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Comments by the Association of Business Recovery Professionals (R3) in response to the Consultation paper issued by HM Treasury.

Reforms to corporation tax loss relief: consultation on delivery

R3 is the leading professional association for insolvency practitioners (IPs) in the UK, promoting best practice for professionals working with financially troubled individuals and businesses, promoting the work to Government and key policy makers, producing guides for insolvency professionals and members of the public, running courses and conferences to promote learning and best practice within the insolvency profession. Our members (approximately 3,000) work in firms of all sizes, from the global legal and accountancy firms through to smaller local firms and sole practices, and include insolvency lawyers and other professionals working in the insolvency and restructuring professions. Our members cover the whole spectrum of work with financially distressed businesses and individuals including advice, rescue and turnaround, and formal Insolvency Act 1986 appointments.

The response does not seek to comment on the complete consultation document and is restricted to issues affecting insolvency and distressed restructuring. R3 has been helped in the collation of this document by a sub-committee of restructuring tax practitioners who are from each of the Big 4 accountancy firms, Grant Thornton, Mazars, Smith & Williamson and specialist tax counsel. We recognise that this is a specialised area. R3, and the specialist tax committee that works with us, would be happy to answer any further queries you may have or to provide technical or practical aid and advice in matters affecting insolvent and rescue situations.

It is important to note that common features of distressed companies are volatile trading results, normally within a relatively short concentrated period, poor quality of information, a changing management team and a generally unstable business environment.

Chapter 3 – Detailed Proposal

R3 broadly welcomes the flexibility that underlies the government's proposals for the use of corporation tax losses.

However, R3 has a number of concerns as to how the proposed regime might impact stressed or distressed companies or ones that have entered a formal insolvency process:

- It is not uncommon for companies in distress or insolvency to have a significant pool of losses in consequence of declining performance over a period of time. The ability to access these losses is often fundamental to either ensuring a business survives or to maximise returns to a company's existing creditors. Conversely, it is entirely possible that an inability to offset losses may push a distressed company into insolvency if this would result in a cash tax charge (as in many instances creditors, who are effectively funding a business in these situations, are likely to be unwilling to make further material cash injections).
- In insolvency, an inability to access the tax losses that would be available to a company in a similar situation today would result in HMRC effectively being given a preferential status. Any tax liability arising during an insolvency ranks as an expense and therefore would be due to be settled before the liabilities owed to unsecured creditors.
- Nor is it uncommon for companies in insolvency processes to have an uneven distribution of income and losses. Good examples might include:
  - insurance business run-offs where an insolvency practitioner ("IP") is required to fair-value potential contingent insurance liabilities at the outset (often crystallising significant losses) and then annually thereafter reassess that fair value and tax affect any movement. Historically this has often meant no tax is due, but under current proposals would almost certainly result in some corporation tax being due, as the losses brought forward can be set against only half the profits of each later year. Whilst unused losses can still be carried forward to later years, in practice the insolvency may not last that long, or, if it does, significant profits may not arise after the first year and this will therefore represent an absolute cash tax cost rather than merely a timing difference.
  - property development businesses where an IP continues to build out a property scheme on the basis that this represents the best way of maximising returns to creditors, but where costs are inevitably front loaded and income only arises in a final period. We accept that many costs will be treated as work-in-progress from an accounting perspective and therefore not as an expense to the income statement in earlier years, but this is certainly not always true and losses will inevitably accrue in earlier periods that can only be partially offset later.
- Companies in insolvency processes or in distress often generate material one-off items of taxable income or gains because of the very position in which they find themselves. Good examples might include:
  - company voluntary arrangements ("CVAs"), which can crystallise significant one-off credits to the income statement. For instance, CVAs have been used by struggling businesses in the recent past to negotiate rent reductions from landlords, but this often results in a one-off reversal of historic onerous lease provisions which currently, before the proposed changes to loss relief, may have been sheltered in full by carried forward losses. Following the proposed changes, however, regardless of the size of the losses brought forward, only half the profits of the period can be covered by them.
  - the disposal of the trade and assets of a business by an IP, including assets with little or no base cost (for instance, internally generated goodwill). If, to take the example, the sale of goodwill generated a significant capital gain or credit within the intangibles regime (either of which could currently have been sheltered with carried forward losses), neither could be reduced in full in the proposed loss regime by (non-capital) losses brought forward.
- At a practical level, it may be difficult (and/or expensive) for the IP to track whether losses were generated pre- or post-1 April 2017. When a company enters insolvency, it is normally the case that neither accounts nor tax returns have been filed for a number of periods prior to the date of appointment. Under the current regime, it may be possible to agree with HMRC that the quantum of losses in a particular case are such that pre-appointment returns need not now be submitted; it may be clear that the losses that were carried forward in the last filed returns will be more than sufficient to materially shelter any possible income or gains and that, as the intervening periods were also loss making, a practical and simple alternative to filing the missing periods is to assume the last

carried forward figures as those brought forward into the start of the insolvency. Clearly that approach will no longer be adequate given that when the losses arose will determine how they can be applied. The proposed regime will therefore increase the administrative burden on IPs to the detriment of a company's creditors. While this is a transitional issue, it is likely to impact insolvencies for a number of years after 1 April 2017 (definitely effecting appointments in 2018 but also some in 2019 and 2020).

In terms of more general comments on the proposal, there are a few other areas that may impact stressed or distressed companies or those in insolvency:

- The ability to carry back losses of a current period to offset taxable profits in an earlier period is an incredibly useful tool for an IP. R3 welcomes the proposal (in paragraph 3.5) to allow a carry back against any profits of a company but wonder whether this should be at a group level as opposed to a company-by-company opportunity?
- R3 also wonders whether similar flexibility could be introduced for terminal loss relief claims, allowing offset of losses against any profits in the 3 years preceding the final year of trading and whether that could be introduced at a group rather than company level?
- There is as yet little guidance as to how the cut off between pre- and post- 1 April 2017 losses should be approached. Assuming a company does not have a 31 March period end, is it proposed that some form of time apportionment or other "just and reasonable" allocation will apply? Given the absence of detailed financial information available to many IPs following an insolvency appointment, R3 would welcome a simple methodology.

Chapter 5 – Detailed Design Points

There are a number of areas within the detailed design points of the Consultation Document that affect stressed and distressed companies and those in insolvency. In particular, R3 highlights the following:

- The proposed accounting based group definition for the purpose of the £5m allowance will be extremely difficult to apply in insolvency. Insolvent companies rarely produce accounts (still less audited ones) and therefore are rarely consolidated in a set of financial statements. We would therefore welcome a standalone legislative grouping test. Either the group relief definition proposed for the purposes of surrendering carried forward losses (our preference from the point of view of the simplicity of the regime) or a general "control" based definition, may work for these purposes. We note, however, that the presence of an insolvent company within a group structure applying either of these definitions may result in multiple "groups" existing for the purposes of loss surrenders and the £5m allowance.
- R3 notes the intention to enact targeted anti-avoidance rules to accompany the proposed loss relief regime. R3 would welcome detailed guidance to ensure that statutorily available techniques (such as disclaiming capital allowances in earlier periods in order to enhance a deduction in a later period) will not be affected by the proposed TAAR.
- In respect of the change of ownership rules, R3 notes that there are currently two main sets of tests: one for trading losses and another for non-trading losses. R3 believes that taxpayers broadly understand and accept how these operate and would suggest that the system be preserved. However, R3 wonders if there might be an opportunity to simultaneously clarify and improve the test around an "increase in capital" for the purposes of non-trading losses? The definitions are often ambiguous and the £1m "significant increase" hurdle has remained unchanged for 20 years.
- In paragraph 5.28 of the Consultation Document, it states the government intends to legislate such that losses expire when there is no longer a practical likelihood of their being used, "e.g. the company is going into liquidation". While R3 has no issue with expiry of losses *per se*, we strongly disagree with the example used and make the following points:

- The Consultation Document references liquidation. However, it is unclear whether this is intended as a synonym for insolvency (i.e. to include administration, administrative receivership, etc)?
- The very act of "going into" liquidation does not mean (potentially significant) taxable profits and gains are not made after that date; indeed in some cases the liquidation may generate these for many years. Accordingly the fact that a company may be dissolved in due course does not mean that its losses are no longer capable of use. As discussed above, insolvency may result in very material one-off items of income or gain. It is also possible that a company in an insolvency process will be, to all intents and purposes, dormant for many years while an IP searches for a buyer for a particular asset; dormancy is therefore not necessarily an indicator that losses will have no future use either. And while not true for liquidations, the statutory primary purposes of an administration, for instance, is to ensure the survival of the company as a going concern and therefore certainly does not mean that a company will have no use for historic losses.
- In Part 3 of Chapter 15, CTA 2009 the current legislation recognises that income (and expenses) can, for instance, be made (or incurred) post-cessation of trade. We assume there is no intention to amend these sections?
- Indeed R3 wonders whether it may be better to take insolvent companies outside of the proposed changes to the regime (see comments in relation to chapter 6 immediately below).

Chapter 6 – Other considerations

Having recognised the importance of supporting companies in stressed and distressed circumstances and providing a supportive legislative framework for insolvency as part of the overall enterprise and rescue culture of the UK, R3 would ask the government to consider adopting a "corporate rescue exception" to both the proposed £5m allowance and the 50% limitation on the deduction of carried forward losses.

A similar provision has been adopted in the loan relationship tax code at section 322(5B) CTA 2009. It recognised that taxing a credit on the release of a debt, which release was designed to place a company back on a firm financial footing in order to ensure its survival, may well imperil that survival and was therefore not in the public interest. In the same vein, effectively asking creditors to bear a tax cost because of an inability of a distressed company (without cash of its own) to offset losses, may well mean companies are not rescued. R3 therefore asks for a similar exception to the proposed loss relief rules where a company is experiencing financial distress.

In the same vein, we would argue that imposing the proposed loss relief regime on a company in insolvency is likely to impede an IP's efforts to save a business and/or reduce returns for existing creditors (enhancing HMRC's own status, effectively as a preferential creditor).

R3 would welcome the opportunity to discuss how such a corporate rescue exception might operate, but would suggest that the following may be a basis on which it might work:

- Companies in an insolvency process (as defined in s323 CTA 2009) should be outside the proposed rules and instead within the corporation tax losses regime that currently exists for periods where such a process subsists. Note, while IPs would welcome the opportunity afforded by the flexibility of the proposed regime and would ideally prefer access to the proposed group loss sharing regime, we believe that they would be prepared to sacrifice this flexibility in order not to be bound by the 50% loss restriction if such a *quid pro quo* were deemed necessary.
- This approach could be extended to otherwise solvent members of the same corporate group as such insolvent companies where those other members have cross-guaranteed the insolvent companies' debts, which were such guarantees ever to be called would result in those other members of the group being themselves insolvent. In this instance, the exception to the loss regime

would last only so long as those other companies were grouped and were not released from the cross-guarantees.

- The corporate rescue exception in the loan relationship regime encompasses companies that are stressed or distressed and would become insolvent within a period of 12 months but for some form of rescue. R3 accepts that there may be difficulties in applying this test in the context of corporation tax loss relief. However, provided the exception for insolvent companies (as noted in the first bullet point above) was also extended to companies in a statutory insolvency arrangement (as defined in s1319 CTA 2009) for the period in which such an arrangement takes place, most rescues of larger corporate groups (where a £5m allowance would otherwise be insufficient) would be accommodated.