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UK Tax Clampdown on Debt Buy-Backs.

The Announcement

Stephen Timms MP (the Financial Secretary to the Treasury) has announced in a *Written Ministerial Statement* that changes will be made in next year's Finance Bill, with effect from Wednesday (14 October 2009), to amend the UK tax rules applying where existing debt of a UK tax resident corporate is purchased at a discount by a company connected with the debtor.

As a general matter, if debt is purchased at a discount by a debtor or connected company, the debtor will be taxed on the amount of the discount. There has been an exception to this general rule. This provides that the debtor will not be liable to tax on the discount where the purchaser of the debt acquires it in an arm's length transaction and the purchaser was not connected with the debtor at any time during the three year period ending twelve months before the purchase.

The Government is now concerned that this exception is too widely drafted and that the provision enables groups to avoid a tax charge on the discount on any debt buy-back simply by purchasing the debt into a newly established company (a "**NewCo**") which will not have been connected with the debtor during the relevant three year period. If after the NewCo had acquired the debt, all or part of the debt were to be released this release would not have been taxable for the debtor as the release would benefit from the exemption for releases of debt between connected parties. Effecting such a release would have meant that a taxable profit that might otherwise have to be recognised by NewCo (eg if the debt ultimately repaid at par) would not need to be recognised.

Changes are therefore to be made with the aim of tying the exception more closely to corporate rescues. In particular, the condition requiring no connection for 3 years will be replaced with three new conditions:

– there must be a change in ownership of the debtor in the period of twelve months before the debt purchase;

– the debt purchase must have been intrinsic to the change of ownership; and
– before the change of ownership, the debtor must have been suffering severe financial problems.

The Ministerial Statement also states that, even if a connected company successfully purchases the debt without a tax charge arising on the discount, a subsequent cancellation of the debt would still be taxable (i.e. the usual exemption for releases between connected parties would not apply).

At this stage no further details, nor any drafting, is available. In particular, there is no further clarification available on the meaning of the concept that the debt purchase must have been "intrinsic" to the change of ownership or on when a debtor will be regarded as suffering “severe financial problems”. Nor is there certainty as to what is meant by a “change of ownership”. Clients considering implementing a debt buy-back should monitor developments in this area closely.

What sort of transactions are impacted?

Opportunistic public or private debt buy-backs by UK corporates who do not have financial problems.

This type of transaction is the particular “mischief” addressed by the Ministerial Statement. In this case, it will be much more challenging to effect a tax-efficient buyback.

Pre-emptive re-organisations

In the wake of the withdrawal of liquidity and repricing of credit risk which has occurred in the last 18 months a number of debtors have used debt buy-backs as part of renegotiating debt terms with their creditors. This has proved a useful tool where it has enabled a debtor to improve its financial (especially leverage) ratios whilst dealing with syndicate members (or layers of debt holders) within its capital structure who would prefer cash or are otherwise not amenable to renegotiating terms. Careful consideration will now need to be given to the tax impacts of this type of transaction since it may be unclear whether, for example, an anticipated financial covenant breach represents “severe financial problems”. It is also unclear whether there can be a change of ownership for the purposes of the new tax rules without the current owners losing economic and voting control. Perhaps most significantly, by providing for the subsequent cancellation of the debt to be taxable, the new rules may mean that tax is effectively deferred rather than eliminated even in situations which are outside the mischief addressed by the changes. In our view, the use of simple debt buy-backs as a pre-emptive restructuring technique is likely to be severely restricted for UK corporates by these new rules.

Distressed debt restructurings

Debt buy-backs utilising the NewCo structure have occasionally been used as part of a re-organisation of a debtor's balance sheet where the debtor clearly has severe financial problems. The new provisions make this unattractive because a taxable profit will be triggered by subsequent release of the bought-in debt. Traditional debt reduction techniques such as converting debt for equity and compromising debt as part of a creditors' voluntary arrangement or company scheme of arrangement (or as part of an overseas scheme considered equivalent for tax purposes) are still available. These techniques are unaffected by the proposal change in law. However, careful consideration needs to be given to the tax implications of debt restructurings where debt needs to be written off without being converted into equity and a CVA or scheme is not viable (for structural or commercial reasons).

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