Operational and financial resilience – managing tax risk on emerging from COVID-19

The scale of the impending financial crisis following COVID-19 is not yet known, or in the words of the Chancellor, "Our economic emergency has only just begun."

Paul Pritchard
Managing Director, Corporate Finance and Restructuring, , FTI Consulting

Paul Pritchard has over twenty years of experience practicing in UK and international tax matters. Over the last ten years he has provided tax advice to both lenders and borrowers, advising on large and complex debt restructurings.

Over 6 in 10
G20 companies are facing challenges servicing their debt requirements since the start of the pandemic

Given unsustainable corporate debt in the UK alone is estimated to exceed £100bn, many corporates will need to be resilient to survive. This may be achieved through operational or financial restructuring.

Financial restructuring may involve debt releases, equity injections and changes to terms of borrowing. These can have unexpected tax consequences for the unwary. Tax payment deferrals, such as VAT, may aid tighter cash flow management.

Operational risks present before the pandemic have been amplified. Now COVID-19 has added complexities of its own to the picture. These include disturbances to the supply chain and general operational disruption stemming from social distancing and hygiene measures – not least the move to mass working from home, all of which have tax consequences.

Whilst issues like supply chain disruption are global, others are more acutely felt in certain jurisdictions. FTI Consulting's latest *Resilience Barometer* survey found that 25% of UK firms believe their financial arrangements are ineffective or non-compliant, compared to just 15% for the G20 as a whole.

Tax directors will seek to ensure that tax is a key consideration in planning as businesses emerge from COVID-19. Many businesses are undertaking contingency planning and tax directors will want to ensure tax is a key factor reflected in such preparations.

The upshot of financial and operational pressures is a looming cloud of unsustainable corporate debt – over 60% of G20 companies report that they have been unable to service their debts during the pandemic.

Over 70%
of businesses are undertaking contingency planning in anticipation of a prolonged downside as a result of COVID-19.

Businesses may seek to execute a combination of strategies to manage the impact of the pandemic. The tax cost associated with these strategies will be an important factor in achieving balance sheet resilience. Specific reliefs and exemptions exist for UK corporates to assist with some options. Tax directors and key stakeholders, particularly creditors, will seek certainty that unexpected tax liabilities are not crystallised as unsustainable debt is restructured.

- Whilst debt releases are normally taxable for a UK corporate debtor, releases which form part of a wider rescue may be exempt. The corporate rescue exemption applies where there is a material risk that the debtor will be unable to pay its debts in the next 12 months but for the release.
- Creditors may be willing to agree to a debt-for-equity swap. Whilst such releases may be exempt, additional structuring and tax risk mitigation may be necessary to provide the creditors with equity in the parent company. The dilution of ownership may cause taxable de-grouping events.
- Where debtors obtain revised borrowing terms, the modification accounting may trigger a taxable profit. A corporate rescue relief is available to exempt substantial modifications so advance discussions with auditors is needed here. Debt covenants should also be checked.

78% of G20 firms believe their business models must fundamentally change as a result of the pandemic.

After navigating the tax risks associated with actual releases or changing the debt terms, further care is needed to ensure no inadvertent deemed release is triggered. Whilst deemed releases can be cancelled in a corporate rescue, this requires awareness when one has been triggered so mitigating action can be taken within 60 days.

Supply chain and operating models may have been revised to manage costs whilst further rationalisation of business units may occur through carve outs and asset disposals.

Changes to supply chains or operating models may affect the allocation of profits in territories involved in the chain. The transfer prices of those arrangements will need to be aligned to the new way of operating and be supported with new documentation.

Further changes to the conduct of activities may put at risk the future availability of tax losses. A debt-for-equity swap may result in a change in ownership so care in preserving existing tax losses may be required. Lenders may expect tax losses are available (subject to offset of 50% of future profits) post restructuring when reviewing future cashflows.

Rationalisation through carving out business units, whether assets or shares, is possible on a tax neutral basis. Relief from de-grouping events on capital gains assets and intangibles may be available where there is a pre-sale hive down followed by an exempt share disposal. However, care is needed with loans and derivatives.

As businesses emerge from COVID-19 in 2021 and increase their balance sheet resilience, changes to operational and financial restructuring present a range of tax risks and opportunities. Stakeholders, including creditors and company directors, should ensure tax risks and opportunities are identified and their impacts evaluated. Steps to mitigate such risks through claiming exemptions and maximising reliefs are taken in a timely manner otherwise unexpected tax liabilities may arise, or opportunities are missed.

Data from the FTI Resilience Barometer – COVID Edition, November 2020. For more information please visit ftiresiliencebarometer.com.

FTI™ CONSULTING