Increasing the burden

Large Corporate | Management of taxes

01 February 2017

Liz Hughes and *Alastair Munro* provide an overview of the new corporate interest restriction

Key Points

What is the issue?

The Government is introducing a new corporate interest restriction to take effect from 1 April 2017.

What does it mean to me?

The new rules are likely to affect many larger businesses and multinational groups and could significantly increase their corporate tax bill.

What can I take away?

Businesses should be reviewing the impact of the proposals to establish how they may be affected and consider appropriate restructuring on their funding where necessary and practicable. They can make representations on the draft legislation to HMRC until the end of January.

HMRC has issued its response to the Government's public consultation on rules to limit the tax deductions that companies can claim for interest expense, along with draft legislation on 5 December 2016. The new rules will take effect from 1 April 2017 (with straddling rules for company accounts that span this date). This package of measures implements Action 4 of the G20/Organisation for Economic Co-operation and Development ('OECD') Base Erosion and Profit Shifting project.

All interest (and amounts considered by the legislation to be similar to interest) is included in the new rules and this includes bank interest and similar payments made to third parties, but with a £2m *de minimis* level of net interest expense below which a UK group does not have to apply these rules.

In some cases, the new rules are expected to result in significant reductions in the level of tax relief for interest expense that a UK business can claim, particularly for certain heavily geared industry sectors. Other UK tax rules that can restrict interest relief such as the transfer pricing, unallowable purpose, hybrid, group mismatch and distributions provisions will be applied in priority to the new rules.

The existing worldwide debt cap (WWDC) legislation will be repealed, subject to the retention of a modified debt cap rule to prevent groups with little third party interest claiming excessive deductions.

Some of the important parts of the rules have not yet been published and it is expected that an updated version of the draft legislation will be available by the end of January. The outstanding draft legislation will set out the definitions needed for the Group Ratio Rule (GRR), including how it will apply to joint ventures, rules concerning related parties and the Public Benefit Infrastructure Exemption (PBIE).

Further draft legislation is also expected in respect of particular issues such as the Patent Box, and industries including leasing, Real Estate Investment Trusts, and securitisations. However, the Government's consultation response document indicates that there will not be separate rules for banks and insurers.

The draft legislation defines a range of new terms that taxpayers need to understand. Some of them we have described in this paper, but there is a lot of complexity in the draft measures and readers should refer to the draft legislation and government response to the consultation to guide them through their calculations.

What is the basic approach?

In overview, the new rules will limit the corporate tax deduction for 'net interest' of a UK group to

1. 30% of the UK group's 'tax-EBITDA', known as the Fixed Ratio Rule (FRR), or if the group decides to adopt,
2. the group ratio (being the net qualifying interest of the worldwide group/worldwide group EBITDA) multiplied by the UK 'tax-EBITDA' (this is the GRR).

Restricted interest can be carried forward and will not be a loss carried forward. Hence, it will not be taken into account under the separate new rules that may restrict relief for corporate tax losses from 1 April 2017.

The £2m de minimis limit

There is a £2m *de minimis* limit so that the new rules will not apply to UK groups with net interest expense below this level. All groups will continue to be able to deduct current period net interest expense and similar financing costs up to the £2m limit.

Meaning of group

The entities subject to the rules (relevant companies) will be UK group companies, which are defined as UK resident companies and non-UK resident companies that carry on a trade in the UK through a UK Permanent Establishment (PE) and which are members of a worldwide group.

A worldwide group essentially comprises an ultimate parent company, which may be a foreign body corporate, and each consolidated subsidiary of that entity following IAS principles, but with an exclusion for subsidiaries that are measured at fair value through the P&L.

Net tax-interest expense

The rules are based on the concept of net tax-interest expense.

A group's net tax-interest expense is the sum of each relevant company's net tax-interest expense for the period. The net tax-interest expense is broadly a company's tax-interest expense amounts less its tax-interest income amounts. Tax-interest expense includes loan relationship debits, certain derivative contract debits or a financing cost implicit in amounts payable under arrangements such as finance lease, debt factoring and service concession arrangements accounted for as financial liabilities. Broadly, debits relating to exchange losses or impairment losses are excluded.

Similarly, tax-interest income includes loan relationship credits, some derivative contract credits or a financing cost implicit in amounts receivable under arrangements such as finance leases, debt factoring and service concession arrangements accounted for as financial assets or amounts received for providing a guarantee. There is an exclusion for credits relating to exchange gains or the reversal of an impairment loss.

Tax-interest expense amounts and tax-interest income amounts are reduced on a just and reasonable basis where the company was not a group member for the whole of the period of account of the worldwide group or where the company's accounting period does not coincide with this period.

Loan relationship credits will also not represent tax-interest income to the extent that they are sheltered by double tax relief, e.g. foreign source interest income that is subject to overseas withholding tax.

From a policy perspective, interest chargeable under the CFC rules will not be included in the calculations as the CFC rules are anti-avoidance provisions designed to prevent diversion of UK profits.

A company's net tax-interest expense can be negative. However, neither the worldwide group's aggregate net tax-interest expense (used in the application of the GRR) nor the adjusted net group-interest expense of a worldwide group used in the context of the FRR can be a negative amount.

The Fixed Ratio Rule

The calculation of the interest allowed under the FRR is the lower of two amounts, namely:

1. 30% of the aggregate tax-EBITDA of the group for the period;
2. a cap based on the adjusted net group-interest expense of the group for the period.

Broadly, tax-EBITDA is defined as a relevant company's adjusted corporation tax earnings for that accounting period (reduced on a just and reasonable basis where the company was not a group member for the whole of the period of account of the worldwide group or where the company's accounting period does not coincide with this period).

A company's tax-EBITDA could be a positive or a negative number. It is important to note that there is an extensive list of amounts that are not brought into account in determining a company's tax-EBITDA, including tax-interest expense amounts or tax-interest income amounts, capital allowances, certain debits and credits for intangibles, losses and loan relationship deficits brought forward or carried back, expenses of management brought forward and certain group relief amounts claimed.

Net chargeable gains will be included in tax-EBITDA but allowable losses will only be taken into account at the time they are utilised.

The aggregate tax-EBITDA is defined as the total of the tax-EBITDA for the period of each company that was a member of the group at any time during the period or, where that aggregate amount is negative, a nil value is applied.

The term, 'adjusted net group-interest expense' of a worldwide group is essentially the net group-interest expense recomputed for certain upwards and downwards adjustments including e.g. amounts relating to fair value movements on derivative contracts and to capitalised interest.

The Group Ratio Rule

An election (which is revocable) may be made to apply the GRR for a relevant period of account.

The calculation of the interest disallowance by the GRR is the lower of two amounts, namely:

1. A proportion, (referred to as the 'Group Ratio Percentage') of a measure of the group's taxable earnings and
2. a cap based on the 'qualifying net group-interest expense', the calculation of which is governed by separate rules from those applied in the FRR referred to above.

The Group Ratio Percentage is the ratio of a measure of the worldwide group's interest expense to a measure of its worldwide earnings (or accounts-EBITDA of the group). It is set at 100%, where it would otherwise be higher or negative.

The Government has decided not to adopt a tax-EBITDA based approach in calculating the Group Ratio Percentage despite representations from some parties on this point, although it will be possible to elect to align the accounts-EBITDA more closely with taxable earnings in certain respects.

It should be noted that interest on related party loans, perpetual loans and results dependent loans will not be included in the calculation of the GRR to prevent equity-like instruments from augmenting interest deductions. However, amounts relating to some convertible loans and other compound instruments will be included in the calculation of the group ratio.

IAS consolidated accounting concepts are used for the purpose of the GRR calculation although it will also be permitted to use UK GAAP or the accounting standards of Canada, China, India, Japan, South Korea or the US.

Interest Capacity

The interest capacity of a worldwide group is calculated as the aggregate of the interest allowance of the period (using the FRR or GRR) and any unused interest allowance carried forward from an earlier period that is available in the current period. However, this is subject to the *de minimis* of £2m if that gives a greater capacity for a deduction.

The rules also set out how much interest allowance of a period is available in a later period for the group. Broadly, it is nil if the group has not submitted its full interest restriction return, otherwise it is the lower of (a) the interest that has not been used up or (b) interest allowance that has not yet expired (the carry forward of unused interest allowance is subject to a five year limit).

In addition, restricted interest can be carried forward indefinitely, subject to there being sufficient capacity under the interest restriction rules of later periods.

Public Benefit Infrastructure Exemption

In response to feedback from the recent public consultation, HMRC plan to introduce an elective PBIE.

The PBIE will be applied on a company-by-company basis and qualifying companies will be fully excluded from their group’s interest restriction calculations, with the exception of any non-qualifying net interest expense.

There are a number of criteria to meet in order to apply the PBIE (for example, undertaking qualifying activities such as the provision, upgrade or maintenance of public benefit infrastructure; not owning any assets other than those representing public benefit infrastructure and ancillary assets).

Importantly, HMRC proposes to introduce some ‘grandfathering’ for qualifying companies. A qualifying company can potentially grandfather a loan agreed prior to 12 May 2016.

Grandfathering will be limited to cases where 80% of the qualifying company’s expected income has been materially fixed for 10 years or more by long-term contracts with, or procured by, public bodies or their wholly owned subsidiaries. All other conditions of the PBIE must be met.

Reporting company notification

The draft legislation requires a group to appoint a ‘reporting company’ for a period of account, where the appointment must be made no later than six months after the end of that period. The notice of appointment has to be signed by more than 50% of the eligible group members and the reporting company must itself be an eligible company. The rules also allow HMRC to appoint a reporting company (or to select an alternative entity) where the group has not made its own notification.

The reporting company will be required to make an ‘interest restriction return’. This return sets out the amounts of interest expense that are disallowed (or to be reactivated for carry-forward purposes) under these rules and how they are to be allocated to group companies.

If a company agrees to the allocation of disallowed interest, then it is considered as a ‘consenting company’. A company may revoke its consent by giving notice to HMRC and the rules set out how much disallowed net interest expense should be allocated to non-consenting companies. The legislation also provides details on the deadlines applied when filing a revised return or when HMRC itself has made a determination in the absence of appropriate filings by the group.

The deadline for filing the return is 12 months after the end of the relevant period or if later, the end of the period of three months beginning with the day on which the reporting company was appointed.

Even if a group is not subject to interest restrictions, it will have to file an abbreviated return.

Anti-avoidance

There is an anti-avoidance rule which applies where taxpayers create arrangements that seek to obtain a tax advantage and that advantage derives in whole or in part from the interest restriction rules.

Commentary

As the consultation began before the ‘Brexit’ vote, some commentators had expressed concerns about the proposals given the current climate of potential economic uncertainty. However, the Government states in the consultation response document published with the draft legislation that it ‘has undertaken an extensive period of consultation to ensure that the rules are proportionate, and maintains the importance of implementing the rules from 1 April 2017 to ensure the UK tax base is protected from erosion’.

We welcome the fact that the new rules have been the subject of a detailed public consultation and HMRC have genuinely wanted to understand the impact of the new rules on businesses. Nevertheless, it is concerning that there will be such a short time from the end of the current consultation period and the implementation of the new rules on 1 April 2017. This leaves groups with very little opportunity to understand what the draft legislation means for them and what actions they must take in order to manage the impact of the rules at a time when they are already having to assess the potential impact of Brexit on their business.

In the longer term, there continue to be concerns that the new rules may make the UK less attractive as a business location.

On the other hand, it is good to see HMRC committing to a broader PBIE including the possibility of grandfathering for some loans. In practice, though, many businesses will not meet the criteria for PBIE and will therefore be subject to the new rules in full.

The £2m *de minimis* threshold is also a positive move by HMRC, and according to HMRC’s own statistics, this level of threshold will exclude 95% of businesses from the new rules. However, those excluded will typically be small UK businesses and stand-alone companies. In practice, it is expected that many multinational groups will need to comply with the new rules. This will mean participating in a new reporting regime and having to pay a share of the additional £3.9bn of extra tax that HMRC expects to raise from this measure between 2017 and 2021.

In the meantime, we suggest that businesses model the impact of the new rules to establish how they may be affected.