Deductible relationships

International Tax | Large Corporate

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Matt Stringer considers the UK's provisions relating to the deductibility of interest expense

Key Points

What is the issue?

For UK-resident companies, complex and detailed provisions can restrict tax relief for interest expense

What does it mean for me?

UK-resident companies and their advisers must be aware of these provisions and their application to be satisfied that interest expense is deductible for tax purposes

What can I take away?

An understanding of the provisions to be aware of when considering interest deductions for a UK company, and to consider the future direction those provisions may be headed

A UK tax resident company has borrowed, so has a loan payable amount. Interest accrues on the loan. Is this finance expense deductible for the company when calculating its corporation tax for the year? Broadly yes, as long as you can jump over the hurdles to interest deductibility. However, UK resident companies and their advisers ought to be aware of the UK's provisions on the deductibility of interest expense. The provisions discussed are not an exhaustive list and other anti-avoidance areas may be relevant too.

General position

Assuming that our loan is a money debt that has arisen from a transaction for the lending of money, it should meet the definition of a 'loan relationship'. The tax treatment of the debits and credits arising from our loan relationship should then follow its accounting treatment. If our loan was taken out to fund our company's trading operations – for example, working capital to buy stock or office space – debits would constitute a trading expense. If the loan was taken out for a non-trade purpose, such as funding an investment property, to buy shares, or for another group company's trade, debits would be pooled with other non-trading loan relationship debits and credits to form a net profit or loss from non-trade loan relationships.

Purpose of the borrowings

Whether our company’s purpose for the loan was a trading or non-trading one is irrelevant for determining whether interest is considered a deductible expense for tax purposes. However, the loan relationship rules disallow the deduction of interest if a loan has an ‘unallowable purpose’, meaning a purpose not among the business or commercial purposes of the company. In practice, the most common unallowable purpose considered relates to tax avoidance.

If securing a UK tax advantage for our company, or any other company, was the main purpose, or one of the main purposes for our company becoming party to the loan relationship, our interest deductions would be disallowed.

The unallowable purpose provisions have been the subject of much discussion since their introduction in 1996 and, more recently, the subject of a number of tax cases. The key question which continues to resonate today is: where and what is the commercial driver for the transaction?

Transfer pricing

Large companies and some SMEs may be required to adjust their taxable profits in accordance with the transfer pricing provisions. These apply when transactions are entered into with associated entities that differ from the ‘arm’s length transaction’ and, as a result, there is a UK tax advantage.

Let us assume that our UK company is part of a large group and has borrowed from another group company. When considering whether a transfer pricing adjustment is required in relation to our interest expense, we should consider: would the company have been able to borrow from a third party at all? Would the company have been able to borrow the amount that it has? What rate of interest and other terms would be attached to a third-party borrowing arrangement?

These questions are not easy to answer. Many jurisdictions have ‘safe harbour’ rules stating appropriate debt-to-equity and interest-cover ratios, but the UK has stayed away from this approach. Each company should be considered uniquely, addressing its particular facts and circumstances – although, increasingly, lenders and HMRC are looking to these ratio-based tests to assess the position. If a transfer pricing exercise reveals that our company’s interest expense is in excess of the arm’s length amount, this excess deduction would be disallowed.

Tax arbitrage

The UK introduced provisions in 2005 to deny UK tax deductions that arise from schemes involving hybrid entities or hybrid instruments. The rules can apply when a UK company makes a payment as part of a scheme where, subject to these rules, it results in an allowable deduction for UK tax purposes and either the recipient is not subject to tax on the corresponding income, or another party is able to claim a tax deduction in relation to the same payment.

If our UK company borrowed as part of a scheme that creates an ‘arbitrage’ of this type, HMRC may issue a notice requiring us to disallow the interest expense. Given that anti-hybrid rules are being considered under the OECD’s base erosion and profit shifting (BEPS) action plan, there is an expectation that the tax arbitrage rules could be subject to change.

Worldwide debt cap

The UK introduced statutory rules in 2009 to prevent UK-resident companies within large multinational groups taking deductions for interest expense that are in excess of those borne by the group as a whole. The rules are complex and must be considered at each accounting period.

Again, let us assume that our company is part of a large group, but not in the financial services industry. First, we must consider a ‘gateway’ test. Is the ‘UK net debt’ in excess of 75% of the ‘worldwide gross debt’? This is a balance sheet test requiring an average from two consecutive years to determine the amount of debt for the period. The phrases ‘UK net debt’ and ‘worldwide gross debt’ take their expected meaning: the former being the sum of the net amount of all loan payables and receivables for all relevant group companies; the latter being the total loan payables amount on a consolidated group basis. Company net debt figures of less than £3 million are excluded from the UK net debt total.

If our UK company is part of a group where UK net debt is in excess of 75% of the worldwide gross debt for an accounting period, the main rules need to be considered as part of an income statement test. The main rules state that a restriction is applied to interest expense when the tested expense amount exceeds the available amount. To the extent that this is the case, the difference is called the total disallowed amount.

Broadly, the tested expense amount is the sum of the financing costs for relevant group companies – ignoring any financing income – and the available amount follows the same concept on a worldwide consolidated basis. A company is excluded from the tested expense amount calculation if its financing costs are less than £500,000.

When there is a total disallowed amount, a mechanism exists for UK group companies with net financing income to take a compensating adjustment by disallowing financing income. Groups with non-wholly owned entities should be particularly aware of the definitions within these rules: a debt cap grouping, a relevant group company, and a UK group company are all different concepts.

Late paid interest

Suppose our UK company is accruing interest expense through its accounts but has not physically paid the interest. If the loan creditor has not brought corresponding credits into account in respect of the accrued interest and interest has not been paid within 12 months of the end of the accounting period in which we have brought our debits into account, the deductibility of interest may be denied until the interest is paid.

There are four scenarios in which these rules may be applied. The most common case I see when working with multinationals is where the debtor and creditor are connected and the creditor is tax resident, or managed in a ‘non-qualifying territory’, those that do not have a tax treaty with the UK containing a non-discrimination clause.

Notably, for loans entered into after 3 December 2014 and all interest accruals from 1 January 2016, two of the four scenarios have been repealed. These include the one discussed above where the late paid interest rules apply. There are transitional rules for interest accruals on existing loans in the interim period.