projects which do not meet the 10% threshold due to their sheer scale to nevertheless qualify for the SSE. Full exemption will be available where, immediately before disposal, the company being disposed of is ultimately owned as to 80% or more by QIIs. Ultimate ownership can be traced through intervening partnerships or companies but not through any company whose shares are listed on a recognised stock exchange (unless that company is a UK REIT or a QII). Proportional exemption will apply to companies which are more than 25% but less than 80% owned by QIIs. QIIs are pension scheme trustees and managers, companies carrying on life assurance business, sovereign wealth funds, charities, investment trusts, authorised investment funds and the trustees of exempt unauthorised unit trusts. Where they invest directly, these investors are all exempt from UK tax on gains due to their status.

Concluding remarks

In an M&A context, reform of the SSE is particularly relevant when considering the suitability of UK acquisition structures and considerations pertaining to future exit scenarios.

The key benefits are increased certainty on application of the rules, the ability to sell shares standing at a gain in tranches and the new exemption for institutional investors.

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Finance Bill 2017: Group relief for carried forward losses

Note to the reader: The measures examined in this article have been removed from Finance Bill 2017. We understand that the Financial Secretariat to the Treasury has notified the House of Commons that these delayed measures are intended to be reintroduced at the earliest opportunity post-election. The expectation is that if the measures are reintroduced, this would occur in a summer Finance Bill soon after the election, and the start dates of these measures are likely to remain at 1 April 2017.

This article summarises the provisions regarding group relief and consortium relief of carried forward losses included in Finance Bill 2017 that was released on 20 March 2017.

Basic rules

The provisions have been expanded to govern group relief and consortium relief for carried forward losses, as well as the basic rules for group relief for carried forward losses arising after 1 April 2017.

It also includes a number of restrictions. In particular, preventing a company from surrendering carried forward losses via group relief where the company has the capacity to use the losses against its own profits, but has chosen not to so that group relief for carried forward losses is only available to the extent that the losses cannot be used by the surrendering company.

Similarly, a company with carried forward losses of its own cannot make a claim for group relief for carried forward losses of another company unless it has utilised its own carried forward losses as far as possible.

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Any losses claimed are offset against the total profits of the claimant company for that period, subject to the limit on relief for losses brought forward to 50% of taxable profits (after any of the £5m deductions allowance allocated to the claimant company). These losses are offset against profits after all other forms of loss relief apart from losses carried back from a later period (s188CK).

Group relief and claims for consortium relief by a consortium company

Chapter 4 limits the surrender of losses under s188CB to the lower of the remaining carried forward losses available to surrender and the remaining profits of the claimant company that can be sheltered by a group relief claim for carried forward losses.

Where a claim for consortium relief has been made, any claim is further limited to the ownership proportion (the lower of the surrendering company's percentage interest in the ordinary share capital, rights to profits, rights to assets on a winding up and voting power held in the claimant company) of the claimant company's relevant profits for the overlapping period.

Where the claimant company under such a consortium relief claim is also the member of a group, its relevant profits in determining the amount of consortium relief for carried forward losses it can claim is reduced by the amount that it could potentially claim via group relief of current year and carried forward losses.

Claims for consortium relief by a consortium member

Chapter 5 similarly limits the surrender of losses by a consortium company to a consortium member (or member of the same group as the consortium member) to the lower of the remaining carried forward losses available to surrender, the remaining profits of the claimant company that can be sheltered by a group relief claim for carried forward losses and the amount that could have been surrendered to the claimant company under the "current year" consortium relief rules for the specified loss-making period.

Restrictions on consortium relief claims are applicable by reference to the ownership proportion of the consortium company held by the claimant company in the specified loss-making period, i.e. the period in which the losses arose rather than in the period of the claim/surrender.

Any claim for consortium relief by members of the same group as the link company are limited to the amount the link company could have claimed as a standalone company, assuming it had sufficient profits to claim its full entitlement.

Where the consortium company is also a member of a group, the carried forward losses that it can surrender to a consortium member are also reduced by the amount of group relief for carried forward losses that could have been claimed from it by members of that group.

Concluding remarks

In an M&A context and practically speaking, in joint venture situations the Shareholders' Agreement should make it clear how carried forward losses of a consortium company should be shared.

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The new corporate interest restriction regime

Note to the reader: the measures examined in this article have been removed from Finance Act 2017. We understand that the Financial Secretary to the Treasury has notified the House of Commons that these delayed measures are intended to be reintroduced at the earliest opportunity post-election. The expectation is that if the measures are reintroduced, this would occur in a summer Finance Bill soon after the election, and we recommend that business assumes that the start date of these measures remains as 1 April 2017 until there is an announcement by Ministers.

Summary of proposal

From 1 April 2017, if reintroduced, a new corporate interest restriction ("CIR") regime will disallow interest-like expenses to the extent that the net tax-interest expense for UK companies (broadly, finance charges taken from the UK tax computations) exceeds the interest capacity.

The interest capacity is based on a percentage of tax-EBITDA (earnings before interest, tax, depreciation and amortisation) or, if lower, a modified debt cap limit, but is always at least £2 million. The percentage to be used is derived from either the fixed ratio method or, by election, the group ratio method.

Some key changes as the legislation has developed

The legislation which was included in Finance (No. 2) Bill 2017 reflected a large number of changes to the draft legislation issued on 26 January 2017. Key changes, in the context of M&A transactions, are as follows.

Group ratio method and related parties

For the group ratio method, interest like expenses arising on amounts owed to a related party are excluded, thereby reducing the capacity to deduct interest.

Related party borrowing includes third party borrowing where a related party provides a guarantee, indemnity or other financial assistance. There was concern that third party debt could be excluded from the group ratio calculation simply because, for example, a parent has guaranteed its subsidiary's third party borrowing. However, this rule will now not apply to a related party guarantee which is:

— provided before 1 April 2017;

— provided by a member of the group;

— a pledge in relation to shares in the ultimate parent of the group or a loan to a member the group; or

— a non-financial guarantee provided in respect of obligations to provide goods or services.

The new corporate interest restriction regime, if reintroduced, will disallow interest-like expenses to the extent the net tax-interest expense for UK companies exceeds interest capacity.

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Persons are treated as related if, for example, one is entitled to receive 25% of income available for distribution or 25% of the assets available for distribution on a winding up of the other. Helpfully, this has been revised so that it only applies for persons who have an equity like interest in the borrower. So, interest on a third party normal commercial loan should not be excluded from the measure of group interest even if the lender would be entitled to more than 25% of the assets of the borrower on a winding up, perhaps because of the nature of their security rights.

There is a new exclusion where persons become related as a result of certain corporate rescue type transactions, using similar wording to reliefs in the loan relationship rules. Persons will not be treated as related parties, broadly, where they would otherwise become related as a result of a release of a loan relationship and it is reasonable to conclude that, without the release and associated arrangements, there would be a material risk that, at sometime within the next 12 months, the borrower would be unable to pay its debts.

Relief for amounts which have previously been disallowed

Net interest-like expenses which have been disallowed under the CIR rules can be carried forward indefinitely and utilised in a later period subject to the limits applying for that later period.

The restriction on relief for interest is based, in part, on a measure of the net financing cost recognised in the income statement in the group accounts, known as the debt cap. The debt cap rule has been amended to make it easier to utilise interest expenses which have been disallowed in an earlier period. This can be modelled when assessing expected cash flows in relation to an acquisition.

Priority rule

A priority rule has been included so that it is clear the CIR rules should be applied after the hybrid and other mismatch rules. The interaction of these two sets of rules is discussed further in another article on Hybrid mismatch rules – practical implications.

Transitional treatment on 1 April 2017, including final period under the worldwide debt cap regime

Where consolidated accounts for the group straddle the commencement date of 1 April 2017, financial statements are treated as drawn up for the period to 31 March 2017 and from 1 April 2017. A similar provision will now apply for the final period of the worldwide debt cap provisions to 31 March 2017.

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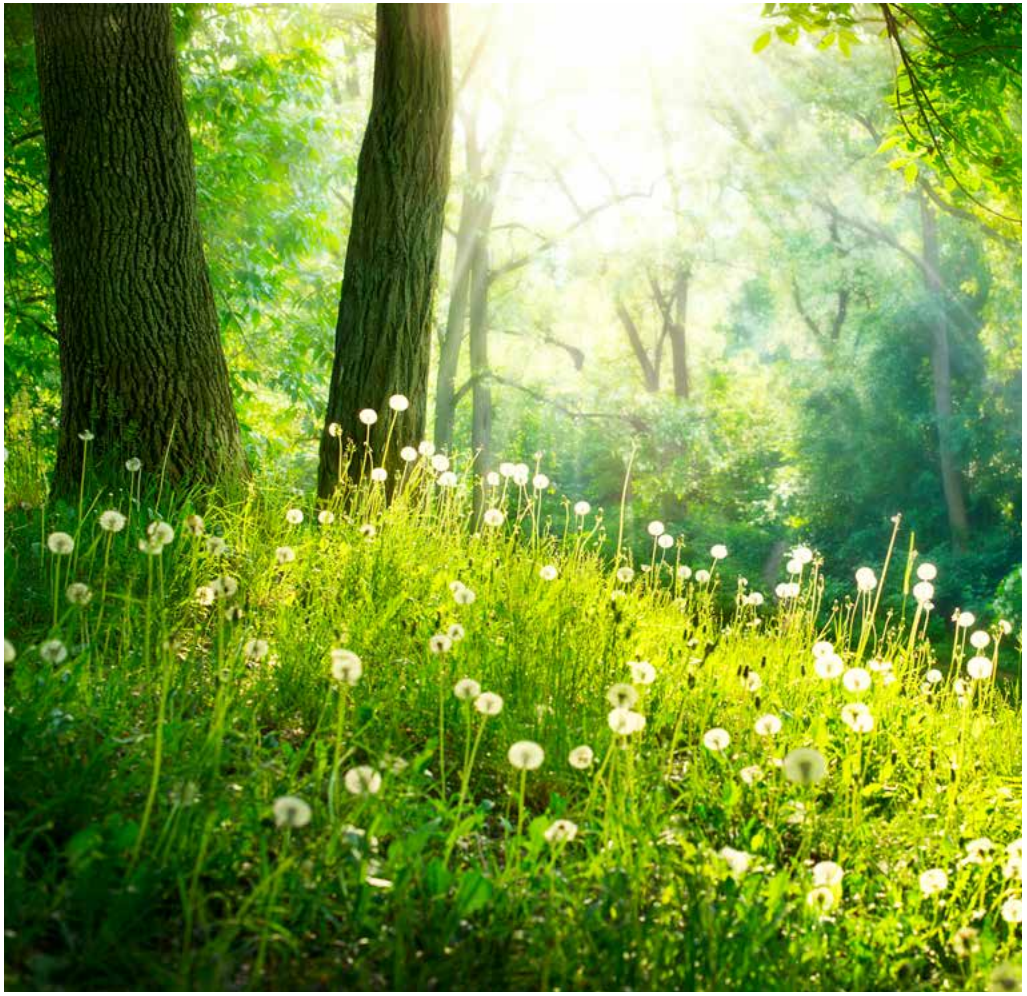
Our view

The CIR regime represents a major reform of the tax treatment of financing transactions. Those adversely impacted will not just be multi-national groups but can include groups which only operate in the UK. Inevitably, even for those groups which do not suffer a disallowance, there will be a significant additional compliance burden.

The large number of changes reflected in Finance (No. 2) Bill 2017 will take time to digest. However, many of the changes result from HMRC's engagement with interested parties as part of the consultation process which has been approached in a positive and open manner and the changes are expected to improve the rules.

We would encourage groups to model the impact of the new rules to assess the potential impact on cash tax payments and start to consider what elections may be of benefit.

For further commentary on the measures included in Finance (No. 2) Bill 2017, visit our website here.



The CIR regime represents a major reform of the tax treatment of financing transactions, and we encourage groups to model their impact on cash tax and to consider what elections may be of benefit.

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Valuation update: Management incentive share issues

Management incentives in the form of share ownership are continuing to be important in the growth profile of Private Equity ("PE") backed companies. The abolition of the tax reliefs available under Employee Shareholder Status ("ESS") in the 2016 Autumn Statement has however, limited the options available, especially with regard to pre-transaction agreements with HMRC Shares and Assets Valuation ("SAV"). This withdrawal, together with the abolition of the Post Transaction Valuation Check ("PTVC") procedure in March 2016, has led to more uncertainty over value. Share valuations are complex and uncertainties over historical valuations can give rise to challenges on sale via tax due diligence ("DD"). It is also important to be aware of SAV's current view and practice on the application of penalties in relation to valuations.

Withdrawal of ESS tax reliefs

Shares awarded under ESS on or after 1 December 2016 will no longer qualify for tax reliefs. There are however other commercial and efficient methods of awarding shares to key management.

HMRC tax advantaged share option schemes such as Employment Management Incentives ("EMI") and Company Share Option Plans ("CSOP") are still available subject to certain conditions and valuations can be agreed prior to their issue. Also the issue of growth shares remains an effective share incentive arrangement in the M&A sector.

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Uncertainty around valuation and potential tax liabilities

As mentioned above, a pre-transaction mechanism for agreeing valuations currently exists for options over shares issued under EMI and CSOP. There is however no such mechanism for the agreement of the valuation of equity issued to employees following the withdrawal of the PTVC procedure. Whilst an incentive to management to build real growth in a business, the actual valuation of growth shares is becoming increasingly complex, with HMRC specifying the consideration of financial forecast information in arriving at the value and also their view on the restriction of the level of minority discount that is applicable where there is a defined potential exit date. (As discussed in the article 'Valuation trends for issuing shares to employees' in M&A Matters Spring 2015).

DD exercises often identify tax risks where share valuations have not been carried out/agreed with SAV. Although the PTVC has taken away certainty regarding the value of shares on issue to management, provided that a contemporaneous share valuation is carried out by an independent professional valuer, HMRC should accept that the company employer has fulfilled its obligations under the PAYE legislation in seeking a 'best estimate' and any review on DD would be more favourable in terms of tax indemnities not being required. Any future challenge on valuation which increases the tax liability of the employee would be a personal tax liability of the employee themselves rather than an amount assessable on the employer under PAYE and NIC.

Penalty regime for valuations

Schedule 24 Finance Act 2007 sets out the general provisions for charging penalties where errors have arisen. The view of HMRC of the application of penalties specifically to tax valuation was confirmed at the latest Fiscal Forum meeting, an annual meeting between valuation practitioners and senior members of SAV. The main areas to be aware of are:

- Application of penalties can be difficult in valuations as there is no defined methodology and there can be a range of reasonably arrived at values. HMRC will however challenge figures that they deem to be outside an acceptable range.
- If reasonable care is taken by a taxpayer, penalties should not arise. Penalties will however be levied in respect of 'careless behaviour' and, even if an adviser is appointed, the taxpayer will still be required to be prudent and reasonable.
- Penalties will be applied for deliberately including incorrect figures in valuation workings and also for concealing incorrect figures.

The current HMRC stance on penalties demonstrates the importance, for any share award, of documenting a contemporaneous, detailed share valuation using figures that can be substantiated and based on the valuer being given all relevant facts to provide a considered view on value.

Conclusion

Management incentive share schemes play an important role in the maximisation of value in the M&A sector. There are various mechanisms that can be used to provide shares to management and the most appropriate will depend on the individual company's commercial objectives and also related tax considerations. As part of this planning, valuation is becoming an increasingly complex area subject to HMRC scrutiny and challenge. It is therefore important to seek specialist valuation advice at the time management shares are provided, particularly to avoid issues arising on a future transaction.

Valuation is becoming an increasingly complex area subject to HMRC scrutiny and challenge. It is important to seek specialist valuation advice at the time management shares are provided.

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385 Regulations: A new paradigm for related party debt?

Tax considerations often play a significant role in the structuring of cross-border mergers and acquisitions and intragroup reorganisations. For transactions involving US subsidiaries to multinational groups, a key planning consideration may involve the implementation of intragroup financing. In particular, the use of debt to reduce a taxpayer's effective tax burden through the deduction of interest expense and financing expenses for US tax purposes has long been a tool of US tax planners.

In the context of related party debt, the recently finalised 385 Treasury Regulations ("385 Regulations" or "Final 385 Regulations"), released in October 2016, introduce a series of rules that apply to potentially recharacterise certain US company issued debt to certain related parties as equity. While the proposed 385 Treasury Regulations ("Proposed 385 Regulations") were released on the same day as targeted corporate tax inversion regulations and launched as part of the broader US effort to reduce the benefits of offshore corporate tax planning, the Final 385 Regulations will apply in the context of the debt financing of US subsidiaries of non-US parented multinational groups regardless of whether an "inversion" transaction has occurred.

The Headlines

— The 385 Regulations were released on 13 October 2016, with a published date of 21 October 2016. The published date is important for determining the effective date of the related-party debt recast rules, which is 90 days from 21 October, 2016 or 19 January, 2017.

— The 385 Regulations set out certain documentation requirements that must be satisfied in order for certain related party debt to continue to be treated as debt for US tax purposes (the "Documentation Rule").

— The 385 Regulations also set out other circumstances in which certain related party debt may be treated as equity for US tax purposes, including in the context of debt issued as part of a M&A transaction (the "Recast Rule").

Background

Proposed 385 Regulations were originally issued in April 2016. In the six months prior to finalisation the Proposed 385 Regulations were subject to widespread comment and in certain instances, criticism by businesses and tax professionals. In response, the US Treasury and the IRS have made significant changes to the Proposed 385 Regulations that reduce the potential impact of the new rules on US parented multinational groups, such as excluding foreign company issued debt from the purview of the Final 385 Regulations. Nonetheless, the Final 385 Regulations introduce new compliance requirements and potential changes in the treatment of certain related party debt that will generally apply to non-US parented multinational groups.

Scope

The 385 Regulations generally apply to certain related party debt due from domestic (i.e. US) corporations and certain controlled partnerships, unless both borrower and lender are within the same US consolidated tax group. In general, only debt between a borrower and lender within the same "expanded group", in which there is a common parent with direct or indirect ownership of 80% of the vote or value of each, is subject to the 385 Regulations.

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Documentation requirements

Subject to certain exceptions, the Documentation Rule implements contemporaneous documentation requirements on certain related party loans, including written documentation on four indebtedness factors. Failure to meet such documentation requirements may result in the reclassification of the debt as equity for US tax purposes.

Furthermore, the definition of "contemporaneous" has been relaxed in the Final 385 Regulations as originally proposed such that documentation will be treated as timely if it is prepared by the due date for the issuer's relevant federal income tax return (taking into account all applicable extensions). However, the Documentation Rule still implements significant administrative requirements on borrowers and concerns remain among certain business and tax professionals in respect of certain types of related party funding, for example, the potential impact on cash pooling and revolving credit arrangements.

The Documentation Rule applies only to debt issued on or after 01 January 2018 rather than the date the regulations became final as initially proposed.

Recast Rule

The Recast Rule features two basic operating regimes that can reclassify certain US company issued debt to members of the same expanded group as equity – the "General Recast Rule" and the "Funding Rule". The "General Recast Rule" identifies three basic types of "suspect transactions" – (1) dividends of self-created instruments of indebtedness, (2) purchase of expanded group member stock in exchange for debt of the purchaser, and (3) debt instruments issued as "boot" in an intra-expanded group reorganization. Subject to certain exceptions, debt to which the 385 Regulations apply could be recharacterised as stock for US tax purposes if issued in one of these suspect transactions.

The Funding Rule generally applies to recharacterise debt as equity when the debt is issued in exchange for property (e.g., cash) and the issuer engages in certain identified transactions ("funded transactions") (e.g., dividend distributions or purchase of expanded group member stock) within a 72-month time-frame (36 months before until 36 months after the date of the funded transaction), unless certain exceptions apply.

In general, the Recast Rule only applies to debt issued on or after 04 April 2016 – however, pre-04 April 2016 issued debt may be subject to the Recast Rules if the terms of such instruments are "significantly modified" as determined under the applicable US Treasury Regulations concerning modification of debt instruments.

The potential impact for M&A transactions

While the introduction of new and expanded exceptions have limited the scope of the Final 385 Regulations as compared to the earlier Proposed 385 Regulations, the potential US tax consequences of the Final 385 Regulations remain substantial for non-US parented multinational groups. In particular, the Funding Rule can be especially relevant for related party debt-funded US sub-group companies engaging in M&A transactions. Close monitoring of the ongoing activities of the US company's activities will be required to avoid unintended recharacterisation of certain debt as equity.

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What to do now

Early consultation with your tax adviser before engaging in transactions involving related party debt-funded US sub-group companies is highly recommended to mitigate the risk of recharacterisation under the 385 Regulations. If you consider that these new 385 Regulations could apply to your US sub-group, we recommend that you take action now to identify the (potential) impact of the Documentation and Recast Rules, including compiling and maintaining a complete inventory of outstanding intragroup loans between US and non-US expanded group members.

Additionally, although the Documentation Rule will enter into force for debt issued on or after 01 January, 2018, following the Documentation Rule should be considered a "best practice" and thus it is highly recommended that US subsidiaries of foreign groups at risk of falling within the ambit of the Final 385 Regulations follow the Documentation Rule currently and not wait until future tax years.

The US tax landscape features challenging, and unsettled terrain as it concerns the use of acquisition and intragroup financing, therefore it is critical now, more than ever, that clients seek appropriate advice and then follow it carefully so they may emerge unscathed.

To find out how the US Tax practice in Europe can help your business with cross-border US tax issues, please contact one of the following professionals listed at the end of the page.

The US tax landscape features challenging and unsettled terrain as it concerns acquisition and intragroup financing. It is critical that clients seek appropriate advice and follow it carefully.

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HMRC consultation: New interest withholding tax exemption for debt traded on a multilateral trading facility

HMRC are consulting on a new interest withholding tax exemption for debt traded on a multilateral trading facility which is due to apply from April 2018. The proposed exemption follows concerns that the requirement to withhold tax is a barrier to the establishment of multilateral trading facilities in the UK. The proposal is intended to make the UK more competitive in this area.

Companies and certain other entities that pay interest with a UK source have an obligation to withhold income tax at 20%. While this withholding tax can be reduced or eliminated if paid to a recipient in a country that has a tax treaty with the UK this comes with an administrative burden.

In addition to the network of tax treaties, the quoted Eurobond exemption removes UK source interest from withholding tax when it arises from a security which is listed on a recognised stock exchange. Securities admitted to trading on a multilateral trading facility are not classified as 'listed' in the UK because they do not meet the admission and disclosure requirements of the UK's listing rules and hence they cannot benefit from the quoted Eurobond exemption.

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Securities admitted to trading on a multilateral trading facility in other countries meet the local regulatory requirements to be classified as "listed" and so payments of interest on such securities can benefit from the quoted Eurobond exemption. For example, a UK company's securities which are admitted to trading on a multilateral trading facility in Luxembourg or Ireland may benefit from the quoted Eurobond exemption whereas the same securities admitted to trading on a UK multilateral trading facility would not.

The consultation proposes that the obligation to withhold tax will not apply to a payment of interest on an interest-bearing security issued by a company which is admitted to trading on a multilateral trading facility operated by a recognised stock exchange regulated in an EEA territory.

The requirement to be "admitted to trading" on a multilateral trading facility is a different threshold from the "listed on a recognised stock exchange" requirement for the quoted Eurobond exemption. It is intended that a security admitted to trading on a UK multilateral trading facility will benefit from the new exemption from withholding tax.

The new exemption will be limited to multilateral trading facilities in EEA territories to ensure that the securities are subject to regulation under the EU's Markets in Financial Instruments Directive.

Comments in response to the consultation are requested by 12 June 2017

As well as this new multilateral trading facility exemption, it should be remembered that there is also the qualifying private placement exemption which has applied since 1 January 2016. We are seeing this being used where debt is not listed on a recognised stock exchange and the double tax treaty does not provide a complete exemption from the obligation to withhold tax.

HMRC are consulting on a new interest withholding tax exemption for debt traded on a multilateral trading facility. The proposal is intended to make the UK more competitive in this area.

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Hybrid mismatch rules - practical implications

The hybrid mismatch rules, which have applied from 1 January 2017 whatever a group's year end, are aimed at counteracting tax mismatches where the same item of expenditure is deductible in more than one jurisdiction or where expenditure is deductible but the corresponding income is not fully taxable (or the income is taxed at a beneficial rate or is deferred to a future period).

The rules are complex, which is illustrated by the draft of HMRC's guidance running to almost 400 pages. As a practical matter, a good starting point is to identify a mismatch in the tax treatment within an arrangement. In order to do this, it will be necessary to fully understand the corresponding overseas tax treatment to each transaction. If there is a mismatch, this can then be tested to see if it is of a type which is within the scope of the rules.

The rules are mechanical in operation and do not contain a purpose test, and so can apply to wholly commercial transactions.

Whilst the rules can apply to all types of deductions, including intra-group fees and payments for goods and services, in the context of M&A activity, we have considered the application of the rules to financing transactions, as illustrated by the following examples.

UK subsidiary disregarded for US tax purposes

Suppose a US parent company receives interest on a loan to its disregarded UK subsidiary. There is a mismatch if the interest expense is deductible in the UK but the corresponding interest income is not taxable because, for US tax purposes, the UK subsidiary and the loan do not exist.

More surprisingly, we recently advised on a situation where the rules were found to apply to loans between two UK group companies (subsidiaries of US group companies) even though there was no mismatch in tax treatment either in the UK or the US.

The situation involved a loan between two UK companies both of which were disregarded for US tax purposes. In the UK, the interest expense and income would be both allowable and taxable as recognised in the accounts, so there is no mismatch in the UK tax treatment. Within the US, the structure of the wholly owned group was such that, within the consolidated tax return, both the interest expense and interest income would be separately recognised, so there would also be no mismatch in the US tax treatment.

Whilst it might not be expected that the hybrid mismatch rules would apply in these circumstances, as there is no mismatch, their application is triggered because the interest expense on the borrowing is deductible in both the UK and the US.

Even where there is a mismatch within the scope of the rules, there is no disallowance of the interest expense in the UK to the extent there is income in the

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UK borrowing company which is taxed both in the UK and the US. However, in this case, as a practical matter, there is expected to be no such income in the borrower. Although the interest income on the lending is taxable both in the UK and the US, this arises in the UK lender not the UK borrower, and so there is no relief from the mechanical application of the rules.

Having identified the issue, it was possible to restructure the arrangements but if the issue had not been identified there would have been a material downside with the UK sub-group being taxed on the interest receipt with no relief for the corresponding interest deduction.

Mismatch occurs outside the UK

The hybrid mismatch rules are not only relevant to the type of mismatch between a UK company and its direct counterparty, as illustrated above. In particular, in order to assess whether the rules are relevant, it will be necessary to fully understand the chain of any linked transactions and the overseas tax treatment throughout this chain.

Suppose that a UK subsidiary has borrowed on interest bearing terms from its Luxembourg parent company. The interest expense is deductible in the UK as recognised in the accounts and the corresponding income is recognised in the accounts of the Luxembourg parent company and taxed at the standard rate. As a result, there is no mismatch in the treatment of the loan interest between the UK and Luxembourg and the group may (mistakenly) believe that the Hybrid rules will not apply.

A common arrangement is where the Luxembourg parent company is financed by preferred equity certificates (or "PECs") issued to its shareholders who are private equity investors. In Luxembourg, the PECs are accounted for as debt and the coupon recognised in the accounts is tax deductible. As a result, the Luxembourg parent company is effectively taxed on a small margin.

A good understanding of the tax treatment of each private equity investor and each entity will be required to determine if there is a mismatch and its nature.

If there is a mismatch in the treatment of the coupon on the PECs between Luxembourg and for the private equity investors, the UK company may be required to self-assess a disallowance of the interest expense on its borrowing from the Luxembourg parent company.

The key point here is that a good understanding of the tax treatment of each private equity investor will be required to determine whether it is reasonable to suppose there is a mismatch and its nature; perhaps the mismatch is only one of timing if the investor is a US company which is taxed on a receipts basis, or of non-taxation if the income is received in a tax haven or a territory were a tax exemption applies.

Interaction with the corporate interest restriction regime

Note to reader: This section examines the interaction between the hybrid mismatch rules and a measure removed from Finance (No. 2) Bill 2017. We understand that these measures are intended to be reintroduced at the earliest opportunity post-election.

Taken together with the new corporate interest restriction regime, which will apply from 1 April 2017, business will be faced with an onerous additional compliance burden in addition to the existing rules which can potentially disallow interest deductions. Accordingly, it will be necessary to find a practical approach to apply the various rules.

▶Continued

In some respects, it is helpful that there will now be no overlap between the existing worldwide debt cap regime, which ceased to apply on 31 March 2017, and the corporate interest restriction regime. However, both regimes, are based, in part, on interest amounts taken from the group accounts. So, if a group's accounts straddle 1 April 2017, it will be necessary to apportion the group results pre and post this transition date. The version of the draft legislation in Finance (No. 2) Bill 2017 now includes an apportionment mechanism for both sets of rules. It may be worthwhile considering how this will be applied in practice.

What are the practical implications?

The interaction of the hybrid mismatch rules with the corporate interest restriction rules is less straightforward because both regimes provide for disallowed amounts to be potentially deductible in later periods.

For example, in the context of the shareholder debt described above, as a practical matter, it might be sensible to first allocate any disallowance under the corporate interest restriction rules to the shareholder debt to avoid testing the application of the hybrid mismatch rules. The compliance burden may be high given that the tax treatment of the various investors needs to be considered, particularly where the investors are in the form of partnerships as it may be difficult to obtain information on the tax status of the partners. It had been hoped that HMRC might simplify the interaction. However, in a change proposed to be made to the hybrid mismatch rules in Finance (No. 2) Bill 2017, it has been made clear that the hybrid mismatch rules must be applied before the corporate interest restriction rules. It therefore appears that groups will need to fully test the application of the hybrid mismatch rules even where it is clear that there is insufficient capacity under the corporate interest restriction rules to deduct an equivalent amount of interest.

Finally, it is noted that there is no grandfathering treatment and so existing arrangements will need to be considered.

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New corporate tax loss relief rules and group relief

Note to the reader: The measures examined in this article have been removed from Finance Bill 2017. We understand that the Financial Secretariat to the Treasury has notified the House of Commons that these delayed measures are intended to be reintroduced at the earliest opportunity post-election. The expectation is that if the measures are reintroduced, this would occur in a summer Finance Bill soon after the election, and the start dates of these measures are likely to remain at 1 April 2017.

Finance Bill 2017 previously included detailed legislation setting out the new rules for tax relief of carried forward losses that emerged from the consultation process that concluded in December.

The new provisions are lengthy (in excess of 100 pages) and complex. From a technical perspective, they will require detailed analysis to ensure that correct and optimal claims are made to utilise carried forward losses and they also pose practical problems, not least how to reflect the new rules in financial models.

This article focusses on one of the more complex aspects of the legislation – the provisions for claiming and surrendering carried forward losses via group and consortium relief, including a particular issue arising in the context of joint ventures.

Overview

The new legislation governing tax relief for carried forward losses is intended to take effect from 1 April 2017. Accounting periods spanning this date must be apportioned so that the old and new rules apply to the profits and losses either side of 1 April.

The basic provisions have been known for some time and are relatively simple in concept:

— The use of carried-forward losses against current year profits will be restricted, subject to an annual £5 million allowance (which can be allocated among companies in a group relief group)

— Above the £5 million allowance, only 50% of profits can be covered by carried-forward losses whether from pre or post 1 April 2017

— There will be greater flexibility over the types of profit that can be relieved by post 1 April 2017 carried forward losses. This change is helpful, for example, where acquisition debt has given rise to losses carried forward in a holding company from its financing costs. Under the old rules these losses were stranded in the holding company but now can be used as group relief against operating profits in the target group.

— Post 1 April 2017 carried-forward losses can be surrendered as group relief and consortium relief, again subject to the 50% restriction and annual £5 million allowance.

However, the detail of the new legislation is complex, as illustrated by the group relief rules. The ability to surrender losses between an acquisition vehicle and a target group, or vice versa, typically have an impact on the valuation of the target, therefore it is important to be able to accurately assess how the new rules will apply in various circumstances.

Group relief for carried forward losses

Detailed provisions governing group relief and consortium relief for carried forward losses are included in the new Part 5A of CTA2010.

Chapters 1 and 2 set out the basic rules for group relief for carried forward losses arising after 1 April 2017.

▶Continued

They also include a number of restrictions. In particular, group relief for carried forward losses is only available to the extent that the losses cannot be used by the surrendering company. Similarly, a company with carried forward losses of its own cannot make a claim for group relief for carried forward losses of another company unless it has utilised its own carried forward losses as far as possible.

The new chapter 3 introduces specific provisions in respect of both group and consortium relief for carried forward losses.

S188CB governs claims for group relief of carried forward losses where the companies are in a group or where the claimant company is owned by a consortium and the surrendering company is a member of the consortium or a member of the same group as a "link" company.

S188CC governs claims for group relief of carried forward losses from a consortium company to a consortium member, or a member of the same group as a member of a consortium (the "link" company).

For a claim to be made under either provision, the surrendering company must consent to the claim and there must be an "overlapping period" common to both the claim period and the surrender period (which will be the whole accounting period where the companies have coterminous accounting periods).

Any losses claimed are offset against the total profits of the claimant company for that period, subject to the limit on relief for losses brought forward to 50% of taxable profits (after any of the £5m deductions allowance allocated to the claimant company). These losses are offset against profits after all other forms of loss relief apart from losses carried back from a later period.

Although the provisions of s188CB and s188CC work in a similar way, and are intended as far as possible to work in the same way as group and consortium relief for current year losses, there are a number of differences within the detail. This means that care must be taken to ensure that the correct rules are applied to each claim.

One difference is that a claim under s188CC may only be made in respect of a specified accounting period of the consortium company ("the specified loss-making period"). In other words, losses of each period must be tracked. This does not apply to claims under s188CB.

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Other differences can be seen by exploring each provision in more detail.

Claims under s188CB – group relief and claims for consortium relief by a consortium company

Chapter 4 limits the surrender of losses under s188CB to the lower of:

(a) The remaining carried forward losses available to surrender; and

(b) The remaining profits of the claimant company that can be sheltered by a group relief claim for carried forward losses (taking into account the limitation of relief to 50% of taxable profits and the £5m annual allowance).

The legislation includes very detailed definitions of these limits and a formulaic approach to calculating the limits. The definitions will need to be applied carefully when quantifying a claim.

Where a claim for consortium relief is made under s188CB, any claim is further limited to the ownership proportion of the claimant company's relevant profits for the overlapping period.

The ownership proportion is the lower of the surrendering company's percentage interest in the ordinary share capital, rights to profits, rights to assets on a winding up and voting power held in the claimant company. This proportion is measured based on the interest held by the surrendering company in the claimant company in the period of the claim/surrender, not the period when the losses first arose.

Where the claimant company under such a consortium relief claim is also the member of a group, its relevant profits in determining the amount of consortium relief for carried forward losses it can claim is reduced by the amount that it could potentially claim via group relief of current year and carried forward losses.

The ability to surrender losses between an acquisition vehicle and a target group, or vice versa, typically have an impact on the valuation of the target. The new provisions will require detailed analysis to ensure correct and optimal claims are made.

Claims under s188CC – claims for consortium relief by a consortium member

Chapter 5 similarly limits the surrender of losses by a consortium company to a consortium member (or member of the same group as the consortium member) to the lower of:

(a) The remaining carried forward losses available to surrender that are attributable to the specified loss-making period

(b) The remaining profits of the claimant company that can be sheltered by a group relief claim for carried forward losses (taking into account the limitation of relief to 50% of taxable profits and the £5m annual allowance); and

(c) The amount that could have been surrendered to the claimant company under the "current year" consortium relief rules for the specified loss-making period (less any surrenders already made).

Again, these limits have detailed definitions that will need to be applied carefully when quantifying a claim.

Condition (c) applies the restrictions on consortium relief claims by reference to the ownership proportion of the consortium company held by the claimant company in the specified loss-making period, i.e. the period in which the losses arose rather than in the period of the claim/surrender, in contrast to claims under s188CB.

Any claim for consortium relief by members of the same group as the link company are limited to the amount the link company could have claimed as a standalone company, assuming it had sufficient profits to claim its full entitlement.

Where the consortium company is also a member of a group, the carried forward losses that it can surrender to a consortium member are also reduced by the amount of group relief for carried forward losses that could have been claimed from it by members of that group.

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A practical issue for joint ventures

The requirement that a surrendering company must offset its carried forward losses as far as possible against its own profits before it can surrender them via group/consortium relief could lead to complications in the allocation of losses to consortium members.

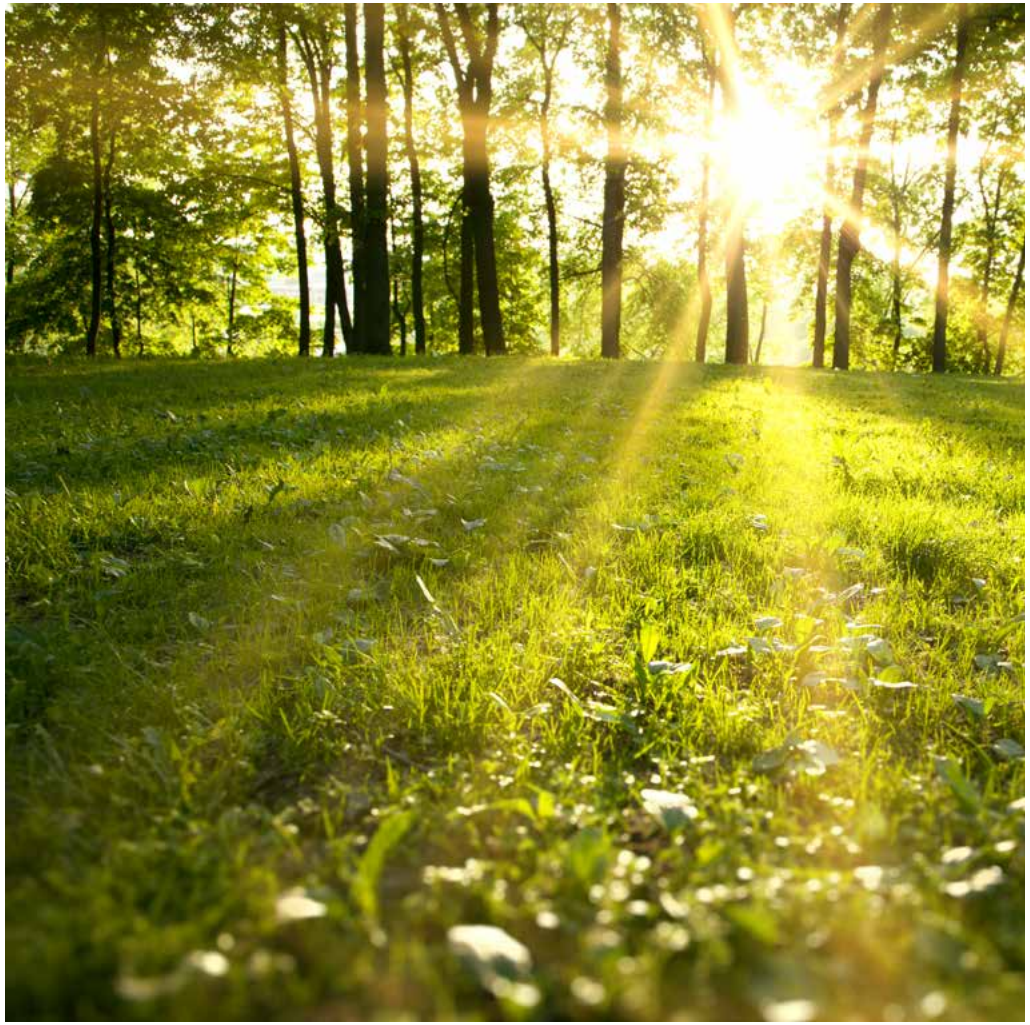
Suppose that in year 1 the consortium company has losses of 100 and has two consortium members, each with a 50% interest in the consortium company. Each would be entitled to claim losses of up to 50. Suppose each claims 25 and the consortium company carries forward losses of 50.

In year 2, the consortium company has profits of 20 and offsets 20 of its losses brought forward, leaving 30 available to surrender to the consortium members.

Based on the methodology set out in the draft legislation, each consortium member could theoretically claim group relief for carried forward losses in year 2 based on its maximum entitlement of 50, less losses already claimed of 25 – i.e. a claim of 25 in year 2. However, the remaining losses available to surrender are now only 30, so both companies cannot claim the full 25.

The draft legislation does not specify any basis of allocating the remaining losses to each consortium member where the consortium company itself has utilised some of its carried forward losses. In theory, each member could claim an amount of the remaining carried forward losses of the specified period up to its original entitlement to claim losses of the specified period, as reduced by any previous claims actually made by that consortium member, but it will not be possible to claim any more than the losses remaining. As the example above shows, this could leave two or more consortium members wanting to claim the same balance of carried forward losses from a consortium company.

Practically speaking, in joint venture situations the Shareholders' Agreement should make it clear how carried forward losses of a consortium company should be shared.



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UK Finance Bill 2017: Corporate Interest Restriction ("CIR") legislation/related party provisions

Note to the reader: The measures examined in this article have been removed from Finance Bill 2017. We understand that the Financial Secretariat to the Treasury has notified the House of Commons that these delayed measures are intended to be reintroduced at the earliest opportunity post-election. The expectation is that if the measures are reintroduced, this would occur in a summer Finance Bill soon after the election, and the start dates of these measures are likely to remain at 1 April 2017.

This article considers whether a 24.9% shareholder ("A") in a company ("B") meets the requirements to be regarded as a "related party" for the purposes of the CIR rules as included in the CIR provisions of the Finance Bill 2017, which was released on 20 March 2017.

Definition of a "related party"

In Chapter 11, section 463(1) states that for the purposes of the CIR rules, a person ("A") is a "related party" of another person ("B") -

(a) throughout any period for which A and B are consolidated for accounting purposes;

(b) on any day on which the "participation" condition is met in relation to them; or

(c) on any day on which the 25% investment conditions are met in relation to them.

a) Consolidated for accounting purposes

Section 463(2) states that A and B are consolidated for accounting purposes for a period if their financial results are included, or are required to be included, in group accounts; or they would be included in group accounts if not for the application of an accounting exemption. Group accounts means accounts prepared section 399 Companies Act 2006 (or the corresponding overseas law).

- A only holds a 24.9% stake in B and so should not meet this condition.

b) The participation condition

Section 463(4) states that the participation condition is met in relation to A and B ("the relevant parties") on a day, if within the period of 6 months beginning or ending with that day –

(a) one of the relevant parties directly or indirectly participate in the management, control or capital of the other; or

(b) the same person or persons directly or indirectly participate in the management, control or capital of each of the relevant parties.

Section 157(2) of TIOPA 2010 provides that a person ("A") directly participates in the management, control or capital of another person ("B") only if that other person is at that time a body corporate or a firm and is controlled by the first person.

- A does not control B and so should not meet the first leg of the participation condition.

Section 159(2) of TIOPA 2010 states that a person ("A") indirectly participates in the management, control or capital of another person ("B") if A would be directly participating in the management, control or capital of B if certain rights and powers were attributed to A.

According to section 159(3) of TIOPA, these rights and powers include -

— the rights and powers which A is entitled to acquire at a future date;

— the rights and powers which A will, at a future date, become entitled to acquire;

— the rights and powers of persons other than A which are required or may be required to be exercised on behalf or A, under the direction of A or for the benefit of A;

— the rights and powers of any person with whom A is connected; and

— the rights and powers which would be attributed by section 159(2) to a person with whom A is connected were it being decided under that subsection whether that connected person is indirectly participating in the management, control or capital of B.

Section 163(2) of TIOPA 2010 states that two persons are "connected" with each other if one of them is an individual and the other is the individual's spouse, relative or relative of the individual's spouse. Further, two persons are connected with each other if one of them is a trustee of a settlement and the other is the settlor of that settlement or is a person connected to the settlor. Therefore, connection for these purposes does not extend to body corporates.

- On the basis that A is not entitled to increase its shareholding in B such that it will control B at a future date or that A cannot direct another person or persons to act at its behest such that it has control of B, A should not meet the second leg of the participation condition.

In order for a company to fall outside the CIR regime and not be viewed as a related party to another company, loan made between them should not be in proportion to their shareholdings and the respective shareholders are not acting together.

Section 160(2) of TIOPA 2010 extends the indirect participation in situations where a person ("A") is indirectly participating in the management, control or capital of another person ("B") as one of a number of major participants in that other person's enterprise. For these purposes A is a major participant in another person's enterprise if at a time that other person is a body corporate or firm and the 40% test is met in the case of each of two persons who taken together control the subordinate, B. The 40% test is met in the case of each of two persons wherever each of them has interests, rights and powers representing 40% of the holdings, rights and powers in respect of which the pair of them fall to be taken as controlling the subordinate.

- On the basis that A is not a 40% shareholder (and is not entitled to increase its shareholding in B such that it will control B at a future date or that A cannot direct another person or persons to act at its behest such that it has 40% control of B), A should not meet this extended participation condition.

c) 25% investment condition

Section 464(1) states that a person ("A") has a 25% investment in a company ("B") if –

1. it possesses or is entitled to acquire 25% or more of the voting power in B;
2. if the whole of B's share capital were sold, A would receive 25% or more of the proceeds of the disposal;
3. on the distribution of dividends by B to equity holders, 25% or more of the amount distributed would be received by A; or
4. in the event of a winding up of B, 25% or more of its assets available for distribution to equity holders would be received by A.

References to "equity" for the purposes of section 464(1) are to shares in B other than restricted preference shares or loans to C other than normal commercial loans.

- On the basis that A is not entitled to acquire additional shares or interests to increase its voting power to 25% and its 24.9% shareholding gives it the right to receive, directly or indirectly, less than 25% of the disposal proceeds if shares in B were sold, distributions made by B or its assets on a winding up, then on first principles this section is not met.

Attribution of rights and interests

Section 465(1) attributes certain rights and interests to A for the purposes of section 464 as follows –

(a) any person connected with A;

(b) any person who is a member of a partnership or is connected with a person who is a member of a partnership, of which A is a member; or

(c) any person who is a member of a partnership or is connected with a person who is a member of a partnership of which a person connected with A is a member.

- Therefore, if A holds its 24.9% interest in B via a partnership, the rights and interests of other members of the partnership may be attributed to A, resulting in A's shareholding meeting section 464.

Section 1122 CTA 2010 defines "connected" for the purposes of section 465(1) as follows:

A company is connected with another company if –

Section 1122(2):

(a) The same person has control of both companies;

(b) A person ("P") has control of one company and persons connected to P have control of the other company;

(c) P has control of one company and P together with persons connected with P have control of the other company; or

(d) A group of two or more persons has control of both companies and the groups either consist of the same persons or could be so regarded if (in one or more cases) a member of either group were replaced by a person with whom the member is connected.

Section 1122(3):

A company ("A") is connected with another person ("P") if –

(a) P has control of A; or

(b) P together with persons connected with P have control of A.

Section 1122(4):

In relation to a company, any two or more persons acting together to secure or exercise control of the company are connected with –

(a) One another; and

(b) Any person acting on the directions of any of them to secure or exercise control of the company.

- On the basis that all shareholders in B are non-related parties, we would not expect A to meet the connection test set out in section 1122 CTA 2010.

Section 465(3) states that in determining whether for the purposes of section 464, the investment that a person ("A") has in another person ("B"), A is to be taken to have all of the rights and interest of a third person ("T") with whom A acts together in relation to B.

Section 465(4) states that A "acts together" with T in relation to B if (and only if) –

(a) For the purposes of influencing the conduct of B's affairs,

  i. A is able to secure that T acts in accordance with A's wishes (or vice versa); or

  ii. T can reasonably be expected to act or typically acts in accordance with A's wishes (or vice versa).

(b) A and T are party to an arrangement which is designed to affect the value of any of T's rights or interests in B; or

(c) The same person manages some or all of both A's and T's rights or interests in B.

Section 465(7) states that for the purposes of section 464, for the investment that A has in B, A is taken to have all of the rights and interests of one or more third persons with whom A has entered into a qualifying arrangement (includes any agreement, understanding, scheme, transaction or series of transactions whether or not legally enforceable) in relation to B. Section 465(8) states that as a result of this "qualifying arrangement", by reference to shares held or to be held (including rights and interests similar to shares), by any one or more of these third persons in U, they can reasonably be expected to act together –

(a) To exert greater influence over B than any one of them would be able to alone; or

(b) To achieve an outcome relating to B that would be significantly harder to achieve alone.

- Whilst a Shareholders' Agreement documents agreed protocols for a joint investment (such as B), this does not necessarily mean that T will act as directed by A. Therefore, whether A and T "act together" for the purposes of section 464 this will be depend on the facts at hand.

Section 466(2) states that if A makes a loan to B which is guaranteed by a person related to B (i.e. an investor in B that meets s.463(1)) then A is treated as a related party of B.

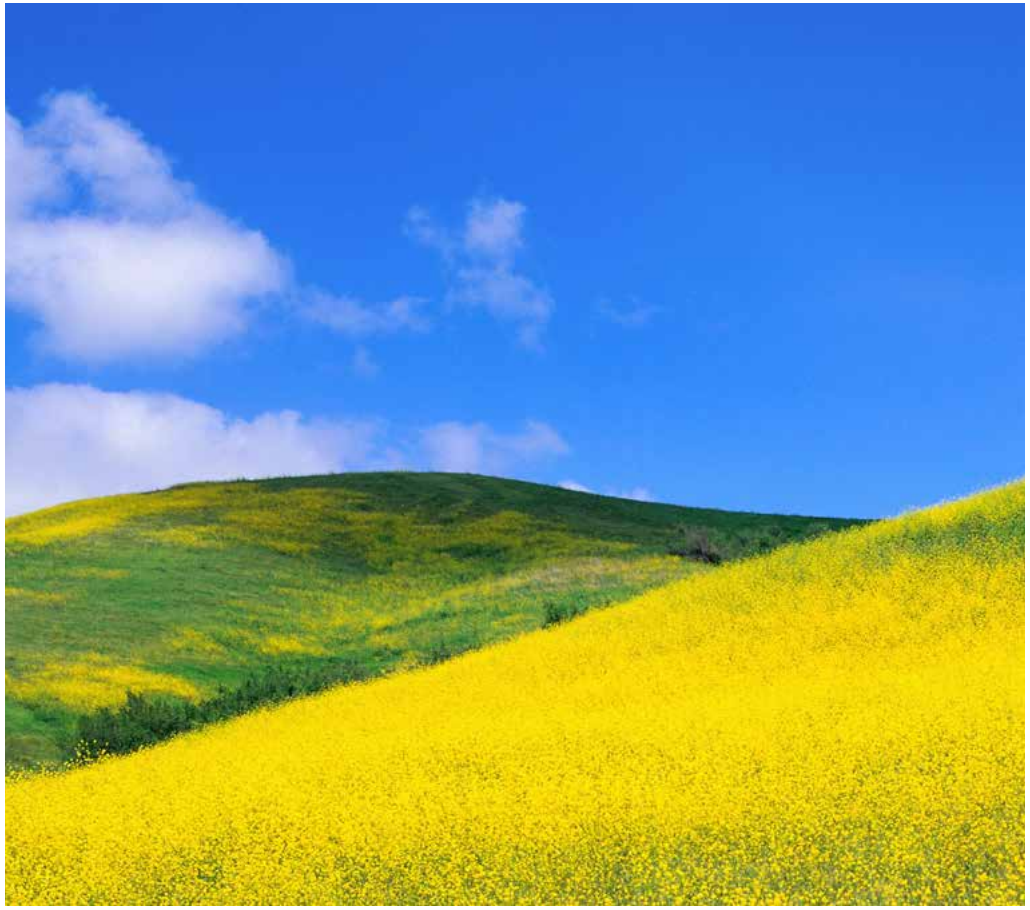
- Practically speaking, it is unlikely that a minority shareholder such as A would request or be able to demand such a guarantee from co-investors as part of its debt funding in a JV investment vehicle. Therefore, the risk of this provision applying in a scenario such as this appears to be a theoretical one.

Section 467 states that where A lends to B and the amount lent "stands in the same, or substantially the same, proportion as the shares or voting power that A has in B, then A is treated as a related party of B in relation to the loan, provided these lenders (taken together) have a 25% investment in B.

- Therefore, unless A's funding of B is substantially less or more than its 24.9% shareholding in B, then it is likely to be treated as satisfying section 464.

Concluding remarks

The CIR rules will have a significant impact on M&A transactions where debt financing features as a key component. The above discussion addresses in detail technical considerations around the drafting of the meaning of "related party" under the CIR rules, that may be particularly relevant in M&A transactions involving co-investors. In the above scenario, in order for A to fall outside of the CIR rules included in the draft Finance Bill 2017 and not be classified as a related party lender to B, any loans made by A to B should not be in proportion to A's shareholding in B, and A will need to demonstrate that it is not acting together with the other shareholders in B.



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