

Tax deductibility of corporate interest expense – An update

Introduction

On 12 May 2016 the UK government published its second consultation on the tax deductibility of corporate interest expense, detailing the policy design and implementation. It is clear that the UK remains committed to adopting the recommendations of Action 4 of the OECD's BEPS project by the deadline of 1 April 2017.

- The consultation confirmed that the UK will be introducing a Fixed Ratio Rule ('FRR') limiting a group's UK tax deductions for net interest expense to 30% of its UK tax EBITDA. This will apply to both third party and related party debt on a UK group rather than a company basis.
- It will include a group de minimis threshold of £2m net UK interest expense per annum.
- The UK will also be implementing a Group Ratio Rule ('GRR') based on the net qualifying interest to accounting EBITDA ratio for the worldwide group as recommended in the OECD report.

This latest consultation adds significantly more detail and discussion relating to the detailed design of the rules.

Further details on the implementation of FRR

Further to the basic framework of the additional FRR, the following details have been provided:

- The definition of UK **group** will be based on the IFRS **accounting** concept i.e. the top UK company and all entities that are consolidated on a line by line basis in the consolidated financial statements which are within the charge to UK corporation tax. *(para 5.9)*
- The 30% cap will be applied to the '**tax EBITDA**' which is based on **profits chargeable to corporation tax** of the UK Group, but excludes tax interest, tax depreciation, tax amortisation, relief for brought forward and carried back losses and group relief. *(para 5.31, 5.32)*
- **Tax interest** is defined as the interest on all forms of debt, payments economically equivalent to interest, and expenses incurred in connection with the raising of finance. As such, exchange gains and losses ('EGL') on **loan principal amounts** will be **excluded** but EGL 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. *(para 5.18 - 5.28)*
- FRR will apply from **1 April 2017**, therefore for accounting periods straddling this date, tax interest and tax EBITDA will have to be **allocated** to the short period. *(para 11.4)*. This creates a complex scenario for Groups whose year end straddles this date.

Further details on the implementation of GRR

The use of the GRR will be **optional**.

- The GRR will be defined as the ratio of **net qualifying group-interest expense to Group EBITDA**. *(para 6.3)*
- Net qualifying group-interest expense is an **accounting** measure of the net interest based on the consolidated accounts of the parent company. This excludes financing costs in respect of **compound** instruments or **other hybrid debt**. *(para 6.29, 6.38)*
- Financing costs to **related parties** will be disregarded in calculating qualifying group interest. Related party is defined as having a 'significant relationship' between individuals or entities who do not come within the definition of group. Further details can be found in *para 6.41*.
- The key difference in the calculation of the GRR to the FRR is the use of **accounting** figures for EBITDA and net qualifying group-interest expense for the **worldwide group**.
- The GRR is then applied to the UK tax EBITDA.
- The interest limit is **capped** at the net qualifying group-interest expense. *(para 6.5)*
- GRR will apply from **1 April 2017**, therefore for accounting periods straddling this date, net qualifying group-interest and Group EBITDA will have to be **allocated** to the short period. *(para 11.5)*. This creates a complex scenario for Groups whose year end straddles this date.

Modified Debt Cap Rule ('MDCR')

In addition to the FRR and GRR, groups will also have to consider the modified Debt Cap Rule ('MDCR').

- This will restrict the group's net UK tax-interest amounts (third party and related party) such that it cannot exceed the global net adjusted group-interest expense (third party and related party) (unless they fall below the de minimis threshold).
- The MDCR will only apply to accounting periods commencing on or after **1 April 2017**. It will not apply for the actual period of account which straddles 1 April 2017. *(para 11.6-11.8)*
- The existing worldwide debt cap ('WWDC') legislation will be repealed for accounting periods commencing on or after 1 April 2017. *(para 5.55 - 5.58)*

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Other considerations

Provisions to carry forward: There will be provisions to allow the carry forward of excess tax interest indefinitely and excess capacity to subsequent periods for 3 years. (*para 5.45, 5.49*)

Consideration of other tax rules: The deductible tax interest will be calculated **after** the application of existing tax rules, including transfer pricing rules (the **arm's length provision**), unallowable purpose rules, anti-hybrid rules, group mismatch rules and distribution rules. (*para 5.22*) There is also a provision to account for the R&D and patent box tax regimes. (*para 8.45 - 8.47*)

Application of de minimis threshold: It is confirmed that where a group has net UK interest expense in excess of the £2m threshold, it will still be able to deduct net tax expense of at least £2m per annum which removes the 'cliff edge' effect of the original proposals in this area. (*para 4.6-4.8*)

Grandfathering provisions: There are currently no proposals for transitional arrangements or a general grandfathering provision for existing debt. (*para 7.9*)

Scope of a public benefit project exemption ('PBPE')

The government's suggested approach for a PBPE would allow groups to elect for **eligible projects** to be excluded from the rules. Eligibility is dependant on meeting the following conditions (*para 7.7*):

- i. The delivery of services which provide a benefit to the public under government policy
- ii. A public body contractually obliges the operator to provide those services, or licenses the operator and thereby regulates the pricing of the services.
- iii. The project involves provision or upgrade, maintenance and operation of infrastructure on a long term basis with a minimum duration of 10 years, or a shorter rolling term which both the operator and the public body have the expectation of continuing indefinitely.
- iv. All the project revenues are subject to UK corporation tax.
- v. At least 80% of gross revenue generated from the project assets over the lifetime of the project is expected to arise from the provision of public benefit services.

Specific industry considerations (section 8)

The consultation document acknowledges specific sectors which require special considerations and include the following:

- i. financial services – banking and insurance activities
- ii. oil and gas
- iii. securitisation companies
- iv. authorised investment funds including tax elected funds
- v. investment trust companies
- vi. collective investment vehicles
- vii. real estate sector

Next steps

We are responding to the formal consultation process which is open until 4 August 2016.

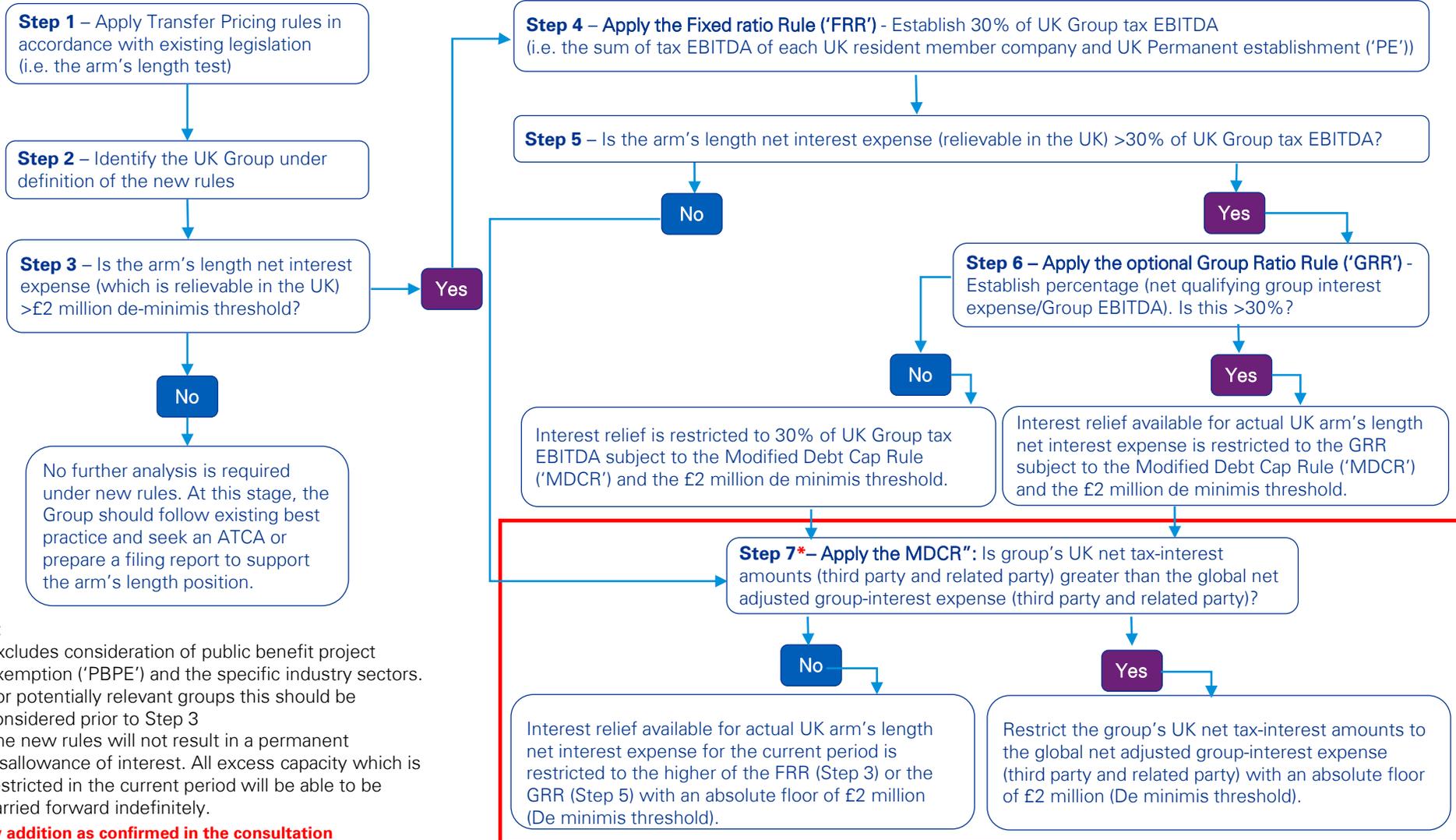
Given the timetable for the introduction of the new rules, UK companies should carry out an initial assessment of the potential impact of the new rules. We have prepared a basic flow chart/decision tree (see next slide) to help you assess whether you may fall within the new rules and what the potential impact may be.

This will evolve and be updated as we hear more and should form an integral part of any feasibility study or wider piece of work regarding the new rules.

In the meantime if you have any immediate comments or queries or would like to form part of our response on the consultation (on an anonymised basis), please contact your usual client service team or one of the following:

- [Daniel Head](#) – 0161 246 4742
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- Note:
- Excludes consideration of public benefit project exemption (‘PBPE’) and the specific industry sectors. For potentially relevant groups this should be considered prior to Step 3
 - The new rules will not result in a permanent disallowance of interest. All excess capacity which is restricted in the current period will be able to be carried forward indefinitely.

***New addition as confirmed in the consultation**





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