CVAs AND CORPORATION TAX ISSUES

1. Introduction

1.1 A company voluntary arrangement ('CVA') is one of the four main formal insolvency processes available to a company experiencing financial stress. The others include administration, administrative receivership and liquidation.

1.2 In a CVA, the company, its members and creditors agree on a programme for the settlement of the company's debts or a scheme of arrangement of its affairs. It is a restructuring process whereby the company enters into an agreement with its creditors to vary its terms of credit and usually involves a reduced payment in full and final settlement of its outstanding debts.

1.3 There are a number of corporation tax issues relating to periods before as well as during a CVA and the main issues are covered below.

2. Accounting Periods

2.1 When a CVA is entered into as, depending on the terms of the arrangement and any restructuring envisaged, the company's accounting period for tax purposes may be brought to an early end, and there may be restrictions on how any trading losses may be used. Further comments are included below.

2.2 The start of an administration or liquidation process will always trigger the end of an accounting period for tax purposes.

3. Tax Losses

3.1 Where a company entering into a CVA has accumulated trading losses for tax purposes, the continued availability of such losses in future periods is likely to be a crucial aspect to the successful implementation of the arrangement.

3.2 Assuming the company continues to trade throughout the CVA process, its unrelieved trading losses may be carried forward for offset against future profits arising from the same trade.

4. Company Reconstructions

4.1 Where there is a restructuring of the company's trade, perhaps with a hive down to another [subsidiary] company, the transferor company will be treated as having ceased to trade and the transferee company is treated as carrying it on.

4.2 Provided the beneficial ownership of the trade is held as to 75% or more by the same persons within two years after the transfer as before the transfer, the trade is not treated as permanently discontinued nor a new one set up. Trading losses and capital allowances, but not capital losses or non trade losses, may be carried across from the transferor company to the transferee and used against future profits from the trade transferred.

4.3 However, if not all of the liabilities of the transferor company are transferred, the trading losses carried across are reduced by the amount of the excess of relevant liabilities over relevant assets retained in the transferor. Following the hive down, the transferor company will have ceased to trade and therefore will have no future trading profits. Any tax losses not hived down will effectively be lost as they can neither be carried forward nor carried back under any terminal loss relief claim which can be available in cases where there is no hive down.

4.4 Where the transferor company has obtained tax relief for a debt owed which is released after cessation, the release will be taxed as a post cessation receipt unless it is part of a statutory insolvency arrangement. If the debtor and creditor companies are connected at the time of the release, the release will not be taxable under new rules applying from April 2009.

5. Debt Waivers And Buy Backs

5.1 Generally where there is a compromise of creditor claims, the element of the claim released will generate a profit in the debtor company for tax purposes. However, irrespective of whether the profit is trading or financing in nature, such a release in a CVA situation should be non-taxable under relieving provisions applying to statutory insolvency arrangements provided the actual compromise of the claim is specifically included within the terms of the CVA.

5.2 Outside of the relieving provisions noted above, the normal tax rules applying to debt waivers and purchases have recently been revised particularly in relation to debt buy backs by connected parties.

5.3 Generally, where a third party lender waives debt, the debtor company is taxed on the release. If the debtor company has tax losses to bring forward, the taxable release may be sheltered.

5.4 Where a connected party acquires the debt from the third party lender at a discount, the tax charge which would otherwise have arisen in the debtor's hands by way of a deemed release on the acquisition of third party debt can be avoided, as under the loan relationship rules, waivers of connected party debt are ignored for tax purposes.

5.5 Under the new rules on a debt buy-back, the deemed release of the debt can no longer be avoided simply by say having a newly formed company acquire such debt from the original third party creditor, unless one of three new exceptions apply, being the 'corporate rescue', the 'debt-for-debt' or the 'equity-for-debt' exceptions.

5.6 Following the initial acquisition of the debt, a subsequent release of the debt by the new connected party creditor will cause the debtor to be taxed on the discount received by the new creditor on its acquisition of the debt, less any amounts taxed in the hands of the creditor in respect of the discount, unless the exception to the deemed release rule, applicable on the acquisition of the debt, was the 'equity-for-debt exception'. Thus, subject to the equity for debt exception, the discount will come into charge to tax on the ultimate cancellation of the debt at the latest, notwithstanding that the debtor and creditor may be members of the same group at that point in time. It will not matter that the debt was not actually released by the original third party creditor.

5.7 The new corporate rescue exception to a deemed release on acquisition of the debt is aimed at the scenario where a third party purchases the shares in the debtor company at broadly the same time as it acquires the rights under the relevant loan relationship at a discount. If this exception is to apply, there is the requirement that, but for the change in ownership of the debtor company, the latter would within one year have been in insolvent liquidation or insolvent administration or would have met one of the other so-called insolvency conditions set out in the new rules. This could however be a difficult test to for the majority of debtor companies with third party indebtedness trading at a discount, outside of a CVA.

6. Debt – Equity Swaps

6.1 HMRC have recently revised their guidance on the statutory relief for a corporate borrower whose debt is released via a debt equity swap. Care will now be required where there are arrangements for a lender to sell the shares it receives on a swap.

6.2 In addition, in a debt equity swap, the debt release must be in consideration of shares forming part of the ordinary share capital of the debtor company, or an entitlement to such shares, such as a warrant.

6.3 Where a creditor, such as a bank, has no interest in being a shareholder in the debtor company and sells the newly issued shares back to the existing shareholders who do not want any dilution of their shareholdings, HMRC would deny the availability of the exemption to the swap.

7. Intercompany Account Balances

7.1 In certain cases, debt owed by a debtor company may include amounts outstanding on intercompany account which will often be a mixture of cash advances (loan relationships) and amounts owed for goods and services (which are not loan relationships). They may also include amounts paid on behalf of the debtor company which are not technically loan relationships but 'non lending' relationships.

7.2 It is important to be able to correctly identify the components of such intercompany balances in order to apply the correct tax analysis particularly where they are waived or written off prior to a CVA. Recent case law has highlighted the importance of having full documentation to support tax claims.

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