

INTRODUCTION

This article discusses the financing of business acquisitions, adopting a similar integrated approach to the article 'Business Acquisitions – Consideration: Form, Structure, Treatment'. Both articles are intended to provide a technical guide to some of the corporate finance, IFRS/IAS financial reporting and UK corporation tax issues encountered in a UK acquisition, up to the point of acquisition (post-acquisition matters are not discussed, other than general financial management issues). There are many other aspects to an acquisition that are not covered¹.

Consideration in the form of cash, shares or securities (the QCBs and non-QCBs discussed in the Consideration article) will require a source for cash financing (equity raising or new borrowings for the cash component) and/or an assessment of the implications for the acquirer and its shareholders if shares and/or securities (e.g. loan notes) are issued, both in terms of dilution of shareholder wealth (shares issued) and risk of insolvency (new borrowings) - a problem for lenders, but an even bigger problem for shareholders.

The main focus of this article is on how the cash component can be debt-financed with loans. The tax benefits of debt finance for the acquirer are discussed in the article 'Business Valuation - Part 2: Discount Rates & Tax Shields' and the focus here is on risks a borrower faces when taking out a loan: loan facility covenants, credit risk and formal insolvency arrangements, financial risk and management, tax treatment and relief for interest paid:

- **Part 1** ('Source & Management of Acquisition Finance') mainly discusses the nature and management of financial risk associated with debt finance (interest rate risks, swaps, hedging), but also covers how financing mix can affect EPS.
- **Part 2** ('Equity Finance ') discusses in brief equity issuance for paper consideration and as a source of financing the cash component.
- **Part 3** ('Debt Finance') is the heart of the article and discusses debt capacity, debt rating by agencies, loan facility issues for lender and borrower, security and insolvency, recognition of debt in the financial statements under IFRS and its treatment under UK tax (Loan Relationship Rules, Corporate Interest Restriction, Loans for Unallowable Purposes).

Financing is linked to the consideration given in the acquisition, so this article should be read in conjunction with the 'sister' Consideration article.

¹ Regulatory, legal, due diligence, human resources, pension, governance and corporate approvals, risk, insurance and warranty & indemnity, IT, systems and data, intellectual property, environmental, social and governance (ESG), integration planning, investor relations.

Financial Risks in General

The choice of consideration or acquisition 'currency' (cash, shares and securities) will have an impact on the buyer and its shareholders, in terms of cost and financial risks associated with (1) the source of funding for the cash component (own cash, debt, equity) and (2) the financial instruments issued to the vendor.

Cash consideration paid from existing cash balances will lower interest income, increase net debt and reduce financial flexibility. If cash is funded from new borrowings, financial risk for the acquirer will increase due to: (1) 'Market Risk', via interest rate risk and currency risk (cash flows exposed to changes in market rates and prices – currency risk will not be discussed), (2) 'Liquidity Risk', if meeting debt obligations from existing financial resources (or refinancing facilities) becomes increasingly difficult, and (3) Insolvency Risk, if formal recovery proceedings commence due to a debt facility default (see 'Loan Facilities' below).

Securities issued to the vendor will create obligations and risks for the acquirer, similar to those where it borrows externally for the cash component, except that the terms will differ as external lenders will have different covenant and pricing requirements. Both create financial risk for the acquirer's shareholders, which might increase their required return and affect the acquirer's cost of capital, although the acquirer will have factored this into its valuation.

The shareholders of the acquirer should still benefit from the economic gains of the acquisition (in NPV terms). An evaluation of the impact of the acquisition on Earnings Per Share ('EPS') should not take precedence over an appraisal of the intrinsic value benefits (based on cash flow present values), however the acquirer and its shareholders may consider how it changes. The EPS for the first forecast year after the acquisition will change (ignoring forecasting differences) due to the following combination: (1) the combined post-tax profits of the target and synergies divided by the acquirer's pre-acquisition shares in issue (the number it uses in its EPS), (2) the post-tax acquisition financing cost (ignoring any other incremental costs) divided by the acquirer shares, and (3) the dilution impact from the issuing of shares to the vendor. Hence merged EPS = (acquirer 'old' EPS + net profit change / acquirer 'old' shares) / (1 + $\frac{\text{shares issued}}{\text{acquirer old shares}}$). For further discussion on 'Exchange Ratios' see the article 'Business Acquisitions – Consideration: Form, Structure, Treatment' and for an example of EPS dilution see [Appendix 1](#).

Shares issued to the vendor will dilute the holdings of the acquirer's shareholders, as discussed. Shares issued to new shareholders on an equity raising, to raise cash for the cash component, will also dilute their holdings, unless they participate in the 'Rights Issue'. Equity raising has financial risk since funding will depend on the acquirer's variable share price.

The acquisition itself will have consequences for the target company's own financing facilities due to 'Change of Control' clauses that may trigger an immediate requirement to refinance (which the buyer may intend doing anyway if better terms can be obtained using its own credit rating).

Interest Rate Risk Management

Using derivatives (Swaps)

Risk-Free Rates

The loan interest rate, whether fixed or floating, will comprise a benchmark/reference rate (a Risk-Free Rate / 'RFR' or Central Bank Base Rate) and a premium or margin that reflects relevant risks the lender has quantified (e.g. borrower default risk), taking into account security and seniority arrangements that reduce risk. The risk premium may be set at a fixed amount or might change over the loan life if certain conditions are not met ('Margin Ratchet'). The Sterling Overnight Index Average rate ('SONIA') would be the RFR used in most large UK loans, following the replacement of 1,3,6 month LIBOR ('London Inter-bank Offered Rate') in late 2021. SONIA is a rate for the interest period ending on the date at which it is set (usually calculated by compounding historic daily SONIA over the period), unlike LIBOR, which was set at the start of the interest period, based on the expected rate (allowing the interest payment for the next period to be known in advance).

The RFR used when valuing instruments or assets would tend to be a rate that reflects the maturity or holding period (a 10-year government bond yield would usually be used for the cost of equity calculation, for example). Changes in the RFR will affect many prices and rates:

- the fair or intrinsic value of non-financial assets (via a higher cost of capital)
- the fair value of financial assets and liabilities (e.g. bond prices affected by yields, lease liabilities)
- the share price (via a higher cost of equity)
- options prices estimated using option pricing models
- option embedded instruments (e.g. risk of bond being called as rates fall)
- fixed rates paid on a 'Swap' (discussed below)
- pension scheme liabilities and
- deferred acquisition consideration (discussed in 'Business Acquisitions – Consideration: Form, Structure, Treatment').

Fixed vs. Floating

A borrower will be concerned that interest rates may increase, affecting interest costs and financial covenants. A fixed rate caps the borrower's interest cost, protecting them if RFR rises, but they lose out if RFR falls (unless it can refinance the facility at a lower rate). Floating rate debt will have a higher / lower interest cost as RFR rises / falls, respectively; a floating rate borrower does not have the fixed rate cap, but benefits if rates fall. A general financing policy may specify a desired mix of fixed vs. floating rates for all facilities in aggregate. An investor with fixed rate assets will lose value on their investments if RFR rises, due to the higher discount rate; the value of a floating rate asset may remain the same if cash flow and discount rate changes offset each other.

Using derivatives to manage Interest Rate Risk

Interest payments can be 'swapped' between fixed or floating rates (forwards, futures and options relating to interest rates are not directly discussed). In an 'Interest Rate Swap' ('IRS'), two parties agree to pay each other an amount at the end of the interest period based on a fixed or floating rate at the start of the period, applied to a notional principal (in £, for our purposes).

In a very simple ('Plain Vanilla') swap, the floating rate 'leg' of the swap would be priced from the market RFR Forward Rate 'Yield Curve' (implied rates for future interest periods, effectively) and the fixed rate would be the rate that equates the present value of both swap cash flows (a swap will have a zero fair value at the start date). Floating and fixed rate cash flows will be discounted at the same 'Zero Coupon' or 'Spot' rates (different for each period), that can be generated ('Bootstrapped') from, amongst others, 'Overnight Indexed Swaps' (the 'OIS' curve). The fixed rate is the implied rate that equates the PV of the two cash flow streams (which can be calculated in an Excel spreadsheet using the goal seek or solver functions). The derived floating and fixed rates will be default-free.

A borrower can effectively convert a loan from a fixed to floating rate or vice versa by paying its desired rate and receiving a rate that exactly matches the benchmark/reference rate on the underlying loan (the net payment is the desired rate plus the loan margin). In a 'Fixed-to-Floating' swap, the borrower pays a floating rate in exchange for receiving a fixed rate that offsets the loan's fixed rate benchmark; in a 'Floating-to-Fixed' swap, the borrower is the fixed-rate payer, converting a floating rate loan to a fixed rate (a 'Floating-to-Floating' or 'Basis' swap exchanges floating rate cash flows that are based on different bases, such as maturity or benchmark rate).

Financial Reporting for Derivatives (IAS)

Derivatives in general

Under IAS 32, 'Derivatives Financial Instruments (such as...interest rate swaps...meet the definition of financial instruments' [para. AG15 IAS 32]. Under IFRS 9, a derivative is a financial instrument (1) whose value changes as the price of the 'underlying' variable factor (such as a specific interest rate) changes, (2) which requires nil, or a small, initial investment (swaps are based on a notional principal amount, without any exchange of principal), and (3) which is settled at a future date [App. A IFRS 9].

Derivatives are initially measured at Fair Value (nil for a plain-vanilla swap at inception) and subsequently measured at Fair Value through Profit or Loss ('FVTPL'), unless designated as a Hedging Relationship (see below). Thereafter, an interest rate swap will be recognised as a derivative financial asset or liability, based on the difference in present values of the revised floating rate cash flows (which change as market expectations change): if floating rates increase by more than estimated at inception, when the fixed rate was determined, the PV of the floating rate cash flows should be higher than the PV of the fixed rate cash flows, so the swap would be recognised by the fixed rate payer as an asset (at a fair value equal to the difference), otherwise as a liability (PV pay fixed > PV receive floating). (See p.1121 and p.1678 EY International GAAP 2026 for examples of the initial recognition of a swap and its use to hedge a floating rate loan).

Hedge Accounting

The borrower (acquirer) will recognise the loan at amortised cost, the swap at fair value. Interest costs will be recognised in the profit and loss account ('P&L'), along with changes in the fair value of the swap. A floating rate loan will expose the borrower to variable interest cash flows, and use of 'Hedge Accounting' will allow the borrower to smooth out financing costs in the P&L if it has hedged the floating rate loan with a floating-to-fixed swap. The effective portion of such a 'Cash Flow Hedge' [para. B6.5.2 IFRS 9] will be recognised and accumulated in OCI and 'recycled' to P&L to offset against the hedged future interest costs when they are recognised in the P&L; the 'ineffective portion' is charged to P&L. The borrower would need to 'designate a hedging relationship' between the whole swap (hedging instrument) and loan (hedged item), and comply with hedge effectiveness testing and documentation [para.6.1.2 - 6.3.3, B6.2.4 IFRS 9].

Taxation of Derivatives (UK)

The profits and losses arising from the change in fair value of the interest rate swap will be taxed in the UK under Part 7 CTA 2009 (s570-710). The swap, as for any derivative, would need to meet the accounting definition (IFRS 9), be a 'relevant contract' (a swap falls under the s582 'contract for differences' relevant contract) and not be excluded [s576 CTA 2009]. As for loan relationships, derivatives debits (losses) and credits (gains) will be treated as trading or non-trading and taxed in the period in which they are recognised in the P&L or re-cycled from OCI to the P&L [s573, s574, s595, s597 CTA 2009]. If a borrower does not use Hedge Accounting for a loan hedged with an interest rate swap, changes in the carrying amount of the swap (fair value) may differ to changes in the carrying amount of the loan (amortised cost), leading to tax volatility that bears little relationship to the economics of the hedge. The 'Loan Relationships and Derivative Contracts (Disregard and Bringing into Account of Profits and Losses) Regulations' were introduced in 2004 (and amended in 2015), effectively to make adjustments to ensure treatment is similar whether or not Hedge Accounting is applied.

Capital Structure Management

The decision about what form acquisition consideration should take and how it is financed should take into account the acquirer's general financing policy and capital structure objectives, as well as the vendor's preference. If the acquisition increases debt up to debt capacity levels or creates significant dilution from a share-for-share exchange, the acquirer's shareholders will not benefit. Even if financed in an optimal manner, post-acquisition financial management will need to focus on maintaining the optimal capital structure, which might require adjustments via debt refinancings, share repurchases or dividends.

PART 2: EQUITY FINANCE

Subject to the requirements of the purchaser's Articles of Association, agreements with existing capital providers and Companies Act 2006, shares may be issued and allotted to the vendor as part of non-cash consideration or to existing and/or new shareholders of the purchaser in a rights issue (or placing). Share issues will be subject to 'Pre-emption' rules that protect existing shareholders from dilution (in the example in [Appendix 1](#), the acquirer's shareholders are diluted to 90.4%, although the value of each share increases, due to the acquisition, from £33.64 to £34.37).

The providers of equity will require a higher return than other capital providers due to equity having the lowest ranking on a payout (no legal obligation to pay dividends or redeem capital; equity will 'absorb' losses on a default and insolvency).

Shares issued to the vendor will be set by the Exchange Ratio ('ER'), discussed in detail in the article 'Business Acquisitions – Consideration: Form, Structure, Treatment'. In [Appendix 1](#) the ER is set at 1.9321, equal to the share component (50%) x offer price (£130.0) / acquirer price (£33.64), which means synergies are shared. The minimum ER in this example is 1.85495 (the vendor does not share in any of the synergies), the maximum 2.36570 (the vendor receives 100% of the synergy value).

PART 3: DEBT FINANCE

Debt Capacity & Ratios

Introduction to Capital Structure

The Intrinsic Value of the merged entity would traditionally be calculated using a DCF valuation and a Weighted Average Cost of Capital ('WACC') (see the article 'Business Valuation - Part 2: Discount Rates & Tax Shields'). The market value of the equity, debt and debt-like instruments that comprise the company's capital structure would normally be optimally balanced so as to minimise the WACC subject to acceptable financial risk. The tax deductibility of debt interest, the contractual cash flows and the priority of debt on a winding up, make debt cheaper than equity, lowering the WACC, but more debt increases financial risk and the required return for equity via the equity beta – at some point the risk of financial distress will increase the credit risk premium embedded in the cost of debt as well, meaning the capital structure is no longer optimal and the financing policy becomes value destructive due to the increasing WACC. A company would assess optimal debt according to its peer group (to align leverage with investors' expectations), but also based on its own debt capacity and servicing ability.

Debt Capacity

The probability a borrower defaults and is unable pay interest or principal is the 'Credit' or Default' risk that lenders will analyse before setting a loan price and terms, once a loan advance is agreed. Default will be contractually defined in a loan agreement (see 'Loan Facilities' below). Rating agencies, that rate publicly issued debt, such as corporate bonds, may have a different definition of default. Financial covenants in loan agreements may include some of the ratios used by rating agencies when they carry

out detailed analysis to give their opinion of credit risk or 'Credit Rating' (Prof. Aswath Damodaran has proposed a method for estimating the cost of debt based on a 'Synthetic' rating, which could be used by private or unrated quoted companies to estimate the credit risk premium that might be required for their own debt – https://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/ratings.html).

The borrower's debt capacity is a measure of how much debt a borrower can prudently have (the balance outstanding, as opposed to the ability to 'service' or pay interest and scheduled principal over a period). Leverage ratios help in the assessment of financial flexibility (the 'headroom' available within the overall debt capacity constraint) that allows the borrower to raise external finance without affecting credit quality. These would include the following (where EBITDA is 'Earnings Before Interest Taxation Depreciation & Amortisation' - see [Appendix 2](#)):

$$\begin{aligned} \text{EBITDA leverage (x)} &= \frac{\text{Debt}}{\text{EBITDA}} \\ \text{Leverage (\%)} &= \frac{\text{Debt}}{\text{Debt} + \text{Equity} + \text{Non-Equity}} \end{aligned}$$

Debt Servicing

Assessing the ability to pay debt principal and interest (and other financing obligations, such as lease payments), both by lenders and rating agencies, involves analysis of financial measures and ratios under different scenarios ('Stress Testing'). This could involve the following approach:

1. Determine which relationships or ratios best indicate the ability of the borrower to service debt today (such as 'Coverage' ratios). Rating agencies¹ place more emphasis on cash flow measures than book value measures, but balance sheet ratios may be used if debt repayment is more likely to come from asset sales.
2. Choose an appropriate measure to use in the numerator and denominator (interest paid, principal balance, interest and principal paid vs. profit, cash flow or balance sheet reference measure).
 - An operating measure (before financing and tax) obtained from IFRS/IAS financial statements (prepared under Generally Accepted Accounting Policies, 'GAAP') could be (1) 'Operating Profit' (from continuing operations) in the P&L or (2) 'Cash from Operating Activities before Income Taxes' in the cash flow statement [see illustrative examples in IFRS 18 and IAS 7 and [Appendix 2](#) for a detailed reconciliation, assuming no Non-Controlling Interests].
 - Adjustments will have to be made to 'normalise' the figures (e.g. removing non-recurring or exceptional items, like impairments, restructurings, gains/losses on disposals) and, if required, to reclassify into debt-equivalents and non-debt items (e.g. pension costs, hybrid instruments). Rating agencies will apply many 'analytical adjustments' to determine the stability of earnings and sustainability of operating cash flows, and will assess the ability to

service debt without recourse to further funding, including adjustments for leases, 'hybrid' financial instruments that have equity and debt features, defined-benefit pensions, debt factoring and securitisations and capitalised interest.

- Coverage ratios would include the following:

$$\text{EBITDA Interest Coverage (x)} = \frac{\text{EBITDA}}{\text{Interest Paid}}$$

$$\text{Adj. OCF Coverage (x)} = \frac{\text{Operating Cash Flows} - \text{Capex}}{\text{Debt}}$$

- Liquidity ratios indicate debt serviceability over the next 12 months and would include:

$$\text{EBITDA Debt Coverage (x)} = \frac{\text{EBITDA}}{\text{Interest Paid} + \text{Debt Repayable in the next 12 months}}$$

A cash flow measure used in some debt facilities (particularly for project finance) is the 'Cash Flow Available for Debt Service' ('CFADS'), typically defined as CFADS = adjusted EBITDA – increase in working capital – maintenance capex – cash taxes paid – movements on reserve accounts (e.g. 'Debt Service Reserve Account'). The following ratio would be typical:

$$\text{Debt Service Coverage Ratio ('DSCR') (x)} = \frac{\text{CFADS}}{\text{Interest Paid} + \text{Debt Repayable in the next 12 months}}$$

- Rating agencies will make adjustments to EBITDA to arrive at their own measures, such as 'Funds Flow from Operations', 'Cash Flow from Operations' and 'Retained Cash Flow', and will have many more ratios than the basic ones shown above.

3. Determine the main factors affecting the size of the reference measures, such as revenue, growth, margins and other 'value drivers' as part of a wide appraisal of the growth and quality of profits, including analysis of ROIC and traditional duPont ratios (see the Appendix in the article 'Business Valuation - Part 3: Alternative DCF Methods & Multiples').
4. Stress test the ratios using simulation or scenario analysis, combined with models that attempt to highlight liquidity or insolvency risks

¹ Rating Agency Sources: Fitch Ratings, *Corporate Rating Criteria: Master* (6 Dec.2024); FitchRatings, *Guide to Fitch's Credit Metrics: Financial Terms and Adjustments* (2020); Moody's, *Financial Statement Adjustments in the Analysis of Nonfinancial Corporations* (9 Oct.2024); S&P Global Ratings, *Corporate Methodology: Ratios And Adjustments* (1 April 2019)

Borrowing limits

When pricing a loan, a lender will assess the probability of default and the loss it would suffer on default, net of any 'recoveries' via enforcing its security or claiming in a liquidation ('Loss Given Default'). Debt capacity and servicing need to be considered together when assessing maximum debt levels. Maximum debt could be set on a target EBITDA leverage multiple applied to sustainable EBITDA or implied from a target DSCR (maximum debt service = CFADS / target DSCR), with the debt being calculated from the PV of the debt service cash flows over the loan term. For asset-backed lending a 'Loan-To-Value' (LTV) ratio (loan amount / asset value or enterprise value) could be used, where maximum debt = LTV x asset value.

Loan Facilities

Facility Types

A loan facility can have a single lender ('Bilateral Agreement') or a number of lenders acting severally (and not jointly liable) in a 'Syndicate'. In the latter, the borrower would mandate a bank to act as 'Arranger' who would help form the syndicate, one member of which would act as 'Facility Agent' to deal with negotiation of the single facility document, payments and administrative matters (this avoids each bank lending in a bilateral arrangement, where facilities would have to be negotiated separately). Syndicated loans are usually Senior loans with floating rate interest

A 'Term' loan may allow 'draw down' of the loan over a 'Commitment' period starting when the agreement is signed (a commitment fee would be paid on the amount of the loan not utilised), rather than full drawdown upfront. Repayment of principal is scheduled in the agreement and may be in full on maturity ('Bullet') or paid by instalments ('Amortised') over the term (structured in any way: in equal instalments of principal and interest, reducing 'step down' or increasing 'step up', etc). Once the loan is repaid, it cannot be re-drawn, unlike a 'Revolving Credit Facility' ('Revolver'), where principal can be drawn down and repaid throughout the term if conditions are met and the amount outstanding is within the maximum facility amount.

Other facilities include (other than an 'Overdraft'): 'Uncommitted' (the lender can refuse a draw down request), 'Demand' (the lender can demand immediate repayment any time), and 'Swingline' (used for very short-term liquidity needs, mainly supporting a 'Commercial Paper' program in case of market disruptions) facilities.

Facility Agreements

Introduction

An indication of lending interest ('Letter of Intent') and lending terms ('Term Sheet' or 'Heads of Agreement'), both expressed in non-legally binding forms, will provide the platform on which the Facility Agreement ('FA') is built, based on commercially agreed matters. The FA will most likely adopt terms

set out in the Loan Market Association's ('LMA') recommended form of FA, which focus on the following:

- Principal: amount, currency (single or multicurrency), drawdowns, repayment dates (at maturity or 'amortised' over the term in equal or structured payments).
- Interest & fees: fixed rate (fixed swap rate + margin) or floating rate (variable SONIA + margin), frequency of payment, cash paid vs. capitalised, default interest, upfront and ongoing fees.
- Security: seniority of lender, security, enforcement of rights.
- Protection: representations, undertakings, covenants, restrictions, borrower information.
- Default: events of default, negotiation, acceleration, insolvency.

Issues for the borrower and lender

▣ Principal

• Drawdown:

B = Borrower, L = Lender

①	What must be done after signing before the loan can be accessed?	B	Conditions Precedent
②	Can it draw down the funds quickly when needed - all at once or in instalments?	B	Drawdown
③	What evidence is required to permit draw-down where conditions are imposed (e.g. completion in project finance)?	B	Drawdown Conditions
④	Will the lender keep the facility available before draw-down?	B	Commitment
⑤	Are there restrictions on how the loan monies may be used?	B	Loan Purpose
⑥	For what purpose is the loan required?	L	Loan Purpose

• Repayment:

①	What will be the source of funds used to repay the loan?	B	Source of Repayment
②	Will principal repayments match the pattern and currency of the cash flows used to repay the loan?	B	Amortisation Profile
③	Will principal repayments be required whenever sufficient cash flow is available, and how is this determined relative to other facilities?	B	Cash Sweep / Waterfall
④	Can it repay early without incurring a penalty or fee?	B	Voluntary Prepayment
⑤	Can it draw down again once repayments have commenced?	B	Revolving Credit Facility
⑥	Could it be forced to repay early (e.g. on demand, change of control, or an event of default)?	B	Mandatory Prepayment
⑦	When is the final principal repayment due?	B	Maturity / Term

Interest & Fees

Interest:

1	How is interest calculated and what are the procedures for payment?	B	Interest Calculation
2	Will interest be a fixed rate on the principal, or fluctuate with a reference rate, and what margin is added?	B	Fixed Rate vs. Floating Rate
3	Will cash flows used to service the debt match the pattern and currency of interest costs?	B	Debt Service
4	How can interest rate and currency risk be reduced?	B	Hedging
5	Can interest be deferred and capitalised into the loan?	B	PIK (Payment in Kind)
6	How likely is the risk-free reference rate to change, and will the margin change?	B	Interest Rate Risk

Fees:

1	What fees are payable over the commitment period and upfront?	B	Commitment / Arrangement / Facility Fees
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Security

Ranking & Priority:

1	Will the lender rank for cash flows before, after or alongside other creditors?	L	Seniority (Senior / Junior / Pari Passu)
2	On insolvency, will the lender have rights to asset-realisation proceeds ahead of others, or claim alongside unsecured creditors?	L	Security vs Pari Passu
3	What is the nature of its interest in the assets — priority over specific assets or over all assets?	L	Fixed Charge vs. Floating Charge

Nature of Security:

1	If the loan is secured on assets, which assets are subject to the charge and what are the borrower's obligations regarding them?	B	Charged Assets
2	How does the lender preserve ranking and prevent security being granted to others over the same assets without consent?	L	Negative Pledge
3	Will any permitted encumbrances be granted that fall outside the pledge?	L	Permitted Encumbrances
4	How will the value of assets available for security be maintained?	L	Asset Cover / Maintenance

- Enforcement & Recovery:

1	Will enforcement on default enable the lender to recover an acceptable proportion of the loan, from asset realisations or claiming as a general creditor in a winding-up?	L	Recovery
2	If insolvency is to be avoided, how could the business and liabilities be reconfigured or restructured and made binding on all creditors?	L	Restructuring

Protection

- Representation & Undertakings:

1	What statements of fact (representations) must the borrower make, and on what dates (repeating or one-off)?	B	Representations & Warranties
2	What affirmative and negative undertakings must the borrower give during the term, and are there any carve-outs?	B	Covenants & Undertakings

- Financial Covenants:

1	Will the borrower be able to service the debt over the term under various business-performance scenarios?	B	Debt Service Capacity
2	What metrics will the lender use to monitor lending risk, how are they measured, and how do they compare with its other facilities?	B	Financial Covenants
3	How will the business, net assets and cash flows be monitored to confirm performance remains as expected?	L	Maintenance Financial Covenants
4	Which metrics will be used to test debt-capacity stress?	L	Debt Capacity Testing

- Restrictions:

1	What restrictions apply beyond financial-covenant thresholds (e.g. asset disposals)?	B	Negative Covenants
2	How will other group members be restricted?	B	Group Restrictions
3	Will lender consent be required for operating or financing actions?	B	Consent Rights
4	What restrictions apply to incurring new indebtedness, and how is "indebtedness" defined (leases, factoring, derivatives)?	B	Limitation on Indebtedness
5	How can transactions detrimental to debt holders be prevented — restricting security, new borrowing, asset sales, capital investment and distributions?	L	Negative Covenants / Restricted Payments
6	How can the risk arising from a transfer of ownership of the borrower be managed?	L	Change of Control

- Information & Monitoring:

①	What information must be provided to the lender on a regular basis?	B	Information Covenants
②	What power will the lender have to compel the borrower to take action to reduce risk?	L	Remedies

Default

- Event of Default ('EOD') Triggers:

①	How will the lender minimise loss if principal or interest is not paid?	B	Security
②	Which events triggering an EOD are outside the borrower's control?	B	Event Risk / Material Adverse Change
③	Will non-payment risk deviate from expected levels, and will liquid assets be adequate to service the debt at all times?	L	Credit or Default Risk

- Management & Cure:

①	What is required on a default that might lead to an actual EOD (e.g. a covenant threshold not achieved)?	B	Potential EOD / Technical Default
②	What grace or cure period is allowed to rectify technical breaches?	B	Grace / Cure Period

- Acceleration & Consequences:

①	What sequence of events leads to an EOD and a demand for immediate repayment?	B	Acceleration
②	What penalty interest applies on demand for immediate repayment?	B	Default Interest
③	What other events lead to an EOD (e.g. non-payment after a grace period, default on other loans)?	B	Cross Default (incoming)
④	What effect will an EOD have on the borrower's or a group member's other debt contracts?	B	Cross Default (outgoing)
⑤	If an EOD occurs, what rights will the lender have to commence insolvency proceedings?	B	Insolvency Proceedings

General & Boilerplate

①	Can the lender transfer "ownership" of the loan to a third party?	B	Assignment & Transfer
②	Will the legal principles that govern enforcement of the terms be as expected?	B	Governing Law & Jurisdiction

Financial Covenants

The borrower's financial risk (the ability to make interest and principal payments as and when due) can partly be assessed by monitoring financial ratios relating to a given measurement period or date. 'Coverage' ratios indicate the ability to pay interest or principal from operating profits or operating cash flows, and setting minimum or maximum thresholds which the borrower undertakes not to breach gives some assurance to the lender the borrower has the resources to service its debt. Indebtedness ratios using ratios that measure leverage (debt / (debt + equity)) or gearing (debt / equity) are another measure of financial strain. Liquidity ratios can highlight short term strain.

Standard financial covenants could include:

min. EBITDA / interest (x)	max. Net Debt / EBITDA (x)
min. CFADS / debt service (x)	max. Net Debt / Equity (%)
min. Free Cash Flows (£)	max. capital expenditures (£)
Min. Net Assets (£)	

The undertakings, in the form of financial covenants, would be tested regularly at agree dates ('Maintenance' financial covenants) if a loan facility requires them (some have the usual full set, others might be limited to leverage covenants). Some covenants are tested before the incurrence of some event (e.g. paying a dividend) ('Incurrence' financial covenants). The covenants are intended to give the lender some control in the event financial risk is increasing, and to take action well before the risk of formal insolvency (for example, by restructuring debt). The 'tighter' the covenants, the more financial discipline will be imposed on the borrower but at the risk of affecting operating performance. Financial ratios are discussed in the section on Credit Risk.

Security & Insolvency

A security creditor is defined for Insolvency purposes as 'a creditor of the company who holds in respect of his debt a security over property of the company', where "security" means... any mortgage, charge, lien or other security' (under English law) [s248 Insolvency Act 1986]. Security granted by the borrower to the lender in the form of a charge is the most common form in a loan facility governed by English Law. A lender benefits from being secured by having priority over unsecured creditors in a winding up, who have to share in funds available for distribution by the liquidator pro-rata to their claims (pari passu). A Fixed Charge, over specific assets (existing or future, under the principles of equity), 'attaches' on creation to specific property (or when a future asset comes into existence), preventing the borrower from disposing of it without the lender's consent (a sale without consent means the asset remains subject to the charge in the hands of any purchaser). A Floating Charge 'hovers' over a changing pool of identifiable assets (which can be all assets), which the borrower can freely deal with. When the conditions in the charging documents have been met (e.g. an event of default), the charge 'crystallises' and attaches or 'fastens' to the assets subject to the charge. The nature of a charge created as a floating charge does not change because of crystallisation ("floating charge" means a charge which, as created, was a floating charge... [s251 IA 1986]), but effectively it becomes a fixed charge.

See [Appendix 3](#) for a discussion on Insolvency scenarios and payouts.

Seniority & Leveraged Loans

A leveraged loan facility might be suitable when the borrower is a mid-cap or larger, has a credit rating below Investment Grade (BB+ and below for Fitch Ratings and S&P Global Ratings, Ba1 and below for Moody's), possibly due to leverage concerns, and wants to borrow a significant amount. A leveraged loan facility would usually comprise a package of Syndicated Term Loan facilities in a single Facility (senior, secured, floating rate with wide 'Credit Spread' or 'Margin' over the risk-free reference rate, such as SONIA for a UK facility), combined with a 'Super Senior' Revolver (for working capital purposes), but might also include Junior Secured Loans, Subordinated High Yield Bonds and Equity. Lenders would include banks, institutional investors (such as 'Securitised' debt funds or 'Collateralised Loan Obligations') and private credit.

The loan facility and 'Intercreditor Agreement' ('ICA') will detail which lenders are 'Contractually Subordinated' ('Junior') to 'Senior' lenders with respect to payment priority (the contractual order in which lenders are entitled to receive cash flows) and security. Junior lenders act as a 'Mezzanine' layer between senior lenders and providers of equity funding ('Sponsors'), if any. 'Structural Subordination' is achieved by the provision of loans via a 'Corporate Stack' (sub-subsidiaries, subsidiaries, parent, ultimate parent), with external borrowing at different levels being passed down the group chain: a third party ('A') lending to a parent ('B') who lends to its subsidiary ('C') will be subordinate to the claims of creditors in that subsidiary - B will only receive any distributions from C if the administrator or liquidator of C has paid off all of C's creditors (assuming funding to C is provided as equity).

The ICA will remain intact despite an Insolvency event. The 'Statutory Waterfall' described in [Appendix 3](#) still applies, however the ICA determines which party is paid first within the statutory category: fixed charge realisations → insolvency costs → preferential creditors → prescribed part → floating charge holders → unsecured creditors. If senior and junior lenders were unsecured, a liquidator would pay *pari passu* and the lenders would allocate between themselves according to the ICA (which would not be binding on the liquidator). If both are secured, the ICA would regulate priority between them, subject to property-law and insolvency rules.

A 'Leveraged Buyout' in a private equity acquisition would typically use features that are designed to allocate risk and distribute financial returns in a pre-determined manner ('Waterfall'), as reflected in the:

- structure ('Special Purpose Vehicles' set up with different objectives: 'Bidco' / Acquirer, 'Midco', 'Topco', Equity Sponsor);
- funding source (ordinary and preference shares, shareholder loans, leveraged finance);
- funding allocation ('Push Down' debt to a level where tax interest relief can be maximised) and financing rights (junior, senior, secured);
- management of risk (guarantees, subordination, security)

Financial Reporting of Debt (IFRS)

A 'Financial Liability' ('FL') includes a 'Financial Instrument' issued under contractual terms that require the delivery of cash or another asset when that liability is settled (for a discussion on recognition of liabilities in general, see p.18 in the article 'Business Acquisitions – Consideration: Form, Structure, Treatment'). This would include loans, bonds and convertible bonds, but also preference shares that meet the IAS 32 liability definition. The rights attached to the share, with respect to dividend payments (discretionary or non-discretionary) and redemption (mandatory or an issuer or holder option to redeem), would need to be examined to determine if it 'exhibits the fundamental characteristics of a FL [para. AG25 IAS 32].

A FL is recognised initially at fair value at the date the entity becomes party to the contract and then at 'Amortised Cost' [para. 3.1.1 IFRS 9], with interest charged to the P&L using the 'Effective Interest Method' and an 'Effective Interest Rate' (see p.4 in 'Security Valuation - Convertible Bond Pricing'). However, an entity may irrevocably designate a FL as measured at FVTPL if the contract contains an 'embedded derivative' or the treatment reduces a recognition or measurement 'Accounting Mismatch', when changes in the fair value of the instrument would be recognised in the P&L [para. 4.2.1, 4.2.2, 4.3.5, 5.3.1 B4.1.27 IFRS 9].

Taxation of Debt (UK)

Loan Relationship Rules ('LRR'): General Treatment

A corporate acquirer subject to UK corporation tax will be taxed under the LRR (Part 5, s292-476, CTA 2009) in respect of 'Money Debts' (settled in cash or shares) arising from: (1) actual loans: the lending of money (e.g. cash consideration financed with new borrowings), (2) deemed loans: the issue of an instrument that represents rights of a debt (e.g. loan notes issued as consideration) and (3) a 'Relevant Non-Lending Relationship' ('RNLR') (including debts subject to interest or exchange differences or debts released or impaired) [s302, s303, s479, s480 CTA 2009].

'Debits' (expenses, losses, capital losses) and 'Credits' (income, profits, chargeable gains) for LRR money debts will be taxed under the LRR, including those of a capital nature and those arising from a 'related transaction' (e.g. sale, exchange, redemption or release) [s292-296, s304 CTA 2009]. The general rule is that the amounts 'brought into account' are those that are recognised in the P&L for the period (including those 'recycled' from Other Comprehensive Income) in accordance with GAAP (UK or IAS) [s307, s308 CTA 2009].

LRR debits and credits are classified as 'trading' if the loan is for the purposes of the borrower's trade (the borrower is party to the LRR 'in the course of activities forming an integral part of the trade' [s298 CTA 2009]). Interest on borrowings relating to an acquisition would normally be treated as 'non-trading'. Debits are offset against credits under each category and any deficit is treated as a trading loss (trading LR deficits) or a Non-Trading LR Deficit ('NTLRD') [s301 CTA 2009].

For deficits arising after 1 April 2017 ('streamed' losses and deficits arising before this date are treated differently and not discussed here), relief is given against total taxable profits in the current year, the previous 12 months or future years, except NTLRD can only be carried back 12 months against non-trading LR profits (or derivative credits). Both deficits can be surrendered to other group companies under 'Group Relief' provisions, however all deficits will be subject to carry forward restrictions that limit relief in any year to a 'Deductions Allowance' (£5m) plus 50% of 'Relevant Profits', being 'Qualifying Profits' in excess of £5m. The CIR rules affect current period taxable profits, so brought forward losses are applied to the CIR restricted profits [s37, s45A CTA 2010; s463A,s463B,s463G CTA 2009] [see HMRC CFM32070].

Exceptions to the General Treatment Rules

Introduction

The general rule is subject to a number of exceptions:

- Interest treated as a distribution: 'credits or debits relating to any amount falling, when paid, to be treated as a distribution must not be brought into account for the purposes of this Part, except, in the case of credits, so far as they are avoidance arrangement amounts' [s465 CTA 2009] [HMRC CFM30150].
- 'Disguised Interest': where a company is party to an arrangement which produces a return economically equivalent to interest, that amount is brought into the LRR, based on the amortised cost method [s486B CTA 2009] [HMRC CFM42040]
- Interest paid 'late' (more than 12 months after the end of the accounting period in which it is accrued) is taxed when paid if the borrower is a 'Close Company' (broadly, a company controlled directly or indirectly by either five or fewer 'Participators' – including a shareholder or loan creditor – or any number of directors who are Participators) and the lender is a Participator in the close company borrower [s373, s375 CTA 2009; s439, s454 CTA 2010] [HMRC CFM35810].
- Restrictions imposed by the Corporate Interest Restriction (CIR) [s372-s498 TIOPA 2010].
- Amounts in respect of loans deemed to be for an Unallowable Purpose [s442 CTA 2009].
- LRR involving connected parties (e.g. intra-group loans): debits and credits are determined using the amortised cost method if the fair value method is used in the financial statements [s349 CTA 2009] [HMRC CFM35030].
- Anti-Avoidance rules that counteract 'relevant avoidance arrangements' [s455B-s455D CTA 2009] [HMRC CFM39560].
- LRR not at arm's length where arm's length adjustments are made, other than those dealt with under the 'Transfer Pricing' rules¹ [s444, s445 CTA 2009] [HMRC CFM38405], and 'mismatches' [Part 21BA CTA 2010 and Part 6A TIOPA 2010] [HMRC CFM77500].

¹ A parental loan to the acquirer to fund the cash component would normally require consideration of 'Transfer Pricing' rules that effectively adjust transactions to arm's length arrangements, but for accounting periods beginning on or after 1 January 2026, a UK-to-UK exemption may apply where the statutory conditions are met and no disqualifying criterion applies (but it will not apply to a cross-border loan from an overseas parent).

Disguised Distributions

'Interest' is not defined in the legislation for tax purposes, but an amount would be considered as 'an interest of money' if it arose from a legal right to payment for the return or compensation for use of a principal sum over time or 'payment by time for the use of money' [Bennett v Ogston (1930) 15 TC 374 - see HMRC CFM33030].

A distribution, by contrast, is defined and would include the following:

- A distribution 'out of assets of the company in respect of shares in the company' in excess of amounts treated as a repayment of share capital or amounts received as consideration for the distribution (cash or non-cash) [s1000B CTA 2010].
- A 'transfer of assets or liabilities by a company to its members, or to a company by its members' where value received by the shareholder exceeds value given by shareholder (distribution at undervalue) (excluding repayment of share capital) [s1000G, s1020 CTA 2010]
- Excessive interest (more than a 'reasonable commercial return') on 'non-commercial securities' [s1000E, s1005-1007 CTA 2010]
- Interest on 'Special Securities', including (i) unlisted convertible securities issued on terms which are not reasonable compared to comparable listed convertibles and (ii) interest payable that depends on the borrower's business performance [s1000F, s1015 CTA 2010].

The formal waiver or release of a loan by the lender would be taxed under the LRR as giving rise to debits and credits. However, the effect will be tax neutral if the lender and borrower companies are 'connected' (wherever tax resident), unless the 'deemed release' rules apply (broadly, where a connected company has acquired the debt at a discount, or the lender and borrower became connected while the debt was impaired, when a taxable credit will arise for the borrower). If a subsidiary waives a loan to its parent, the LRR are 'switched off' but the waiver would still be treated as a distribution, although not subject to tax as distributions to and by companies are not charged or relieved. An intra-group debt release may be required if a parent is disposing of a subsidiary to the acquirer, in which case it would generally be tax neutral, for these reasons [s322, s354, s358, s361, s362, s472 CTA 2009] [see HMRC CFM41060, CFM41070].

Corporate Interest Restriction ('CIR')

The CIR rules were introduced in Finance Act (No.2) 2017 in response to the OECD's 'Action 4: 2015 Final Report', issued under its Base Erosion and Profit Shifting ('BEPS') Project, that recommended a cap on tax deductions for interest and interest-equivalent costs. Under Part 10 TIOPA 2010 (s372-s498) (all references below are to TIOPA 2010, unless stated otherwise), the maximum amount of the *UK* 'Aggregate Net Tax Interest Expense' ('**ANTIE**') that is deductible for tax purposes ('**Interest Capacity**') is the *greater* of (1) the '**Interest Allowance**' ('**IA**') for the period (plus unused IA brought forward from the previous 5 years), and (2) the £2m de minimis amount (for the group, not per company) [s389, s390, s392]. The IA is calculated as the Basic Interest Allowance ('**BIA**') plus Aggregate Net Tax Interest

Income, where the BIA is the *greater* of the Fixed Ratio Interest Allowance ('FRIA') and Group Ratio Interest Allowance ('GRIA') (if a group-ratio election is made – the default is FRIA) [s372, s396]:

- The FRIA is the *lower* of (1) 30% x UK 'Aggregate Tax-EBITDA' and (2) the Fixed Ratio Debt Cap, equal to¹ the *Worldwide Group* 'Adjusted Net Group Interest Expense' ('ANGIE'), which is equal to the Net Group Interest Expense ('NGIE') +/- adjustments ['A1']. [s372, s397, s405, s496]
- The GRIA¹ (the BIA calculated using the 'Group Ratio Method') is the *lower* of (1) the 'Group Ratio Percentage' ('GRP') x UK 'Aggregate Tax-EBITDA' and (2) the *Worldwide Group* 'Qualifying Net Group Interest Expense' ('QNGIE', the GRIA 'Debt Cap'), equal to ANGIE - adjustments ['A2'], so QNGIE = NGIE +/- A1 - A2. GRP is defined as QNGIE as a percentage of Worldwide 'Group EBITDA' (max 100% or 100% if negative). [s396, s398-399, s416]

The figures derive from UK corporation tax returns (ANTIE, tax-EBITDA) and consolidated financial statements for the Worldwide Group prepared under International Accounting Standards (IAS) (NGIE, ANGIE, QNGIE, Group EBITDA) [s373, s479, s488, s492].

The Total Disallowed Amount of interest (= ANTIE – IC) [s373] is allocated between UK group members and can be carried forward indefinitely for deduction in future periods if claimed as 'Reactivated Interest' (subject to further restrictions). If there is no restriction, unused IA (= IA – ANTIE) can be carried forward for up to 5 years [s393-395]. See [Appendix 4](#) for an example.

¹ Amounts in respect of prior periods (Excess Debt Cap brought forward) have been ignored to simplify matters, as are the rules for Qualifying Infrastructure Companies ('QICs').

Loan for an Unallowable Purpose

If a LR has an Unallowable Purpose ('UP'), interest payable on the loan, or any portion that is attributable to the UP on a just and reasonable basis, will not be allowed as a tax deduction. A UP will arise in an accounting period if, 'at times during that period', the purposes of the loan include a purpose (the UP) which is not amongst the business or other commercial purposes of the company. If one of the purposes of the loan is to secure a 'tax advantage' for the company or any other person ('tax avoidance purpose'), it will not be amongst the business or other commercial purposes unless it is not the main purpose or one of the main purposes for the loan [s442 CTA 2009]. With regard to interest payable on a loan, a tax advantage would include 'a relief from tax or increased relief from tax' [s1139 CTA 2010]. HMRC provide guidance on assessing whether securing a tax advantage is the main purpose [HMRC CFM 38170].

A main purpose may be a commercial purpose that obtains a non-tax related commercial benefit, but if a tax avoidance purpose is one of the other main purposes, an UP will exist: 'The company will have a "tax avoidance purpose" if it is seeking to play its part in a scheme which, to the knowledge of the relevant decision-makers, was designed to secure a tax advantage.....The fact that the decision-makers consider that entering into the loan relationship is in the company's interests for other reasons does

not preclude them from having a “tax advantage purpose” [JTI Acquisition Company (2011) Ltd v HMRC [2024] EWCA Civ 652, Lord Justice Newey at 51].

Financing the acquisition of a third-party company by a group subsidiary in a manner that obtains a tax advantage for the group, may well be caught, as illustrated in the JTIAC case, where, although the acquisition was commercially driven, the LRR existed only for a tax avoidance purpose. In that case, a newly incorporated UK subsidiary (JTIAC) of a US parent (‘JTI’, a subsidiary of the ultimate US parent, Joy Global Inc., ‘JGI’) acquired a US company for \$1.1bn, \$550m of which was funded by JGI via a loan from JTI. As JTIAC was not trading, the interest on the loan would have been treated as non-trading LR debits that could be transferred to other UK group subsidiaries via group relief and so obtain ‘a relief from tax’. The decision-makers included directors higher up the group: ‘The directing minds in the present case on whom the purpose test is to be applied’ [at 173] ‘...would not be confined to those three directors ... appointed to the board of the Appellant [JTIAC], but would extend to include the directing minds of JGI as the ultimate parent’ [at 148] ‘...and their object in implementing the Deloitte scheme was to bring into existence the loan relationship of which the Appellant would be a party, thereby securing a UK tax advantage by generating the free-standing loan relationship debits for the UK members of the JGI group’ [at 153].... The post-completion evidence ... points overwhelmingly to the fact that to obtain the UK tax advantage was the sole purpose for the Appellant being party to the loan relationship’ [at 170] [First Tier Tribunal 2022: Judge Heidi Poon]. The Court of Appeal agreed. By contrast, in BlackRock HoldCo 5 LLC v HMRC [2024] EWCA Civ 330, unlike JTI (sole tax-avoidance purpose), BlackRock had both a commercial main purpose and a tax-avoidance main purpose, and the Court of Appeal still disallowed the interest under the unallowable-purpose rule.

CONCLUSION

The consideration ‘currency’ (cash, shares or securities) and the way any cash element is funded (existing balances, new debt or new equity) together determine the acquirer’s financial risk, its cost of capital and the way both risk and return are shared between the acquirer’s shareholders, the vendor and the providers of finance. These are a few of the many issues that an acquirer needs to consider when making an acquisition of shares – an acquisition of the business and assets is different and raises new issues relating to: the legal transfer of ownership of assets acquired, continuing relief for capital expenditure on acquired assets (capital allowances on tangible assets, amortisation of Intangible Fixed Assets, etc), relief for past trading and capital losses, stamp duty land tax, value added tax and the transfer of employee contracts.

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Suggested reading

Books:

- Arzac, E.R. (2008) *Valuation for Mergers, Buyouts and Restructurings* (2nd ed.) Wiley.
- Beale, S., Keddle, P., Bromley-White, T. (2023) *Insolvency and Restructuring Manual* (4th ed.) Bloomsbury Professional
- Brunner, R.F. (2004) *Applied Mergers & Acquisitions* Wiley
- Choudhry, M., Moskovic, D., Wong, M. (2014) *Fixed Income Markets: Management, Trading, Hedging* (2nd ed.) Wiley
- Corb, H. (2012) *Interest Rate Swaps and Other Derivatives*, Columbia Business School Publishing
- Ernst & Young (2026) *International GAAP 2026* (available at: https://www.ey.com/en_gl/technical/ifrs-technical-resources/international-gaap-2026-the-global-perspective-on-ifrs)
- Fabozzi, F.J. (2021) *The Handbook of Fixed Income Securities* (9th ed.) McGraw Hill
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- Lajoux, A.R. (2024) *The Art of M&A: A Merger, Acquisition and Buyout Guide* (6th ed.) McGraw Hill
- Singleton, S. (2018) *Beswick and Wine: Buying and Selling Private Companies and Businesses* (10th ed.) Bloomsbury Professional
- Slaughter & May (2022) *A Borrower's Guide to the LMA Investment Grade Agreements* (6th ed.) Association of Corporate Treasurers (available at <https://www.treasurers.org/best-practice/borrowers-guide-LMA-investment-grade-agreements>)
- Southern, D. (2017) *Taxation of Loan Relationships and Derivative Contracts* (10th ed.) Bloomsbury Professional Online
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- Wright, S. (2014) *The Handbook of International Loan Documentation* (2nd ed.) Palgrave Macmillan
- Yates, G., Hinchliffe, M. (2010) *A Practical Guide to Private Equity Transactions* Cambridge University Press
- Van Zwieten, (2019) K Goode on Principles of Corporate Insolvency Law (Student Edition) (5th ed.) Sweet & Maxwell

Tax Legislation:

- Corporation Tax Act 2009 (CTA 2009)
- Corporation Tax Act 2010 (CTA 2010)
- Taxation of Chargeable Gains Act 1992 (TCGA 1992)
- Capital Allowances Act 2001 (CAA 2001)
- Taxation (International and Other Provisions) Act 2010 (TIOPA 2010)

A.I. Disclosure

The words in this article are those of the author. A.I. assistance (Claude Opus 4.8) was obtained to check detail in Appendix 3 and 4 and the CIR formulae.

APPENDIX 1: Merger Evaluation Example

Transaction Information

		Acquirer	Target
Accounting year end		30 June	30 June
Next a/c y/e		30 Jun 2027	30 Jun 2027
Closing Date			30 Jun 2026
Shares	No.	5,592,443,754	308,766,200
Price (excl. bid)	£	35.91	107.00
Price (current)	£	33.64	129.00
Market Capitalisation	£m	188,139.3	39,830.8
Net Debt	£m	3,308.0	3,350.2
Enterprise Value	£m	191,447.3	43,181.0
Offer price	£		130.00
Shares to buy (100.0%)(no.)	No.		308,766,200
Pre-bid rumour equity value	£, £m	107.00	33,038.0
Premium (21.5%)	£, £m	23.00	7,101.6
Purchase cost (308.766m x £130.00)	£, £m	130.00	40,139.6
Fees	£, £m	0.00	-
Acquisition Cost	£, £m	130.00	40,139.6
Cash consideration %	%		50.00%
Ex. Ratio (130.00 / 33.64 x 50% shares)	x		1.932126
Shares issued (1.932126 x 308,766,200)	No.		596,575,291
Shares consideration	£m		20,069.8
Cash consideration	£m		20,069.8

Transaction Benefits

£m, £		Intrinsic Value	
		Target	Synergies
DCF Enterprise Value		34,616.5	
less: net debt - borrowings less cash		(3,350.2)	
less: debt equivalents		(569.3)	
DCF Equity Value - Minority Quoted		30,697.1	
Control Value	40.0%	12,278.8	
DCF Equity Value - Majority Quoted	80.0%	42,975.9	5,265.6
Relative Equity Value (multiple)	20.0%	49,000.0	3,000.0
Intrinsic Value (weighted)	129.0	44,180.7	4,812.5
		Gains	
		Market Value	Intrinsic Value
Target Equity Value	129.00	39,830.8	44,180.7
Value of Synergies	16.23	4,812.5	4,812.5
Target Value	150.52	44,643.3	48,993.2
less: consideration + costs	130.00	(40,139.6)	(40,139.6)
Gains		4,503.7	8,853.6
Acquirer Equity Value	33.66	188,139.3	
Merged value less share consideration		192,643.0	
Add back: non-cash consideration		20,069.8	
Merged Value		212,712.8	

This Appendix shows highlights of the evaluation of a hypothetical acquisition (both parties quoted), focusing on the position on closing, the source and application of funds and EPS impact in the first year.

Acquirer is to offer £130.00 per share to purchase 100.0% of Target for total consideration of £40.14bn, payable 50.0% cash (£20.07bn debt financed) and 50.0% shares. The offer was made when Target was trading at £107.00, but the price has since increased to £129.00 (£39.83bn). Assuming Acquirer's price increases to reflect the estimated synergies (£4.81bn), the proforma merged value of the entity will be £212.71bn equal to: (Acquirer £188.13bn + Synergies £4.81bn) + (Target £39.83bn - £20.07bn cash consideration). Acquirer's share price should increase from £33.64 to £34.37.

596.57m shares will be issued to Target's shareholders (based on a fixed Exchange Ratio of 1.932126) for the £20.07bn paper consideration, giving them a 9.6% shareholding and £40.57bn wealth (£20.07bn cash + £20.5bn shares). Target shareholders will be £0.74bn better off than their £39.83bn pre-acquisition value as they will be sharing in the synergy value. Their share of synergies can be shown as follows: (Value of Acquirer + Synergies) x target holding = 192.952 x 9.64% = 18.6 less (Value of Target – Cash Consideration) x acquirer shareholders holding = (39.831 – 20.07) x 90.36% = 17.86, equal to £0.74bn.

Target shareholders take 9.64% of everything the Acquirer brings (its standalone value plus the synergies), and give up 90.36% of what they contribute net of the cash received. With an estimated standalone DCF equity value of £30.697bn. Acquirer has identified significant improvements it can make, adding £12.328bn to obtain a DCF control value of £42.976bn. A multiples valuation suggests £49bn control value, and applying 80% : 20.0% weighting the final control value is £44.18bn with extra value of £4.8bn coming from synergies. The total gain based on Intrinsic Value is therefore £8.85bn (£48.99bn value - £40.14bn cost).

Exchange Ratios (ER) and Gains Sharing

	Pre-Acq	Post-Acquisition				
Chosen ER¹	Value	Shares	Shares	Value	Cash	Value
<i>ER = 1.93213</i>	£m	No.	£m	£m	£m	Value gain
Acquirer	188,139.3	5,592,443,754	192,208.9		192,208.9	4,069.6
Target	39,830.8	596,575,291	20,503.9	20,069.8	40,573.7	742.9
	227,970.1	6,189,019,045	212,712.8	20,069.8	232,782.6	4,812.5
Minimum ER²						
<i>ER = 1.85495</i>						
Acquirer	188,139.3	5,592,443,754	192,951.8		192,951.8	4,812.5
Target	39,830.8	572,746,660	19,761.0	20,069.8	39,830.8	-
		6,165,190,414	212,712.8	20,069.8	232,782.6	4,812.5
Maximum ER³						
<i>ER = 2.36570</i>						
Acquirer	188,139.3	5,592,443,754	188,139.3		188,139.3	-
Target	39,830.8	730,448,899	24,573.5	20,069.8	44,643.3	4,812.5
		6,322,892,653	212,712.8	20,069.8	232,782.6	4,812.5

Notes

¹ Exchange Ratio Merged share price: Gains are shared pro-rata

$$\begin{aligned}
 \text{Used} &= \frac{\text{Purchase price}}{\text{Acquirer price}} \times \% \text{ Shares component} \\
 &= \frac{130.00}{33.64} \times 50.0\%
 \end{aligned}$$

² Minimum Exchange Ratio Merged share price: Value for Target shareholders = purchase price (all gains accrue to Acquirer)

$$\begin{aligned}
 \text{Min ER} &= \frac{\text{Acquirer shares}}{\text{Target shares to acquire}} \times \frac{\text{Target Value} - \text{Cash Consideration ('T' - C')}}{\text{Acquirer Value} + \text{Synergies Value}} \\
 1.85495 &= \frac{5,592,443,754.0}{308,766,200.0} \times \frac{19,761.0}{192,951.8}
 \end{aligned}$$

³ Maximum Exchange Ratio Merged share price: Value for Acquirer = pre-acquisition value (all gains accrue to Target shareholders)

$$\begin{aligned}
 \text{Max ER} &= \frac{\text{Acquirer shares}}{\text{Target shares to acquire}} + \frac{\text{T - C} + \text{Synergies Value}}{\text{Acquirer Value}} \\
 2.36570 &= \frac{5,592,443,754.0}{308,766,200.0} + \frac{24,573.5}{188,139.3}
 \end{aligned}$$

SHAREHOLDINGS

	PRE-ACQUISITION			POST-ACQUISITION			
	Holding		Value	Holding		Value	Cash
	%	No.	£m	%	#	£m	£m
Shareholder A1	26.8%	1,500,000,000	50,462.5	24.2%	1,500,000,000	51,554.1	
Shareholder A2	13.9%	775,000,000	26,072.3	12.5%	775,000,000	26,636.3	
Shareholder A3	11.6%	650,000,000	21,867.1	10.5%	650,000,000	22,340.1	
Shareholder A4	47.6%	2,664,640,700	89,643.0	43.1%	2,664,640,700	91,582.1	
Shareholder A5	0.1%	2,803,054	94.3	0.0%	2,803,054	96.3	
Acquirer	100.0%	5,592,443,754	188,139.3	90.4%	5,592,443,754	192,208.9	
Shareholder T1	17.8%	55,000,000	7,095.0	1.7%	106,266,946	3,652.3	3,575.0
Shareholder T2	24.3%	75,000,000	9,675.0	2.3%	144,909,471	4,980.5	4,875.0
Shareholder T3	8.6%	26,500,000	3,418.5	0.8%	51,201,347	1,759.8	1,722.5
Shareholder T4	45.4%	140,096,176	18,072.4	4.4%	270,683,504	9,303.2	9,106.3
Shareholder T5	3.9%	12,170,024	1,569.9	0.4%	23,514,023	808.2	791.1
Target	100.0%	308,766,200	39,830.8	9.6%	596,575,291	20,503.9	20,069.8
Merged				100.0%	6,189,019,045	212,712.8	
Acquirer share price (£)			33.64			34.37	

SOURCE OF FUNDS

	Max	% of Cash Component	Rate	Term	Currency	Raised	Net Raised
Existing Acquirer Cash	12,456.0	0.0%	-	--		-	-
Existing Target Cash	366.7	0.0%	-	--		-	-
Equity - rights issue	None	-		--		-	-
Revolving Facilities	None	12.8%	5.400%	4.0 yrs	£	2,569.8	2,569.8
Senior Term Loan A	None	62.3%	5.400%	1.0 yrs	£	12,500.0	12,500.0
Senior Term Loan B	None	24.9%	5.300%	3.0 yrs	£	5,000.0	5,000.0
CASH		100.0%	5.375%			20,069.8	20,069.8
Shares to be acquired	308,766,200		@ 130.00				
Exchange Ratio		1.932126					
Shares component		50.0%					
SHARES	596,575,291		@ 33.64				20,069.8
Acquisition of shares							40,139.6
Transaction fees and expenses							-
Cost of Acquisition							40,139.6
Assumed Debt and Other							3,753.8
Transaction Value							43,893.4

USE OF FUNDS

	% of Cash Component	Non-current Debt	Current Debt	Target Debt	
Purchase of target shares	91.4%				40,139.6
Transaction Fees & Expenses	0.0%				-
Target debt: Refinance?					
Commercial Paper	No	-	395.8	395.8	
Senior Term Loan A	No	8.0	-	8.0	
Senior Notes A	No	2,750.0	600.0	3,350.0	
Debt Assumed and Refinanced	8.6%	2,758.0	995.8	3,753.8	3,753.8
Cash for Working Capital Requirements	0.0%				
Transaction Value	100.0%				43,893.4

Acquirer's forecast EPS on a standalone basis is £2.4842 (see below), compared to the merged EPS of £2.3785 (the transaction is therefore dilutive). The increase in net profit from the merger (£0.827bn) divided by the number of Acquirer shares (5.592bn), increases Acquirer's EPS by 0.1480 to £2.6322, but this is reduced by dilution due to the 10.668% increase in shares issued for the 50% share component = $\text{£}2.6322 / (1 + \frac{596,575,291}{5,592,443,754}) = 2.3785$:

Year 1

Operating Profits	23,133.7	Acquirer Net Profit (£m)	13,893.0
Acquirer	498.2	Old Shares (no.)	5,592,443,754
Target	14.7	EPS £	2.4842
Finance income	512.9		
Acquirer	(838.7)	Merged Net Profit (£m)	14,720.4
Target	(189.9)	New Shares (no.)	6,189,019,045
Acquisition financing	(1,115.2)	EPS £	2.3785
Finance costs	(2,143.8)		
Acquirer	(6,418.4)		
Target	(656.6)	Increase in profits	827.4
Acquisition financing	352.4	Increase in shares	596,575,291
Synergies	(59.9)		
Income tax expense	(6,782.4)		
Acquirer	13,893.0		
Target	1,457.3		
Acquisition finance	(762.8)		
Synergies	132.9		
Net Profit	14,720.4		

The net finance cost relates to the first year's post-tax interest on the £20.1bn cash component, calculated using a blended 5.56% interest rate and the applicable tax rate.

APPENDIX 2: Financial Measures & Ratios

Balance Sheet – Profit – Cash Flow Reconciliation (ignoring Non-Controlling Interests)

Increase in Retained Earnings		
Operating Assets	x	
Non-Operating Assets	x	
Financial Liabilities	(x)	
Other Liabilities	(x)	
Net Assets = Equity (Balance Sheet)	x	
Adjustments to leave Retained Earnings (Share Capital, Share Premium, Reserves)	(x)	
Retained earnings at end of period (Statement of Changes in Equity)	x	
Less: Retained earnings at start of period	(x)	
Increase in retained earnings		x
Adjustments to reconcile to net profit:		
Other Comprehensive Income (component not recognised in Reserves)	(x)	
Transfers from reserves to retained earnings	(x)	
Equity-settled share-based payment transactions	(x)	
Dividends paid	x	
Increase in retained earnings adjusted to profit		x
Profit For The Period		x
Adjustments to reconcile to operating profit:		
Profit from discontinued operation, net of tax (to sale date)	(x)	
Income tax expense	x	
Share of profits of associates and joint ventures	(x)	
Net finance costs	x	
Operating Profit		x
Adjustments to add back or remove non-cash flow items:		
Depreciation of property, plant and equipment and right-of-use assets	x	
Amortisation of intangible assets	x	
EBITDA (non-GAAP)		x
Further adjustments to add back or remove non-cash flow items:		
Impairment of goodwill	x	
Share-based payment expense (equity settled)	x	
Net foreign exchange differences	x	
Fair value adjustment of a contingent consideration	x	
Net loss on derivative instruments at fair value through profit or loss	x	
Movements in provisions and pensions	x	
Gain on disposal of property, plant and equipment	(x)	
Increase in fair value of investment property	(x)	
Gain on sale of discontinued operations	(x)	x
(Increase) / Decrease in working capital		x
Cash from Operating Activities before Income Taxes		x
Income taxes paid		(x)
Net Cash from Operating Activities		x
Cash flows from Investing Activities (acquisitions, capex, interest & dividends received)		x
Cash flows from financing activities		x
NET CASH FLOWS		x
Cash at start of period		x
Cash at end of period		x

APPENDIX 3: Insolvency Procedures

Insolvency Commencement under Scenarios

If an Event of Default is declared with respect to a loan facility and the lender accelerates the loan and demands immediate repayment, the consequences depend on the nature of the security:

- Unsecured (no other charges) If the borrower takes no action, an unsecured creditor may initiate a *compulsory winding-up*:

Compulsory Liquidation 'A company may be wound up by the court...by petition presentedby any creditor...if.....the company is unable to pay its debts....A company is deemed unable to pay its debts:

- if a creditor...to whom the company is indebted in a sum exceeding £750 then due has served on the company...a written demand ...requiring the company to pay the sum so due [within] 3 weeks....or
- if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due..... [or] that the value of the company's assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.

When a winding-up order has been made or a provisional liquidator has been appointed, no action or proceeding shall be proceeded with or commenced against the company or its property, except by leave of the court...'

[s122, s123, s124, s129, s130 IA 1986]

Liquidation will lead to the eventual dissolution of the company and is therefore terminal.

Administration Liquidation can be avoided if an unsecured creditor applies to the court for an *Administration* order:

'An application to the court for an administration order in respect of a company...may be made only by the company, the directors of the company, one or more creditors of the company....The court may make an administration order in relation to a company only if satisfied (a) that the company is or is likely to become unable to pay its debts, and (b) that the administration order is reasonably likely to achieve the purpose of administration [by] (a) rescuing the company as a going concern, or (b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or (c) realising property in order to make a distribution to one or more secured or preferential creditors.' [para.3,11,12 Sch.B1 IA 1986]

A moratorium on insolvency proceedings applies once the company is in Administration.

'No resolution may be passed ...[or] order may be made for the winding up of the company.... No step may be taken to enforce security over the company's property except with the consent of the administrator, or with the permission of the court.' [para. 42, 43 Sch.B1 IA 1986]

- Fixed charge only
Receivership A formal insolvency process is not required because the **receiver** will have power to take possession and control of the charged property and dispose of it for the benefit of the charge holder under the debenture instrument or Law of Property Act 1925. Any surplus will be paid back to the company or be made available to any fixed charge on the same property that was created after the charge in question. Any shortfall will require the lender to take action as an unsecured creditor (see above), since it cannot appoint an Administrator *out of court* (only a floating charge holder can).
- Fixed and Floating charge (same loan)
Receivership A charge created after 15 September 2003 means the charge holder cannot appoint an **Administrative Receiver** (subject to certain exceptions):
Administration 'The holder of a qualifying floating charge which relates to the whole or substantially the whole of the company's property may not appoint an administrative receiver of the company' [s72A Insolvency Act 1986]
The charge holder would enforce its rights over fixed charge property (appointment of receiver – see above) and would appoint an out-of-court Administrator if the floating charge was qualifying:
'The holder of a qualifying floating charge in respect of a company's property may appoint an administrator of the company ...[except if] a provisional liquidator of the company has been appointed under [compulsory liquidation]... [para. 14, 17 Sch.B1 IA 1986].
- Unsecured (1st loan)
Floating Charge (2nd loan)
If the lender of the first loan applies for an Administrator order as an unsecured creditor (see above), a floating charge holder on another loan can intervene and appoint its own Administrator under para.14, provided the first order has not actually been made.
The unsecured creditor is required to notify the floating charge holder (no minimum notice period), but it must be served before the hearing for the Administration order application.

The charge holder would then appoint an Administrator under para.14 (if qualifying) without the moratorium under para.44, before the order is made on the first application.

‘As soon as is reasonably practicable after the making of an administration application, the applicant shall notify. . . any person who is or may be entitled to appoint an administrator of the company under paragraph 14’ [para. 12(2) Sch.B1 IA 1986]

‘Notification for the purposes of paragraph 12(2) of Schedule B1 must be by service of the application [for the Administration order]. . . .The service of an application or petition must be verified by a certificate of service. . . .[which] must be filed with the court as soon as reasonably practicable after service and in any event not later than the business day before the hearing of the application.’ [Rule 3.8(2), Para.6 Sch.4, Rule 3.8(4) Insolvency (England and Wales) Rules 2016]

‘Where an administration application in respect of a company has been made and. . . .but the administration order has not yet taken effect. . . This. . . does not prevent or require the permission of the court for the appointment of an administrator under paragraph 14. . . .’ [para.44 Sch.B1 IA 1986]

‘A person may not be appointed as administrator of a company which is in administration’ [para.7 Sch.B1 IA 1986]

- Fixed Charge (1st loan) Generally, a fixed charge takes priority over a floating charge over the same asset under common law (in the absence of a negative pledge of which the fixed charge holder had notice). The fixed charge holder could appoint a receiver as discussed above, however if the floating charge holder has already appointed an Administrator, it would need the consent of the Administrator or the permission of the court before doing so. [para.43(2) Sch.B1 IA 1986].
- Floating Charge (2nd loan)

Insolvency Realisations & Distributions

Administrator powers to distribute

The administrator can realise assets subject to a fixed or floating charge and distribute to the charge holder (and pay preferential creditors from the proceeds from the floating charge assets):

‘The administrator of a company may dispose of or take action relating to property which is subject to a **floating charge** as if it were not subject to the charge.’ [para.70 Sch.B1 IA 1986]

‘The court may by order enable the administrator of a company to dispose of property which is subject to a security (**other than a floating charge**) as if it were not subject to the security. . . subject

to the condition that there be applied towards discharging the sums secured by the security... the net proceeds of disposal of the property.’ [para.71 Sch.B1 IA 1986]

“Property” includes money, goods, things in action, land and every description of property wherever situated and also obligations and every description of interest, whether present or future or vested or contingent, arising out of, or incidental to, property.’ [s436 IA 1986]

However, distribution to unsecured creditors requires either the permission of the court or the commencement of ‘Creditors’ Voluntary Liquidation’, when the liquidator would make the distributions (assuming Administration does not follow a Part A1 Moratorium).

‘A payment may not be made by way of distribution under this paragraph to a creditor of the company who is neither secured nor preferential unless (a) the distribution is made by virtue of section 176A(2)(a)[the prescribed part, discussed below], or (b) the court gives permission.’ [para.65(3) Sch.B1 IA 1986].

Payout Order

Distribution of proceeds from the sale of assets follows a set order. Using the example below, amounts due to fixed charge holders (£90) are paid first from the net proceeds (after costs) of their charged assets (£100), usually by a receiver appointed by the charge holder. Any surplus (£10) is added to proceeds from the realisation of unsecured ‘free’ assets (£250), before ‘Preferential Creditors’ (£50) are paid off. The funds available for the floating charge holder from the sale of its charged asset (£150) would be reduced by the prescribed amount (see formula below – capped at £0.8m if the floating charge was created on or after 6 April 2020) set aside for unsecured creditors (£33) before the balance is paid to floating charge holders (£117). Cash available for distribution to unsecured creditors (£243) is used to pay unsecured creditors up to the prescribed amount (£33), with funds remaining (£210) being paid to the unsecured creditors and floating charge holders *pari passu* (166 and 44, respectively). Unsecured creditors and floating charge holders in the example will lose £21 and £14 respectively (10p and 8p in the pound, respectively). [s176A Insolvency Act 1986]

	Fixed		Floating		Free	
	Cash	Debt	Cash	Debt	Cash	Debt
Proceeds from sale of assets / (Debt)	100	(90)	150	(175)	250	(220)
less: paid to fixed charge holders	<u>(90)</u>	<u>90</u>				
Surplus	10	<u>=</u>				
Transferred to general estate	(10)				10	
less: liquidation costs			-			
less: paid to preferential creditors					(50)	
less: ‘Prescribed Part’ (50% x £10k + 20% x (£150k - £10k))			(33)		33	
less: paid to floating (in excess of prescribed part, up to cash available)			<u>(117)</u>	<u>117</u>		
			<u>=</u>	58	243	
Less: repayment of unsecured creditors – prescribed part					(33)	33
Less: repayment of unsecured creditors + floating charge deficit (<i>pari passu</i>)				<u>(44)</u>	<u>(210)</u>	<u>166</u>
				<u>14</u>	<u>=</u>	<u>21</u>

APPENDIX 4: CIR Definitions & Example

Interest Reconciliation

		TIOPA 2010
LR Debits [A] - excl. LR forex and FV impairment exceptions	x	s383
Derivative Debits [B] [IR, currency A/L only] - excl. forex and impairment	x	s384
Finance charges [C]: finance lease, debt factoring, repos etc	x	s382
Less: qualifying Infrastructure Company expense amounts	(x)	s432-449
Tax Interest Expense	x	
LR Credits	x	s385,386
Derivative Credits	x	s385,387
Finance income on relevant arrangement transactions	x	s385
Debt guarantee fees	x	s385
Less: qualifying Infrastructure Company income amounts	(x)	s432-449
Tax Interest Income	(x)	
Aggregate Net Tax Interest Expense [ANTIE]	x	s389, s390
Relevant Expense Amount	x	s410-412
Relevant Income Amount	(x)	
Net Group Interest Expense (NGIE)	X	s410
Add: Upward Adjustments	x	
Less: Downward Adjustments	(x)	
Adjusted Net Group Interest Expense (ANGIE)	x	
Share of Associates ANGIE if non-consolidated investment election made	x	
Adjusted Net Group-Interest Expenses (ANGIE)	X	s413
Less: Downward Adjustments		
• Relevant expenses for related party transactions	(x)	
• Payments for results-dependent securities	(x)	
• Equity Note payments	(x)	x
Qualifying Net Interest Expense (QNGIE) (Worldwide Group)	X	

EBITDA Reconciliations

		1 "Relevant asset" include:	
Group Pre-Tax Profit	x	- plant, property and equipment,	s416
+ NGIE	x	- an investment property,	s416
+ Depreciation, Amortisation, Impairment on Relevant Assets ¹	x	- an intangible asset	s417
+ / - Fair value movements on Relevant Assets ¹ measured at FV	x	- goodwill	s418
+ / - Losses/(Gains) on disposals of Relevant Assets ¹	x	- shares in a company, or	s419
- R & D Expenditure Credit	(x)	- an interest in an entity which	s416
		entitles the holder to a share of	
		the profits of the entity.	
Group EBITDA			
- EBITDA for Qualifying Infrastructure Companies (QICs) in group	(x)		
Group EBITDA (Worldwide Group)	x		
Taxable Total Profits for period	x		s406
+ / - Excluded amounts:			s407
- a tax-interest expense / income amount	x		
- claimed capital allowance or charge under CAA 2001	x		
- excluded relevant intangibles debit /credit	x		
- a loss not allowable under TCGA 1992	x		
- a deficit from the company's LR	x		
- brought forward or carried back LR deficits	x		
- expenses of management	x		
- group relief deductions	x		
- a qualifying tax relief	x	(x)	
Tax EBITDA (UK tax companies)	x		s372,405-406

Example: CIR A company incurs £10.9m of net interest costs (ANTIE) and has tax-EBITDA of £12.9m. Its ANGIE, QNGIE and Group EBITDA are £9.8m, £9.8m and £30.65m. The FRIA 30% ratio is less than the GRP 32% (£9.8m / £30.65m), so the borrower elects for GRIA. Interest Capacity is £4.125m (=31.97% x £12.9m tax-EBITDA), and the Disallowed Amount £6.775m (£10.9m - £4.125m).

INTEREST RECONCILIATION			
			<i>TIOPA 2010</i>
LR Debits	12,000		s383
Derivative Debits	1,500		s384
Tax Interest Expense		13,500	
LR Credits	2,000		s385,386
Derivative Credits	600		s385,387
Tax Interest Income		2,600	
AGGREGATE NET TAX INTEREST EXPENSE [ANTIE]		10,900	s389, s390
Interest payable under a LR and relevant non-lending relationship	12,500		
Relevant Expense Amount		12,500	s410-412
Relevant Income Amount (income version of all above)		(3,350)	
NET GROUP INTEREST EXPENSE (NGIE) or Net Group Relevant Expense		9,150	s410
<i>Add: Upward Adjustments:</i>			
Relevant expenses included in carrying value of A/L	500		
Relevant expenses not recognized in P&L or OCI	200		
Capitalised relevant income written off	100		
Relevant income not permitted under s322-323 CTA 2009	150	950	s413
<i>Less: Downward Adjustments</i>			
Relevant income included in carrying value of A/L	(300)	(300)	
ADJUSTED NET GROUP-INTEREST EXPENSES (ANGIE)		9,800	s413
<i>Less: Downward Adjustments</i>			
Relevant expenses for related party transactions	-		
Payments for results-dependent securities	-		
Equity Note payments	-	-	
QUALIFYING NET INTEREST EXPENSES (QNGIE)		9,800	s414

EBITDA RECONCILIATIONS			
			<i>TIOPA 2010</i>
Group Pre-Tax Profit	12,000		s416
+ NGIE	9,150		s416
+ Depreciation, Amortisation, Impairment on Relevant Assets ¹	8,000		s417
+ / - Fair value movements on Relevant Assets ¹ measured at FV	1,000		s418
+ / - Losses/(Gains) on disposals of Relevant Assets ¹	500		s419
GROUP EBITDA		30,650	
Taxable Total Profits for period		2,000	s406
+ / - <i>Excluded amounts:</i>			s407
Tax-interest expense / income amount	10,900		
Qualifying tax relief		10,900	
TAX EBITDA (Adjusted Corporation Tax Earnings)		12,900	s372, 405-406

DISALLOWANCE CALCULATION

	FRM	GRM
Relevant Expenses	12,500	
Relevant Income	(3,350)	
NGIE	9,150	
+ / - Adjustments	650	
ANGIEt	9,800	9,800
- Adjustments - (only)		-
QNGIEt		9,800
Group Ratio Percentage = QNGIE / group-EBITDA _t		32.0%
[A] Debt Cap	9,800	9,800
[B] 30% or GRPt x Tax-EBITDA _t	3,870	4,125
Basic Interest Allowance (lower of A or B)	3,870	4,125
+ Net Tax Interest Income (if any)	-	-
Interest Allowance (IAt)	3,870	4,125
Interest Capacity (IC) [min £2m de minimis]	3,870	4,125
 <i>Basic Interest Allowance = higher of FRM / GRM</i>		
Interest Allowance (IAt)		4,125
Interest Capacity (IC)		4,125
ANTIE		10,900
Total Disallowed Amount	('DA' = ANTIE - IC)	6,775