Q&A

Tax deductibility of corporate interest: the new consultation

Speed read

HM Treasury's latest consultation on the UK's new interest deductibility regime sets out further detail on the design and implementation of the rules. It is clear that the UK remains committed to implementing the OECD's recommendations by the challenging deadline of 1 April 2017. However, the proposals in the document suggest a greater level of complexity than anticipated, with the introduction of a raft of new definitions and concepts. The challenge for UK business is to assess the impact of these new rules, without also having clarity on how other tax jurisdictions will implement the OECD's recommendations.

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Following a consultation at the end of last year and the related announcements in the 2016 Budget, the government has now published its second consultation on the tax deductibility of corporate interest expense (see www.bit.ly/1kvUMKR). It is intended that this consultation will provide stakeholders with the opportunity to provide final comment on the proposed design and implementation of the new rules.

What has already been announced by the government?

Prior to the publication of this second consultation document on 12 May 2016, the UK government had announced certain headline features of the proposed new regime in the 2016 Budget.

This confirmed the UK's commitment to adopting the recommendations of Action 4 of the OECD's BEPS project, and to the introduction of a new rule to restrict the tax deductibility of corporate interest by reference to a fixed ratio rule (FRR), to be set at 30% of EBITDA. High level details of the broader regime were also provided. It will include a de minimis threshold of £2m net UK interest expense per annum; special provisions for public benefit infrastructure; a supplementary group ratio rule (GRR) that could apply in addition to the FRR; and measures to manage volatility in earnings or interest. It was also confirmed that the new regime will apply from 1 April 2017.

This latest consultation adds significantly more detail and discussion relating to the detailed design of the rules. For example, the consultation document sets out proposals for a number of the key technical definitions (such as 'tax interest', the term used to define all the forms of interest potentially falling within the restriction). It also introduces the proposal for a modified debt cap rule to replace the existing worldwide debt cap (WWDC) regime, and it states that there are no current proposals for transitional arrangements or a general grandfathering provision for existing debt.

What further detail has been provided on how the FRR may operate in practice?

The basic framework of the FRR remains as set out in the previous consultation document, but more details are provided on the definitions and key terms. The definition of group will be the (IFRS) accounting concept. Exchange gains and losses on loan principal amounts will be excluded from the calculation of tax interest, but exchange gains and losses arising on the retranslation of interest will be included. Impairment losses arising on loan relationships and finance lease receivables will be included in tax interest. The exclusion of foreign exchange movements from tax interest is an example of the government appearing to listen to the concerns of stakeholders during the previous consultation, which is welcomed.

Tax interest will be limited to 30% of 'tax EBITDA'. Tax EBITDA is based on profits chargeable to corporation tax, but excludes tax interest, tax depreciation, tax amortisation, relief for brought forward and carried back losses and group relief. There is also provision to account for the R&D and patent box tax regimes. Further explanation of each of these amounts is provided in the consultation document. Tax EBITDA is the aggregated amount of each UK resident member company and UK permanent establishments (PE). Whilst the actual tax EBITDA of a company or PE may be negative, the group's aggregated tax EBITDA for the purposes of the rules is subject to a floor of zero.

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It is confirmed that tax interest will be calculated after the application of certain existing tax rules, including transfer pricing rules (the arm's length provision), unallowable purpose rules, anti-hybrid rules, group mismatch rules and distribution rules.

Even without reading on to the later chapters of the consultation covering the GRR and the impact on specific industries and regimes (more on each of these areas below), it is clear that the new rules will be incredibly complex and introduce a raft of new concepts and definitions into a core area of corporate taxation. There is no doubt that this will lead to an increased burden for business in all areas of compliance with the new regime, both financially and administratively.

Will the de minimis allowance be available to all taxpayers?

The consultation document confirms a de minimis group threshold of £2m net UK interest expense. Where a group has net UK interest expense (after the other UK tests described above) in excess of this, it will still be able to deduct net tax interest expense of at least £2m per annum. This appears to be a welcome change from the initial communications and removes the 'cliff edge' effect of the de minimis rule.

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What provisions will be included to ensure the regime is sufficiently flexible?

As promised in the Budget announcements, the new regime will include a number of provisions which are intended to provide the taxpayer with a set of tools to allow for flexibility in applying the FRR. There will be provisions to allow the carry forward of excess tax interest (indefinitely) and excess capacity (for three years).

In addition, the group may choose to apply the GRR if this results in a better position. The GRR will be calculated with reference to accounting EBITDA but then applied to tax EBITDA.

In our response to the original consultation, we were keen to highlight that one of the reasons why the UK's current regime has been so effective at balancing the needs of business and the Exchequer has been its flexibility and ability to target BEPS activity appropriately. We are of the view that the new regime must replicate this flexibility. To this end, the continued inclusion of these provisions is welcome.

Nine pages of the main body of the consultation document are dedicated to the GRR, along with five detailed examples in Annex D. Why is the GRR so complex?

In its origins, many believe the GRR was intended to be a simple mechanism to provide relief for commercial and industry norm levels of gearing; broadly, a straightforward calculation which should provide relief for amounts equivalent to the third party debt of a group. Whilst the first example at Annex D of the consultation does present a clear and straightforward application of the GRR, in practice this is unlikely to be the case.

However, what has become clear is that the GRR is considered by many stakeholders (and perhaps also the government) as being the answer to many of the complexities which are expected to arise from the practical implication of the new regime, the answer to all problems of all stakeholders – a holy grail of sorts.

To achieve this effectively, the GRR would need to juggle a great many factors. These include differing industry norms for gearing levels; uneven gearing across a group across markets (geographies), products or divisions; the impact of intra-group transactions; and the effect of one-off transactions or events. It is precisely this which is causing the complexity, however. Whilst we agree that the proposed detail of the GRR is necessary to achieve at least some of what was intended, we note that those respondents to the original consultation who warned against making the GRR too complex will be disappointed.

Taking all of this into account, it is reassuring that the application of the GRR has been kept as optional to allow taxpayers to choose the most tax efficient result.

The GRR in practice

This example, whilst very simple, illustrates some of the challenges the GRR faces in trying to match tax deductions with commercial interest costs.

A UK parented MNC has group EBITDA of £180m and the UK parent has external net interest expense of £60m. This gives a GRR of 33.3%. The UK has pushed £15m of this expense down to its subsidiaries, where local law allows such a push-down. If we assume that the subsidiaries have sufficient local EBITDA to fully deduct their interest expense under local rules, this leaves a balance of £45m net interest expense in the UK.

In this example, the UK sub-group has EBITDA of £100m. This is insufficient to enable it to obtain a full tax deduction, and the maximum deduction available will be £33.3m under the GRR (or £30m under the FRR).

The GRR is being positioned as facilitating the full deduction of (genuine) external interest costs. In practice, however, this is reliant on the group operating in territories where debt push-down is possible and on the business supporting such a push-down. In reality, the situation is further complicated by the fact that many countries have not yet announced how they intend to adopt the OECD recommendations (if at all), creating the potential for cross-border mismatches. It will also be interesting to see how the OECD discussion paper (to be released 6 July) on the GRR aligns with the UK consultation document.

What information is provided on the scope of a public benefit project exemption (PBPE)?

In its 2016 Budget communications, the government committed to ensuring that the new regime does not impede the provision of private finance for public benefit infrastructure in the UK. The discussions surrounding the PBPE have been keenly followed by all parties in the sector, and the consultation document does provide some initial direction as to how the legislation may achieve this aim.

Unfortunately for these stakeholders, however, the proposed PBPE appears to be very narrow in application and does not extend to cover related party interest. As a result, this is likely to have limited additional benefit to a key sector for inward investment into the UK.

It is proposed that groups would elect for eligible projects to be excluded from the rules, with eligibility defined as being the delivery of services which provide a benefit to the public under government policy. The project must be delivered as a result of a contractual obligation with a public body, must be a long term project (i.e. greater than ten years duration), and must generate at least 80% of its gross revenue from the provision of the public benefit services.

Will the new regime apply to the financial services sector?

It is expected that the rules will apply to banking and insurance activities, but there is recognition that the FRR would not be expected to impact on such groups operating in the UK, due to the significant net interest income arising from their main operating entities. In particular, it is noted that this means that the effectiveness of the FRR may be reduced for those groups which have a mixed portfolio of business activities (with an example given of a vehicle manufacturer with a financing arm).

The consultation document acknowledges that this is an aspect of the new regime where work is ongoing (see below). It has invited comments on various points, including the impact of the FRR, how BEPS risks can be assessed, possible approaches and targeted anti-avoidance.

What other specific sectors or regimes are identified in the consultation as requiring special consideration?

In addition to the infrastructure and financial services sectors, particular mention is given to the oil and gas sector, securitisation companies, authorised investment funds, investment trust companies, collective investment vehicles and the real estate sector. There is also recognition that the new regime will need to interact with certain tax incentive reliefs, such as the patent box, R&D tax relief and expenditure credits and the CFC regime.

Will the new regime replace the current rules on interest deductibility?

On the whole, the new rules are intended to sit alongside the existing provisions relating to the deductibility of interest expense. However, the existing legislation for the WWDC will be repealed. Instead, rules with a similar effect will be integrated into the new interest restriction rules, referred to as a 'modified debt cap rule'.

The intention is that this will prevent a group's net UK deductions exceeding the net total group-interest expense (unless they fall below the de minimis threshold). However, we note that elsewhere in the document (para 3.8) makes reference to the restriction being with reference to the global net third party interest expense of the group; further clarity will be required on this point.

On our reading of the proposals, it would appear to be even more restrictive than the current WWDC regime. Furthermore, it is proposed that the modified debt cap will apply to *accounting periods* beginning after 1 April 2017.

For an entity with a year ended 31 December 2017, this will result in a rather complex and changing picture during the first year:

- The existing interest deductibility rules and WWDC will apply for the first three months of 2017.
- The revised interest deductibility regime and WWDC will apply for the following nine months.
- It will only be from 1 January 2018 that both the new interest deductibility regime and the modified debt cap will apply.

The OECD work is still ongoing, and it has announced that it will be publishing discussion drafts on the GRR and FS sector in the coming weeks. How will the various consultations interact?

Whilst there is no explicit mention of these upcoming discussion drafts and consultation processes, we understand that the UK remains committed to continuing to work alongside the OECD in developing appropriate rules. The UK consultation period runs to a broadly parallel timetable to the OECD. It is hoped this means that the results of the OECD's consultations can be taken into account by the UK government when preparing the draft legislation for the new UK regime.

How will the UK's new regime compare to those of our competitors?

For many, it is the UK's competitiveness which will be the single biggest concern (after the impact of the rules on their own specific facts and circumstances). The UK government has been very vocal in its commitment to promoting the UK as a competitive place for business and investment. It has demonstrated this through its reduction to the headline rate of corporate tax (albeit seemingly 'paid for' by changes to rules in other areas).

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But investors and multinationals can often be flexible in how and where they invest, so it is important to understand how the UK's proposed rule compares to other countries. At one end of the scale, a number of European countries have a regime which is already very much in line with the OECD's recommendations – Germany, Italy and Spain all have a 30% FRR, and various reliefs to provide flexibility. Australia, Canada and the US permit relatively higher levels of gearing (1.5:1 debt to equity ratios, or greater), although with certain additional potential restrictions. At the far end of the scale, Ireland and the Netherlands do not currently have thin cap restrictions.

The new UK regime, as detailed in the consultation document, appears to position the UK squarely at the Germany/Italy/Spain end of the scale. In the long term, this may be where the vast majority of the UK's competitors also end up. In the short to medium term, however, this could result in disruption for the UK's competitiveness – and we would be interested to know what modelling, if any, HM Treasury has undertaken to assess the potential impact of this on the broader economic and commercial environment.

How do I respond to the consultation?

The consultation is open until 4 August 2016, and we would encourage all taxpayers to consider their position and provide 'real life' examples of where the rules cause unintended results, either directly or via their tax advisers. ■

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- A green light for restrictions on interest deductibility (Sandy Bhogal, 14.4.16)
- Q&A: Deductibility of corporate interest expense – October 2015 consultation (Ashley Greenbank, 12.11.15)
- BEPS: Interest deductions and other financial payments (Charles Yorke, 29.10.15)
- 30 questions on BEPS (Jill Gatehouse & Susanna Brain, 29.10.15)