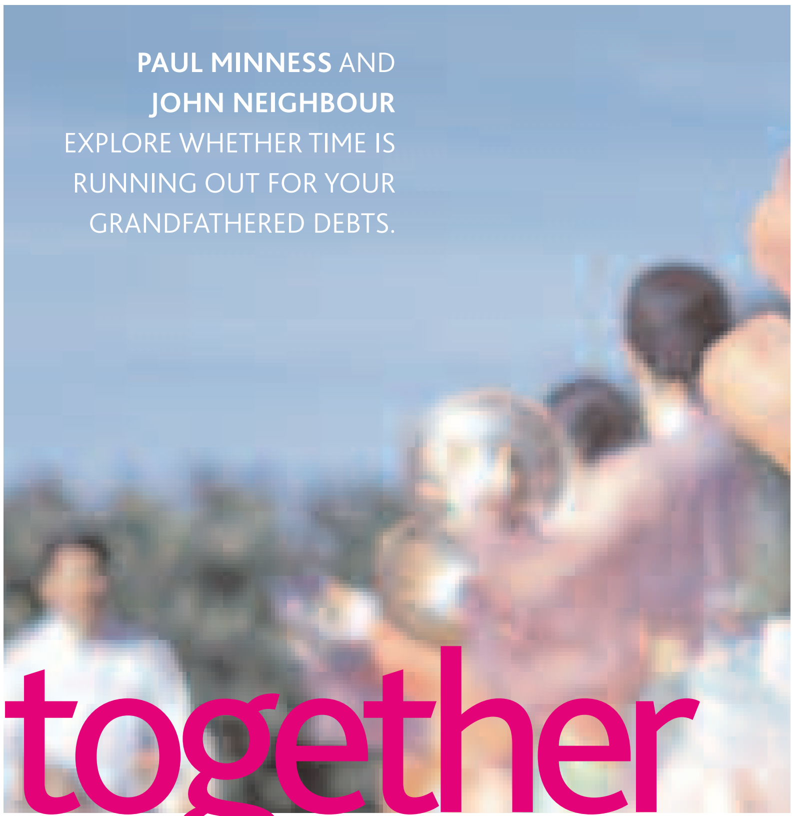


**PAUL MINNESS** AND **JOHN NEIGHBOUR** EXPLORE WHETHER TIME IS RUNNING OUT FOR YOUR GRANDFATHERED DEBTS.

## Executive summary

- Private equity or venture capital-backed investments initially fell outside UK-to-UK domestic transfer pricing legislation introduced in 2004. The government has now reversed this anomaly, and next year sees the end of the grandfathering period. While this does not appear to have slowed the flow of private equity deals, companies – especially those that are highly leveraged – need to consider how the rules will affect their tax deductions.

# Acting together

The introduction of the UK-to-UK domestic transfer pricing legislation in 2004 required many companies to consider the financing that they received from their shareholders and investors. The impact of this is that, where funds are advanced to a subsidiary from a parent company or a company under common control, the terms of the financing must be on an arm's-length basis.

However, the requirement for control meant that a number of investments backed by private equity or venture capital fell outside the initial legislation. This was because of the diverse ownership structure of the investment funds and the way in which they often used a number of different partnerships to make the investment. Given this, borrowing subsidiaries in such situations continued to claim tax deductions for all of their interest, effectively ignoring the arm's-length principle.

In February 2005, Her Majesty's Revenue & Customs (HMRC) decided to review this apparent anomaly. The ensuing Finance Act (No2) 2005 enabled it to challenge, through the application of the transfer pricing rules, the deductibility of interest on highly leveraged companies, potentially wiping out millions of pounds' worth of tax deductions overnight.

While the new rules have had an immediate impact on the way that new deals are valued and structured, they were not applied to existing shareholder debt.

Financing arrangements that were in place before 31 March 2005 have been "grandfathered" (in other words, left outside the rules) until the earlier of either 1 April 2007 or when the terms of the debt are changed.

As the end of the grandfathering period approaches, it is essential for companies to consider how the rules are likely to affect their tax deductions going forwards and the effect that this will have on their profit, cashflow forecasts and value on exit.

**HOW DO THE RULES OPERATE?** In order to remove the perceived anomaly excluding private equity and venture capital investments from the transfer pricing rules, HMRC widened the scope of the control requirement as it applied to finance. Now, rather than applying only to loans advanced from companies where there is a clear control situation, the new legislation operates in situations where parties "act together" to provide financing arrangements (see *Figure 1*).

The diagram represents a simplified structure that is common in leveraged acquisitions. There is a holding company into which various investment funds and management subscribe for share capital, and a set of tiered holding companies that allows debt to be introduced in a structured, subordinated way.

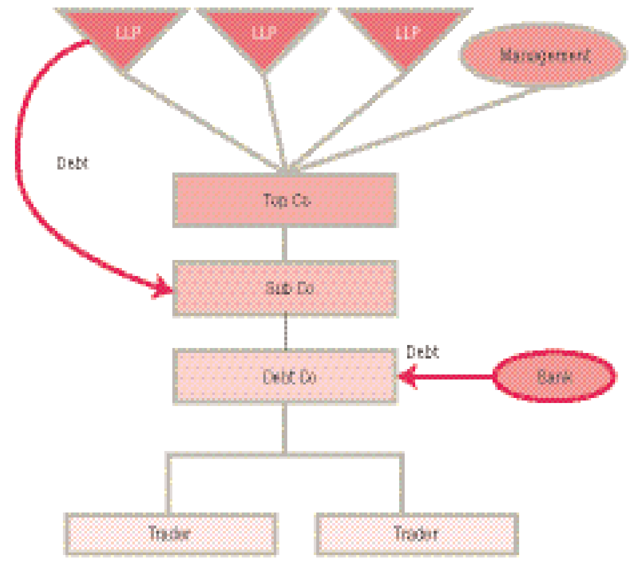
In the majority of structures of this type, the historic view has always been that the nature of the investment funds, which are usually partnerships, meant that no single person controlled the investment. As such, any debt provided by the investment funds was automatically deemed to be arm's length and all interest relating to it was treated as allowable for tax purposes.

The new legislation alters the control rules. Now, investors are deemed to be indirectly participating in the control or management of a company if they have acted together with other people in relation to providing financing arrangements.

Since all leveraged transactions will involve an investment agreement, the practical implications of these rules are that the investors will always be treated as connected to the borrower, and the legislation will catch all finance provided by them.

It is important to note that if an investor is deemed to be connected in this way, the transfer pricing rules will apply only to the financing arrangements. If control arises only under the new legislation, then the transfer pricing rules will not apply for other, non-financial transactions.

**Figure 1.** Parties acting together




Source: KPMG LLP (UK) 2006

When the rules were first enacted, there was some concern from industry bodies that it could also be applied to certain loans that have always been considered as third-party debt (for example, the senior bank debt in *Figure 1*). The structures that raised particular issues were where the bank also had a shareholding in the borrower through its investment arm, or the bank debt provided equity warrants that converted into shares on a triggering event.

Fortunately, HMRC issued guidance[1] on this issue. While reserving the right to review transactions on the basis of individual circumstances, it is generally prepared to accept bank loans as being third-party debt, providing that the amount of any equity interest is disproportionately small when compared to the lending risk being assumed. To ensure certainty, however, many banks that use these sorts of structures have applied to HMRC for clearance that the new legislation will not apply to their senior debt.

If a loan is caught by the "acting together" rules, the usual transfer pricing principles apply. To obtain a tax deduction for the interest payable on a loan, a borrower must be able to show that the loan would have been advanced on similar terms by an independent lender. To the extent that the loan would not have been provided, or the interest rate is too high, the excessive portion of the interest will not be allowed as tax-deductible.

**WHAT HAPPENS ON 1 APRIL 2007?** The end of the grandfathering period will leave non-March year-end companies with a split accounting period for their loans (see *Figure 2*). The period up to 31 March 2007 will assume that the debt is unconnected and all the related interest charge will be allowed for tax purposes. For periods from 1 April 2007 onwards, only an arm's-length amount will be allowable. The impact of this is that companies will have to undertake some transfer pricing analysis to assess what they could have borrowed from other sources on an arm's-length basis.

**WHAT SUPPORTING EVIDENCE IS AVAILABLE?** Historically, many companies would have spoken to their main banker and asked them to confirm that they would have provided further finance if required. However, unless a bank's confirmation is in the form of a credit-committee approved offer, HMRC is unlikely to be convinced of its value as evidence.

One option for a company is to do nothing and to continue to claim an interest deduction as under the old legislation. Potentially, though, this could prove a very costly decision as it is well known that HMRC is intending to review all private equity debts. If it is found that a deduction is being claimed when the debt is clearly not arm's length, then penalties of up to 100% of the tax lost could be levied.

The next option companies should consider is some financial and business analysis to support the level of debt. The widely held belief among tax professionals and companies alike is that HMRC will consider loans to be arm's length providing that the gearing ratio is no greater than 1:1 and the interest cover is no worse than three times.

It should be noted, however, that these were never 'safe-harbour' ratios. They have never been enshrined in legislation and Tax Bulletin 17, in which they were first set out by HMRC as a guide to circumstances where companies would not generally be regarded as thinly capitalised, has now been withdrawn. That said, any private equity-backed company able to meet such covenant requirements is likely to be able to argue successfully that its interest payments are fully deductible.

However, many companies with grandfathered debt will not meet these ratios. It is not uncommon for lenders in private equity situations to lend on different terms than they use for established businesses. The gearing ratio often takes less prominence in the financial covenants, with greater focus being given to cashflows, income cover and total debt to earnings ratios.

IF IT IS FOUND THAT A DEDUCTION IS BEING CLAIMED WHEN THE DEBT IS CLEARLY NOT ARM'S LENGTH, THEN PENALTIES OF UP TO 100% OF THE TAX LOST COULD BE LEVIED.

One of the impacts of this different approach is that the greater risk perceived in many private equity situations is reflected by a higher interest rate. Borrowers should focus on these same issues when assessing what level of debt would be available.

In completing the borrowing analysis, it is important to use both the quantitative and qualitative information that would have been available to a third-party lender at the time the loan was first advanced. The reason for this is that the analysis is attempting to recreate that original decision-making process. Hindsight, whether it has a positive or negative impact on the overall position cannot be used either to justify or challenge the terms of a loan.

However, this does not mean that the period since the loan was advanced should be ignored completely, since it is important to understand whether the debt would have continued to remain in existence in a third-party situation. For example, if a borrower has consistently failed to meet its covenant agreements, would the loan have been called in or renegotiated by a third-party bank?

It is important to remember that the ratios form only part of the story. The specific circumstances of the company and the industry must also be considered. For example, it is likely that a third-party lender will be prepared to lend more to an established company that has secure contracts from recognised customers, than to a new start-up in a sector perceived as greater risk.

Once the analysis has been undertaken, borrowers will face a choice. The financial position may be so strong that no further work is required to support the interest deduction. Alternatively, they may decide that further evidence is needed to support the position. This evidence may be in the form of a credit assessment of the borrower or a search for comparable loans, advanced to companies in similar positions. In extreme situations, it may be that on reviewing the debt, the conclusion reached is that not all of the interest deductions are supportable and that the best way forward is to restructure the financing arrangements, a process that is seldom quick and straightforward.

A further option for the borrower is to apply to HMRC for a ruling under the COP10 procedure. This will result in HMRC reviewing the loan and providing an opinion as to the level of interest deduction available. Such certainty may well be desirable for the borrower, especially if it is in the process of moving towards an exit such as a secondary buy-out.

**NO AUTOMATIC DEDUCTION** It could be argued that the introduction of this legislation has resulted in an unfair position for venture capital and private equity-backed companies, since they can no longer automatically enjoy tax deductions for their interest payments. However, the introduction of the rules does not appear to have slowed investment in the private equity market. Furthermore, an alternative argument, certainly put forward by HMRC, is that private equity investments are now on the same level playing field as subsidiaries of foreign entities, many of which have had to deal with thin capitalisation rules for many years.

Whatever view is taken as to the appropriateness of the rules, the fact remains that they will affect all investor debt from 1 April 2007 at the latest. Therefore, whichever approach and level of analysis companies choose to take to justify the arm's-length nature of their debts and preserve their interest deductions, it is important that they start to consider their position now rather than in March 2007.

1. *Clause 40 & Schedule 8 FB 2005: Draft Guidance on Risk Assessment*, HMRC, August 2005.

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**Figure 2.** Split accounting periods