Analysis

Critical treasury transactions: the tax implications

Speed read

Maximising liquidity has been central to companies' responses to Covid-19, and treasurers have been taking various actions accordingly. Unexpected tax liabilities could limit the effectiveness of such actions, and could arise from, for example: reduced interest deductibility; accounting profits from debt reorganisations; foreign exchange and fair value movements on financial instruments; and terminating or restructuring derivatives. This includes intragroup, as well as external, transactions. The pace of treasury transactions being entered into, and the current volatility in financial markets, means that it's more important than ever for tax practitioners to be proactive in understanding treasurers' objectives, and contribute to the design of transactions.

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Corporate treasurers have been busy recently. As the world has changed for so many companies, their focus has been on maximising liquidity to deal with reduced cash generation, in amounts and time periods which can only be estimated.

As a result, some treasurers have been taking action to raise new funding, renegotiate existing debts, and restructure hedging transactions.

Treasury operations have the potential to affect taxable profits to a significant extent – particularly when dealing with volatile foreign exchange rates, interest rates and commodity prices. Market movements which are unhedged for tax purposes can result in unexpected cash tax liabilities, and capital structures which are tax-inefficient can impact on a company's overall cost of funds – potentially offsetting the work treasury are doing to preserve cash.

So, now more than ever, it's important that tax is brought into the conversation around treasury actions early, with tax considerations built into the design of transactions. This includes how such transactions could affect intra-group relationships, which may not be high on treasurers' agendas, but can have significant tax impacts.

What follows is an overview of the key tax points to think through in relation to the actions treasurers are taking, or considering taking, in response to Covid-19.

New external funding

Various sources of external funding are available to companies, including some introduced as a response to Covid-19. This article focuses specifically on debt and derivatives.

To give some commercial context, there is diversity in the types of debt being raised:

- drawing down under existing facilities where possible;
- new bank facilities, typically short-term;
- private placement or listed debt issuances, where companies have sufficient financial strength to access the conventional capital markets;
- new government-backed facilities; and
- non-standard debt issuances like convertible loans.

So, there are a real variety of commercial options – but what are the tax consequences to look out for?

Key tax considerations on raising external debt

Tax deductibility of interest

Increased external debt will likely result in higher finance costs for the group, even if the group initially retains the cash raised on deposit. This is the 'cost of carry', which is essentially the price companies are paying for increased liquidity.

If tax relief is not available for finance costs, the group's cost of capital effectively increases because the cost of debt increases (one of the features of debt is that tax deductions are generally available for interest). Consequently, it's important to review likely interest deductibility and take action accordingly.

This is particularly important if profits are falling as many countries now have earnings before interest, tax, depreciation and amortisation (EBITDA)-based restrictions on interest deductibility; for example, the UK's corporate interest restriction (CIR) rules at TIOPA 2010 Part 10, which restrict deductibility to 30%, or the group finance cost to EBITDA ratio if higher, of tax-EBITDA.

Where debt and finance costs are located can therefore be important. For example, if some jurisdictions have tax capacity to claim finance cost deductions, or if the ability to carry forward excess deductions and 'reactivate' them when profits recover (as is possible under the UK CIR rules) is better in some countries than others.

The location of debt and finance costs can be changed through intragroup financing, but this is subject to other anti-avoidance rules such as transfer pricing and purpose-based rules like the UK's unallowable purpose rule in CTA 2009 s 441. On transfer pricing, current market conditions could make it more difficult to benchmark appropriate interest rates, and/or to support debt levels at arm's length.

Tax practitioners need to carefully consider the impact of increased finance costs. Where will they end up within the group? How can they be deducted now and in future? Tax and treasury departments should talk to each other regularly, so that tax practitioners can give input into decisions on how funding is routed to where it is needed within commercial constraints.

Other tax considerations

Further tax considerations in relation to additional debt-raising include:

- ensuring that the requirement to withhold tax from interest payments is managed;
- if debt is raised in a currency other than the borrowing company's functional currency, or is swapped into such a currency under derivative contracts, ensuring that foreign exchange exposures are hedged for tax purposes; and
- managing volatility in cash tax liabilities caused by the requirement to fair value any hedging derivatives taken out in respect of debt (e.g. interest rate swaps or cross currency interest rate swaps).

Non-standard debt issuances

Convertible loans may be an attractive source of funds to borrowers who find it difficult to access more conventional debt financing, or simply because the pricing is more favourable.

Debt instruments with convertible features can result in accounting complexity, and the taxation of loan relationship and derivative instruments in the UK is based on the accounting, with specific computational rules then applying. It is possible that companies could do one of the following:

- account for such instruments at fair value in entirety, with fair value movements being taxable (subject to exclusions, e.g. where the funds raised are on-lent intragroup and certain conditions are satisfied; CTA 2009 s 352B); or
- recognise embedded derivatives at fair value, which could be taxable on an income basis (resulting in volatile profits) or a capital basis (e.g. for certain options to convert into shares; CTA 2009 s 652).

Given the current volatility in financial markets, fair value movements can be substantial and give rise to unexpected cash tax liabilities, so it's important for tax practitioners to talk to treasurers and finance colleagues about such non-standard debt issuances at an early stage, as such volatility can often be managed with adequate forward planning.

Government-backed facilities

New government-backed debt facilities are welcome for companies that qualify for them, but they have their own potential complications.

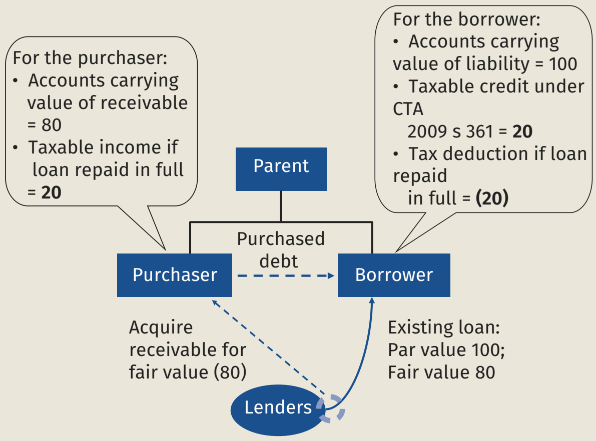
If such facilities are considered to carry an interest rate which is below current market rates (e.g. because it is set by reference to pre Covid-19 conditions), the liability may be recognised at less than par value, with a profit recognised either immediately or over time as a government grant/subsidy. Whilst this should, at worst, give rise to a timing mismatch for tax purposes, in some cases on-lending intra-group on the same terms could lead to more permanent tax disadvantages. Again, this outcome may be prevented through involvement of tax practitioners from an early stage in the design of transactions.

Opportunistic actions

On a more positive note, not every company has been adversely affected by Covid-19 and some companies are taking actions to, for example, access low market rates of interest, change the currency mix of debt portfolios to reduce interest costs, or buy existing debt back at a discount. Such transactions can give rise to tax exposures:

- If replacing existing debt with cheaper debt, groups need to consider the possible implications for intra-group loans. For example, at arm's length, could intra-group borrowers take similar action and could this lead to transfer pricing risks?

Figure 1: Repurchase of a group's external debt



- Changing the currency mix of debt can result in foreign exchange exposures, which need to be hedged for tax purposes.
- The repurchase of debt by connected companies at a discount to the carrying value of the liability in the borrower can result in immediate taxable credits on a deemed release of the debt, of an amount equal to the discount (see figure 1). Limited exemptions are available for companies in financial distress (CTA 2009 ss 361D and 362A).

In summary, commercial requirements will dictate the actions that corporate treasurers take in relation to external debt, but adverse tax consequences can result in these actions being less effective in securing or preserving liquidity. Such consequences can often be mitigated through tax input into the design of transactions; hence the importance, now more than ever, of tax practitioners having a regular dialogue with their treasury colleagues.

Bear traps to avoid on an external debt restructuring

Companies may also be looking to preserve liquidity and reduce liabilities through negotiating with their existing lenders. This could involve changing the terms of the debt (reducing forthcoming interest payments, extending maturities etc.), through to groups seeking an absolute reduction in their debt through forgiveness or debt-for-equity swaps.

These transactions carry an important accounting question: will a potentially taxable credit be recognised in the borrower company's financial statements? This could arise from:

(a) changes in terms being treated as a substantial modification for accounting purposes, resulting in the existing debt being derecognised and the amended debt being recognised initially at its fair value, with the difference recognised in profit and loss;
(b) changes in terms which don't reach this accounting threshold can still result in profit and loss entries representing the change in net present value of cashflows; or
(c) debt waivers or debt-for-equity swaps can result in amounts being recognised in profit and loss, or potentially in equity (but sometimes amounts recognised in equity can still be taxed, depending on when the loan was entered into; CTA 2009 s 321).

Accounting credits arising from these transactions – at least, those recognised in profit and loss – are taxable unless an exemption applies. Exemptions are available for debt-for-equity swaps, or where transactions in (a) and (c) above form part of a corporate rescue (broadly where, without the transaction, there would be a material risk that at some time in the next

12 months the borrower would be unable to pay its debts) (CTA 2009 s 322).

Transactions in (b) above generally do not qualify for an exemption and so transactions like this carry the risk of a cash tax cost which could affect the commercial benefit of the restructuring.

Therefore, specific tax input is essential when considering actions in relation to external financing. It may not always be possible to fully mitigate taxable credits arising from debt reorganisations, but early tax input can reduce the risk of surprises down the line.

Aligning intra-group arrangements to current funding needs

Most businesses will have experienced a change in their trading environment, which may have affected the cash requirements within a group. For instance:

- entities which have historically been cash generative may now need financial support;
- cash-rich entities may need to quickly repatriate cash to the head office; or
- the re-routing of trade flows may have given rise to new intragroup positions.

Such changes can have a significant tax impacts.

Cash pooling

Groups often manage short-term cash needs and surpluses by way of a cash pool. Cash pools can be of varying levels of sophistication, ranging from informal movement of funds via intragroup balances, to physical or notional cash pools managed by a counterparty bank, to in-house bank arrangements.

Changes in cash requirements within a group could result in increased surpluses and deficits in cash pools, which might subsist for a longer period than usual. This leads to a number of tax risks, including the following:

- Tax authorities challenging the interest rates applied to cash surpluses in the pool, the remuneration of a 'core' depositor into the pool, or the income of the pool header company, under transfer pricing principles. For example, tax authorities could seek to recharacterise a cash pool surplus, or deposit, as a longer-term loan, and seek to increase the remuneration to that depositor for tax purposes.
- The imposition of withholding taxes if balances are in place for a longer period of time (e.g. in the UK, income tax needs to be withheld from yearly interest; see ITA 2007 s 874).
- Inefficiencies caused by taxpaying jurisdictions effectively lending to jurisdictions where interest deductions are restricted; this reinforces the need to holistically review interest deductibility.
- Foreign exchange exposures arising from depositors having a different functional currency to borrowers, which could either lead to profit volatility, or external hedges needing to be entered into.

It is therefore important for tax practitioners to undertake an early evaluation of intra-group balances arising from a change in cash requirements, to assess any risks, and take appropriate action. This might include, stripping out certain balances from the pool and formalising them as longer-term loans with appropriate pricing, or indeed waiving or capitalising them (if there is a risk of, effectively, one-sided taxation of interest).

Intragroup loan reorganisations

Actions described above in relation to external debt instruments (changes in terms, waivers, debt-for-equity swaps) could be entered into in relation to intragroup loans as well, as individual companies' financial positions change.

Potential tax exposures are similar to those described above in relation to external debt; in particular, there is the potential for tax charges to arise from profit and loss credits. Whilst there are generally more exemptions available for intragroup loans (e.g. in the UK, credits in respect of releases of connected companies loan relationships are non-taxable; CTA 2009 s 358), this will not always be the case (e.g. credits arising from accounting substantial modifications do not fall within this exemption).

There is the potential, therefore, for intragroup transactions to give rise to tax mismatches, even within the same country (e.g. a loss in a UK lender on the change in terms of a loan could be disallowed under CTA 2009 s 352, whereas the corresponding gain in a UK borrower could be taxed).

Transfer pricing considerations

The current environment can make the pricing of intragroup loans on arm's length terms challenging, as credit spreads have increased and borrowing for lower credit quality companies has become harder. This may impact on the ability to borrow at all, or necessitate a financial guarantee in an intra-group context, which itself may need pricing, documenting, and paying for. Groups need to consider the impact on their transfer pricing policies and documentation, i.e. how is the current economic situation going to be factored into the pricing of intragroup loan positions?

Summary

Overall, there are a number of complexities associated with changes to intragroup funding. Group treasury may be less concerned with the mechanics of intragroup transactions and more concerned with the result, i.e. is cash getting to where it needs to be? Tax practitioners need to understand treasury's needs and consider how those needs can be satisfied, whilst managing the risks above.

Impact of volatility in financial markets

The past few months have seen large market movements impacting on companies, with certain oil prices at record lows, substantial movements in exchange rates, and contrasting movements in interest rates (reductions in base and risk-free rates, but increases in credit spreads).

This volatility is affecting companies in a number of ways – impacting cash interest costs, the functional currency equivalent amount of income and expenditure, and variable accounting results.

Foreign exchange differences

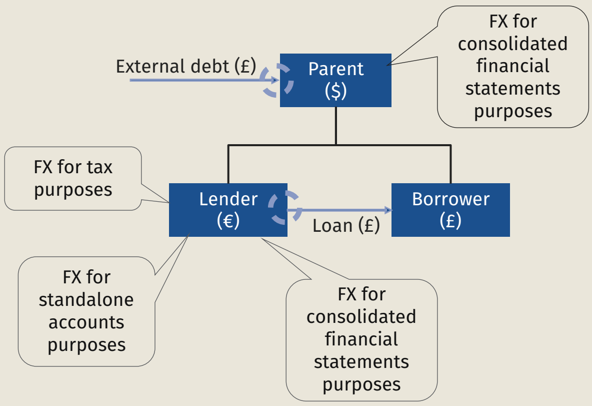
The starting point in the UK is that foreign exchange differences on loan relationships, and fair value movements on derivative contracts, are taxable as recognised in determining a company's profit and loss, on an unrealised basis. Market volatility can therefore result in unpredictable taxable profits. The extent of movement we have seen in foreign exchange rates, for example, could easily turn a current year tax loss into a taxable profit. It's therefore extremely important to manage the taxation of foreign exchange differences and fair value movements where possible; which will often be by virtue of applying the disregard regulations (SI 2004/3256) for tax purposes.

Foreign exchange differences can arise on external debt and derivatives, or intra-group items. There are a number of possible ways for a company to manage exposures to tax on foreign exchange gains and losses, but tax practitioners need to know about the exposures before they can consider the required steps; demonstrating the importance of understanding the actions being taken by treasurers at the moment.

Loan and derivative liabilities can be matched (with the foreign exchange disregarded for tax purposes) against investments in shares (SI 2004/3256, regs 3 and 4) where there is either a designated accounting hedging relationship, or an intended economic hedging relationship. It is important, though, for the hedging loan/derivative to sit in a company with the underlying economic exposure. It's also possible for companies to match loan and derivative assets against their own preference share capital, and investment companies may be able to elect to have a particular designated currency for tax purposes, to remove foreign exchange exposures (CTA 2010 s 9A).

It's often important for groups to hedge FX exposures for accounting purposes too – these exposures could be different to those for tax purposes, so hedging plans need to be drawn up by treasury, finance and tax teams together. These various exposures are illustrated at figure 2.

Figure 2: Types of foreign exchange (FX) exposure



Restructuring hedges

Treasurers may be considering various actions in relation to their hedging activities:

- Firstly, derivatives which are standing at a fair value gain for the company could be another source of liquidity – and so treasurers are considering terminating these derivatives early to generate cash.
- Secondly, many groups hedge foreign exchange and commodity price exposure on their sales and purchases, and the current situation might mean that groups are over-hedged, in that the forecast transactions being hedged are no longer likely to take place. Groups may seek to terminate such positions, or enter into offsetting contracts to essentially close out by 'locking in' the gain or loss but without an immediate cash flow.
- Finally, some companies have sought to restructure derivatives like interest rate swaps, to reduce cash outflows (or generate cash inflows) in early years and pay out more in future years.

The tax implications of these transactions can be complex, particularly if the disregard regulations apply to effectively override the accounting and tax the contracts on an accruals or realisation basis. For example:

- Terminating a foreign exchange or commodity price derivative contract, which hedges a forecast purchase of goods or services, will not necessarily result in the gain or loss being taxed immediately. This can be deferred until the underlying hedged purchase is recognised in cost of sales (SI 2004/3256, reg 10(3)), or rolled into a replacement contract (reg 10(7)).
- There is no specific rule for such foreign exchange or commodity derivatives ceasing to hedge because the hedged transaction is no longer forecast to happen (as opposed to interest rate derivatives, where there is a rule to determine when amounts are brought into account; reg 9(2A)). The gain/loss up to the time when the contract ceases to hedge would likely be held over until the termination of the contract (reg 10(2)) – which means that the tax position can be different where over-hedged contracts are terminated compared to where the contracts remain in existence, but with an offsetting contract entered into.
- Fair value movements arising after the contract ceases to hedge anything should be taxed as recognised in profit and loss – but it may be difficult to determine exactly when the contract ceased to hedge.
- When restructuring a derivative, it may be important to confirm that inherent fair value gains and losses would continue to be deferred under the disregard regulations, which means examining case law on when contracts are considered to have been rescinded as opposed to varied (e.g. *Shell UK Ltd v HMRC* [2007] SpC 624).

The tax result of transactions in hedging derivatives will be highly fact specific, and different transactions which achieve similar commercial outcomes will not necessarily be taxed in the same way. It's important, therefore, to factor the tax implications of a proposed transaction into the economic outcome, to allow a full evaluation.

Conclusion and action points

The discussion above demonstrates that the taxation of loans and derivatives can be complex, and there are risks of unexpected cash tax liabilities where tax is not sufficiently involved in the planning for a transaction. Given the importance of corporate treasury to companies' responses to Covid-19, it is vital that tax practitioners engage in a regular dialogue with their treasury colleagues, along with finance and legal teams.

The good news is that many tax exposures associated with treasury transactions can be managed, but to solve a problem, one must first know that it exists.

Tax practitioners should speak to treasury to understand treasury's objectives and proposed actions for financing, cash management and repatriation, foreign exchange and other risk management.

They should consider any tax risks associated with those proposed actions, and input into the design of transactions, particularly any consequential intragroup transactions on which treasury may be less focused.

In that regard, they should undertake a review of the group's potential tax result and interest deductibility in different jurisdictions, to make informed decisions as to efficient intragroup transactions; and take into account the OECD's guidance on transfer pricing for financial transactions.

Corporate treasurers are going to be busy for some time to come, and tax professionals will be too. ■

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- How to handle the taxation of restructuring transactions (Matthew Mortimer & Kitty Swanson, 17.4.20)