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M&A Tax Matters

Spring 2014

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Welcome to the first edition of the refreshed M&A Tax matters

We hope that you will find our updated quarterly publication useful as we move through 2014.

To kick things off, James Andrews and Anna Roberts walk us through HMRC's approach to compensating adjustments, now that some time has passed following the introduction of new rules in October 2013. Next, Julie Bronzi discusses VAT and considers the implications of the recent Court of Justice of the European Union (CJEU) judgement in the Paul Newey case.

Turning to transaction valuation matters, Iain Kerr unravels the somewhat confusing situation of unascertainable deferred contingent consideration when faced with a subsequent disposal before such consideration becomes paid; staying with valuation matters, Anna Roberts shines a light on the often forgotten possibility of negative consideration.

Next we're back with the EU looking at the impact of proposed amendments to the EU Parent Subsidiary Directive (EUPSD) on the use of hybrid structures; Adrian Crouch discusses the proposed changes. We then move locally, where Christine Hood and Anna Roberts evaluate the impact of the impending changes to the Worldwide Debt Cap rules. Staying with the theme of change, Rob Norris, Gavin Little and Stephen Hunt discuss the potential impact of the consultation document on corporate debt to financial restructuring transactions.

Finally, Simon Yeo looks at Stamp Duty Land Tax ("SDLT") considerations on getting properties out of SPVs. We hope you'll enjoy this Spring edition of our publication, and if you have any thoughts or feedback on our new design, or if you would like further detail on the articles in this issue, please call us, the authors, or your usual KPMG contact.

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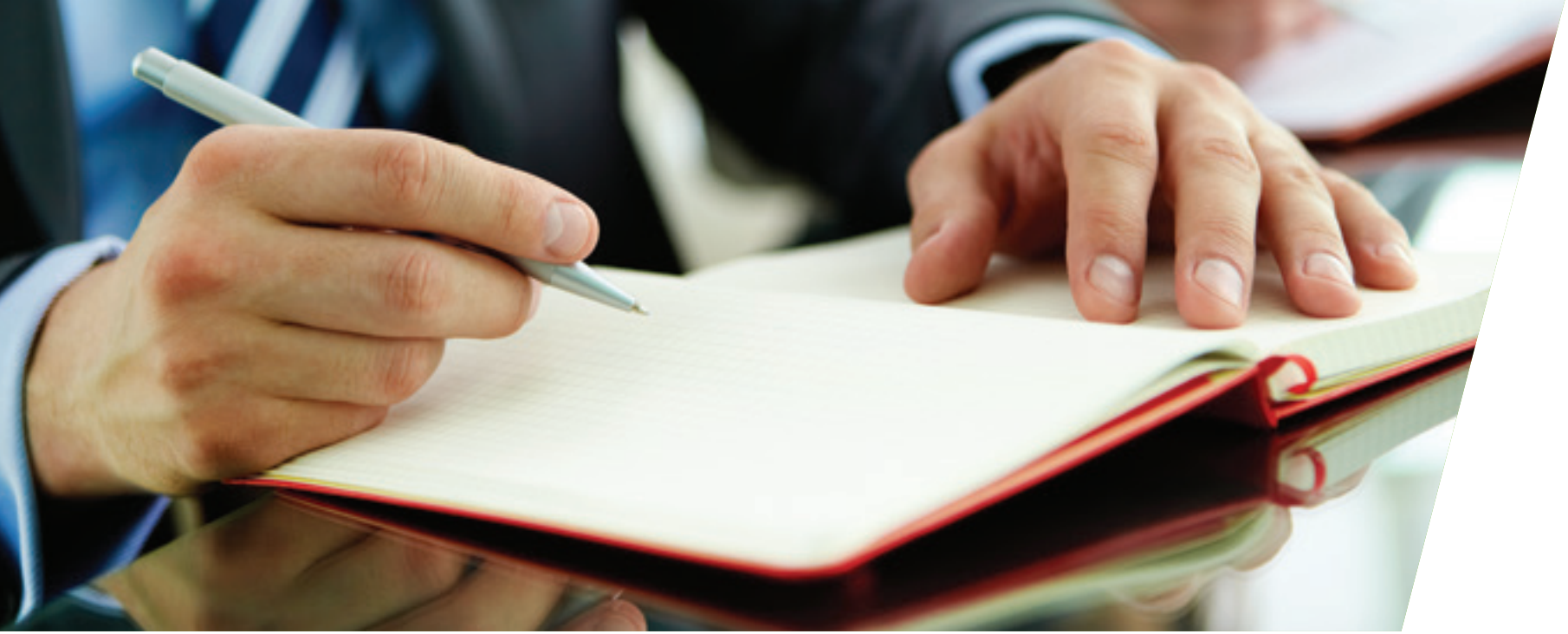
Following recent changes to the rules for transfer pricing compensating adjustments for individuals we are now seeing a co-ordinated review by HMRC of claims made by individual taxpayers under the previous rules.

Compensating Adjustments

The use of compensating adjustments to relieve income tax on interest received on investor loan notes, for UK individual investors and management teams, in portfolio businesses has been a key topic of interest over the past few years. This relief, provided that where a business was excessively leveraged due to the presence of related party debt, the tax treatment of the related excessive interest payments mirrored their treatment in the borrowing company – that is, interest which was non-tax deductible for the company was equally non-taxable in the hands of the recipient. With the divergence in tax rates over recent years between individuals (being 40%-50%) and corporates (falling from 28% to 20% from 2015), this generated a significant tax saving for the loan note holders and an effective tax saving in the region of 20% for the borrower and investors overall.

This relief mechanism forms part of the transfer pricing rules which are currently a hot topic on the international stage as an area undergoing a number of changes and significant scrutiny. However, these changes sit to the side of this debate and reflect an approach by HM Treasury and HM Revenue & Customs ("HMRC") to what they perceive to be tax 'avoidance'. In most situations the leveraging of portfolio groups follows key commercial drivers. However, we understand that some taxpayers sought to take advantage of the rules by excessively leveraging the business and potentially abusing the 'relief' available.

We set out below an overview of the recent changes, HMRC challenges and our thoughts on the impact for future transactions.



The Finance Bill 2014 Changes

At the Liberal Democrats' annual conference in September 2013, Danny Alexander, Chief Secretary to the Treasury, took to the stage to announce the changes to the compensating adjustment rules by closing the "loophole". The changes were designed not only to counter the situation discussed above but also to capture service company structures which achieved similar results for professional partnerships. This was followed in short order with draft legislation, following a brief consultation period.

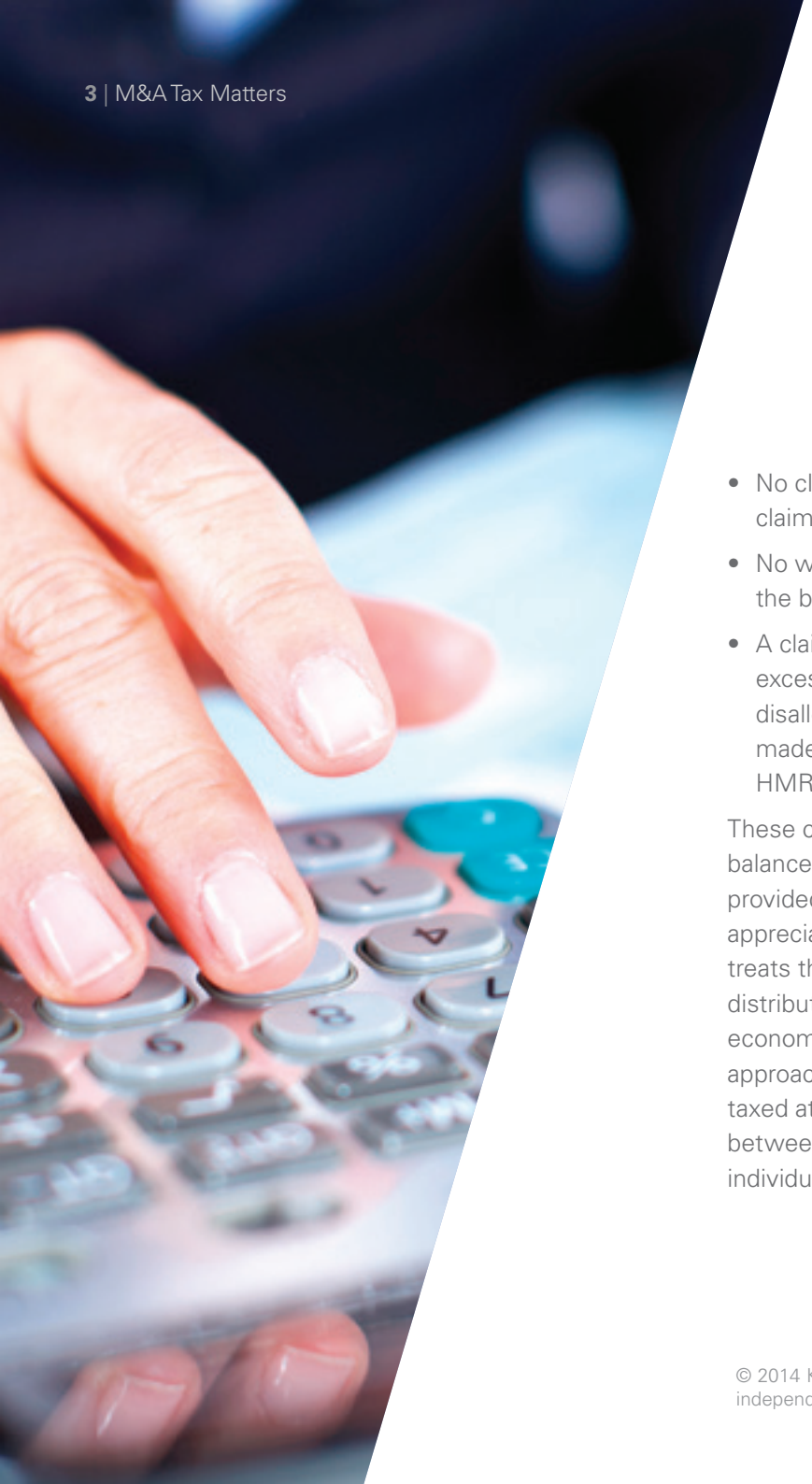
The new legislation takes effect for "excessive" interest accruing post 25 October 2013 where interest is paid by a company, and received by a person (other than a company) within the charge to income tax, and where some or all of the interest expense is disallowed to the company under the transfer pricing rules. Excessive interest is that which is treated as disallowed under the transfer pricing rules by the company. The legislation is contained within the draft Finance Bill 2014.

The person receiving interest, which has been disallowed to the company, is to be treated as receiving a qualifying distribution. Previously, the person could have made a claim for a compensating adjustment which would have resulted in that interest not being subject to tax.

The transition arrangements are particularly important; in many cases, this interest has been rolled up so individuals have amounts which they have earned but which they have not yet received. The new legislation does not apply to interest which is "referable to a period before 25th October 2013".

This means:

- For excessive interest accruing from 25 October 2013 onwards, it is treated as a qualifying distribution. An individual is entitled to a tax credit, and taxed at the appropriate dividend rate. Thus although the receipt is taxable, it is not taxable at the full income tax rate that would have applied if it had been taxed as interest without the compensating adjustment.



- No claim is required for this treatment, whereas a claim was required under the previous legislation.
- No withholding tax is required to be accounted for by the borrowing company on payment.
- A claim for a compensating adjustment in relation to excessive interest accrued pre-25 October 2013 and disallowed in the tax computations can still be validly made: however, as detailed below there is increased HMRC scrutiny in this area.

These changes reflect what we consider to be more balanced position than the initially announced proposals provided for. Following the consultation HM Treasury appreciated the need to ensure an answer that in effect treats the excessive payments out of the company as distributions for tax purposes, thereby reflecting the economic substance of such payments. The alternative approach would have been that the interest would be taxed at the full income tax rate, providing asymmetry between the tax position of the company and the individual recipients.

S174 and s182 TIOPA 2010

Prior to the introduction of new rules, s174 TIOPA 2010 enabled an individual or trustee to claim a 'compensating adjustment' where interest paid by a company has been disallowed for corporation tax purposes under the transfer pricing rules.The effect was that the interest in excess of the arms length provision was not subject to income tax.

There have been a number of recent HMRC enquiries demonstrating a change in HMRC's attitude and established practice in relation to compensating adjustments for interest payments made in relation to interest accruing pre-25 October 2013.

The previous approach taken by HMRC was that they would not seek to tax the excess interest under any other legislative provisions. However, there have been recent cases where HMRC are now adopting a wider policy to seek to tax the interest under other taxing provisions in the legislation. For example, there has been several recent cases where HMRC have put forward an argument that the interest should be taxable as a distribution under s1000(1)E CTA 2010, (which relates to interest on non-commercial securities).

We are also aware of letters from HMRC which have requested that a technical analysis should be submitted, where compensating adjustment claims have been made, setting out the technical basis on which the excessive interest has not been treated as a distribution or any other form of income or gains.

HMRC have stated that the introduction of the new legislation is intended to put beyond doubt that excessive interest accruing and paid post-25 October 2013 should be treated as a distribution; however, this should not be interpreted that excessive interest accruing and paid prior to this date would fall outside being classified as a distribution. This is a change to the previous practice noted above and given the absence of references to the changes being in place to clarify existing legislation the authors question whether the approach by HMRC will yield much fruit. KPMG, has raised this issue with the HMRC thin cap policy team and we await a detailed response.

Action required

It is important to understand the risk of HMRC challenge to compensating adjustment claims and the effect of the Finance Bill changes. When groups seek to assess the deductibility of the related party debt, either by way of an Advanced Thin Capitalisation Agreement or preparation of self assessment documentation, they should be considering the application of the compensating adjustments rules.

For cases where pre-commencement interest is being paid it is important to remember that a compensating adjustment will only be available on the making of a valid claim, and that until such a claim has been made income tax at the basic rate of 20% should be withheld on any such payments. The time limits for making such a claim are restricted and it is not possible in this situation to make a claim until the corporate tax return including the interest disallowance has been filed with HMRC. For post-commencement interest the process is much simpler but there will be a need to ensure that investors are provided with the information required to distinguish pre and post commencement interest in their tax returns.

The changes provide that where businesses are excessively leveraged, the treatment of interest payments to individuals is the same as they would be if they had contributed equity rather than loan notes. In terms of structuring future acquisitions, a tension may emerge between how management want to finance a transaction (for example through preferred shares with certainty of tax treatment) and the private equity houses who may still want to leverage the transaction by way of shareholder debt.

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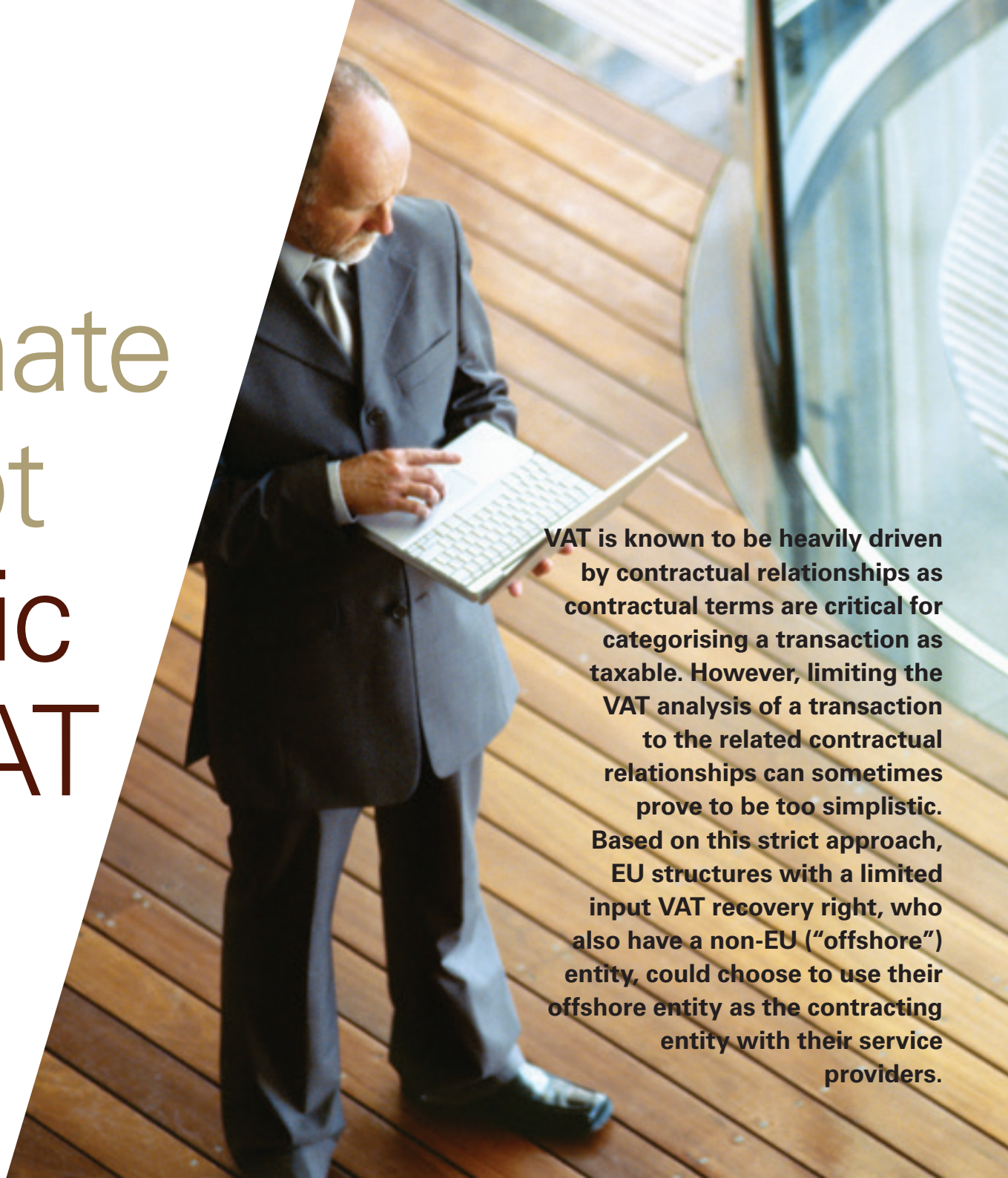
Don't underestimate the concept of economic reality in VAT



VAT is known to be heavily driven by contractual relationships as contractual terms are critical for categorising a transaction as taxable. However, limiting the VAT analysis of a transaction to the related contractual relationships can sometimes prove to be too simplistic. Based on this strict approach, EU structures with a limited input VAT recovery right, who also have a non-EU ("offshore") entity, could choose to use their offshore entity as the contracting entity with their service providers.

Based purely on the form of contractual relationships undertaken, such structures would be able to limit their EU VAT costs. This example sounds extreme as in practice safeguards exist to prevent such abusive practice, but this illustrates the concern with relying solely on contractual relationships to organise a structure in a VAT efficient way.

As recently reiterated by the Court of Justice of the European Union (CJEU) in the Paul Newey (trading as "Ocean Finance") case (C-653/11), contractual relationships are important but they only constitute one factor to be taken into consideration, and this factor alone is not decisive. The fundamental criterion is the economic and commercial reality. This criterion is actually natural when you think about the aim of the VAT system, which is to tax at the place of consumption. It should be noted that this is not a new concept. It is one of the underpinning criteria of the whole VAT system and its efficiency.

Should it appear that the contractual arrangements do not reflect the economic and commercial reality of the transaction, these arrangements could be ignored for the purpose of defining the supplier and recipient of the supply for VAT purposes. As stated by the CJEU in the Newey case, this is particularly relevant where the arrangements are wholly artificial. However, it would be underestimating the significance of the economic reality test to limit its application to wholly artificial and abusive arrangements.

In M&A deals and structuring, it is not uncommon to have discussions on who should contract with the service providers and whom the fees should be invoiced to. The determinants are usually of an operational nature; e.g. cash availability, new entities in the process of being incorporated but not yet in existence, and key decision-makers for the deal. VAT may not be on the short list of the decisive criteria.

With this in mind, it becomes difficult to argue that where a contractual arrangement and related fee expenses end up in an offshore entity, that this arrangement is artificial and has only been put in place so as to obtain a tax advantage. That is one of the reasons why successful application of the abuse of law test established by the CJEU in the Halifax case (C-255/02) has been limited so far.

However, looking at this through the lens of economic and commercial reality, there could be grounds to contend that, although not artificial and abusive, some of the contractual and fee arrangements do not wholly reflect the economic and commercial reality of the transaction for VAT purposes. Therefore, VAT treatment should not rely on the contractual and invoicing relationships but instead, on other criteria such as the effective beneficiary of the services or their intrinsic link with an entity which is not the contracting party. Coming back to the M&A deals and structuring example, should the conclusion be that the recipient of the services for VAT purposes is not the contracting offshore entity but an onshore entity, such services would attract VAT although contracted by and invoiced to an offshore entity.

This approach is comparable to that taken under transfer pricing rules, whereby adjustments are often required in order to better reflect the economic reality. Although transfer pricing adjustments will not automatically imply VAT consequences, they cannot be ignored when assessing the VAT efficiency of a structure. A transfer pricing adjustment required in an M&A deal and structuring could be a sign that the existing contractual arrangement – even if not abusive and justified by operational reasons – does not wholly reflect the economic and commercial reality of the transaction; hence creating a ground to also reanalyse the transaction for VAT purposes.

In their Revenue & Customs Brief 18/13 (issued further to the Newey decision), HMRC make it clear that the economic reality of an arrangement must be taken into account and contractual relationships are not necessarily decisive to a VAT treatment. This Brief also confirmed that HMRC will continue to investigate where they believe that artificial structures have been put in place with the aim to derive a tax advantage. This does not mean that other structures could not also be challenged on this ground. As mentioned above, economic and commercial reality is a fundamental criterion to the VAT system. With this in mind and in order to circumscribe the risk of challenge, it is crucial that arrangements put in place do clearly evidence their economic and commercial benefits.

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Unascertainable deferred contingent consideration & base cost

Suppose X Ltd buys Y Ltd for an upfront cash sum plus unascertainable deferred consideration contingent on the future performance of Y Ltd. The amount of any unascertainable deferred contingent consideration ultimately paid should represent base cost for X Ltd on a future disposal of Y Ltd under s38(1)(a) TCGA 1992. ICAEW Technical Release 667 (issued August 1987) confirms this. But what happens if X Ltd sells Y Ltd before any deferred consideration has been paid?

X Ltd's promise to pay the deferred consideration has value and so represents money's worth for s38(1)(a) purposes. The original vendor of Y Ltd will have put a value on this promise in its disposal calculation, as required by the decision in Marren v Ingles [54 TC 79]. Section 17(1)(b) TCGA, which applies a market value override where an asset is acquired for a consideration that cannot be valued, should not therefore apply to X Ltd. Nevertheless, the value of X Ltd's promise to pay the deferred consideration when X Ltd disposes of Y Ltd may well differ from the value of that promise at the time X Ltd acquired Y Ltd because the consideration payable depends upon the performance of Y Ltd. HMRC has suggested that in general terms X Ltd may be entitled to deduct as base cost an amount representing the continuing detriment suffered by reason of X Ltd's obligation to pay the deferred consideration. The value to be deducted would be the amount that a third party would charge X Ltd to relieve it of the obligation to pay the deferred consideration at the time of X Ltd's disposal of Y Ltd.

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Taxing Negative Consideration

Whilst there are now encouraging signs of forecast economic growth, due to the poor economic environment of recent years we have seen, and are still advising on, a number of acquisitions of distressed groups.

In these deals, it is common place that the consideration payable for the shares is minimal or even negative; that is, it may be financially preferable for the vendor to make a payment to a purchaser to acquire the distressed company/ group rather than incur costs of say closing down operations. This can have adverse tax consequences for the unwary and there are some helpful pointers below to manage those unforeseen pitfalls.

Whilst as a matter of fact negative consideration may have been received at the outset of a deal or post completion, say where a payment is required to be made under a warranty or indemnity, HMRC do not recognise negative consideration as a concept and guidance in the Capital Gains Manual (CG14807) is explicit on this point.

Therefore, considering the position where a payment is required to be made by a vendor under a warranty or indemnity, and this payment is greater than the consideration received for the disposal of shares:

- From the vendor's perspective, the legislation reduces the consideration received for the disposal of the shares. However, HMRC will only accept that this reduces the consideration to nil rather than producing a negative figure. Therefore, any balance is not allowed for capital gains tax purposes and does not create a capital loss, although this may indeed be a moot point if substantial shareholding exemption applies to the transaction as capital losses would not be taken into account anyway.
- From the purchaser's perspective, there will typically be a clause in the sale and purchase agreement that stipulates that any payment received by a purchaser under the warranties and indemnities will be treated as an adjustment to the purchase price and therefore an adjustment to the base cost of the shares rather than a taxable receipt. However, where the sum received exceeds the consideration paid for the shares then the excess is likely to be taxable as a capital sum derived from an asset.

Action

In order to manage this potential tax exposure for the purchaser, there are some practical steps that can be taken. When drafting the sale and purchase agreement, an appropriate gross up clause could be included such that if a payment under the warranties and indemnities gives rise to taxable negative consideration, the party that will economically bear the cost of meeting the resulting tax liability is identified. In practice the legal documents can be drafted such that this could be the buyer, vendor or a joint liability.

A further option is to enter into pre completion restructuring so that more consideration is paid for the shares, for example the vendor could subscribe for additional equity to repay outstanding debt. However, the impact on any transfer taxes (e.g. stamp duty at 0.5% for a UK company) should be compared with the potential to save corporation tax at c.20% should there be any future claim under the warranties and indemnities which would otherwise have given rise to taxable negative consideration.

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Impact of Proposed Amendments to the EU Parent Subsidiary Directive on use of hybrids and substance

In 2013 the OECD announced its Base Erosion and Profit Shifting ("BEPS") review. This is the OECD's response to perceived aggressive tax avoidance by multinational corporations.

In response to BEPS, the European Commission announced, in November, proposed amendments to the EU Parent Subsidiary Directive (the Directive) to close off perceived opportunities for corporate tax avoidance. The proposals consist of an amended anti-avoidance rule, and changes to exclude payments on cross border hybrid loans from a tax exemption.

The primary aim of the Directive is to prevent double taxation of the same income between members of a corporate group that are based in different Member States. This is achieved by providing a withholding tax exemption on distributed profits and an exemption or credit for the recipient. The current proposals are aimed at preventing certain perceived abuses of these rules.

The first change would be an amendment of the anti-abuse provision in the Directive. Specifically, the benefits under the Directive will not apply in the case of "artificial arrangements" put in place with the "essential purpose of obtaining an improper tax advantage". For these purposes, arrangements are artificial if they do not reflect "economic reality". The proposal also lists a series of situations that are relevant for the existence of artificial arrangements. The Commission gives as an example of the kind of structure that could be impacted by this rule (and therefore could be denied the benefits of the Directive), as an intermediate holding company, described as a "letter box company with no substance" that is inserted in a structure to avoid withholding taxes in a Member State.

At this point, it is not clear how the anti-abuse provisions relating to substance will be enacted across Europe and consequently the extent to which they may impact existing holding structures. However, it remains possible that it may result in additional substance being required to enable the requirements of the EU directives to be met.

The second change as envisaged in the Commission's proposal would deny the benefits of the Directive to specific tax planning arrangements such as hybrid loan arrangements. The Commission gives as an example the case where a loan is treated as debt in the Member State of the debtor/subsidiary and as equity in the Member State of the lender/parent, so payments on the loan are deductible in the former and exempt in the latter Member State. Under the proposed amendment, the payments would no longer be exempt in the latter Member State, which would then tax the portion of the payment which is deductible in the Member State of the paying subsidiary.

It is currently thought that this is targeted at intra-EU hybrid structures such as exist between Luxembourg and France or Luxembourg and Sweden, rather than for example US/ Luxembourg hybrid instruments. Where the deduction is allowed in the borrower, as a result of these changes, the income will no longer be exempt in the lender.

Member States are expected to implement the amended Directive by 31 December 2014. However, the proposal must first be approved by the EU Parliament and the Member States themselves. In addition, the new Luxembourg Government has recently announced its policy programme. As part of the tax measures, the "Implementation of new general requirements to have physical and operational substance in Luxembourg" has been noted as a policy.

Existing structures should be reviewed and, where they are likely to be impacted by the proposed changes, consideration should be given to amending the structure to remove intra-EU hybrid instruments. Similar results may be achievable with non-hybrid financing structures and such structures should be considered going forward.

Further, existing arrangements for holding companies should be reviewed with a move away from the use of trust and domiciliation companies where relevant.

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Worldwide Debt Cap – Changes to the Debt Cap Rules Finance Bill 2014

Who is affected?

The draft legislation, to be enacted in the Finance Bill 2014, includes changes to the debt cap rules which are likely to be relevant to larger more complex groups that include entities that have not issued ordinary share capital, for example, companies limited by guarantee, foreign entities that do not issue ordinary share capital and entities that are not bodies corporate, for example, trusts. The changes will take effect in relation to accounting periods commencing on or after 5 December 2013.

Summary of the changes

The worldwide debt cap legislation is applied to "relevant group companies" in a worldwide group. For these purposes, a "group" is defined by reference to those companies which, under international accounting standards, would be included as a subsidiary in the consolidated accounts of the parent company. To be a "relevant group company" a company needs to be a 75% subsidiary of the ultimate parent of the group by reference to the ownership of ordinary share capital and the equity holders' entitlement to profits available for distribution or assets available for distribution or on a winding up. For these purposes, we are directed to the group relief legislation for the definition of equity holders.

For accounting periods commencing on or after 5 December 2013, there will be amendments to the legislation that will ensure that a company which does not issue ordinary share capital can still be a relevant group company and in addition it will be possible to trace the indirect ownership of companies through non-bodies corporate, for example, trusts.

In considering the relevant group company amendments, these apply where there is a holding or interest in an entity, trust or other arrangement that provides the holder with economic rights corresponding to those provided by a holding of ordinary shares in a company ("corresponding ordinary holdings"). HM Revenue & Customs illustrate this point in the explanatory notes with the following example:

"A foreign partnership may have different classes of interests: preferred interests that convey rights to only a fixed amount of profit or a percentage return on capital and residual interests that convey the rights to a share of the residual profit or surpluses on asset disposals. A holding of residual interests would be considered to be a corresponding ordinary holding, whereas a holding of preferred interests would not."

In addition, the sections within the existing group relief legislation which contain provisions to prevent companies which, prima facie are 75% subsidiaries, from being members of a group relief group due to the shares in those companies carrying variable or complex rights are to be excluded from the worldwide debt cap rules. Again, this widens the ambit of the relevant companies that the worldwide debt cap rules apply to.

Action

These are important changes which need to be considered, in particular, when performing due diligence on a target group to ensure that from a risk perspective the worldwide debt cap rules have been correctly applied. In addition, on determining the appropriate investment and acquisition structure, the impact of the revised worldwide debt cap rules will need to be considered when modelling future interest deductibility.

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Financial restructuring transactions and the consultation document on corporate debt and derivatives

HMRC have been consulting since June last year on changes to the rules on the taxation of corporate debt and derivative contracts. HMRC issued a consultation document outlining some options to rewrite and simplify the legislation and, at the same time, ensure it is more robust against tax avoidance. The various options are being discussed and developed in a series of working groups taking account of the view of representatives from industry and the professions.

The implications of the proposals are wide ranging and have significant consequences in terms of how debt restructuring transactions are implemented. The legislation as it stands at the moment, whilst fairly complex, is subject to much HMRC guidance which helps to remove a significant element of uncertainty to a distressed company when it looks to undertake a debt restructuring. Significant changes to this legislation would potentially remove the clarity of tax treatment applicable to such a restructuring.

Furthermore, the introduction of the requirement for many UK companies to adopt one of EU-endorsed IFRS, FRS 101 or FRS 102 ("New GAAP") for periods commencing on or after 1 January 2015 adds further complexity and uncertainty to a distressed company looking to refinance. Of particular concern from a debt restructuring perspective is the lack of clarity on proposed changes to deal with the potentially huge impact of New GAAP on a company's ability to 'amend and extend' distressed debt.

Many respondents to the consultation document raised their concerns about the timetable for the proposed changes, suggesting that not only was the timetable ambitious in view of the scope of the work involved, but the 2015 date for new legislation would leave almost a year where the new legislation would not be in place to deal with the transition to New GAAP.

Our current expectation is that there will not be separate changes to deal with issues arising from the conversion to New GAAP but this will be dealt with as part of the wider reform. The majority of changes proposed by the consultation are most likely to come into effect on or after 1 January 2016 when the dust has settled on the New GAAP conversion. In addition, we would note that there are currently no proposals (even outside the consultation document) that would

deal with the potential accounting credit that could arise when amending and extending distressed debt under New UK GAAP (see example below).

Some of the key changes under consideration are (amongst many others) as follows.

- The current exemption from tax for a release of a loan owed by a company in an insolvency process could be extended to include companies which are facing the possibility of an insolvency procedure.
- HMRC had raised the possibility that the exemption that allows tax free capitalisation of loan liabilities may be removed i.e. debt for equity swaps may result in tax liabilities for the borrower under the new rules. However, this has been strongly resisted by the working groups and it is now possible that the relief will be preserved as part of a wider corporate rescue relief.
- Consideration is being given to introducing a targeted anti-avoidance rule directed at avoidance in relation to the loan relationship and derivative contracts rules.

To illustrate how some of these changes might affect a distressed company, let's say a company wishes to undertake a financial restructuring in order to support its under-performing debt in the future, perhaps by amending the payment terms or eliminating a portion of it using a debt for equity swap. If the company has already adopted New GAAP, it is highly likely that an amendment to payment terms of distressed debt would be deemed to be a substantial modification of the terms of the debt, such that a restatement of the liability would give rise to an accounting profit. This is because New GAAP states that a borrower's own credit risk is taken into account in considering fair value for the purposes of initial recognition. For example, if 100 of debt was refinanced but it was thought, based on current expectations, that the fair value of the debt was only 80 (i.e. the debt was out of the money by 20) a profit of 20 would arise. Under current tax rules this accounting profit would in most cases be taxable.

It may be the case that the company does not currently use New GAAP accounting but will do so next year. As a result, it will be necessary to determine whether there could be a taxable transitional adjustment. When the company draws up its 2015 accounts, it will be required to prepare a comparative 2014 balance sheet, restated as if New GAAP had applied at the time of the refinancing, which may result in a taxable transitional adjustment, potentially subject to spreading over ten years. Had this substantial modification taken place in 2013, no credit may fall on the borrower on account of there being no requirement to include it in the 2015 comparative balance sheet.

Where do things stand now?

HMRC published its draft Finance Bill 2014 (accompanied by draft guidance) on 10 December 2013, which was subject to consultation until 4 February 2014. Of the changes proposed in the original consultation document of 6 June 2013, it has been confirmed that the changes in relation to bond funds and partnerships will come into effect in 2014, though there may be other changes subject to Ministerial approval.

HMRC are consulting on the timing of introducing changes to the rules. We would expect to the see the proposed changes relating to debt restructuring some time in 2015, prior to the election; however these changes may not take effect until 1 January 2016.

Clearly then, there is some uncertainty on when (and what) we can expect to see over the next 12-18 months. What we do know is that the accounting and tax landscape of financial restructurings is subject to significant change, most pressingly due to the introduction of New GAAP, and great care needs to be taken to ensure that any financial restructurings taking place today are dealt with appropriately to minimise the likelihood of unexpected tax implications in the future.

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SDLT on getting properties out of SPVs

Stamp duty land tax ('SDLT') is always a potential cost when real property needs to be extracted from a company or unit trust by an investor. This is perhaps counter-intuitive, given economically at least the investor already owns the property, and hence it is often a cost taxpayers are reluctant to incur. HMRC has recently been trying to delineate which transactions should attract SDLT and which should not.

This HMRC exploration began in the summer of 2012 when a number of taxpayers were told that the purchase of a company holding real property ('PropCo') and subsequent extraction of that property to shareholders was in itself SDLT avoidance. It therefore followed that group relief from SDLT (ie where the shareholder was grouped with PropCo) would not be available as the 'no tax avoidance' pre-condition of the relief would not be met. It also raised concerns with taxpayers that in specie distributions of property (on a liquidation or otherwise) could also be affected by this view because of the potential application of section 75A FA 2003 (the SDLT Ramsay style anti-avoidance provisions) where PropCo debt was to be repaid before the distribution. This is sometimes necessary as in specie distributions of property encumbered by debt (or sometimes merely charged with debt) are not necessarily free of SDLT.

HMRC eventually accepted that merely buying a company (or presumably a unit trust) and extracting the property from it was not in itself indicative of tax avoidance. That resolved the position where the extraction was made within group (in principle group relief was available) and taxpayers became more comfortable dealing with debt in the context of in specie distributions where there was no opportunity to claim group relief, on the basis that HMRC had advised that it would not seek to apply the mechanistic provisions of section 75A where there was no SDLT avoidance.

The decision in Project Blue Ltd v HMRC a year later changed that as the Tribunal ruled that HMRC were not entitled to read a tax avoidance motive test into section 75A (more on this below) and hence taxpayer anxiety returned that an in specie distribution, where PropCo had borrowings or the borrowing was elsewhere but secured on the property, could be subject to SDLT.

We now have guidance (published on 20th December last year) which addresses how HMRC may apply section 75A to financing transactions associated with distributions of property to shareholders. The December note reaffirms some old guidance that where a company holding real property has any borrowings and distributes the property to its 100% shareholder, HMRC will accept that SDLT is not payable if the borrowing comes solely from the shareholder and the company is being liquidated. This is helpful and appears to be because HMRC sees the property as already belonging to the sole shareholder by reason of its rights as a shareholder (and not transferred in satisfaction of the debt) because the liquidator does not have to concern himself with liabilities owed to a 100% shareholder.

However, the note goes on to say that in other circumstances, where the shareholder provides funds to enable the company to repay third party debt, the anti-avoidance provisions of section 75A may bite, as there will be a number of transactions 'involved in connection with' the distribution, and Project Blue has established that claiming there is no avoidance of SDLT is no defence against section 75A.

But is that right? Firstly, the decision in Project Blue is hardly definitive: it is a First Tier Tribunal decision and it contradicts itself. The Tribunal held that it was not permissible to read into the legislation a tax avoidance motive test, but it was necessary to identify the person who has 'avoided' the SDLT. Secondly, HMRC's note does not make any reference to some key provisions in section 75A which indicate that the rules do not apply and were not intended to apply to some of these financing transactions: section 75A can only bite if the relevant transactions are for consideration. If PropCo owes debt to a third party and its shareholder can make a loan to the company to enable it to repay the debt and the company is liquidated, has any consideration been given for section 75A to get its teeth into? And if these kinds of financing transactions do involve some form of chargeable consideration (the point is a complex one), it is not clear they should be taken into account at all - there is a broad (and deliberate) exclusion from section 75A for arrangements relating to the provision of loan finance (sub-section 75B(3)(c)). HMRC's original view drew a distinction between funding a PropCo to repay debt out of existing resources (not vulnerable to section 75A) on the one hand and using new loan finance (vulnerable to section 75A) on the other. Interestingly, that distinction is absent from the December 2013 guidance.

Also worth noting in this context is that if you buy a company or unit trust and then wish to make the extraction, just as the financing arrangements above appear to be removed from account for section 75A, the purchase of the securities (which would be for consideration) is not taken into account if it is the first of the transactions involved in connection with moving the property (sub-section 75C(1)).

So putting all that together, where does that leave us?

As ever, the devil is in the detail of each specific transaction and there are a large number of variables: Is the property charged? Where is the borrowing? Is the lender the shareholder or a third party? Is the distribution a liquidation distribution? What is the source of the funds put into PropCo? But we can broadly conclude that where there is no finance or the property transfer is within group, there may well be no problem. Where there is shareholder finance, HMRC may look favourably on a distribution, or at least on a liquidation distribution. Where there is third party finance that needs to be repaid, the position is more complex but it is not as bleak as HMRC's note immediately suggests, particularly if the shareholder can refinance the debt.

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