Practice guide

Debt releases between companies with common shareholders

Speed read

The current trading environment is causing many companies to consider releasing wholly or partly recoverable inter-company debts. When considering such debt releases, the corporation tax consequences are often considered first. What is sometimes overlooked is the fact that a debt between companies with common shareholders is usually a distribution to the shareholder; and it is this fact that may deter directors from proceeding with such debt releases. For such debts to be lawfully waived, reserves at least equal to the net book value of the debt are required, but it is the market value of the debt released upon which the shareholder's tax is calculated. Releasing an irrecoverable loan may therefore mathematically not be taxable, as it has no or little value.

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The release of a debt between companies with common shareholders is usually a distribution to the shareholder, unless the loan is to a subsidiary. That is an oft-overlooked fact when advising on a release of debt by a corporate to another corporate.

Most clients and advisers seem to be happy that if a loan to a shareholder is released, that would constitute a distribution but, for some reason, many do not recognise that the same is usually true for loans to a related company with common shareholders, and many will push back when the matter is raised.

Historically, this is not usually an issue, either because (a) the companies are within the same group (so the distribution to the corporate parent is exempt to tax) or (b) the loan is irrecoverable (so the value of the loan is nil or negligible), and in each case the lending company in fact had sufficient profits available at the relevant time. However, the current trading environment is causing many companies to rethink their strategies, and many are looking at the release of wholly or partly recoverable inter-company debts outside of a group at a time when they may be less likely to have available profits. This article specifically considers such loans.

The legal position

There are three key questions in this scenario from a legal perspective:

1. What is a distribution and why does it matter?
2. Can a waiver of a loan be a distribution?
3. Can a waiver of a loan between companies with common shareholder(s) be a distribution?

1. What is a distribution and why does it matter?

What is a distribution?

A distribution is a return of value by a company to its shareholder(s); it involves the relevant company making a disposition of its assets to, or for the benefit of, its shareholder(s). There is no clear statutory definition of a 'distribution' (Companies Act 2006 s 829 refers to distributions of every description). All dividends (being a payment to a member of its share in the company's profits) are distributions, but distribution has a far broader meaning than just dividends.

Whether a given transaction is a distribution is a question of substance and not form. Not every transfer of an asset to or for the benefit of a shareholder is a distribution (for example, where genuine market value consideration is received).

Further, whether a transaction is a distribution must be determined at the time of the transaction. If the consideration received is later determined to be worth less than the value of the asset disposed of, that does not necessarily mean the transaction was a distribution if the relevant parties acted in good faith and genuinely believed that it was conducted at market value.

Why does it matter?

It matters because of the consequences if the relevant transaction is an unlawful distribution (i.e. it breaches the relevant legal rules).

The rules

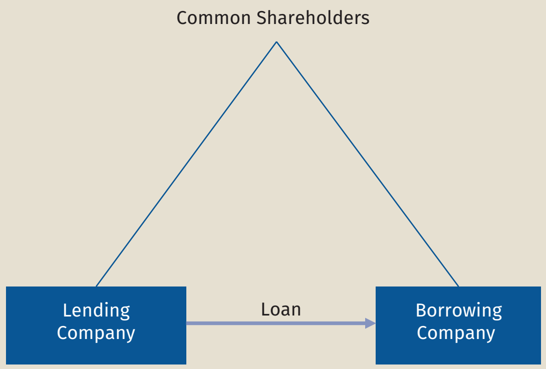
In brief, and ignoring specific exceptions, distributions must be made out of profits available for the purpose, and capital cannot be returned to shareholders other than in very limited circumstances.

The 'maintenance of capital' rule provides that, in return for limited liability, shareholders accept that capital can only be returned to them in limited circumstances. Together with the rule that no distributions should be made by a company unless out of its profits, these form the common law rules on distributions, which have been supplemented by additional rules set out in statute, now contained within Part 23 (distributions) of the Companies Act 2006.

The common law and statutory rules are different, but broadly, if a transaction is a distribution under the statutory rules it will also be a distribution under the common law rules. However, one key difference in practice is that under statute whether a distribution can be made is determined by reference to 'relevant accounts' as at the date of those accounts, and under the common law rules it is the position of the company at the time of the distribution that is assessed; that is why directors must always consider the position of the company since the date of the 'relevant accounts' when making a distribution.

We note that 'relevant accounts' are typically the last statutory accounts that have been prepared and (subject to

Example scenario



any exemption) audited or, if the distribution would not be lawful under those accounts, interim accounts prepared for the purpose (which needn't be audited, but must allow a reasonable judgement to be made of the company's profits, losses, assets, liabilities, provisions, share capital and reserves). Relevant accounts must always be individual accounts for the relevant company, and not consolidated accounts.

Breaking the rules

Transactions that constitute distributions and are not made in accordance with the common law and statutory rules are unlawful. Unlike some other failures to follow procedure for companies, these rules are for the protection of creditors, and cannot be waived by the shareholder(s).

A transaction constituting an unlawful distribution is an *ultra vires* act, meaning that it is outside of the powers of the company. The shareholders and directors involved may be found liable to repay the relevant amount to the company and, in addition, the directors may be in breach of their duties through having authorised or permitted the transaction. Where the company is solvent, there are ways to remedy the situation, but this is more difficult where, for example, there are no available profits, or a liquidator is involved; a liquidator will focus on the interests of creditors, and may seek recovery from the shareholders or directors.

Directors involved in such transactions must remember that whilst there may be benefits to the relevant company in being part of a healthy and successful group which can rightly be taken into account, they must exercise their powers in the best interests of the relevant company, rather than for the benefit of other members of the group or connected companies. It is also worth noting that auditors may be held liable where the reason for the distribution being unlawful relates to accounts not properly prepared as a result of their negligence or breach of duty.

2. Can a waiver of a loan be a distribution?

Let us first ignore the complication of common shareholders and look at a simpler situation where a company has made a loan directly to its shareholder(s).

A waiver of a loan to a shareholder, where the lender does not receive sufficient consideration for doing so, will be a distribution to the shareholder; effectively, it is the disposition of the debt to the shareholder. Assuming no consideration is received, the amount of the distribution would be the amount of the debt as stated in the accounts (after any provision made against it; the making of any such provision has already reduced profits by the amount of the provision).

However, note that it is the market value, and not book value, of the debt upon which tax is calculated (see below). As the loan will be an ascertained (or ascertainable) amount, it is a liability for a liquidated sum, and the detailed legal rules that apply to distributions in kind will not apply (and are not considered further in this article).

To the extent that the lender does not have sufficient available profits to make such a distribution, it will be unlawful. This means that the sum released is liable to be repaid, and so in effect the debt remains recoverable.

It is sometimes thought that the entry into an intra-group loan arrangement might of itself be a distribution at the point the loan is entered into. However, provided the loan is repayable on demand, there will be no disposition of assets (as the lender can request the money back whenever needed) unless there is in fact no intention the loan would ever be repaid or (i) it is objectively likely that the borrower will not be able to repay the loan when demanded, and (ii) the lender did not receive appropriate value for any such risk of not being repaid (see *Notes on intra-group guarantees and intra-group loans* (Law Society of England and Wales and the Company Law and Financial Law Committees of the City of London Law Society), 5 June 2018, at bit.ly/3nXQDjq). That analysis is true, notwithstanding whether interest is charged (or is charged at less than market rate), though it is noted that under FRS 102 the accounting treatment can create a different impression.

3. Can a waiver of a loan between companies with common shareholder(s) be a distribution?

We have established that a waiver of a loan to a shareholder can be a distribution. If, as in our scenario, the borrower is not itself a shareholder of the lender, but is instead another company with common shareholders, can it still be a distribution?

In short, with the same assumptions as noted above, it is still a distribution. The rules apply to both direct and indirect distributions to shareholders, and a distribution to another company with the same shareholders can be treated as a distribution for the benefit of those shareholders. The question is whether a distribution is, in substance, made to the shareholder(s). A transaction constituting a distribution between sister companies with common shareholder(s) is likely to be treated as a distribution to the relevant shareholder(s). However, it is fact-specific, and a transaction with another company in which not all shareholders are common and the shareholders of the transferring company only have a small (and not controlling) interest might not be treated as a distribution – although such a transaction may still constitute a breach of duty for the directors if not in the best interests of its shareholders as a whole.

Note that where there are a number of companies in a chain of ownership between the company making the distribution (in our case the lender) and shareholder(s), the position of each such company should be considered. For example, if we were to add a holding company between the shareholders and lending company in our scenario, and that holding company is participating in the making of the distribution, it may also be treated as having made a distribution. We would then need to consider, amongst other matters, whether it has sufficient profits available for the purpose to make the distribution.

The tax position

For UK-resident companies, the definition of distribution for both corporation tax and shareholder income tax is CTA

2010 Part 23. Specifically, CTA 2010 s 1000 includes eight cases of distributions, of which the first two are of most relevance here:

A. 'Any dividend paid by the company, including a capital dividend.
B. Any other distribution out of assets of the company in respect of shares in the company, except however much, if any, of the distribution–
   (a) represents repayment of capital on the shares, or
   (b) is (when it is made) equal in amount or value to any new consideration received by the company for the distribution.'

Let us break down case B, as it might apply to the release of inter-company debt between companies with common shareholders:

- 'Any other distribution': although in this context 'distribution' must take its ordinary meaning, where the loan release is a distribution in law we would expect it to fall within this definition.
- 'Out of assets of the company': the value of the debt asset is certainly leaving the company.
- 'In respect of shares in the company': a release of a debt which is fully recoverable without adequate consideration being received is not a commercial transaction for the company, and would not be carried out other than for the fact that the borrower is a company owned by the shareholders. So, on the basis the purpose of the release is to benefit the shareholders, or rather another company owned by the shareholders, it is difficult to say that it is not in respect of the shares.
- Exceptions: neither exception would usually apply on a loan release, except perhaps if it was structured as a debt for equity swap, or adequate consideration was otherwise received.

CTA 2010 Part 23 does include additional provisions that can bring other transactions within the definition of 'distribution' for tax purposes (for example, capital repayments following a bonus issue (s 1026)), or remove them from the definition (for example, statutory demergers (s 1076 and s 1077) and purchase of own shares (s 1033). However, no such provisions exist in respect of loan releases, so if the release is considered a distribution in law, we would expect it also to be a distribution for tax purposes.

Common corporate shareholders

CTA 2009 Part 9A exempts 'any dividend or other distribution' from a UK-resident company, providing that is not made as part of a tax advantage scheme. The definition of 'distribution' is cross-referenced to CTA 2010 Part 23 described above. Consequently, we would usually expect that a common corporate shareholder would not be taxed on such a distribution.

However, if the lender is non-resident, that exemption will depend on the detailed conditions of Part 9A.

As we note above, if the lender is a member of a group, there may be a series of distributions through the group until 'received' (indirectly) by the shareholders who are common with the borrowing company or group. Intermediary companies may therefore need to consider Part 9A in addition to the question of having sufficient reserves.

Common individual shareholders

ITTOIA 2005 s 382 imposes an income tax charge, at the dividend rates, on 'dividends and other distributions of UK resident companies.' Again, the definition of 'distribution' is cross-referenced to CTA 2010 Part 23 described above. Consequently, we would usually expect that a common shareholder would be taxed on a distribution arising from an inter-company loan being released.

However, ITTOIA 2005 s 402 applies income tax only to 'dividends of a non-UK resident company,' which by excluding other types of distributions is a narrower definition. Therefore, for a lending company registered overseas, it would be necessary to consider whether under the equivalent of the Companies Act for the country of registration the release of the loan might constitute a dividend rather than any other type of distribution (as noted above, under English law a dividend is a distribution and is essentially a payment of the member's share of the company's profits).

Non-resident shareholders may, of course, not be taxed on the distribution, due to the limitation of income tax provisions where, for the cost of losing their personal allowance, tax on dividend income is restricted to the amount withheld at source, which in the UK is currently zero.

Value of distribution

It is the market value of the debt released upon which the shareholder's tax is calculated. Releasing an irrecoverable loan may therefore mathematically not be taxable, as it has no or little value. To reiterate: the tax is calculated with reference to the market value of the loan, but the quantum of reserves required to make a lawful distribution is the net book value of the loan asset in the lender's accounts, which may be different.

In our experience, the single factor that will stop directors in their tracks from considering such a release is the potential shareholder tax – which is why, when asked, you may want to lead with that

Other tax issues to consider

For completeness, we note that there are many and diverse tax issues that can arise from a loan release, which include the following:

- For corporation tax purposes, the connected company provisions for loan relationships may mean that P&L debits and credits for the respective companies are essentially ignored. If these do not apply, then relief for the lender may be denied under the unallowable purpose rules, and the income credit for the borrower may not be chargeable under the corporate recovery exemptions.
- Otherwise, where the common shareholdings do not exactly mirror, the release of an inter-company loan could create a value shift out of shares held by some shareholders in the lender into shares held by other shareholders of the borrower. Such a value shift could crystallise an employment-related securities charge for employee shareholders receiving value into their shares, and would probably constitute an inheritance tax potentially exempt transfer by any shareholder losing value.

Final thoughts

It is perhaps understandable that when considering the release of loans between companies, we first consider the corporation tax consequences. However, in our experience the single factor that will stop directors in their tracks from considering such a release is the potential shareholder tax – which is why, when asked, you may want to lead with that. ■