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Contents

US Tax Reform: what it means for US inbound multinational groups and M&A transactions

Fred Gander, US Tax Principal and Christina Visintainer, US International Tax Manager at KPMG in the UK, outline the relevant provisions and implications of the US Tax Reform for UK multinationals engaged in M&A transactions.

US Tax Reform has been a long time in the pipeline, but the final bill, H.R. 1 (Pub. L. No. 115-97), was signed by President Trump on 22 December 2017. The new law makes fundamental changes to the current US tax system.

What's new about US Tax Reform?

This is the most significant overhaul of the US tax system since the Tax Reform Act of 1986, transitioning the US from a worldwide system of taxation closer to a system of territorial taxation, while also establishing measures to prevent base erosion from the US. However, instead of simplifying the US tax system, the provisions create significant additional complexity.

The significant changes include, but are not limited to:

- Permanent reduction in the corporate income tax rate to 21%;
- Temporary (for a five-year period) 100% expensing on certain qualified capital expenditures;
- Limiting net business interest expense to 30% of adjusted taxable income (approximately EBITDA until tax years beginning before 1 January 2022 and then EBIT thereafter);
- Taxing gain or loss from the sale or exchange of a partnership interest on a look-through basis with respect to US trade or business income, as well as a gross proceeds withholding regime implementing such tax;
- Minimum tax on certain deductible payments made to a non-US affiliate (referred to as 'base erosion anti-abuse tax' or 'BEAT');
- One time tax charge of deemed repatriation of previously untaxed accumulated overseas earnings (referred to as 'mandatory repatriation');
- 100% deduction for dividends received from 10% owned non-US corporations (referred to as 'participation exemption').

Other significant provisions target cross-border transactions (such as a new special deduction for certain foreign-derived intangible income and a new tax on global intangible low-taxed income). The new law also imposes new limitations on the use of carryforward net operating losses to 80% of taxable income. (These provisions and the extensive provisions affecting individuals will not be discussed in detail here.)

Treasury and the Internal Revenue Service (IRS) have now started to issue regulatory and other guidance, prioritising mandatory repatriation and the net business interest expense limitation. This additional guidance will help taxpayers to comply with the new rules. It is also possible that so-called 'technical corrections' legislation will be enacted in the future to modify the new provisions.

A closer look at the significant provisions and impact on UK multinationals

Reduction in corporate tax rate to 21%

In recent years, the US corporate tax rate of 35% has been the highest in the Organisation for Economic Co-operation and Development (OECD) countries. The new legislation reduces that rate to 21%, effective for tax years beginning after 2017. This reduction will make the US more competitive globally and hopefully boost the overall economy. However, at the same time, the new bill eliminates or restricts certain tax benefits (such as domestic production activities deduction) that previously drove down the effective corporate tax rate for certain corporations.

The key impact of this will be:

- Increased investment in the US and re-evaluate the choice-of-entity for expanding US operations.
- Potentially less need for tax-free transactions, thanks to the lower tax rate.
- State corporate income taxes possibly becoming more important in comparison to US federal income tax. Reduction in corporate tax rate to 21%.

Immediate 100% expensing for certain business assets

The new law provides for immediate and full expensing for qualified property acquired and placed in service after 27 September 2017 and before 2023. This provision provides a phase down, by increments of 20%, of the bonus depreciation percentage for property placed in service from 2023 to 2026.

Broadly speaking, qualified property is tangible depreciable property with a class life of 20 years or less. The 100% expensing applies to new and used property if it is the taxpayer's first use. This provision is not applicable to assets used in any business not subject to the new net business interest expense limitation (for example, certain public utilities and electing real estate businesses).

The key impact of this will be:

- Immediate expensing may increase the number of taxable transactions.
- Increases the incentive for buyers to structure taxable acquisitions as actual or deemed (for example, pursuant to section 338 or a purchase of 100% of the interests in a partnership) asset purchases, particularly for asset-intensive targets.
- May result in contentious purchase price allocation negotiations.

Net business interest expense limitation

- The earnings stripping rules under the old section 163(j) have now been amended to disallow a deduction for unrelated or related-party net business interest expense of any taxpayer, measured at the filter level (for example, the partnership versus partner level and consolidated tax return filing level), in excess of 30% of its 'adjusted taxable income'. This is similar to EBITDA for taxable years beginning after 31 December 2017 and before 1 January 2022 and then similar to EBIT thereafter.
- The new rules allow disallowed interest expense to be carried forward indefinitely. The carryover amount would be subject to a limitation under section 382 in the event of an ownership change. The new net business interest expense limitation does not provide any grandfathering for pre-existing debt.
- Certain categories of taxpayers are exempt from the new rules including certain public utilities and taxpayers with average annual gross receipts for a three year period not exceeding $25 million among other requirements. Additionally, real estate and farming businesses can elect out of this limitation.

The key impact of this will be:

- The reduced appeal of debt financing for US acquisitions, necessitating the review of existing US group capital structures and requiring the modelling of optimal global debt placement.

Tax gain on the sale of a partnership interest on a look-through basis

A hot topic in recent years – starting with the IRS issuing Revenue Ruling 91-32 in 1991 – is whether to tax gain on the sale of a partnership interest by a non-US partner. The IRS took the position that the gain realised by a non-US person from the disposition of a partnership interest should, loosely speaking, be treated as effectively connected income ('ECI') to the extent that the partnership assets are used or held in a US trade or business. In 2017, the US Tax Court addressed the IRS's controversial position in the revenue ruling and determined that the non-US partner should not be subject to US federal income tax on the gain realised from the sale or redemption of a US partnership interest (to the extent the gain was not attributable to US real property interests).

The new law codifies the IRS position in Revenue Ruling 91-32. In addition, the new law requires the buyer of the partnership interest to withhold 10% of the amount realised unless the seller certifies that it is not a non-resident alien individual or non-US corporation. If the buyer fails to withhold the correct amount, the partnership is liable to deduct and withhold from distributions to the buyer an amount equal to the amount it failed to withhold, plus any interest assessed.

The substantive rule imposing an income tax liability is effective for transfers occurring on or after 27 November 2017, but the withholding requirement applies only to transfers occurring on or after 1 January 2018. The withholding requirement is suspended with respect to transfers of interests in publicly traded partnerships.

The key impact of this will be:

- Non-US partners investing in fund structures, directly or indirectly, through other partnerships in portfolio companies – classified as partnerships engaged in a US trade or business – will generally be affected.
- Buyer should withhold 10% of the amount realised on a sale in all cases unless a non-foreign affidavit and a US tax ID number from the transferor is received from the transferor.
- The potential for duplicative withholding obligations where a non-US partnership transfers an interest in a US trade or business partnership, unless certain coordination rules are provided.

Base Erosion Anti-Abuse Tax ('BEAT')

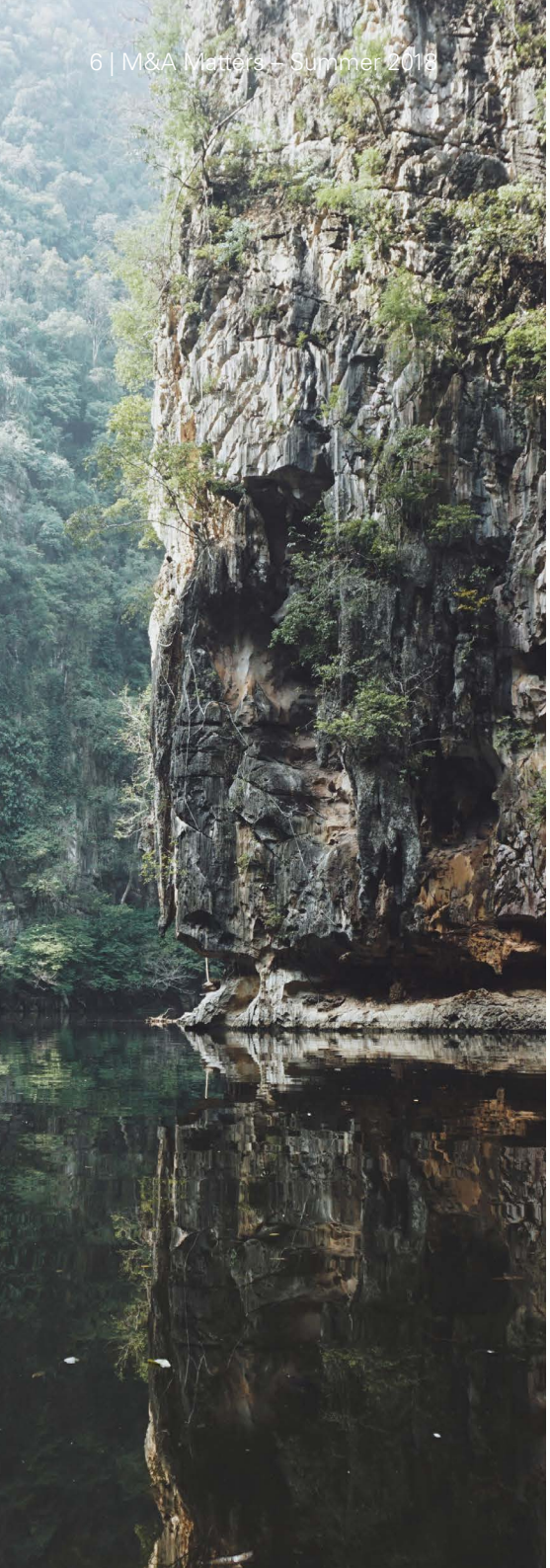
The new law implements a base-erosion-focused minimum tax on US corporations, with certain deductible 'base erosion payments' made to related non-US corporations. The purpose of this provision is to level the playing field between US multinationals and non-US multinationals, by effectively reversing a portion of deductions attributable to payments to non-US related parties.

A two-prong test applies to determine if the taxpayer is subject to a potential BEAT liability as follows:

- Whether the US corporation is part of a group with at least $500 million of annual US gross receipts over a three-year averaging period, and
- Whether it has a 'base erosion percentage' of 3% or higher for the tax year (2% for certain financial institutions). The 'base erosion percentage' is the ratio of the corporation's 'base erosion deductions' to its total allowable tax deductions for the year. Base erosion deductions generally consist of most outbound deductible payments to non-US affiliates including interest, royalties, certain management services fees, and depreciation expense attributable to property purchased from a non-US affiliate. Importantly, they do not include payments treated as cost of goods sold or otherwise as a reduction to gross receipts. The base erosion percentage of any NOL deduction is also treated as a base erosion payment/benefit for these purposes.

Assuming both prongs of the applicability test are satisfied, the BEAT liability for the tax year is:

- The excess of 10% of the taxpayer's modified taxable income (i.e. net taxable income increased by adding back base erosion payments/benefits) for the year (5% for 2018 and 12.5% beginning in 2026) over
- The regular income tax liability reduced by certain tax credits computed on a separate entity basis except for US consolidated groups. (The applicable rates for certain financial institutions may be different.)



This new law introduces new reporting requirements under the existing regime in connection with Form 5472, Information Return of a 25% Foreign-Owned US Corporation or a Foreign Corporation Engaged in a US Trade or Business, to collect information regarding applicable taxpayers' base erosion payments and increases the reporting regime's existing penalty from $10,000 to $25,000.

Where a group is owned by private equity partnerships, particular care will be required to identify funding from related parties.

The key impact of this will be:

- The need for possible supply chain modifications (such as using unrelated parties) and determining whether additional items may qualify as cost of goods sold or for exceptions applicable to low value services.
- The potential impact of BEAT in planning for/pricing acquisitions.

Mandatory Repatriation and Participation Exemption

To facilitate a move towards a territorial system, mandatory repatriation requires that post-1986 untaxed earnings of certain non-US corporations should be subject to a one-time tax, depending on the type of asset (in other words, tax of 15.5% for cash and cash equivalents and 8% for all other assets). This mandatory repatriation applies to a US shareholder (including US corporations, partnerships, trusts, estates, and US individuals) that directly, indirectly, or constructively own 10% or more of the non-US corporation's voting power.

This income inclusion is included as part of Subpart F income for the last tax year beginning before 1 January 2018 (i.e. 2017 for calendar-year taxpayers). The tax can be payable over eight years and the US shareholder can choose not to use its net operating losses against the repatriation income to maximise the use of those losses against taxable income subject to the higher 21% tax rate.

Untaxed earnings of non-US subsidiaries distributed to certain US shareholders after 31 December 2017 should generally be exempt, as long as those earnings are neither Subpart F income nor subject to the new tax on 'global intangible low-taxed income'. The participation exemption applies to a US corporation that owns at least 10% of the voting power of the non-US corporation not considered a passive foreign investment company – provided that the distribution is not a 'hybrid dividend', with respect to which the paying corporation receives a deduction, among other requirements. Additionally, the participation exemption allows certain deemed dividends under section 1248 relating to a portion of a US corporation's gain from selling the stock of a controlled foreign corporation to be exempt from tax. However, the taxation of non-US earnings invested in US property under section 956 are retained, as are most of the old laws for taxing a controlled foreign corporation's earnings under Subpart F.

The key impact of this will be:

- Mandatory repatriation computations will be an important item to review during the tax due diligence process.
- Analysis and related restructuring with respect to the repatriation of non-US cash.
- Identifying non-US tax consequences (and potential legal and operational impediments to bringing cash home to US).
- The appropriate pricing/contractual provisions will need to be determined to allocate tax between buyer and seller because the tax from mandatory repatriation may be spread over eight years.
- For private equity, funds or fund partners that qualify as US shareholders of the non-US corporations may be subject to inclusions that are required to be reported on tax returns and schedules K-1.
- In general, there are likely to be practical challenges in verifying the accuracy of the earnings and profits and foreign tax pools associated with mandatory repatriation.

Anti-inversion rules

The prior law US anti-inversion rules were complex and punitive. Under the new law, they have been strengthened to further deter inversions. Broadly speaking, the new law requires a recapture in which the US shareholder is denied:

- A participation deduction with respect to dividends from certain non-US subsidiaries;
- The reduced rates under the mandatory repatriation provision (instead the taxable income would be subject to a 35% tax rate), and
- The ability to offset the additional US federal income tax imposed by these rules with foreign tax credits.

This recapture occurs if a US shareholder becomes an 'expatriated entity' at any point during the 10-year period following the enactment of this bill. In general, an expatriated entity is when a non-US corporation acquires the stock (or substantially all of the assets) of a US corporation, using its stock as consideration and the former shareholders of the US corporation receive at least 60% of the vote or value of the non-US corporation.

The key impact of this will be:

- Anti-inversion rules becoming an important item to assess for future merger and acquisition transactions and considerations other than stock may need to be contemplated.

How can we help?

As we gear up for Treasury and the IRS to issue additional guidance and regulations, KPMG can assist with assessing how the new law will impact your current operations and the operations of US acquisition targets. Supplemental due diligence will be needed to ensure that the target entities are complying with the new laws and correctly assessing the impact of the new legislation on their operations.

KPMG is able to provide a wide range of services for assisting clients with US Tax Reform:

- Modelling the impact of the new rules on US and global effective tax rate;
- Performing earnings and profits studies to quantify mandatory repatriation;
- Performing US debt deductibility and BEAT analysis;
- Conducting customised workshops to assess the impact on a client's supply chains and operating model;
- Performing financial statement impact reviews and computations; and
- Considering opportunities to maximise the 100% expensing of qualifying capital investments (such as actual or deemed asset acquisitions).

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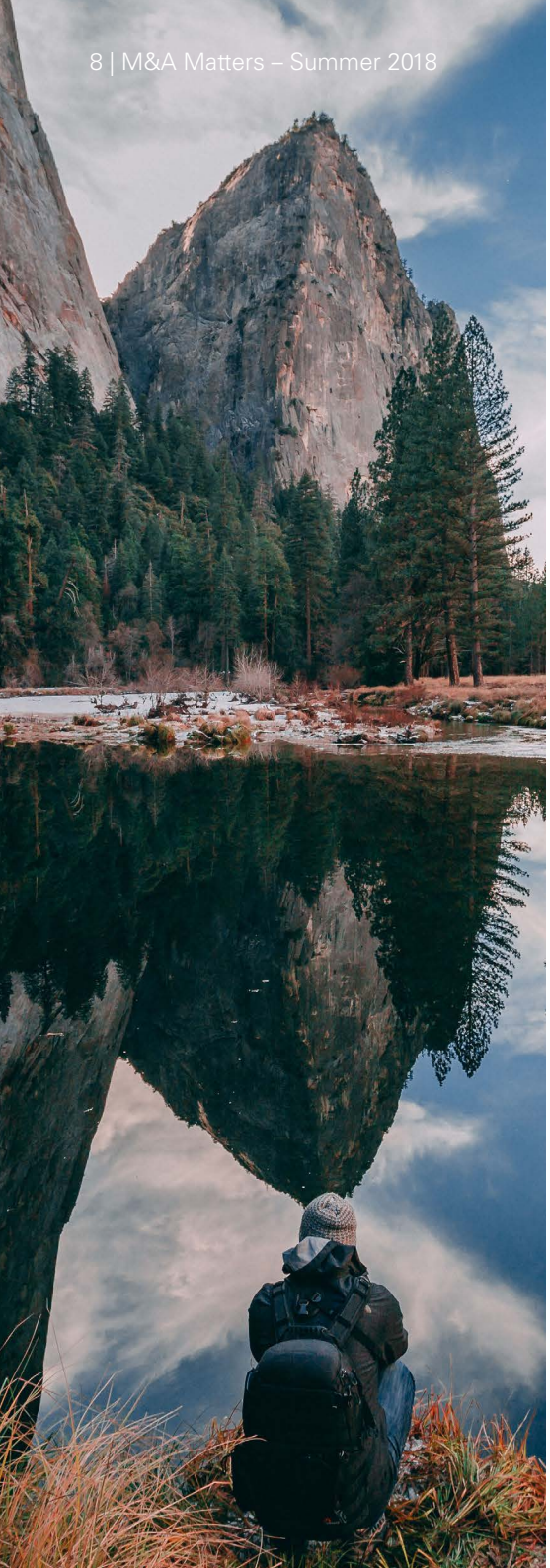

Normal commercial loans: some pitfalls to avoid

Rob Norris, Director at KPMG in the UK, and Mark Eaton, Director at KPMG in the UK, outline examples of instances where a non-commercial loan may be inadvertently established.

When is a loan not a normal commercial loan?

Various conditions apply as to whether or not a debt is seen as a normal commercial loan. It would not be termed a normal commercial loan, for example, if it entitles the lender to any amount of interest which exceeds a reasonable commercial return on the new consideration lent.

If, say, a company issues a loan note with a face value of £100 and receives £100 cash from the lender, the new consideration received is the £100 of cash; the interest can then be tested to see if it represents a reasonable commercial return to the lender on this amount. In practice, however, the position may be less straightforward – as we explain later in this article.

What are the implications if a loan is not a normal commercial loan?

Where a debt is not a normal commercial loan, there may be implications concerning tax groupings, the substantial shareholding exemption, and the new corporate interest restriction regime.

These parts of the tax code provide for favourable treatment where there is a certain level of ownership. In order to prevent these rules from being manipulated, the required level of ownership takes into account the entitlement to profits and assets available for distribution on a notional winding-up, consistent with real economic ownership.

The entitlement to profits and assets is tested by reference to the rights of "equity holders" which, in addition to the holder of ordinary shares, can include a loan creditor in respect of a loan which is not a normal commercial loan. The related party treatment within the corporate interest restriction regime also takes account of rights inferred from a non-normal commercial loan.

First of all, we will look at the relevance of a debt not being a normal commercial loan.

If the funds raised by a group company are not in the form of a normal commercial loan, the effect will be to reduce the share of profits and assets to which the company's parent is entitled. This may result in the company and its subsidiaries being excluded from the group. For example, if a subsidiary borrows in a form other than a normal commercial loan and, because debt ranks ahead of equity, the lender is entitled to more than 50% of the assets on a winding up, this could break the capital gains group. Similar rules apply, for group relief and stamp taxes (though with a 75% threshold).

A related issue can arise with intra-group debt if an assessment is being made as to whether a vendor company can apply the substantial shareholding exemption to the gain arising on the sale of a subsidiary. One of the conditions for the exemption to apply is that the vendor company has a substantial shareholding in the company being sold. This requires

that the vendor company holds shares in the target company which entitle it to not less than 10% of the ordinary share capital, profits available for distribution to equity holders, and assets on a winding up available to equity holders. To give a simplified example, suppose the parent owns 100% of the share capital of its subsidiary and has previously made a loan of £95 to the subsidiary which is not a normal commercial loan. If the assets of the subsidiary are, say, £100, the parent could be entitled to all of the assets available for distribution but only 5% would arise by virtue of its holding of shares in the subsidiary. As a result, the 10% requirement is not satisfied and the substantial shareholding exemption would not apply.

When applying the corporate interest restriction, a group may elect to calculate the amount of the interest disallowance using the 'group ratio method'. This is based on a measure of net interest payable and economically similar expenses taken from the consolidated financial statements, where amounts owed to a related party are excluded. The rules to identify related parties are complicated. For example, persons will be regarded related parties if a 25% investment condition is met. This is tested by reference to holdings of "equity" which includes non-normal commercial loans.

This illustrates the importance of understanding whether or not a debt is a normal commercial loan.

Examples of instances where a non-commercial loan may be inadvertently established

Exchange of loan notes on a refinancing

Let us suppose a company has previously borrowed from third parties on fixed interest terms. Prior to maturity, the borrowing is exchanged for new third party fixed interest borrowing at a lower, current market rate. The lenders are entitled to compensation because the interest rate on the existing debt is higher than current market rates. The implications for the new borrowing may depend on whether the compensation is settled in cash or in additional loan notes.

Suppose that a lender currently holds £100 of loan notes for which £100 was paid on issue. The market value of the existing loan notes is now £110. The extent to which the £10 additional payment is cash settled will depend, in part, on choices to be made by the lenders. The £100 of existing loan notes could be exchanged for £110 of new loan notes with no cash payment or, say, £104 of new loan notes and £6 of cash.

It may be assumed that the interest rate on the new loan notes is a market rate. This could still, however, be treated as a more than a reasonable commercial return. For example, if £100 of existing loan notes are exchanged for £110 of new loan notes, the new consideration received for the £110 of new loan notes might be restricted to the £100 of cash received for the existing loan notes. A market rate payable on £110 may exceed a reasonable commercial return on the original loan notes of £100.

While 'in the round' the refinancing may be considered to be at arm's length (i.e. agreed on terms consistent with a third party arrangement), careful consideration needs to be given to the reasonable commercial return requirement. You could say that interest payable on the new loan notes is more than a reasonable commercial return to the lender on the new consideration provided, because the new consideration received (possibly restricted to £100) for those loan notes is less than their face value (£110).

In practice, it may be possible to structure the arrangements to avoid such issues and, if an uncertainty is material, HMRC can be approached for clearance.

Novation of loan notes – guarantee call

When a group that is in financial difficulty undertakes a refinancing, a company may take on additional debt.

This could be the case if a guarantee is called and the lender agrees that the amount due from the guarantor company will be left outstanding as an interest bearing debt. While the guarantor may have the right to recover the amount from the original borrower, that right may have little value. Alternatively, if there is a consensual arrangement, part of the debt may be released with the 'right sized' debt then being transferred to a company within a sub-group. New consideration does not have to be provided in the form of cash and it may be possible to structure the arrangements so that assets, representing sufficient new consideration, are transferred to the new borrower.

In either case, it will be necessary to assess whether sufficient new consideration is received by the company for taking on the debt obligations. Otherwise, the liability may not be a normal commercial loan. A key point here is that the new consideration received by the original borrower does not carry over to the new 'borrower'.

Novation of loan note – intra-group

We sometimes see situations where a loan relationship liability is transferred between two UK subsidiaries within a group. The intra-group rule for transfers of a loan relationship might apply to determine the consideration paid and received for the transfer, so there is neither a gain nor a loss for loan relationship purposes. But this deemed consideration does not carry over to the normal commercial loan provisions. It is vital to check that the new 'borrower' has received new consideration equal to the amount borrowed. Otherwise, this could lead to the new 'borrower' and its subsidiaries being degrouped and losing the ability to surrender losses as group relief.

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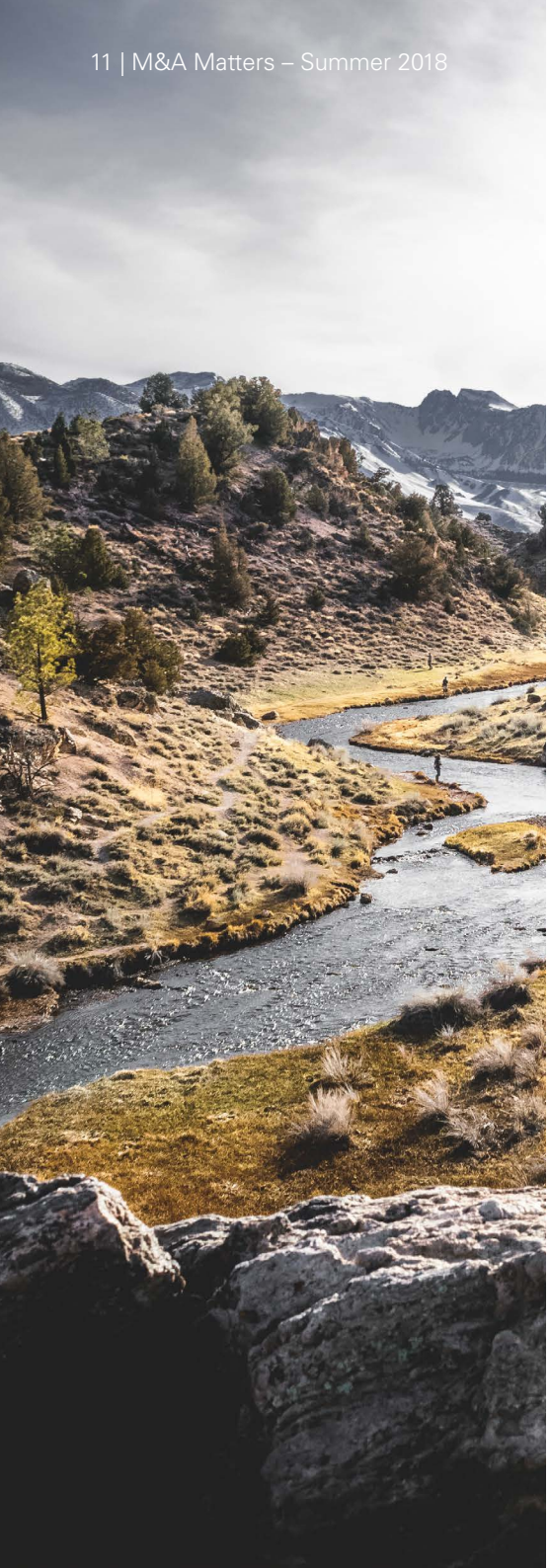


Hybrid and other mismatch rules: experience to date

The hybrid and other mismatch rules have applied since 1 January 2017. Mark Eaton, Director at KPMG in the UK, and Rob Norris, Director at KPMG In the UK, reflect on the implications for M&A transactions so far.

Which mismatches are affected?

Much of the initial focus when applying these rules has been on the term "hybrid". Many groups are under the impression that the rules are only relevant to those who undertake tax planning using the most complex entities or instruments. However, their scope is actually much wider.

A useful approach has been to first identify circumstances where there is a mismatch in the tax treatment and then assess whether the rules apply.

The hybrid and other mismatch rules are aimed at two types of mismatch:

- Where there is a deduction but the corresponding income is not taxed at all, or is taxed in a later period.
- A deduction is claimed for the same amount twice, perhaps by more than one person or in more than one jurisdiction (i.e. a double deduction).

The points below are not intended to be exhaustive but set out some commercial situations where the rules could bite unexpectedly.

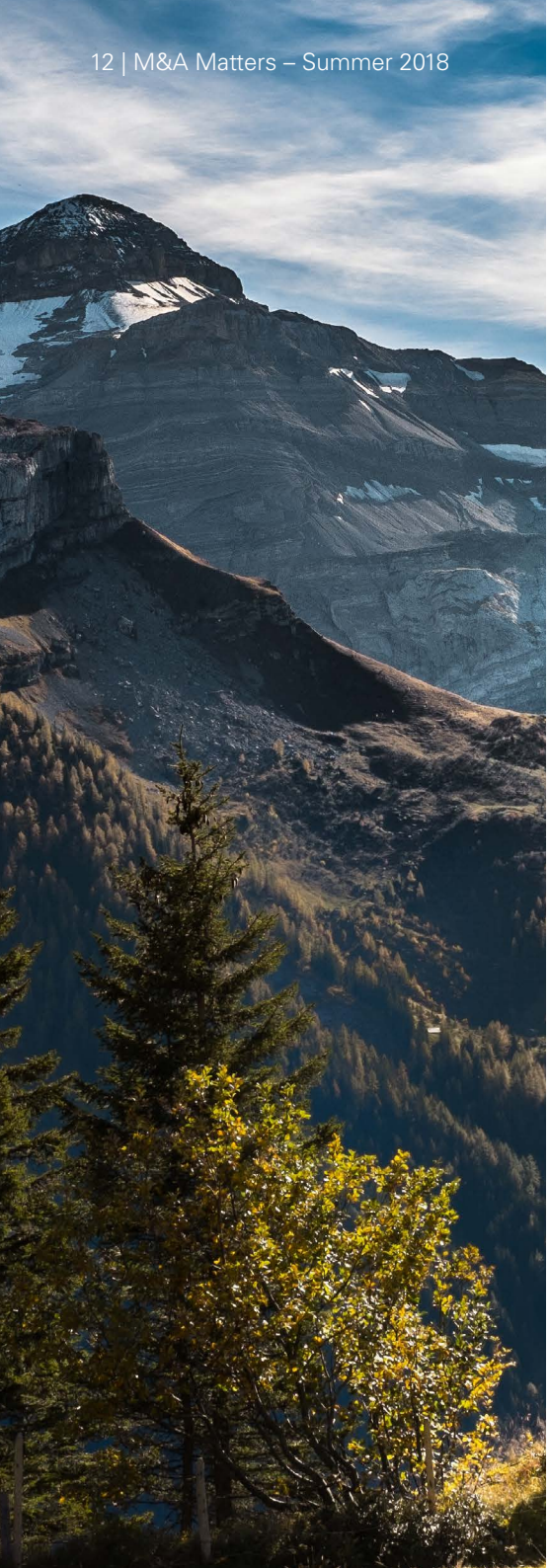
Release of an intra-group loan

An example of the first type of mismatch is where an overseas group company has previously made a loan to a UK subsidiary, which is now being sold and where the debt is not fully recoverable and part of the loan is released. The release credit is typically recognised in equity and is not taxable. To the extent that the loan arose in a period beginning on or after 1 January 2016, the credit is not taxable on first principles, since nothing is recognised in profit or loss or within the statement of other comprehensive income. If the loan arose in an earlier period, there is a statutory exemption for releases of loans between connected companies.

Before the introduction of the hybrid and other mismatch rules, that would probably have been the end of the matter. However, we now need to determine whether the overseas lender obtains a tax deduction in relation to the loan release, resulting in a mismatch in the tax treatment. If so, the UK borrower may be required to recognise taxable income corresponding to the deduction.

Whilst the hybrid and other mismatch legislation does contain an exemption where the release credit is not taxable due to certain statutory reliefs, HMRC considers that this exemption does not apply where the release credit is not taxable on first principles (such as for loans entered into in a period beginning on or after January 1st 2016). As a result, the hybrid and other mismatch rules could apply to create a taxable profit for the UK borrower and it may be necessary to restructure the transaction.

This example illustrates how the rules can apply much more widely than expected.



Third party funding

One area of significant uncertainty is whether borrowing from a third party falls within the rules – and, practically, how the self-assessment of these rules should be approached.

The hybrid and other mismatch rules are relevant not only when there is a mismatch in relation to the borrowing entered into by a UK company, but also when there is a mismatch in the chain of funding which includes the loan to the UK borrower. HMRC draft guidance outlines the required level of linkage in the chain of funding, where it is reasonable to assume that the funds provided to the UK borrower became available as a result of another loan in that chain.

A borrower is unlikely to fully understand the chain of funding in a third party lender and the associated tax treatment, perhaps because the lender regards this as confidential. The borrower may not therefore know if there is a relevant mismatch. In order to test whether there is a disallowance, a UK borrower may aim to conclude that a third party lender is not a related party or in the same control group (referred to below as a related party).

There are some fundamental difficulties here:

– The tests of whether borrowers and lenders are related parties are extensive and cover the entitlement to distributions on a winding-up. This type of test is reasonably well understood from existing legislation which defines tax groupings. However, unlike these other provisions, the hybrid and other mismatch rules do not exclude rights arising from 'normal commercial loans'. There is a lack of clarity as to how the rules should be applied in practice.

– The related party rules also include detailed provisions which can require rights to be attributed to a third party lender. This means that even if a third party lender is not a related party, based just on its own rights to income and assets on a winding up process, it could still qualify as a related party taking account of the rights of others. If a borrower is relying on the lender not being a related party, the application of these attribution rules will need to be tested.

It would be helpful if HMRC could provide guidance on how the tests of entitlement to income and assets on a winding up should come into practice.

Mismatch created by UK tax rules

Although uncommon, the rules also have to be considered where there is a mismatch in the recognition of taxable profits and losses, when dealing with transactions between UK resident companies.

Take the example where one UK group company borrows on floating rate terms, with another UK group company entering into an interest rate swap to fix the interest payments. In this instance, the two companies may enter into an intra-group swap which mirrors the terms of the external hedging contract to transfer the benefit and burden of that to the company undertaking the borrowing. In economic terms, each company is naturally hedged, but how is this intra-group contract to be taxed?

– Within the company with the external borrowing, taxable profits and losses may be determined on an accruals basis, as a result of applying the Disregard regulations.

– Within the company with the external hedging contract, taxable profits and losses may be determined by following the fair value profits and losses in the accounts.

Even though all of the profits and losses from the contract will be taxed in each company, there is likely to be a mismatch in the exact timing of recognition of these taxable profits and losses. This raises questions as to whether this mismatch is within the scope of the rules and requires counteraction.

For example:

- Does it make a difference if the mismatch is only one of timing?
- How do the rules apply if a fair value loss recognised in one period is reversed by a fair value profit in the same company in a later period?
- Does it matter if a loss is recognised in a group company following commencement of the rules, but the corresponding profit is recognised in the counterparty prior to commencement?
- Depending on the particular circumstances, it may be concluded that there is not a mismatch which requires counteraction. But this is unlikely to be straightforward and further HMRC guidance would be helpful on how they see the rules applying in such a context.

Relevance beyond financing

- These rules are relevant to all types of deductions, including payments for goods and services. Their potential application to all types of deductions will therefore need to be covered as part of the due diligence on a target group, as well as in structuring the acquisition.
- Examples of situation where the hybrid and other mismatch rules can apply in unexpected circumstances are included in a series of articles here.

Interaction with other rules

- The combination of the hybrid and other mismatch rules with the corporate interest restriction and corporation tax loss reform means that a group's tax profile post-acquisition may now be much more complex, both in terms of modelling and managing the use of tax attributes. Tax models will need to deal with the order in which the various rules apply and when carrying forward amounts which have been disallowed.

Review the application of the rules?

- Our experience to date of the hybrid and other mismatch rules is that there are significant deficiencies in the legislation which means that it applies in unexpected circumstances and can produce inequitable results. Changes being made in Finance Bill 2018 will generally clarify and improve the workings of the rules but there is still much to do. We would suggest that the key reason for these deficiencies is that although there was a consultation on the draft legislation, the practical implications were insufficiently understood by business, advisers and HMRC so problems were not identified at that time. We believe that there is a case for reviewing and updating the rules. A good starting point would be the approach taken in the successful HMRC consultation on modernising the taxation of corporate debt and derivative contracts starting in June 2013, which involved working groups looking as particular aspects of the rules.

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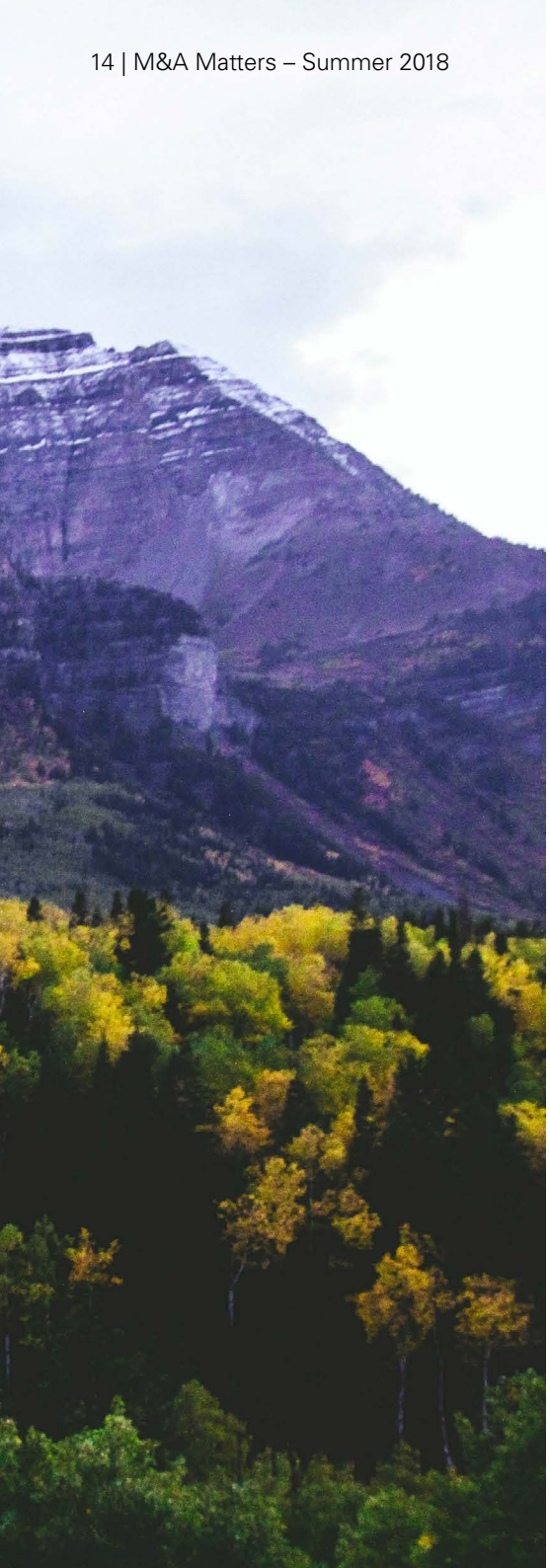

Acquisition planning: the benefits of focusing jointly on regulatory capital and tax

This article highlights the opportunities that may exist to drive value from an acquisition and subsequent structuring, if due diligence and planning are undertaken jointly in terms of both tax and regulatory capital. It also demonstrates why tax specialists are well placed to help achieve these benefits.

Many banks' corporate development teams are increasingly optimistic that they will soon be focusing on acquisition pipelines, after years of primarily executing disposal programmes. Similarly, private equity funds, backed by large investor demand, are showing a growing interest in challenger banks and other regulated businesses.

Whether it's a case of those buyers subject to PRA prudential regulation in relation to regulatory capital, or the potential targets themselves, capital management and planning are essential parts of an acquisition. That includes:

- The impact the acquisition can have on existing capital ratios of an acquiring bank; and
- The increasingly onerous capital requirements and stress tests that PRA regulated businesses have to meet more broadly, with their knock-on impact on profitability and investor returns.

Joint focus on regulatory capital and tax

It is often thought that management of the effective tax rate alone is the main way in which tax departments and advisers can boost a regulated business's capital position. However, focusing on balance sheet items can also highlight immediate capital benefits, including:

- Subsidiaries
- Deferred tax assets ('DTAs'); and
- Other assets that can lead to material capital inefficiencies, if held in the wrong entity.

A tax specialist is well placed to look at these issues holistically, With some regulatory capital knowledge, they can work with their Corporate Development and Treasury colleagues to help create value for the business.

Focusing on the target business

Some easy wins may be possible simply by focusing on the balance sheet of the target business. By understanding the underlying cause of DTAs and other tax balances, these could be offset against other items in the balance sheet (perhaps by simply understanding whether an alternative accounting treatment might be available post-acquisition). For instance, DTAs will often arise in respect of a pension fund deficit, but it might be possible to offset that DTA against the deficit itself. Similarly, DTAs and current tax liabilities may be inter-related and so eligible to be offset.

The result of netting off these opposing balances is neutral from a book perspective, but can improve the regulatory capital position, given their different capital treatments.

Form of acquisition and structure

All tax advisers know that the acquisition structure and related funding can be absolutely key in driving value. However, in the context of a regulated business, there is an extra dimension; often the type of funding required to make the structure tax efficient will not count towards regulatory capital funding and ratios. Proper consideration is therefore essential, as it may be possible to introduce a structure that achieves both sets of objectives.

Banking surcharge and bank levy

For a bank looking to acquire assets/liabilities, the post-tax returns of the new business will depend on the choice of acquiring legal entity and whether it is subject to the 8% banking surcharge. That, broadly, means banks and building societies with profits in excess of the £25m annual allowance (see Chapter 4 of the Corporation Tax Act ('CTA') 2010). The choice of entity may be determined by regulatory requirements, but to the extent that there is flexibility, this issue should be one of many considered before the decision is made. That is particularly true because acquiring it into an entity subject to the surcharge could prevent that business being transferred out to a different entity at a later date, without it still being subject to the surcharge given anti-avoidance provisions contained in s269DN of CTA 2010. Additionally, for those larger banks subject to the UK bank levy or close to the £20bn bank levy threshold, consideration needs to be given to the bank levy impact of acquisitions and/or financing through the UK.

It is therefore important that these issues are raised with the appropriate decision makers at the very outset, to ensure the transaction is carried out in the right way and analysis on the capital returns is undertaken correctly.

Acquisition or subsequent restructure of capital intensive assets

Management of capital intensive assets between entities is a key area and should be considered at the time of the acquisition, and/or post-acquisition. It can improve, perhaps materially, the solus capital position of the respective entities. While moving such assets will not necessarily improve the consolidated capital position in itself, it can mean excessive group capital can be released, if it has arisen simply to fund inefficient underlying solus capital positions.

Deferred tax assets

DTAs are one such asset. In an entity with Core Tier 1 capital requirements, the capital treatment of DTAs is determined according to their size, relative to the entity's 'DTA threshold' (broadly 10% of its solus Core Tier 1 capital). The proportion of the DTA in excess of this threshold is treated as a total deduction from capital, while the amount below the threshold is treated as a risk weighted asset (risk weighted at 250% – see Article 48 of the Capital Requirements Regulation. These regulations also take into account a regulated entity's investment in subsidiaries in determining the size of the DTA threshold – hence the importance of legal entity structures and positioning of subsidiaries).

In relation to an acquisition, improving solus capital efficiency might therefore be possible if a target business with related DTAs can be acquired into an entity where the DTA threshold will not be exceeded (or indeed an entity that has no solus prudential capital requirements if possible). Given the creation of large DTAs as a result of the introduction of IFRS 9 and the amendments to the Loan Relationships and Derivative Contracts (Change of Accounting Practice) Regulations 2004 that spread the deduction over 10 years, the acquisition of loan portfolios is one area where this could be relevant.

On a post-transaction basis, or if internal restructuring is to be undertaken, the same opportunity exists. Transferring DTAs from an entity where they exceed that entity's DTA threshold to one in which they will instead be treated as risk weighted assets should be considered, or even transferring them to a non-regulated entity, depending on the nature of the assets and related DTAs involved. This might be possible, for example, through the use of an election under s198 of the Capital Allowances Act 2001. However, this may need to be balanced against the impact of having to write down the value of the DTA and its one-off impact on group returns, to the extent that the DTA has moved to a relatively lower taxed entity (in other words, one whose profits are not subject to the banking surcharge).

Intangible property

Another capital inefficient asset to consider is intangible property, representing a total deduction from capital. If it is possible to transfer it out of the regulated entity into a separate group company (for example, a service company) an immediate improvement in the transferor's solus regulatory capital can potentially be achieved.

Tax will need to play a key part in structuring the transfer to ensure, for instance, that potential taxable gains in the UK (or other jurisdictions that may claim part ownership) are understood. However, transferring it from the regulated entity as user of the asset to a new owner may also represent a further opportunity where ongoing capital returns can be increased, through qualification for the UK Patent Box regime under Part 8A of CTA 2010, so that profits arising from patents are taxed at 10%. This is an area of focus for banks and others in the FS sector due to the increasing importance, and development, of technology and related patents. The ability to separate the owner of the asset from the user can mean it is now possible to identify such profits – an issue with which groups have struggled in the past when a single entity both owned and used the asset.

Opportunities arising from regulatory reform

The insights above have been made in the context of acquisitions. However, many of these issues should also be considered if an internal restructuring is being planned, whether driven by external factors, such as Brexit, or due to internal operational or business change.

Conclusion

Whether in the context of an acquisition or restructuring, proper due diligence and planning involving both tax and regulatory capital at one and the same time can realise material value. Tax specialists with some regulatory capital knowledge, or in regular dialogue with their Corporate Development and Treasury colleagues, are well placed to help achieve these benefits.

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The new Corporate Criminal Offence: how to protect your organisation

Tax evasion has long been a criminal offence, as has someone helping make that evasion happen. However, the Criminal Finances Act 2017 goes one step further, creating a criminal offence when a company does not stop its representatives from helping the taxpayer evade tax.

The consequences are far reaching. Assume that someone connected with your business is evading tax. Now assume that someone you are responsible for has helped them do it. Once both these things happen, then your company is accountable under criminal law. That means an unlimited fine, significant reputational damage and regulatory interest – all seriously damaging your ability to do business.

If you think this doesn't apply to your company, think again. Every sector and every business should be concerned with this. Some sectors may be more at risk than others. But all are affected.

For example, consider any company that makes or sells goods or services. One of your buyers might ask for an invoice that enables them to claim what is clearly a private expense as a business deductible. Or a supplier might want payment to a bank account in a tax haven. If someone in your organisation goes along with either of these scenarios, then the company could be guilty of a criminal offence.

Defensive action

The only way to protect your business is to create a defence: to take reasonable steps to prevent your agents from committing the criminal act.

How to approach this? The first barrier to cross is a mental one: to understand that this is a business conduct issue, not a tax issue. It's about setting a standard and telling all your associates that you expect them to keep to that standard and behave in an appropriate way. That's why the defence project is best led by those who have tackled other financial crime, legal, compliance or business conduct projects.

The first practical step is to conduct a risk assessment. This requires getting the right people and the right commitment, the budget, a project manager and a senior sponsor. It also requires deciding early on what methods to use and how much detail to go into. For example, a big bank will need a number of different risk assessments, while an equity house with a few dozen partners and employees will more likely only need one.

The assessment needs to consider all the inherent risks. Once these are mapped, review controls. Many companies think they can do these two exercises together. But that's a mistake. You need to ignore your controls and think about what would happen if you didn't have them. Then think about what controls you have that would stop the egregious behaviour. Are you sure they would stop it? Or would they only stop people who are complying with your controls?

All this should be done in a proportionate way. This is not about boiling the ocean – it's about having procedures that are appropriate to the risks involved, not worrying about theoretical small risks.

To create and maintain a proper defence, senior and middle management need to actively buy in to the principle behind the new rules, setting the right tone and being consistently supportive. Other requirements include carrying out due diligence; communicating and training throughout the organisation; and monitoring and reviewing your procedures regularly.

Above all, remember it is important this is done properly and is maintained. In any future HMRC investigation, they will not be asking what your defence measures are today; they will be asking about several years ago. That's why you will need a documented trail of a plan and project which was followed through – and even improved over time.

And if HMRC does come calling, there's unlikely to be any prior warning. You will suddenly be in the midst of a criminal investigation and will need to account for the steps you took perhaps years before. There will be no chance to remediate.

If that sounds scary, well, it should. But if you mount a proper defence you have nothing to fear. There's no time to lose: start planning now.

Relevance in an M&A context – proportionate policies and procedures

Having completed an initial risk assessment as part of the wider deal, the next step would be to implement procedures in your portfolio companies designed to deal with those risks. These may initially form a written policy for the business, setting out:

(i) A zero tolerance approach to tax evasion;

(ii) A summary of possible offences including examples of how the offences could be triggered in the business' ordinary course of trading, this will be specific to each portfolio company;

(iii) A summary of the additional controls put in place by the business to deal with these risks (e.g. enhanced contractual terms and requirements or perhaps even additional layers of sign-off);

(iv) A summary of the how the portfolio company will enforce and monitor its compliance with these procedures; and

(v) Details of the options available to people and what should they do if they have any concerns.

Best practise would be to review the policies and procedures on an annual basis at least to ensure that employees are kept aware and to ensure that compliance is adhered to.

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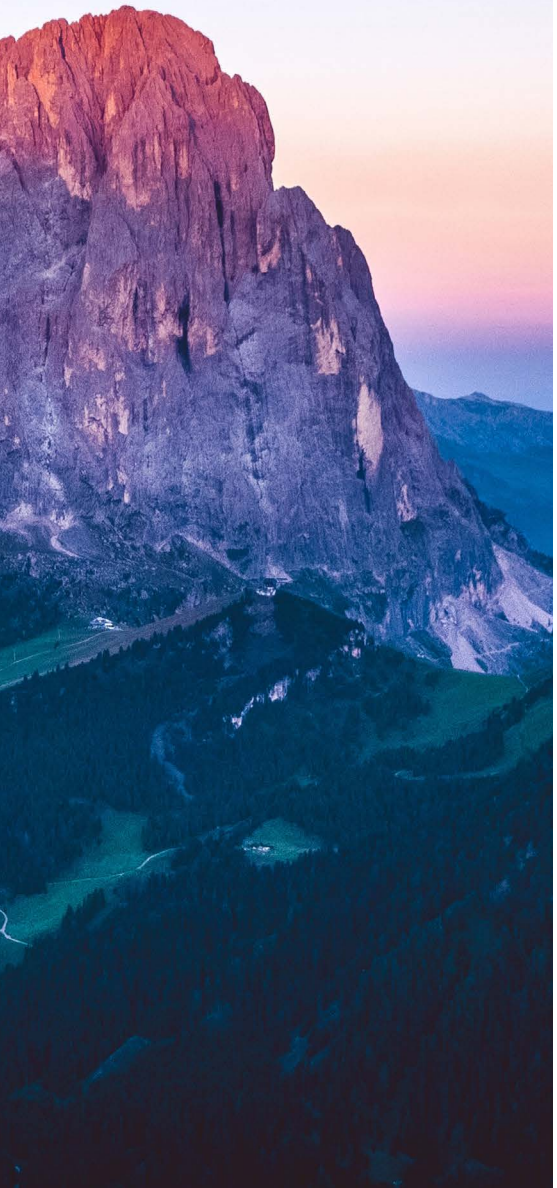

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