

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2026

MODULE 3.05 – BANKING OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Dear Client

Prairies UK Ltd – corporation tax liability for the year ended 31 December 2026

I have considered the UK corporation tax position on the assumptions provided.

First, the intercompany loan must be considered under the UK transfer-pricing/thin-capitalisation rules. Prairies UK has borrowed US\$1.15 billion, equivalent to £1 billion (US\$1 = £1/1.15). However, the accountants consider that an independent lender would have lent only US\$575 million (£500 million) and would have charged 7%. Accordingly, the arm's-length interest deduction is restricted to:

$$£500m \times 7\% = £35m.$$

The actual 5% interest would be £50m, so £15m is non-arm's-length and disallowed. UK thin-capitalisation applies the arm's-length, stand-alone borrowing test rather than a fixed debt/equity safe harbour.

The acquisition of India Growth Ltd is financed through the loan, but dividends on the preference shares should generally fall within the UK exemption for distributions received by a UK company. Consequently, no taxable income from those dividends is assumed.

The next issue is the Corporate Interest Restriction (CIR). Since net financing costs exceed the £2 million de minimis, the restriction applies. Under the fixed-ratio method, the basic interest allowance is generally 30% of tax-EBITDA, subject to the relevant debt-cap rules.

Assuming the stated £30m represents taxable profits before financing costs and therefore tax-EBITDA for these purposes:

$$30\% \times £30m = £9m.$$

Adding the £2m de minimis gives a maximum deduction of £11m. Thus, although £35m is arm's-length interest, only £11m is deductible in 2026 under CIR. The remaining £24m is subject to the CIR carry-forward mechanism.

Taxable profits are therefore:

$$£30m - £11m = £19m.$$

Prairies UK is subject to the 25% main corporation tax rate because its profits exceed £250,000.

Corporation tax liability: $£19m \times 25\% = £4.75$ million.

Potential grounds for challenge by HMRC

HMRC could dispute the corporation tax calculation on several grounds.

First, HMRC may challenge the arm's-length amount of the Delaware LC loan under the UK transfer-pricing rules. The provisional evidence indicates that an independent lender would have advanced only US\$575 million at 7%. HMRC could therefore argue that interest relief should be restricted to £35 million, rather than the £50 million actually payable.

Second, HMRC may apply the Corporate Interest Restriction (CIR). Even where interest is arm's length, the deductible amount may be restricted by the 30% tax-EBITDA rule (subject to the group ratio and other relevant provisions). Any excess would generally be carried forward rather than immediately deducted.

Third, HMRC could invoke the unallowable-purpose rule if it considers that obtaining a UK tax deduction was a main purpose of the borrowing, particularly given the artificial circular financing structure.

Fourth, the check-the-box election may create a hybrid mismatch issue. Delaware LC and Prairies UK may be treated as disregarded entities for US purposes but as separate companies for UK purposes. HMRC would therefore consider whether the arrangements produce a deduction/non-inclusion or double-deduction outcome under the UK hybrid-mismatch rules.

Finally, HMRC could scrutinise the 5% preference shares issued by India Growth Ltd, including whether the dividends are genuinely distributions qualifying for the UK dividend exemption and whether the arrangement has any anti-avoidance implications.

Counterarguments to potential HMRC challenges

There are several counterarguments available against the challenges identified.

First, although an independent lender may have limited lending to US\$575 million, the transfer-pricing rules require an arm's-length analysis of the actual circumstances. The group may argue that Prairies UK's access to group support, the value of India Growth Ltd and the expected preference dividends provide sufficient commercial substance to justify the borrowing. Alternatively, the 7% rate may be challenged by reference to the actual creditworthiness and security of the wider group.

Second, any Corporate Interest Restriction (CIR) should be applied only after determining the arm's-length deductible interest. Moreover, Prairies UK could consider the group-ratio method, which may provide a greater interest allowance than the 30% fixed ratio where the worldwide group has a high level of external borrowing. The £2 million de minimis also applies before CIR restricts deductions.

Third, the unallowable-purpose rule should not deny interest merely because obtaining a UK tax deduction is an incidental consequence. The borrowing has a clear commercial purpose: financing the acquisition of an established Indian fertiliser business. The subsequent investment in India Growth Ltd and its substantial distributable reserves support the commercial rationale and expected return.

Fourth, in relation to the hybrid-mismatch rules, the US check-the-box elections do not automatically create a UK mismatch. The relevant UK rules require an actual mismatch producing a deduction/non-inclusion or double-deduction outcome. If the interest income is appropriately brought into account in the US tax computation, the necessary mismatch may not arise.

Finally, the preference-share dividends should generally qualify for the UK distribution exemption, provided the statutory exemption conditions are satisfied. Their being preference dividends does not, by itself, make them taxable. The substantial distributable reserves and five-year expected dividend stream provide evidence of a genuine investment return rather than a purely tax-driven arrangement.

Hedging the US dollar liability

Prairies UK has a US\$1.15 billion loan from Delaware LC, while its functional currency is sterling. It is therefore exposed to US\$/£ exchange-rate risk: if the dollar strengthens against sterling, the sterling amount required to repay the loan increases.

The liability could be hedged using a currency swap. Prairies UK could enter into a five-year US\$/£ cross-currency swap under which it effectively exchanges sterling for US dollars at an agreed exchange rate. The company could receive US dollars under the swap to meet the loan interest and principal payments, while making sterling payments to the swap counterparty. This would substantially eliminate the exchange-rate exposure.

Alternatively, Prairies UK could use forward foreign-exchange contracts to lock in the sterling cost of the future US dollar interest and principal payments. Separate forwards could be entered into for each scheduled payment. This provides certainty over the sterling cash flows, although the hedge would need to be regularly renewed or adjusted if repayment dates change.

A further possibility is a US dollar option, giving Prairies UK the right, but not the obligation, to purchase dollars at a predetermined sterling/dollar exchange rate. Options provide protection against an adverse movement while retaining the benefit of favourable movements, but involve an upfront premium.

Given the five-year term and substantial principal, a cross-currency swap is likely to provide the most comprehensive hedge, potentially matching both the US\$ interest and principal payments.

Yours faithfully
Head of Tax

Question 2Part 1

Under **FRS 102**, the accounting treatment depends on whether the cryptocurrency holdings constitute **intangible assets** or **investments held for trading**.

Bitcoin and Ethereum are generally capable of being treated as **intangible assets** because they are identifiable non-monetary assets without physical substance. Finance Guard Corp. does not hold them for trading purposes; indeed, its stated intention is to retain them as part of its long-term reserves. Accordingly, the cryptocurrencies should be accounted for under **FRS 102 Section 18 (Intangible Assets other than Goodwill)** rather than as financial assets.

The key issue is subsequent measurement. Under Section 18, an intangible asset is initially recognised at **cost**. It is subsequently measured at cost less accumulated amortisation and impairment, unless the revaluation model is available and applicable. However, cryptocurrency such as Bitcoin and Ethereum has an **indefinite useful life** where there is no foreseeable limit to the period over which the asset is expected to generate economic benefits. An intangible asset with an indefinite useful life is **not amortised**, but must be reviewed for impairment.

Therefore, the significant increases in market value during 2025 do **not automatically result in recognition of the unrealised gains** in the accounts. If Finance Guard Corp. is applying the normal cost model, the holdings remain recorded at their cost, subject to impairment.

Thus, assuming no impairment:

<u>Cryptocurrency</u>	<u>Cost at 1 January 2025</u>	<u>Amount reported at 31 December 2025</u>
Bitcoin	\$1,000,000	\$1,000,000
Ethereum	\$500,000	\$500,000
Total	\$1,500,000	\$1,500,000

The **\$1.2 million increase in market value** (\$1m Bitcoin + \$0.2m Ethereum) would therefore not be recognised in profit or loss under the cost model. The closing market values of \$2 million and \$700,000 are relevant as evidence when considering impairment, but are not themselves the carrying amounts.

Accordingly, the cryptocurrency holdings should be reported at **\$1.5 million in total**, assuming no impairment and no applicable revaluation.

Part 2

Although Finance Guard Corp. is US-based, the accounting treatment under FRS 102 does not determine the tax treatment. Assuming the question is concerned with UK corporation tax principles, the key issue is whether the cryptocurrency is held as an investment or as trading stock.

Here, the company acquired Bitcoin and Ethereum as part of a long-term reserve strategy and has no intention of selling or trading them. This strongly indicates that the holdings are investments rather than trading assets.

Accordingly, the company should generally be subject to corporation tax on chargeable gains when the cryptocurrency is disposed of. A disposal can include selling the cryptocurrency for dollars, exchanging it for another cryptocurrency, or using it to acquire goods or services. The gain would broadly be calculated by comparing the disposal proceeds with the allowable acquisition cost.

On the facts, the unrealised increases during 2025 are:

Bitcoin:	\$1,000,000
Ethereum:	\$200,000
Total unrealised appreciation:	\$1,200,000

If the company merely continues to hold the cryptocurrency at 31 December 2025, these unrealised gains would not normally give rise to an immediate corporation tax charge under the chargeable-gains regime. Tax generally crystallises on a subsequent disposal.

However, if the cryptocurrency were instead regarded as trading stock, the treatment would differ: profits arising from movements in value could potentially be brought into the corporation-tax computation as trading profits. The company's investment-management business and the substantial amounts involved could therefore be relevant to HMRC's analysis, although the stated long-term investment intention supports capital treatment.

Future tax could also arise from staking, lending or other returns generated from cryptocurrency, if Finance Guard Corp. undertakes such activities; these may produce taxable income rather than capital gains.

Therefore, on the stated facts, the principal potential liability is corporation tax on the \$1.2 million accrued gains when the cryptocurrency is eventually disposed of, rather than an immediate tax charge merely because its market value increased during 2025.

Part 3

The Bitcoin and Ethereum holdings should be regarded as non-trading (investment) assets on the facts given.

The distinction depends primarily on the purpose for which the assets were acquired and are held, considered in light of all the surrounding circumstances. An asset acquired with the intention of being turned over and sold at a profit as part of a trading activity is more likely to be a trading asset. Conversely, an asset acquired as a long-term investment or reserve is generally a capital/non-trading asset.

Here, Finance Guard Corp.'s board decided in 2024 to maintain 25% of its reserves in cryptocurrency. The cryptocurrency was acquired on 1 January 2025 specifically to implement that investment strategy. Most importantly, the company has no plans to sell or trade the Bitcoin or Ethereum. The substantial increase in value during 2025 does not, by itself, turn the assets into trading assets.

The fact that Finance Guard Corp. operates in financial services and investment management should be considered, but it does not override the evidence of the company's actual purpose. The holdings appear to form part of the company's long-term reserve/investment portfolio, rather than its trading stock.

Accordingly, the cryptocurrency should be treated as non-trading assets held as investments. The unrealised appreciation of \$1.2 million at 31 December 2025 therefore does not, merely because of the increase in market value, indicate that the assets are trading assets.

The classification should nevertheless be kept under review: if the company subsequently begins regularly buying and selling cryptocurrency with a view to short-term profits, the tax treatment could change.

Part 4

Under FRS 102, Finance Guard Corp. should provide sufficient disclosures to enable users of the financial statements to understand the nature and financial effect of its cryptocurrency holdings.

First, the accounting policies applied to the Bitcoin and Ethereum should be disclosed, including their classification as intangible assets and the basis of subsequent measurement. The company should explain whether the cost model or revaluation model has been applied and, where relevant, the useful life and amortisation policy.

The financial statements should disclose the carrying amount of the cryptocurrency holdings at the reporting date. On the assumptions given, this would be \$1.5 million under the cost model (\$1 million Bitcoin plus \$500,000 Ethereum), assuming no impairment.

FRS 102 also requires relevant information about significant judgements and estimation uncertainty where these are material. This could include the judgement that the cryptocurrency is held as an investment rather than for trading and the assessment of its useful life and recoverability.

If the holdings are material to the financial statements, additional disclosure may be necessary to explain their nature, significant risks and valuation considerations, particularly given the volatility of cryptocurrency prices.

The company should also consider disclosure of the fair value where required or useful for users, even where fair value is not used as the carrying amount. Thus, the market values at 31 December 2025—\$2 million for Bitcoin and \$700,000 for Ethereum—may provide useful supplementary information, clearly distinguished from the accounting carrying amounts.

Finally, any material subsequent events, such as significant movements in cryptocurrency values after 31 December 2025, should be disclosed where required by FRS 102.

PART B

Question 3

Part 1

For UK tax purposes, an offshore fund is broadly a non-UK resident mutual fund or similar investment vehicle that allows investors to participate in the underlying investments collectively.

The definition is principally contained in the UK offshore funds legislation. A fund will generally fall within the regime where it is constituted by a company or other vehicle that is resident outside the UK, and investors have rights to participate in the underlying assets or returns of the fund.

In this case, the proposed UK Fund is likely to constitute an offshore fund because it will be a Cayman Islands company, with its units offered to investors and its underlying investments managed through Cayman Master Fund. Its non-UK residence is therefore central to its classification.

The fact that the fund is specifically aimed at UK investors does not prevent it being an offshore fund. However, if UK investors are to benefit from the offshore reporting-fund regime, UK Fund must satisfy the relevant statutory conditions and obtain HMRC approval as a reporting fund.

The reporting-fund status is important because it determines how UK investors are taxed on their interests, including taxation of reported income and gains on disposal.

Part 2

The principal distinction is the UK tax treatment of investors on income arising within the offshore fund.

A UK reporting fund is an offshore fund that has successfully applied to HMRC for reporting-fund status and complies with the relevant reporting requirements. It must generally calculate its reportable income and provide investors with information about their share of that income annually, whether or not the income is actually distributed.

UK investors are normally subject to UK tax on their share of the fund's reported income, as well as on any distributions actually received. However, when they dispose of their units, a gain will generally be taxed under the capital gains regime.

By contrast, a non-reporting fund does not have reporting-fund status. UK investors are generally not taxed annually on the fund's undistributed income. However, on disposal of their units, any gain is generally treated as an offshore income gain and taxed as income rather than as a capital gain.

Thus, reporting status can be particularly valuable to UK investors because it can convert the tax treatment of future disposal gains from income tax to capital gains tax, although annual tax may arise on reported but undistributed income.

Part 3

Prosper Co. is resident in South Korea and performs the administration and management of the funds there. On the facts, it should not ordinarily be subject to UK corporation tax merely because UK investors participate in the UK Fund. However, UK tax could arise if Prosper Co. is found to have a UK permanent establishment or carries on a UK trade through a dependent agent.

The 5% annual fees paid to Prosper Co. (3% of investors' holdings) should therefore generally be taxable in South Korea rather than the UK, assuming the services are performed there and no UK taxable presence exists.

Cayman Master Fund is a Cayman Islands company and is stated to be an exempt Cayman Islands company. It should therefore not normally suffer Cayman Islands tax on its investment income or gains. Its UK tax position depends on whether it has a UK permanent establishment or central management and control in the UK. On the facts, its activities and administration appear to be outside the UK, so UK corporation tax should not arise.

The 2% annual fees paid to Cayman Master Fund should consequently not themselves create a UK tax liability for the Master Fund.

The UK reporting-fund regime primarily imposes obligations and tax consequences on UK investors, rather than automatically taxing the offshore fund or its South Korean manager.

Part 4

For a UK-resident individual investor, a reporting offshore fund provides more favourable treatment than a non-reporting fund. The investor is subject to Income Tax annually on their share of the fund's reportable income, whether or not that income is actually distributed. Any dividends or other distributions received are also subject to the normal UK income-tax rules, subject to any available exemptions or allowances.

On disposal of the units, a gain is generally subject to Capital Gains Tax (CGT) rather than being treated as an offshore income gain. Importantly, amounts on which the investor has already been taxed as reportable income can generally be taken into account in calculating the gain, preventing double taxation.

For a UK-resident corporate investor, reportable income is generally subject to corporation tax as it arises. Any distribution is also brought into the corporation-tax computation, subject to the normal rules and exemptions applicable to corporate distributions.

On disposal of the reporting-fund units, the resulting gain is generally subject to corporation tax under the chargeable-gains regime, rather than income tax.

Thus, reporting status effectively gives investors capital treatment for disposal gains, while requiring annual taxation of their share of undistributed reportable income.

Part 5

A UK reporting fund can be attractive to UK investors because gains on disposal of units are generally subject to Capital Gains Tax (CGT) for individuals, or corporation tax on chargeable gains for companies, rather than being taxed as income. This can produce a lower tax rate for individual investors. Reporting status also provides greater tax transparency, because investors receive information about their share of the fund's reportable income.

The principal disadvantage is that investors may have an annual tax liability on reportable income, even where that income has not actually been distributed. This can create a cash-flow problem.

A non-reporting fund has the advantage that investors are generally not taxed annually on undistributed fund income. Tax is instead generally deferred until disposal of the units.

However, its major disadvantage is that a UK investor's gain on disposal is generally treated as an offshore income gain and taxed as income, potentially at a significantly higher rate than CGT. For individuals, this can therefore result in a materially higher overall tax liability.

Accordingly, reporting status generally favours investors seeking capital treatment and long-term investment, whereas non-reporting status may favour investors who value tax deferral and expect to retain their units for a long period.

Question 4

Part 1

Under the Authorised OECD Approach (AOA), the attribution of free capital to a bank permanent establishment (PE) is important because the PE must be treated as if it were a separate and independent enterprise. The amount of capital attributed to the PE affects both the interest expense deductible by the PE and the amount of debt funding that can properly be recognised.

For banks, the OECD 2010 Report identifies AG's case, the bank has €100 million of RWA and €20 million of free capital. Glynn two principal approaches to determining the free capital attributable to a PE:

- Capital allocation approach: the bank's total regulatory capital is allocated to the PE by reference to the PE's proportion of the bank's risk-weighted assets. The PE's functions, assets and risks are therefore reflected in the allocation. This approach is relatively straightforward and closely connected to regulatory capital requirements.
- Thin capitalisation approach: the PE is attributed the amount of free capital that it would have required if it were a separate and independent bank. This involves determining an appropriate capital structure by reference to comparable independent banks and the risks undertaken by the PE. The resulting free capital can then be used to determine the appropriate level of debt and deductible interest.

The OECD also recognises that a risk-weighted assets (RWA) approach can be particularly appropriate for banks because capital requirements are fundamentally related to the risks associated with their assets.

In Glynn AG's case, the bank has €100 million of RWA and €20 million of free capital. Glynn UK is responsible for 25% of the bank's RWA, so an allocation based purely on the RWA method would attribute €5 million of free capital to the UK PE.

However, this is not necessarily the final answer under the AOA. Glynn UK performs all risk-management functions for the bank's financial assets and has a substantial deposit-taking business. Those functions and risks must be considered in determining the PE's appropriate capital. The OECD approach therefore seeks to ensure that the capital attributed to the PE is consistent with the risks and assets actually assumed by it, rather than merely applying a mechanical percentage.

Thus, the principal methods are the capital allocation/RWA approach and the thin-capitalisation approach, with the choice requiring consideration of the PE's functions, assets and risks.

Part 2

Glynn UK's governance arrangements are potentially unsatisfactory from a UK regulatory perspective, particularly given the scale and nature of its activities.

As a UK branch of a German bank, Glynn UK is subject to UK prudential and governance requirements applicable to branches of overseas banks. The fact that it has an extensive deposit-taking business and performs all risk-related management activities for the bank's financial assets means that effective local governance and senior management oversight are particularly important.

Glynn UK has a chief executive who reports to the management board in Germany. While reporting to the German board is not inherently inappropriate, the concern is whether the UK branch has sufficient senior management authority, accountability and independence to identify, monitor and control risks arising from its UK activities.

In particular, because Glynn UK undertakes all risk-management functions for the financial assets, it would be important for the UK operation to have appropriate local risk-management, compliance and internal-control arrangements, with clear responsibility for UK regulatory compliance.

The UK regulators would also expect appropriate senior manager accountability and oversight, rather than the UK branch being effectively managed from Germany without adequate UK governance.

Therefore, the existing structure is not necessarily prohibited, but the facts provided do not demonstrate that the arrangements satisfy UK regulatory expectations. The bank should ensure that the UK chief executive has clearly defined responsibilities and sufficient authority, supported by appropriate risk and control functions and effective escalation to both UK and German management.

Part 3

Glynn UK is a UK permanent establishment (PE) of Glynn AG. For UK tax purposes, its profits should be determined under the Authorised OECD Approach (AOA), treating the PE as if it were a separate and independent enterprise.

The principal potential adjustment concerns the allocation of free capital. Glynn UK holds 25% of the bank's risk-weighted assets and performs all risk-management functions for the financial assets. The amount of capital properly attributable to the PE therefore needs to reflect the assets, functions and risks undertaken by Glynn UK. If insufficient free capital has been attributed, the corresponding amount of head-office interest expense may be disallowed, increasing taxable UK profits.

Using a simple RWA allocation, 25% of Glynn AG's €20 million free capital would be €5 million. However, because Glynn UK undertakes all risk-related management and has significant deposit-taking activities, HMRC may argue that a greater amount of capital should be attributed to the PE.

The €3 million deduction for head-office expenses and interest charges could therefore be adjusted if it does not reflect an arm's-length allocation under the AOA. Expenses must be properly attributable to the UK PE and calculated on an appropriate basis.

In addition, HMRC could examine whether transactions between the PE and head office have been priced on an arm's-length basis, including any internal funding or interest allocation.

Accordingly, the stated €10 million UK profit may be increased, principally by restricting inappropriate interest/head-office deductions and ensuring that Glynn UK has an appropriate level of attributed free capital.

PART C

Question 5

Part 1

The Special Bonds are best regarded as regulatory capital securities, with the precise regulatory tier depending on whether their terms satisfy the applicable CRR/PRA requirements. Their important feature is the automatic conversion into preference shares when the bank's free capital falls to 20% or less of risk-weighted assets. This loss-absorption mechanism is characteristic of hybrid regulatory capital.

Under the modern prudential framework, instruments capable of conversion into equity following a specified trigger can qualify as Additional Tier 1 (AT1), provided all the relevant conditions are satisfied. In particular, the trigger for an AT1 instrument must generally be linked to the CET1 ratio falling below the prescribed regulatory threshold. The PRA confirms that the regulatory framework is indifferent to whether an AT1 instrument is accounted for as debt or equity.

Thus, assuming the Special Bonds meet the other regulatory requirements, their principal purpose is to provide loss-absorbing regulatory capital, rather than ordinary commercial debt.

Part 2

The 5% coupon should generally be tax deductible for Middleton Bank, provided the Special Bonds fall within the UK rules for hybrid/regulatory capital instruments.

UK tax legislation specifically recognises that banks need to issue debt-like hybrid instruments to satisfy regulatory capital requirements. The tax rules are designed so that qualifying regulatory capital instruments receive loan relationship treatment, with payments treated as interest rather than distributions. HMRC confirms that the policy objective is to preserve deductibility of interest on regulatory capital instruments.

Consequently, the annual coupon is $\text{£}100\text{m} \times 5\% = \text{£}5\text{ million}$ and this £5 million should normally be deductible in computing Middleton Bank's taxable profits, subject to the ordinary corporation-tax rules, including any applicable Corporate Interest Restriction.

The fact that the bonds can convert into preference shares should not, by itself, prevent deductibility. HMRC specifically recognises that regulatory conversion provisions do not necessarily make an instrument a non-commercial loan.

Part 3

If the conversion trigger is reached, the £100 million of Special Bonds will cease to be debt-like capital and become 0% preference shares. The key effect is therefore a change in the composition and quality of regulatory capital, rather than necessarily an increase in total capital.

Before conversion, the bonds provide regulatory capital while carrying a 5% coupon. Following conversion, the bank has £100 million of preference-share capital instead, with no interest/coupon cost.

If the preference shares qualify as AT1 capital, conversion would strengthen the bank's Tier 1 capital relative to its lower-quality capital. If they qualify as CET1, the improvement in the highest-quality capital would be greater. In either case, assuming the £100 million remains recognised as regulatory capital, total regulatory capital and the risk-weighted-asset denominator are initially unchanged, so the overall capital adequacy ratio would not automatically change merely because of the conversion.

The principal benefit is therefore that the capital becomes more loss-absorbing and equity-like, while the bank also ceases paying the 5% coupon.

Question 6

Part 1

Under FRS 102 Section 22, a bond convertible at the holder's option into a fixed number of the issuer's ordinary shares contains both a liability and an equity component. This is the classic example of a compound financial instrument.

Hereditaments should initially recognise the £50m proceeds as:

- a liability component, measured at the present value of the contractual interest and redemption cash flows, discounted at the market rate for equivalent non-convertible debt; and
- an equity component, being the residual £50m proceeds less the liability component.

The liability is subsequently measured at amortised cost using the effective interest method, while the equity component is not remeasured.

Part 2

For investors, the instrument is a hybrid financial asset, rather than a compound instrument. The conversion option is not an equity instrument of the investor.

Under FRS 102, unless the investor has elected to apply the relevant IAS 39/IFRS 9 requirements, such a non-basic financial instrument is generally measured at fair value through profit or loss. Therefore, subsequent changes in the fair value of the bonds, including changes attributable to the conversion feature, will normally be recognised in profit or loss.

Part 3

For corporation tax, the bonds fall within the loan relationship rules. Importantly, where a company uses amortised-cost accounting, a debt released in consideration of the issue of its ordinary shares is generally excluded from a taxable credit under CTA 2009 s322(4).

Thus, on conversion, Hereditaments should generally have no immediate taxable credit merely because the £50m debt is exchanged for shares, assuming this is a genuine debt-for-equity transaction. The fact that the market value of the shares may be substantially below £50m does not, by itself, prevent the exemption.

Part 4

Conversion removes the £50m debt liability and replaces it with 50,000 £1 ordinary shares. Hereditaments therefore becomes substantially less leveraged and avoids the future 1% interest payments.

It also improves the company's financial position from the perspective of creditors: the £50m liability is eliminated and equity increases. The existing 51,000 shareholders will, however, be diluted. Following conversion there will be 101,000 ordinary shares, so the new investors will hold approximately 49.5% and existing shareholders approximately 50.5%.

This is particularly significant because the company currently faces liquidation proceedings. Conversion could therefore provide the balance-sheet restructuring needed to allow the developments to be completed and sold.

Part 5

For a corporate investor, the convertible is subject to the relevant corporate financial-instrument rules. A convertible security may be excluded from the normal QCB treatment because it gives the holder rights to acquire shares.

Where the investor's accounting does not bifurcate the instrument for tax purposes, conversion generally constitutes a disposal of the convertible security, with the shares received treated as acquired at the market value of the security immediately before conversion.

Accordingly, any taxable gain or loss is determined by comparing the investor's tax basis in the bonds with their value immediately before conversion, with the subsequent shares taking an appropriate base cost. The precise result depends on whether the investor is a company or individual and on the accounting/tax treatment adopted.

Question 7

The OECD/G20 BEPS Action Plan seeks to align taxation more closely with economic activity and value creation, so that multinational enterprises (MNEs) cannot artificially shift profits to low-tax jurisdictions where little or no substantive activity occurs. This is achieved through 15 actions, several of which directly address the location in which profits are generated.

Action 5 – Harmful tax practices strengthens the requirement for substantial economic activity in jurisdictions offering preferential regimes. The “nexus approach” for intellectual-property regimes links the availability of tax benefits to the extent of qualifying R&D expenditure actually undertaken by the taxpayer.

Actions 8–10 – Transfer pricing revise the rules so that profits are allocated according to the functions actually performed, assets used and risks controlled. In particular, the guidance on intangibles seeks to prevent legal ownership alone from attracting the profits generated by valuable intellectual property. Similarly, financing and risk-related returns should follow genuine economic functions rather than contractual arrangements that lack substance.

Action 7 – Preventing artificial avoidance of permanent establishment (PE) status makes it harder for businesses to avoid taxation in a country where they genuinely conduct substantial activities. It addresses arrangements such as commissionaire structures and artificial fragmentation of activities. Where a business has a taxable PE, profits attributable to its activities can therefore be taxed in that jurisdiction.

Action 6 – Treaty abuse introduces measures against treaty shopping and arrangements lacking genuine economic substance. This prevents taxpayers from obtaining treaty benefits that move profits or reduce source-country taxation without corresponding economic activity.

Actions 1 and 2 address the digital economy and hybrid mismatches. Action 1 recognises that highly digitalised businesses can generate substantial value and market revenues without a traditional physical presence, while the later OECD Pillar One work seeks to allocate some taxing rights to market jurisdictions. Action 2 neutralises mismatches that can otherwise produce double deductions or deductions without corresponding taxation.

Action 13 – Country-by-Country Reporting (CbCR) increases transparency. Large MNEs must provide tax authorities with information showing, by jurisdiction, revenues, profits, employees, assets and taxes paid. This enables tax authorities to identify situations where reported profits are disproportionate to the company's real economic presence.

Finally, Action 14 improves dispute resolution so that countries can enforce their taxing rights more effectively, while Action 4 limits excessive interest deductions that can be used to shift profits from high-tax to low-tax jurisdictions.

Overall, BEPS does not simply impose a single “source-country” taxation rule. Instead, it uses substance requirements, revised transfer pricing, PE rules, treaty anti-abuse measures, interest restrictions and greater transparency to ensure that taxable profits are more closely connected with the jurisdictions in which the underlying economic activities and value creation actually occur.

Question 8

Part 1

BEPS Action 4 recommends limiting the tax deduction for net interest expense to a fixed proportion of a company's earnings, commonly measured using tax-EBITDA. In practice, a country might impose a fixed ratio of, for example, 30% of tax-EBITDA. Thus, if a company has tax-EBITDA of £10 million and net interest expense of £4 million, only £3 million would be deductible in the current period, with the £1 million excess potentially carried forward, subject to domestic rules. Some regimes also permit a group ratio rule, allowing companies within highly leveraged groups to deduct more interest where their external financing supports it. The rules therefore seek to prevent excessive interest deductions, particularly those arising from intra-group financing, while allowing commercially justified borrowing.

Part 2

BEPS Action 4 advocated interest limitation rules because excessive interest deductions can be used to shift profits from high-tax jurisdictions to lower-tax jurisdictions, reducing the overall tax paid by multinational groups. Groups may, for example, arrange for companies in high-tax countries to bear disproportionate levels of debt or make large intra-group interest payments to entities in lower-tax jurisdictions. This creates opportunities for base erosion and profit shifting (BEPS) because interest is generally deductible for the borrower but taxable at potentially lower rates for the recipient.

Action 4 therefore sought to ensure that interest deductions are more closely aligned with a company's genuine economic activity and ability to service its debt. The objective was to establish a consistent framework that limits excessive deductions while allowing businesses to obtain relief for genuine commercial borrowing.

Part 3

No, BEPS Action 4 interest limitation rules have not rendered the arm's length principle redundant. The two approaches address different risks and can operate alongside each other. Transfer pricing rules apply the arm's length principle to determine whether the terms and amount of related-party financing, including the interest rate, are consistent with those that independent parties would have agreed.

Action 4, by contrast, generally imposes a quantitative restriction on the amount of net interest that may be deducted, often by reference to a fixed percentage of EBITDA, regardless of whether the interest is arm's length. Therefore, an interest expense may satisfy the arm's length principle but still be restricted under an Action 4 rule. Transfer pricing remains important for determining the appropriate pricing and terms of intra-group financing.

Part 4

To implement BEPS Action 4, domestic tax systems need to introduce legislation restricting the deductibility of net interest expense. Typically, this requires defining which financing costs and interest income fall within the rules and establishing a benchmark, such as a fixed percentage of tax-EBITDA. Countries must also decide whether to provide a group ratio rule, allowing greater deductions where justified by the group's external gearing, and whether to introduce carry-forward provisions for disallowed interest or unused interest capacity.

The rules must be integrated with existing corporate tax and transfer pricing provisions to avoid conflicts and determine their interaction with other anti-avoidance measures. Domestic legislation should also establish appropriate compliance, reporting, documentation and enforcement requirements, while ensuring that genuine commercial financing remains appropriately recognised.

Part 5

BEPS Action 4 is primarily intended to influence corporate behaviour, rather than simply raise tax revenues. Its objective is to discourage multinational groups from structuring excessive debt in high-tax jurisdictions in order to obtain disproportionately large interest deductions and reduce their taxable profits. By restricting interest deductions, the rules encourage companies to align the level of debt in an entity more closely with the group's overall financing position and its genuine economic activity. Although the rules may increase tax revenues where deductions are denied, this is a consequence rather than their principal purpose.

The broader BEPS objective is to ensure that profits are taxed where the underlying economic activities and value creation occur. Therefore, Action 4 is best viewed as a behavioural and anti-avoidance measure, with increased revenues being a potential secondary effect.