Answer-to-Question-_1_

1) Ordinary shares are equity capital instrument issued by company to raise funds. Shareholders have right to participate in dividends but this is not guaranteed and if dividends are declared, they would be paid out from profits after tax or distributable reserve. The amount of pay out is not brought into account in computing profit and loss of the company. Due to the ordinary shares' capital nature, the payout, i.e., dividends are not deductible for tax purposes. There is no requirement in the UK to withhold tax on dividend distribution.

Similarly, preference shares are also equity capital instrument issued by company to raise funds. Shareholders will be expected to be paid a fixed dividend amount akin to 'interest'. Their payability not dependent on the company's performance unlike ordinary shares. Despite its 'interest-like' pay-out, it is still treated as dividend and they would be paid out from profits after tax or distributable reserve. The amount of pay out is not brought into account in computing profit and loss of the company. Due to the preference shares' capital nautre, the payout, i.e., dividends are not deductible for tax purposes. There is no requirement in the UK to withhold tax on dividend distribution.

Redeemable preference shares are also equity capital instrument issued by the company and the company will have to redeem these shares back at the end of a fixed period through repayment of capital. As mentioned, holders of preference shares will be expected to be paid a fixed divdend amount that is not dependent on the company's performance unlike ordinary shares. The dividend would be paid out from profits after tax or distributable reserve. The amount of pay out is not brought into account in computing profit and loss of the company as it is dividend and not interst expense. Due to the preference shares' capital nautre, the payout, i.e., dividends are not deductible for tax purposes. There is no requirement in the UK to withhold tax on dividend distribution.

Preferred participating bonds are a combination of equity/debt capital instrument issued by the company. In this scenario, the agreed interst to be paid by Loamshire to its bondholders are fixed at £1 instead of based on a %, which is more commonly seen. However, unlike other type of bonds, the bondholders have the right to participate to divdiend similar to an ordinary shareholder would. With the additional rights attached, this explains the unusually low interest payment that would be expected for debt capital instrument. At APE 31/03/2024, Loamshire would pay an interest payment of £1m to each of its bondholders, which would be expensed into the P&L and it would be tax deductible. Where interest is paid to non-UK individual/company, or UK individual/company who is not the beneficial owner to receive the interest income, WHT may apply and relief may be available subject to the DTA between the UK and concerned countries. If a dividend payout is declared by Loamshire in the APE 31/03/2024, the dividend payout is not brought into account in computing profit and loss of the company. Due to the dividends' capital nature, the dividend payout is not deductible for tax purposes and it would be paid out from profits after tax or distributable reserve.

Subordinated bonds are debt capital instrument issued by the company. The interest payment will be paid to the bondholders and the amount would be expensed into the P&L and it would also be tax deductible. Where interest is paid to non-UK individual/company, or UK individual/company who is not the beneficial owner to receive the interest income, WHT may apply and relief may be available subject to the DTA between the UK and concerned countries.

Profits available for distribution are follow:

		£m	£m	
Pre-tax profits (after deduction of mgt expenses)			2.5	
<u>less</u>				
Preferred participating bonds interst	£10m/£100 x£1	0.1		
Subordinated bonds interst	£10m x(5%+3%)	0.8		
Total interest expenses			(0.9)	
Profit before tax (after deduction of interst expenses)			1.6	

Despite profit before tax of £1.6m is available for dividend distribution but as the holders of the redeemable preference shares did not wish to continue their investment and no other investors are going to continue this type of security, the £10m issued become redeemable and profit after tax and any distributable reserve should be utilised to redeem these shares first. If there are any distributable profits/reserve remained after redemption, this would be paid out as dividend to shareholders based on the priority order, i.e., preference shares given its preferred status rank above ordinary shares (in the event of insolvency), followed by ordinary shares and preferred participating bonds.

Answer-to-Question-_2_

Bank is required by their national and also international banking regulators to hold regulatory capital to ensure they can absorb any losses in the event of financial stress. This includes a combination of Tier 1 equity capital and Tier 2 debt capital.

The €100m Z bonds issued by Gamma is one example of debt capital instruments on issuance despite some its equity-like features, in which the bondholders will receive a fixed interest income from Gamma annually with no end date. Interest income paid is brought into the accounts in computing Gamma's profit and loss, i.e., €7m per annum. In the UK, the amount is tax deductible under the loan relationship rules. Depending on the country in which Gamma is resident, Gamma may be required to withhold tax before making itnerst payment to its bondholders. Relief on WHT may be available subject to the DTA between the country in which Gamma is resident and countries in which bondholders (assuming they are beneficial owners) are resident.

In the event of trigger event materialises as in this case, the bonds will be converted into Class Z ordinary shares to absorb the losses as a going-concern. The bonds have been recharacterise into special ordinary shares, which in turn become an equity capital instrument. The interst payment attached to the bonds are no longer payable as that instrument no longer in existence. It is assumed that in addition to their voting rights, the shareholders of Class Z ordinary shares will also participate in dividend distribution (if any). Where a dividend payout is made, the payment will be distributed from profits after tax or from a distributable reserve, i.e., retained earnings. The distribution will not be brought into the P&L unlike the interst payment. Dividend is also not tax deductible due to its capital nature. Gamma could be subject to to withhold tax before making a dividend distribution, and similar to WHT on interst payment, relief may be available.

It is understandable that Class A shareholders would be in favour of the takeover as without the bail out from Beta, their shareholding would become worthless if Gamma is to go into insolvency and they will be ranked bottom in the creditors prioirity list. Whether the Class Z shareholders can block the proposed takeover would depends on whether this proposed takeover would be classed as public sector support and therefore they will forfeit their voting rights, which means they will be unable to vote anyway.

If Class Z shareholders maintained their voting rights, it would depends on whether quorum has been met for the takeover voting. It is not clear in what % does the Class Z shares made up of the total share issued by Gamma. Assuming that Class A shares made up of over 50% of the total share issued assuming there is no other shares with voting rights attached, then it is unlikely that Class Z shareholders could block the proposed takeover. However, if the conversion from Z bonds into Class Z shares have diluted the total share issued and that Class Z shares made up of more than 50% of total share issued and there is no other shares with voting rights attached, then it is possible that Class Z shareholders could block the proposed takeover from Beta. However, the benefit in doing so is unclear as without the takeover or publich support, it is likely that Gamma will go into insolvency making both Class Z and Class A shares worthless. However, Class Z shares rank above Class A shares so Class Z shareholders are ranked above Class A shareholders in the creditors priority list and they may be entitled to any repayment of capital if there are any money remained once all the other priority creditors have been paid off (which is unlikely).

Answer-to-Question-_3_

Repo transactions are where the holder of the security sell the security, i.e., gilt, to a lender who would provide the required funds to the seller, at an agreed interest rate, and the seller would agree to pruchase the gilt (or equivalent security) at a later date which is agreed when both parties enter into the repo transaction.

commercial purpose of repo transactions include,

- liquidity where the seller is expecting a short-term liquidity need, for example expected cash flow problem for the business operation.
- funds obtained may be used for other investment opportunities that may achieve a higher return than the interst rates paid to the lender.
- seller cannot obtain liquidity through another mean perhaps due to poor credit rating, or if the business is already highly geared.

For accounting purpose, the legal title of the security has been passed onto the lender but they are required to record the movements of the security (if any) in the sller's balance sheet due to the obligation that the seller will be buying back the security at a future date. Interest payment made to the lender is tax deductible under the loan relationship rules in the UK. The seller may be required to withhold tax when making interest payment depending on whether the lender is a UK resident and beneficial owner, in such case, no WHT is required. However, if the lender is a non-UK resident or UK resident who is acting as a conduit for non-UK resident then WHT may be due. Relief may be available depending on the DTA between the UK and the country concerned.

Directors may have exceeded their powers if they are found not acting in the interest of their investors by entering into for their own benefits rather than for the interest of their investors and incurring unnecessary interest expenses. Borrowing is only permitted for short term liquidity purposes and given the repo transactions have been ongoing for many years repeatedly, it is unlikely to be for short term liquidity purposes. As mentioned, the transactions enhance the returns of the gilt holdings and directors have a duty of care and exercise caution but not entering into highly speculative transaction to ensure they do not suffer heavy losses as the case in September 2022. They should ensure they are doing every possible to mitigate such losses through other means such as hedging.

Answer-to-Question-_6_

The arm's length principle is to ensure transactions entered into between associated entities are comparable to those thtt would be entered between independent enterprise under the same or similar terms and conditions.

Corporate interest restriction (CIR) was introduced in the UK in response to BEPS Action 4 to prevent multinational (MNE) group claiming excessive interest expense that is tax deductible in the UK, on debts that are not incurred from the UK operations.

CIR applies to the higher of the following,

- £2m de minimis (per annum per group),
- 30% of tax-EBITDA,
- group fixed ratio

Interest expense exceeded the higher of the 3 criteria would be restricted under the CIR rules.

Where the MNE group falls below the de minimis limit or there is no restriction adjustment required, the nominated reporting company can file an abbreviated return. However, if the group apply the 30% of tax-EBITDA or group fixed ratio rule and there is unused allowance, in order to utilise the unused allowance in future periods, the group is required to file a full interest restriction return (IRR) which contains details on,

- composition of the group
- computation of any restricted interest expense
- unused allowances carried forward/restricted interest expense carried forward
- any election made by the group

The benefits to carry forward any unused allowance for up to 5 years and restricted interest expense indefinitely make CIR more appealing to MNE group with considerable loan arrangements across multiple group entities and jurisdictions which gives arguably same or similar effect in comparison to the use of transfer pricing (TP) to restrict interest expense incurred outside of the arm's length range would involve significantly amount of work. It involves the accurate delineation of the financial transaction through performing a factual and functional analysis, for each financial transaction between associated entities before the MNE group can price the transaction using comparable benchmark which are costly to carry out and not always easily obtainable given the complexity on some of the financial transactions.

It is argued that figures used in apply the CIR rules are readily available from the company financial statements or consolidated financial statements, and any adjustments required to calculate the tax-EBITDA and/or fixed ratio are purely mechanical. This makes the CIR regime easier to administer. Entities within a CIR group is determined in accordance with the IFRS consolidation rules and the group ought to know this when preparing their consolidated financial statements. The downsides of CIR in particular in large MNE group are that the same group entity may belong to multiple CIR group, the various calculations required to determine the available allowance to restrict interest expenses would require a high-level of understanding of the financial arrangements within the group. The different tax teams involved means no one team have the full picture of the financial arrangements that could result in error in determing the available allowance or figures used to comply with the CIR rules.

Answer-to-Question-_8_

Banking activities are highly regulated both nationally by their local regulators and internationally in accordance with the Basel 3 requirements.

Under Basel 3, banks are required to maintain a minimum of 4.5% of CET1 capital with a buffer of 2.5% so that minimum Tier 1 capital is at 7%. Banks are allowed to maintain regulatory capital using a combination of equity- and debt-based (Tier 2) capital instruments. The level of regulatory capital maintained by the banks are dependent on the types of assets held by the banks, which are then risk-weighted according to the BIS ratio. The more risky of an asset, the higher level of capital is required to maintain. Assets that are considered to be less risky, such as government bonds or gilts, their risk-weighting is considerably lower as they are considered to be low or minimal risk.

liquidity requirements were also introduced under Basel 3 to ensure the bank holds highly liquid capital so that in the event of financial stress, they can continue to operate for 30 days without disruption to the market. The stress scenario would be set by their local regulator. In addition, the bank need to maintain liquidity to cover any maturity mismatch should the financial stress continue for a prolonged period.

Reason for banks to maintain regulatory capital include:

- to ensure they have sufficient capital to operate and manage their risks.
- in the event of financial stress, such as the financial crisis, it ensures the banks have the necessary means to absorb any stress/loss without resort to insolvency which could lead to financial instability locally and internationally. Banks that are considered to be systemic important banks are required to hold a higher buffer as their insolvency could have a wider impact to the global financial instability that could lead to another financial crisis.
- to protect users of the banks and not reliant on potential public/government bail out which are damaging to the economy.