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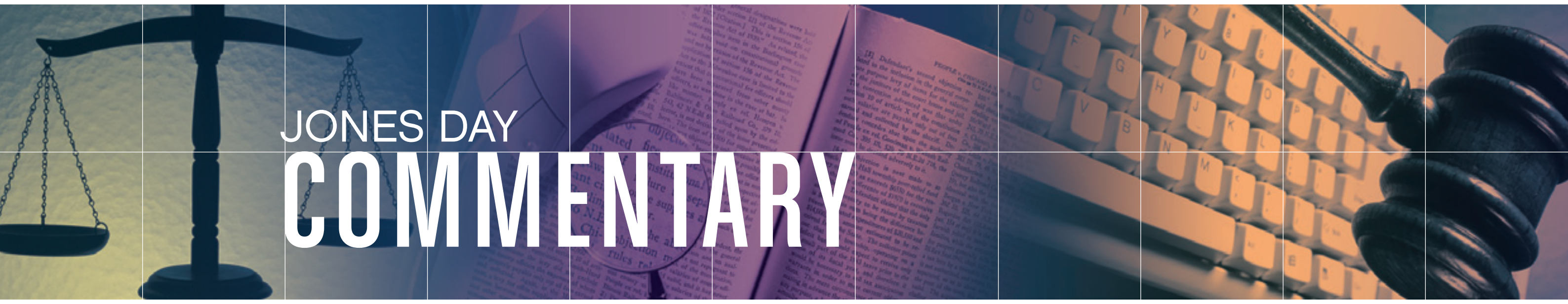

IMMEDIATE CLAMPDOWN ON DEBT BUY-BACKS

The Government have announced in a Written Ministerial Statement that changes will be made in next year's Finance Bill, with effect from 14 October 2009, to amend the UK tax rules applying where existing debt is purchased at a discount by a company connected to the debtor.

BACKGROUND AND CURRENT LAW

In the present economic conditions, many banks and other businesses have issued debt that is trading at a discount to the amount borrowed. Given the uncertainty and volatility in the financial markets, many banks and other businesses are seeking to buy back their debt.

Under existing legislation, if debt is purchased at a discount by either the debtor or a company connected with the debtor, the debtor will generally be taxed on the amount of the discount. However, there is an exception to this general rule which provides that the debtor will not be subject to tax on the discount where the purchaser of the debt acquires it in an arm's length transaction, and the purchasing company was not connected with the debtor at any time during the three-year period ending 12 months before the purchase. Therefore, provided the acquisition was at arm's length and debtor and purchaser were not connected prior to one year before the acquisition, no tax charge would arise on acquisition of the debt or on subsequent release.

The purpose of the one-year arm's length window was to facilitate corporate rescues. The Government is concerned that this exception is too widely drafted, and that the provision enables groups to avoid a tax charge on the discount on any debt buy-back simply by purchasing the debt into a newly established company which will not have been connected with the debtor during the relevant three-year period. The setting up of a connected company to acquire debt, whilst within the letter of the law, was not considered by HMRC or the Treasury to be within the spirit of it—hence the announcement about the proposed change of law. This amendment is to ensure that the exception is only available in relation to genuine corporate rescues.

PROPOSED CHANGES

The new rules will be introduced in the Finance Bill 2010 and apply retrospectively from 14 October 2009. It is proposed that, instead of the condition requiring that the purchasing company not be connected with the debtor for a prescribed period, the following three new conditions will be introduced to limit the availability of the exception:

1) there must be a change in the ownership of the debtor in the period of 12 months before the debt purchase;
2) the debt purchase must have been intrinsic to the change of ownership; and
3) before the change of ownership, the debtor must have been suffering from severe financial problems.

The Ministerial Statement also provides that, even if a connected company successfully purchases the debt without a tax charge arising on the discount, a subsequent cancellation of the debt would still be taxable (meaning that the new rules will defer the tax charge only until the debt is ultimately cancelled).

IMPLICATIONS

At this stage no further details, nor any draft legislation, is available. Until any new legislation is passed there will be considerable uncertainty going forward. In particular, no guidance has been published outlining when or how a debt purchase may be "intrinsic" to the change of ownership, or in relation to when a debtor will be regarded as suffering severe financial problems.

However, what is clear is that setting up a connected company to acquire debt is unlikely to work from a tax perspective, as from 14 October 2009. Groups considering a debt buy-back should monitor developments in this area closely.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact us" form, which can be found at www.jonesday.com

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