Merger and acquisitions: the deductibility of interest and finance costs

Large Corporate

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In the third and final part of the series on mergers and acquisitions, we look at the deductibilityof interest and finance costs and the various restrictions which may apply.

Key Points

What is the issue?

Purchasers will often use debt as a means of financing acquisitions. One of the key attractions of this method of financing is the expected UK tax deduction for interest and related costs. However, numerous restrictions may prevent this being the case.

What does it mean for me?

When advising companies on the acquisition or disposal of investments, or acting for a company which has recently been acquired, consider how the various restrictions may apply to the deductibility of the additional interest and related costs.

What can I take away?

There are numerous restrictions which may apply to restrict the tax relief available for interest and related finance costs. They should be considered in turn, ending with the corporate interest restriction.

This article is the final piece in a series of three exploring some of the tax issues faced by companies or groups in relation to mergers and acquisitions – in this case, the tax deductibility of interest and finance costs on various types of debt.

Types of debt

Vendor debt is outstanding consideration, which is likely to be formalised as an interest-bearing loan note. Inter-company financing is debt provided by other parts of the acquisition group.

In a leveraged buy-out situation, other forms of debt may arise. Senior debt, typically provided by a bank or a syndicate of banks, has priority over other types of debt in terms of repayment. It is typically secured by the assets of the group and therefore has a lower interest rate than other types of debt. This debt is normally drawn down at a lower tier in the holding company structure than other forms of finance, to provide structural seniority to the lenders.

Subordinated debt has a lower priority than senior debt in terms of repayment. It is typically unsecured and carries a higher interest rate than senior debt. The most common type of subordinated debt in an M&A context is mezzanine debt. Mezzanine debt can also include equity features, such as warrants or options, allowing the holder the ability to subsequently acquire equity in the company.

Interest as a distribution

Interest payments can be recharacterised as distributions when these are in respect of either ‘non-commercial securities’ or ‘special securities’.

Non-commercial securities are those where the interest charge exceeds a reasonable commercial return on the lending. HMRC’s Company Taxation Manual at CTM15502 confirms that the test will be imposed when the borrowing is taken out and will not be retested based on subsequent events. As senior and mezzanine debt is generally borrowed from third parties, there should normally be no issue around commerciality. However, care should be taken where borrowing is from a connected party or where the debt has a particularly high yield or unusual feature.

Where a restriction applies, only the excess interest above the reasonable commercial rate of return will be reclassified as a distribution. Where any withholding of tax is required, this would not apply to the recharacterised amount.

Special securities, in an M&A context, are likely to include those which are convertible into shares or carry a right to receive shares, such as convertible loan notes or debts with an equity ‘kicker’, warrant or option. However, no restriction will apply if the securities are listed on a recognised stock exchange or are issued on terms ‘reasonably comparable’ to such listed securities. HMRC should take a broad view of what this means (CTM15515).

Securities where the interest paid varies based on the results of any of the borrower’s business (and this is not an inverse relationship), such as limited recourse loans, will be special securities.

Finally, securities and shares which are ‘stapled’, such that one is likely to be acquired or disposed of with the other, will be special securities. However, this only applies to securities and shares issued by the same company. There should therefore be no restriction where these are issued by different companies in the acquisition structure.

Transfer pricing

In the context of an acquisition, the transfer pricing rules may apply to inter-company borrowing and any borrowing involving the shareholders of the acquisition structure. The transfer pricing rules deny interest deductions between connected persons if the relevant borrowing is not on arm’s length terms. To comply with the arm’s length principle, the terms, amount and availability of the debt will be adjusted (for tax purposes) to reflect what they would have been on an arm’s length transaction.

Although third-party senior and mezzanine financing is typically on arm’s length terms, HMRC considers the terms of the senior and mezzanine debt as useful comparables when trying to establish the overall arm’s length position, as the debt is from an independent party, relates to the specific business and is usually provided at the same time as the shareholder debt.

If a borrower is denied a deduction for interest under the transfer pricing rules, a UK lender can make a claim for a compensating adjustment and the lender will not be treated as receiving interest income.

Careful consideration of each relevant loan is necessary, with the terms and amount being compared to what would have been agreed between independent persons dealing at arm’s length. Various accepted methods can establish an arm’s length price, and details of the methods employed should be recorded.

Late paid interest

Interest is generally deductible when it accrues, rather than when it is paid. Even if the borrower rolls up the interest and pays it at the end of a loan relationship, the timing of the deduction will be spread throughout the term of the loan.

The late paid interest rule prevents tax mismatches where the borrower claims relief for interest as it accrues, but the lender is only taxed when the interest is received or is outside the UK tax net entirely. The rule defers the borrower's deduction for interest relief until the interest is actually paid. The rule was partially repealed in Finance Act 2015 and now applies only to loans by participators to close companies (and where this is a company rather than an individual, it only applies if the company is in a non-qualifying territory) and loans by trustees of pension schemes.

Similar rules apply to deeply discounted securities and prevent the mismatch that arises where the borrower claims tax relief on interest as it accrues, but the lender doesn't recognise the interest payment until the deeply discounted securities are redeemed. The tax relief available to the borrower is deferred until the deeply discounted securities are redeemed. The deeply discounted securities rule was also partially repealed in Finance Act 2015 and now applies only to loans by participators to close companies.

Both rules can apply to loans from individuals or partnerships in a UK acquisition, to the extent that they are not brought into account under the loan relationship rules by partners in the partnership.

Deeply discounted securities are sometimes preferred to loan notes with interest that rolls up where the lender is subject to withholding tax on interest because there are no payments of interest throughout the term of the borrowing and so no withholding is required. However, if there is a risk that tax relief will be deferred, it may be more efficient for the borrower to pay the interest in kind; for example, by issuing funding bonds.

Interest free and non-market loans

Companies may need to account for non-market loans, such as interest-free loans, at less than their face value in certain circumstances. The difference between the two values (the discount) will then be debited to the company's income statement over the loan's life.

A tax asymmetry may arise if corresponding credits arising on the discount are not brought into account by the lender. Legislation restricts the deductibility of debits relating to these loans where the lender is an individual (including individuals in a partnership) or is a company resident in a non-qualifying territory.

Hybrid and other mismatches

In the context of finance costs, the hybrid rules can deny a tax deduction where the payment is not taxed by the recipient, or where another party also obtains a deduction for the same payment, because of a structural mismatch (hybridity) in an instrument or structure. Hybridity can arise in relation to the way payments are treated (as equity or debt) or in relation to the way entities are treated (transparent or opaque) by different jurisdictions.

These rules can apply to both connected party transactions and any third party transactions which are 'structured arrangements', as well as wholly domestic transactions involving a UK tax mismatch. These rules will therefore need to be considered in relation to every debt. The most commonly affected debt in an M&A context will be debts due to investors within the structure, including the investors in any fund which ultimately owns the company. Hybridity is also most often found in relation to the fund structure itself.

The rules in relation to hybrid and other mismatches are complex. Helpfully, changes introduced in Finance Act 2021 have relaxed the requirement to treat lenders and investors holding direct investments of 5% or less in a borrower company as 'acting together'. In addition, where investors hold interests through a 'transparent fund' (broadly, a UK tax-transparent collective investment scheme or authorised investment fund), it is generally possible to ignore a hybrid mismatch where a person (together with any related parties) has less than a 10% interest in that amount.

Unallowable purposes

The unallowable purpose rule can disallow a tax deduction for a company's interest expense if it is attributable to an unallowable purpose or intention, such as securing a tax advantage. The rule can apply even if the tax advantage does not arise directly from the loan relationship in question. The rule operates on an accounting period basis, and a loan may fall under the rule in some accounting periods and outside it in others.

The unallowable purpose rule is likely to apply to borrowers who enter into or retain a borrowing for artificial, tax-driven arrangements, retain a loan they no longer need for their commercial or business purposes, refinance an existing borrowing purely to obtain a tax advantage, or use the loan to fund activities that cannot make a pre-tax profit.

The unallowable purpose rules have been prominent in tax cases in 2022, with *BlackRock Holdco 5* [2022] UKUT 199 and *JTI Acquisition Company* [2022] UKFTT 166 being particularly relevant to M&A activity. Prior to these cases, it was generally acknowledged that borrowing to finance a third-party corporate acquisition is typically not considered an unallowable purpose, even when a non-trading holding company surrenders a non-trading deficit generated by interest payable on such borrowing via group relief.

The approach taken by HMRC in *JTI Acquisition* appears to be at odds with the guidance provided in the Corporate Finance Manual at CFM38180 regarding the application of the unallowable purposes rule. The guidance indicates that obtaining tax relief in multiple jurisdictions should not trigger the unallowable purpose rule, as long as the structure is commercially sound and relief is not available more than once in the UK. In contrast, the First-tier Tribunal supported HMRC's view that all debits were attributable to an unallowable purpose and should be disallowed, where a new UK company was established within a global group to purchase shares from a third-party vendor, borrowing from its parent company to do so and securing a tax advantage that allowed for relief from tax for other UK group companies through group relief. However, it should be noted that the group being acquired had no UK nexus, which appears to have been an issue for HMRC.

In *BlackRock*, the Upper Tribunal concluded that the group's acquisition structure, including the formation of the UK-resident company and the resulting loans, was solely intended to gain a tax advantage. It was therefore determined that the commercial purpose would not have existed without the tax purpose and all of the debits were deemed to be associated with the unallowable purpose.

These decisions suggest that structuring a commercial transaction in a tax-efficient manner may be enough for the rules to apply, even if the loan used to fund the transaction is commercial and therefore the specific facts and circumstances surrounding the use of a UK acquisition vehicle should be carefully considered.

Corporate interest restriction

The final restriction which may apply, as it is applied after consideration of all of the others above, is the corporate interest restriction (CIR). The CIR is a group-wide, structural restriction on tax relief – unlike the other restrictions above, which are transactional. The CIR regime, despite its complexity, can be explained simply in principle. First, determine the relevant worldwide group to which the regime applies, and calculate the UK group's aggregate UK net tax-interest expense (ANTIE). If ANTIE is more than the annual £2 million de minimis, apply the fixed 30% ratio to the UK tax-EBITDA or the elective group ratio, based on the worldwide position, to determine the total disallowed amount. Finally, the total disallowed amount must be allocated to UK members of the group in the interest restriction return.

Each of the fixed and group ratios are subject to debt caps based on the worldwide net group interest expense. There are also several further elections which may be beneficial. The complex workings of the CIR have cannot be covered in detail here.

However, in an M&A context, several different CIR-related issues may arise. Following completion of an acquisition, the worldwide group for CIR purposes may change. A group for CIR purposes is a parent company and its subsidiaries which are (or would if it applied those standards) be consolidated under the International Financial Reporting Standards. Prior to a transaction taking place, this may be Target itself. Following the transaction, this should be another entity in the purchaser’s group. However, if there is a controlling corporate investor in an investment fund which owns Holdco, the relevant group would be extended to include the investor, the fund partnership and its subsidiaries, along with any other subsidiaries consolidated by the majority investor for accounting purposes. Any change in the company’s ultimate parent company for CIR purposes will necessitate the ANTIE and tax-EBITDA being split around the date of the change, on a ‘just and reasonable basis’. Following the change, any disallowances of interest may be computed by a reporting company elsewhere in the wider group.

As part of an acquisition, external finance and shareholder debt is often introduced into the structure. Interest will be payable to the external lender(s), as well as up the acquisition chain of companies to the ultimate shareholders/fund. These amounts are potentially subject to restriction as they form ANTIE, which should increase as a direct result of the acquisition. For the purposes of the group ratio election, related party interest is disregarded and therefore substantial borrowings from investors, which are generally treated as related parties for these purposes, may result in this election becoming unfavourable. The UK group’s tax-EBITDA and worldwide group-EBIDTA and interest expense may also change if the company is joining part of a larger group.

Following the completion of the acquisition and the likely increase in ANTIE, the group may wish to consider reorganising its debts (provided there is a commercial purpose for doing so) to bring loan assets into the UK, which would reduce ANTIE and therefore the level of any potential disallowance.