

Write off of corporate debt

(Lecture B1232 – 17.56 minutes)

When companies are in difficult there is often consideration of debt restructuring but this can be a problematic area due to the loan relationship provisions.

The loan relationship (LR) provisions were always something of an experiment when first introduced in FA1996. The Government wanted to consider moving to a situation where accounts prepared under generally accepted accounting principles would give a profit which would also be the taxable profit, with few adjustments.

The broad policy objective of the LR rules is to ensure that the tax treatment of lending transactions follows the accounting treatment unless this would be inappropriate for tax avoidance reasons or inconsistent with other policy objectives.

It is the extent to which the rules have been tweaked to ensure that they have not been used in a way which the Government feels is inconsistent with policy objectives that have given the rules their complexity.

There are also significant considerations where there are changes in accounting policy which result in differences in accounting treatment of LR type transactions. We are just going to look at the basics of loan relationships and then think about debt restructuring where businesses are in difficulty.

The basics of loan relationships

The basics of the loan relationships provisions can be summarised as follows. The legislation is found in CTA2009 Parts 5 and 6:

- A LR arises where there is a money debt arising from a transaction for the lending of money in respect of which a company stands in the position of either creditor or debtor;
- Certain other arrangements may be treated as LR of a company and these are described in Part 6 CTA 2009;
- Profits and losses on LRs are taxed or allowed for corporation tax purposes as income ie there is no distinction between capital and revenue for these purposes;
- Profits and losses from related transactions and foreign exchange gains and losses are also brought into account under these provisions.

There is a distinction between trading and non-trading loan relationships. Where a company is party to a trading LR, then the debits and credits are dealt with in calculating the company's trading profits. If they are non-trading LRs then credits and debits are brought into account separately and the excess of credits over debits in an accounting period is charged to tax or the excess of debits over credits (called non-trading deficit) in an accounting period can be relieved against specified profits of the company or of fellow group members

Similar rules apply in relation to derivative contracts (DCs).

In most cases, the treatment of lending transactions under the loan relationships rules follows the accounting treatment. The majority of companies will not have complex borrowing or lending arrangements and will not be attempting to exploit the loan relationships rules for tax avoidance purposes, in which case the legislation is generally simple to apply and helpful. However, the rules behind the ostensibly simple principle of taxing and relieving the amounts recognised for accounting purposes can be complex.

There are also modifications of the basic rules for certain types of debt for example where there are connected party debt releases including release of trade debts between connected companies.

Connected parties

The tax treatment of a loan relationship must be determined in accordance with an amortised cost basis of accounting for any accounting period in which the loan relationship is a connected companies loan relationship. This then triggers various changes to the normal rules.

Connected companies' relationship

A connected companies' relationship exists for the whole of an accounting period if there is a connection, at any time in that accounting period, between a debtor and creditor company in relation to the same debt.

For this purpose, a company is treated as a debtor or creditor if it indirectly stands in that position by reference to a series of loan relationships or money debts.

A company has a connection with another company in an accounting period if at any time in that period one company has control of the other or both are under control of the same person. There can also be a connection where one company has a major interest in the other. Where such a connection exists at any time in an accounting period, that connection is treated as applying for the entirety of the period.

It is expressly stated in the re-writing of this legislation in CTA 2009 that a 'connected companies' relationship' exists solely between companies, and not between companies and any non-companies.

The definition of control for these purposes is taken from the old s840 ICTA 1988. The definition is, broadly, that control is the power of a person to secure by means of the holding of shares, possession of voting rights or as a result of any powers conferred by the articles of association or other document regulating the affairs of the company (or any other company) that the affairs of a company are conducted in accordance with that person's wishes.

Broadly, a major interest exists where:

- 1) a company ('A'), together with one other person (regardless of status), controls another company ('B'); and
- 2) that other person and A each have 40 per cent or more of the controlling stake in B; and
- 3) for accounting periods beginning before 17 March 2004, both A and the other person (or, subject to status, companies connected with them) are either debtors or creditors of B. This last condition was removed with effect for accounting periods beginning after 16 March 2004, as it was felt it was open to exploitation. For those and subsequent accounting periods, only conditions (1) and (2) are required to be satisfied for a major interest to exist.

In looking at (1) and (2), the rights and powers of a connected company are attributed to A or the other person (but only to that other person if it, too, is a company).

The write off of impaired debt

When a company A loans money to company B and that debt becomes impaired due to the inability of B to repay it, a debit arises for A and a credit arises for B if the loan is written off. This is on the assumption that the parties are not connected.

If this is a connected party loan relationship, then there is still a balanced treatment but there is no debit for tax purposes in A and no credit for tax purposes in B. Whether or not this is a beneficial treatment or not will depend on the circumstances.

There are going to be cases where this does not seem as being helpful; for example, if B has large levels of accumulated losses so that the credit is not going to be taxable then it might be desirable for the debit to be available to A. However, there is no choice in this matter.

Example

Company A lends £150,000 to company B. They are under common ownership. Company A decides that they are not going to get this money back and so formally releases half of it. Although there will be amounts going through the accounts, A will not get any tax relief for the £75,000 written off and B will not be taxed on this amount.

However, even when there is no connection between the parties, there are some cases when there will be no taxable credit arising for the debtor company. This would apply if any of the following conditions are met:

- Release The release of the debt is part of statutory insolvency arrangement;
- The release is in consideration for issue of shares;
- Not a deemed release (see below) and reasonable to assume that in the absence of the release, there would be a material risk that within 12 months the company could not pay its debts;
- The debtor relationship is modified or replaced with another for the reason mentioned in the previous heading.

It is important to note that you are only connected if both parties are companies. If there are loans to or from participators, then there are complications as these do not fall within the connected party provisions.

The write off of a loan from a participator would give rise to a taxable credit for the company with it being unlikely that the participator would get relief on the write off. If you write off a loan to a participator it is taxed on that individual as a dividend but there is legislation which specifically precludes the company from getting a deduction for the write off.

Provisions to avoid abuse

There are various provisions aimed at tackling potential abuse of the connected party provisions:

- Where the position of the debtor is altered;
- An impairment loss is not available even if a connection ends;
- An impairment loss available even though a connection exists;
- Where the position of the creditor is altered;
- Where the credit is brought into account despite connection;
- A loss not available after a connection ends.

If the connection is broken, no debit is available to the creditor for any impairment loss which relates to a period when the companies were connected (CTA 2009, s355). It is not open to the creditor company cease the connection and then write off the debt when they are not connected to secure available of tax relief on the write off.

Example

Company A owns 100% of company B. A Ltd has loaned £100,000 to B Ltd but B Ltd is struggling and it is perceived that it is unlikely to repay the loan. However, two employees of B Ltd believe that they can turn the company around and offer to buy the shares for £1. It is also agreed that the loan will be written off. A Ltd would like to get a deduction for the loan write off and so suggest that they could wait until the company is sold before writing off the debt so that the connection has ceased. However, s355 will mean that the debit is still denied where it is clear that the impairment of the loan has happened whilst they were connected.

Creditor gets an impairment loss even though connection

The creditor can get impairment loss in two situations even though they are connected:

- Where there is a debt for equity swap;
- Where there is an insolvent creditor.

The debt for equity provisions apply where the following conditions are met:

- There is a liability discharged by the creditor;
- In consideration for the issue of shares;
- There was no connection before the shares were acquired;
- This only applies to debt written off at the time of the swap.

Example 1

RM Ltd has a 31 December accounting year. It makes a loan to unconnected company PH Ltd of £10,000 on 1 January 2018, repayable in 5 years. PH Ltd gets into difficulties and at 30 November 2020, RM Ltd releases £7,000 of the loan, with the balance (£3,000) swapped in return for a controlling shareholding in PH Ltd.

Even though they are connected after the transaction, RM would get tax relief on the write off of the debt. There would not be a taxable credit for PH as the connected party rules are not superseded.

Example 2

RM Ltd has a 31 December accounting year. It makes a loan to unconnected company PH Ltd of £10,000 on 1 January 2018, repayable in 5 years. PH Ltd gets into difficulties and at 30 November 2020, RM Ltd releases £3,000 of the debt, with £2,000 treated as repaid in return for a minority (25%) shareholding in PH Ltd.

This proves insufficient and on 1 March 2021 it releases a further £2,000 of the loan, with £3,000 treated as repaid in return for a further 40% shareholding PH Ltd.

For the first write off, a debit of £3,000 is allowed for RM Ltd as the parties are not connected.

For the second write off, the debt for equity provisions would apply and so relief would be available despite the connection.

In relation to the first write off, the amount written off would be taxable in PH as the parties are not connected. In relation to the second write off, there is no taxable credit for PH as the connected party rules are not superseded.

Example 3

RM Ltd has a 31 December accounting year. It makes a loan to unconnected company PH Ltd of £10,000 on 1 January 2018, repayable in 5 years. PH Ltd gets into difficulties and at 30 November 2020, it releases £3,000 of the debt, with £4,000 treated as repaid in return for a majority (55%) shareholding in PH Ltd. This proves insufficient and on 1 March 2021 it releases a further £1,000, with the balance of the loan, £2,000, treated as repaid in return for a further 25% of the shares.

A debit is allowed in RM for the initial write off of the loan because the debt for equity exception applies. However, no debit is allowed for the write off of the final £1,000 as the companies were connected before this took place.

There is no taxable credit for PH for either transaction as the connected party rules are not superseded.

There are then provisions where the creditor is insolvent.

CTA 2009 s357 provides for an impairment loss to be allowed where condition A, B, C, D or E is met by the creditor:

- The creditor is in insolvent liquidation;
- The creditor is in insolvent administration;

- The creditor is in insolvent administrative receivership;
- An appointment of a provisional liquidator is in force in relation to the creditor under section 135 of the Insolvency Act 1986 (c. 45) or Article 115 of the Insolvency (Northern Ireland) Order 1989 (S.I. 1989/2405 (N.I. 19); or
- Under the law of a country or territory outside the United Kingdom, circumstances exist corresponding to those described in condition A, B, C or D.

This seems the wrong way around in many ways because to many it seems more logical that there should be some variation of the rules where the debtor is insolvent.

There may actually be some capacity to get relief for the creditor if the debtor is insolvent because if the company is in liquidation, then the companies may no longer be connected. If, as a matter of fact, the connection has been broken, then the creditor would get an impairment loss if a debt is written off but there would also be a tax charge for the debtor. For a company in insolvent liquidation this would probably be an irrelevant point as there would be no funds to pay any additional tax.

Taxed credit even where connection

There are problems when, perhaps as part of debt restructuring, parties become connected. This would then mean that you could get the advantage associated with the connected party provisions although, as noted above, this is not always an advantage.

There are provisions which cover the tax treatment of two particular scenarios. These are essentially anti-avoidance provisions designed to prevent companies gaining a tax advantage. These are called 'deemed releases'. The provisions are complex because there are exceptions to both charges.

The first scenario applies when unconnected debtors and creditors become connected. The second scenario applies where a connected company acquires impaired debt to which the debtor is party. This could also apply where someone acquires debt and becomes connected at the same time.

It is assumed that there will be release of part of the impaired debt and if the legislation applies, there is a deemed release of a portion of the debt which would be taxable on the debtor. Effectively the no credit rule in CTA 2009 s358 is disapplied.

Acquisition of debt by connected party

CTA 2009 s361 applies if:

- A company (D) is a party to a loan relationship as debtor;
- Another company (C) becomes a party to it as creditor;
- Immediately after it does so C and D are connected;
- Where the person from whom C acquires its rights under the loan relationship is a company, they were not connected in the period of account in which C acquired the debt;
- The amount or value of any consideration given by C for the acquisition is less than the pre-acquisition carrying value; and

- No relevant exception applies.

Example

W Ltd owes £100,000 to Sutton Bank plc to which it is not connected. Sutton Bank judges W Ltd to be a bad credit risk so writes the loan down to £20,000. CG plc, the parent of W Ltd, offers to purchase the loan for £5,000. SB claims an impairment loss of £15,000. There is a deemed release of value of £95,000 which has to be recognised by W Ltd. SB would have claimed relief for the whole right off of the value of the loan and no further relief is available for CG

Unconnected debtor and creditor become connected

CTA 2009 s362 applies if a company (D) is a party to a loan relationship as debtor and another company (C) which is a party to the loan relationship as creditor and not connected with D becomes connected with D.

Example

C plc holds £1 million of loan notes issued by D plc (part of a retail group). The group of which C plc is part makes a successful takeover of D plc.

Before this, C plc had written down the value of the notes on a fair value basis to £800,000 due to profit warnings issued by D. C has claimed a deduction for that reduction. D was still carrying the liability at its full value.

The difference between those is £200,000 and there would be a deemed release of that amount taxable in D.

Exceptions to the deemed release rules

There are two possible exceptions:

- 1) Corporate rescue exemption
- 2) Equity for debt exemption

Corporate rescue exemption

The legislation is at CTA 2009 s361D for the s361 provisions and s362A for the s362 provisions although the basic conditions are the same. The conditions for the corporate rescue exemption are:

- The transaction was at arm's length;
- There has been a change in the ownership of company D at any time in the period beginning one year before and ending 60 days after the date of the acquisition of the debt;
- It is reasonable to assume without the release and any arrangements of which the release forms part, there would be a material risk that at some point within the next 12 months the debtor company would have been unable to pay its debts.

Equity for debt exemption

This is probably the most likely one that we would see and only applies to deemed releases within s361.

The conditions in CTA 2009 s361C must be met, being:

- the acquisition is an arm's length transaction;
- the consideration given by C for the acquisition consists only of shares forming part of the ordinary share capital of C or companies connected with C.

Example

A Ltd owes money to an unconnected party who are now threatening to withdrawn funding due to A's precarious position. B Ltd is within the same group and offer to acquire the loan from the creditor in exchange for shares to B Ltd with the value of shares issued being assessed on an arm's length basis to be the same value as the loan.

Contributed by Ros Martin