Teneo
The Global CEO Advisory Firm

Lender Considerations

Tax Advisory

Teneo Insights
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Lender Options

When a portfolio business is facing distress, there are several options lenders can take to minimise losses and ensure participation in potential future upside.

This insight document considers the three most commonly utilised options which have material tax implications for lenders.

It should be noted that all of the options discussed are likely to reduce the future interest expense arising on third party debt and therefore impact the existing ‘corporate interest restriction’ and available tax deductions, and hence tax cashflows should be carefully forecast going forwards.

Enforcement over shares or a sale of the trade and assets

- Lenders accelerate debt and obtain business through an enforcement
- Establishing new holding structure
- Preserve tax attributes

Amend and restate the debt

- Debt terms are amended (normally eased)
- Where tax follows accounting principles, the key issue is whether this results in a credit to the income statement

Consensual refinancing

- Existing shareholders retain control
- Avoiding taxable release of debt at the group level
- A non controlling portion of equity may be handed to the lenders under a debt-for-equity swap

Enforcement and Change of Control

Lenders may want to take control of the business either through acquiring the shares of the operating group or the trade and assets of the operating entities.

Typically the lenders will establish a new holding structure where the assets are transferred. The choice between taking shares or the trade and assets will be dependent on many factors, although where shares are taken, the lender will inherit the historical tax issues which are important to diligence.

Disposal of shares

- Where shares are transferred, any gain arising on the disposal of the shares may qualify for the UK's substantial shareholding exemption ("SSE") which broadly requires that the shares have been held for 12 months and the company does not have significant non-trading activities. Several overseas jurisdictions also have similar participation exemptions which can be beneficial. The SSE can also exempt certain 'de-grouping' charges arising.
- However, it is common in a distressed scenario that the enterprise value of the business is worth less than the debt (assuming a simple debt structure) and therefore the equity will have only nominal value. This is likely to mitigate any gain on disposal but also minimise stamp duty.
- Following a change of ownership of a company, it is possible that the company may lose access to its existing unutilised tax losses (particularly vulnerable are non-trading losses of holding companies). This therefore warrants careful consideration.

Deemed releases

- There are certain anti-avoidance rules that can be triggered where a lender acquires control of a borrower company.
- In particular, any impaired debt between the parties may be treated as being released. The amount of the deemed release will be based upon the difference between the carrying value of the debt in the accounts of the lender and of the borrower. This would give rise to taxable income in the borrower.

Intercompany debts

Depending on where the transaction perimeter is drawn, certain intercompany balances that straddle the transaction perimeter may need to be released, or acquired, with any releases being prima facie taxable. There is a specific tax exemption where intercompany debts which are loan relationships are released between 'connected companies'. Connection for these purposes means that either:

- One of the companies 'controls' the other; or
- Both companies are under the 'control' of a common third person.

Transfer taxes

- UK stamp duty will arise on the transfer of shares at 0.5% of the consideration given.
- UK stamp duty land tax will be payable on any consideration attributable to the UK land and property assets in a trade and asset deal, which will be a cost to the buyer.

Disposal of trade and assets

- The extent of any taxable gains or losses will be driven by the cash consideration allocated to each asset. It may be possible to shelter any taxable gains arising using the group's surplus tax losses or other tax attributes.
- It would be unusual for taxable profits to arise on the transfer of stock and debtors.
- It may be harder to shelter from tax any consideration allocated to intellectual property ("IP"). This is because those assets often have very little 'base cost' from a tax perspective. Whether the IP creates a gain or a trading / non-trading profit will depend on the date the IP was created.
- It should be considered if VAT will apply to the transfer of trade and assets, in particular, if the transfer is consider a transfer of a going concern such that the transfer is outside the scope of VAT.

'Hive down' opportunities

- In some transactions, it can be commercially beneficial to hive down the target assets into a new company before the sale.
- This can also have certain tax benefits. In particular, it may allow the existing capital allowance pools (and in some circumstances, trading losses) to be transferred with the target business.

Amendment and Restatement

Where debt is amended and restated, the terms of the debt are typically eased.

Whilst there may not be a reduction in the quantum of debt as such, typically, any accounting credits arising in relation to the modification of a debt instrument may be taxable in the hands of the borrower. However, an exemption is available for corporate rescue transactions where a 'substantial modification' of the debt occurs.

Substantial modification of debt

There are two key limbs to the substantial modification analysis:

- Quantitative test: the net present value of the cash flows under the new terms, discounted at the original effective interest rate, is at least 10% different from the carrying amount of the original debt. This test is commonly referred to as the "10% test."
- Qualitative test: A significant change in the terms and conditions that is so fundamental that immediate de-recognition is required with no additional quantitative analysis (e.g. change of currency).

Tax interaction with substantial modifications

- The corporate rescue exemption (in s323A CTA 2009) may apply in situations where a liability to pay an amount under a company's debtor relationship is 'substantially modified', an amortised cost basis of accounting is used, and immediately before the modification it is reasonable to assume that, without the modification and any arrangements of which it forms part, there would be a material risk that at some time within the next twelve months the company would be unable to pay its debts.
- For the purposes of these provisions, a company is "unable to pay its debts" if either it is unable to pay its debts as they fall due or the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.

What if a substantial modification has not occurred?

- Unfortunately, there is no similar exemption in the event that a non-substantial modification has taken place but it has been necessary to book a credit in the accounts anyway, which will be prima facie taxable.
- Hence, it is crucial to have a clear understanding of the facts and circumstances and ensure detailed analysis has been undertaken to support the position reached (and/or make sure you have sufficient losses or other attributes to shelter the credit) given that both the substantial modification and corporate rescue exemption tests have a degree of subjectivity.

Consensual Refinancing

Where a business is over indebted, the existing debt may be split into a performing and a non-performing tranche.

The performing tranche may be amended (see Amendment and Restatement section) or new debt on different terms may be drawn down to repay the performing debt.

The non performing tranche may be released in consideration for the lenders obtaining a non-controlling stake in the equity (a debt for equity swap) or a HoldCo payment-in-kind ("PIK") instrument (or similar).

Debt for equity swaps

- The release of debt may give rise to accounting credits which would be prima facie taxable under the UK's loan relationship rules.
- However, there is a specific exemption where debt is released in consideration for the issue of new shares. The exemption has the following conditions:
  - the release must be in consideration for shares forming part of the ordinary share capital of the debtor company; and
  - the release must take place in an accounting period for which the debtor uses an amortised cost basis of accounting for the debt.
- Shares will generally constitute 'ordinary shares' for these purposes if they are entitled to an income distribution with a variable right to future profits (i.e. rather than a fixed return).
- Alternatively, (a portion of) the non performing debt could be novated up the corporate chain and amended as a PIK or pay-if-you-can ("PIYC") debt. The tax implications as a result of this should be carefully considered, in particular, if the interest on this is deductible and/or if lenders becoming connected taints the tax status of performing debt.

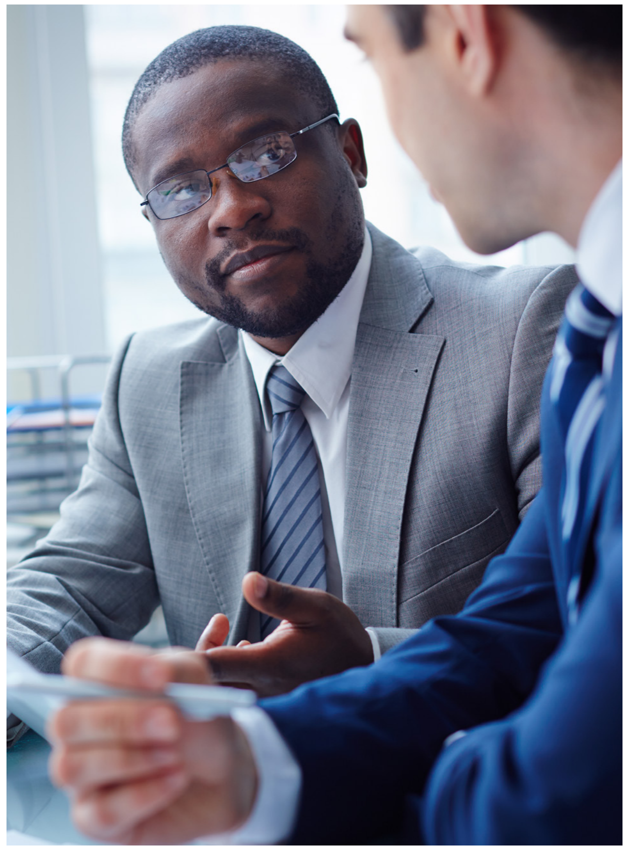
How Teneo's Tax Advisory Team Can Help

Delivering Certainty from Uncertainty

We have a market leading team of experienced and commercial tax professionals who are focussed on the restructuring market.

We are therefore able to deliver:

- Transaction structuring guidance aimed at preventing the investor falling foul of any of the tax pitfalls that might crystallise immediate taxable income.
- Corporate structuring advice aimed at maximising the return to an investor and potentially also encompassing advice on appropriate incentive arrangements for the management team going forward.
- Focused reviews of tax cashflow forecasts aiming to employ our specialist knowledge to ensure that the cashflow forecasts of a business reflect reasonable assumptions in the circumstances and are technically accurate.
- Specialist due diligence expertise not only investigating the standard issues, but focusing on the specific concerns of a distressed-company investor.
- Advice on preservation of tax attributes calling on our experience to provide practical guidance on how best to ensure tax losses are maintained
- Assisting in managing relationships with tax authorities, dealing with historic issues and, where possible, securing unclaimed tax cash refunds.



- In addition to our work in the UK, we provide cross-border, multi-jurisdictional solutions in conjunction with our network worldwide. Our core team is very experienced in co-ordinating multi-territory projects and providing clients with a single point of contact and integrated advice.
- We work closely with our our Teneo colleagues to ensure that our advice is always, above-all, practical and user friendly. Clients also view us as professionals who have strong project implementation skills and who, critically, can ensure that our advice is translated into appropriate steps and actions such that it is infact deliverable in the real world.

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