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Consultation over Fixed Cap on UK Tax Deductibility of Corporate Interest Expense: Plucking the Feather in the Cap?

The UK Government launched a consultation on 22 October 2015 regarding the UK corporate tax rules for interest deductibility. The consultation seeks views on the design of a general limitation for UK corporation tax deductions for interest and similar finance costs, imposing a cap calculated by reference to a fixed percentage of the borrower's EBITDA. The exact percentage is yet to be decided, but would be between 10% and 30% of EBITDA. The proposals follow the recommendations on interest deductibility made earlier in October by the OECD Base Erosion and Profit Shifting (BEPS) project. Any new rule is unlikely to come into effect before 1 April 2017. However, the UK Government has indicated that grandfathering of existing loans will be available "only in exceptional circumstances."

High Level Commercial Implications

While the consultation paper seeks views on different design options, it is clear that the UK Government intends to introduce a fixed deductibility cap in some shape or form. This will represent a significant change to the UK rules on interest deductions. It is likely to result in an increase in the cost of funds for UK finance and debt capital markets transactions, particularly in the context of leveraged acquisitions. It would also introduce a measure of volatility in the UK tax position of borrowers, a factor that may be considered by banks when making lending decisions and when considering appropriate interest coverage ratios (although banks themselves are expected to be excluded from any general cap and instead subject to more tailored rules). The consultation process will also be monitored closely in an M&A context and in particular by the private equity sector, where models assume predictable tax deductions for the costs of acquisition finance.

Any ratio involving EBITDA will involve an element of inherent uncertainty. Borrowers would need to predict future earnings in order to understand the UK tax consequences of future interest payments on their debt and, therefore, to calculate their cost of funds. While the OECD has recommended certain measures to mitigate the effect of earnings volatility, a cap could nevertheless have potentially perverse effects where a company suffers a drop in EBITDA for a particular year, which thereby constrains the deductions it can claim for its financing costs and, in turn, increases its effective tax rate for that year. That could be significantly unhelpful where a business is already in trouble.

A further source of uncertainty is the lack of hard detail in the UK consultation, which largely repeats the design options set out in the OECD BEPS recommendations for individual countries to choose between in implementing an interest deductibility cap. Until design decisions are made in the wake of the consultation, it will be difficult for

the market to predict the final form and consequences of the new cap, leaving companies to wonder about the extent to which interest payments on loans entered into now (or previously) will be deductible in 18 months' time.

From a more general perspective, while there are several features of the UK tax system which will continue to make it an attractive holding company jurisdiction (a very wide double tax treaty network and no withholding on dividends, for instance), its liberal regime on interest deductions has historically been a feather in the cap of the UK corporate tax regime. It is unfortunate that the current proposal will cause uncertainty and additional complexity in this area.

However, it can be easy to be too pessimistic about the proposals. As an international project, the OECD's BEPS recommendations are likely to be adopted by many other taxing jurisdictions which have not previously imposed a deductibility cap. Shearman & Sterling's experience in jurisdictions such as Germany and France, which have had similar caps for several years, is that after initial concern, particularly in the leveraged finance and private equity sectors, once the rules had bedded down the overall behavioural effects were limited in practice. Businesses will still need cash for general purposes and to fund acquisitions, and the debt markets will still be an important source of funding.

Background

The OECD BEPS project has been exploring the modernisation of the international taxation system over the last two years, particularly in relation to the digital economy and multinational enterprises. The UK Government has supported the project, for instance announcing last year that the existing UK rules on hybrid instruments and structures would be conformed to OECD recommendations on BEPS once those recommendations have been finalised. The BEPS project delivered detailed reports in 15 different areas, including interest deductibility, early in October 2015. The UK Government's consultation closely follows the recommendations in the October BEPS report on interest deductibility.

Traditionally, the UK has had a relatively liberal regime for corporate interest deductibility, so long as financing is provided by third parties, or intra-group on arm's length terms.

Existing UK domestic rules have for many years covered a number of the measures identified by the OECD BEPS project in relation to the taxation of interest. These include withholding tax on UK-source interest payments (subject to several exceptions and the provisions of an extensive double tax treaty network) so as to retain taxing rights within the UK; transfer pricing measures (whereby deductions for intra-group financing expenses are limited to the amount that would have been paid on an arm's length basis); anti-avoidance rules (which could operate where the relevant loan has an "unallowable purpose" or where hybrids are involved); and the worldwide debt cap ("**WWDC**") which limits total net UK financing deductions by reference to a group's total finance expenses. The latter rule is a species of cap within the existing UK tax framework, but set at a sufficiently high level that it is a real concern only in fairly extreme circumstances, for instance where a group loads more shareholder debt into the UK than it draws from third parties on a group-wide basis.

Broadly speaking, therefore, no general limit has previously operated within the framework of UK corporate tax rules on interest to deny UK deductions for financing on arm's length terms, outside clear avoidance scenarios. In particular, UK deductions have been available for acquisition finance, whether the acquired assets are used in the

UK or elsewhere. The proposed fixed deductibility cap, potentially limiting deductions by reference to a formula regardless of the purpose of the loan or the identity of the lender, therefore represents a significant departure for the UK rules in this area.

The Consultation Proposal

The UK Government consultation sets out a number of options and design questions for an interest deductibility cap, without going into great detail. At the centre of any new cap is the "**fixed ratio rule**," which would place a limit on the UK tax deductibility of interest incurred in an accounting period by a UK sub-group within a multinational group or, potentially, by a single UK corporate taxpayer or UK domestic group, by reference to a fixed percentage of the EBITDA of the UK sub-group/UK company/domestic group. Asset value was considered as an alternative metric to EBITDA, but the OECD concluded that this was likely to give rise to difficult valuation and accounting issues.

Interest payments would therefore no longer be tax deductible for UK corporation tax purposes to the extent that net interest expense exceeds the set fixed percentage of EBITDA. "Interest" is defined widely by the OECD, going beyond traditional interest payments to include economically equivalent amounts such as accrued discount on zero coupon bonds, the finance return element on finance leases and notional interest payments under derivatives related to borrowing, as well as guarantee fees, arrangement fees and similar costs of raising finance. There would be special rules governing the calculation of EBITDA for these purposes, substituting taxable earnings calculated on UK corporation tax principles where this differs from the accounting measure of earnings.

The consultation does not propose a particular amount for the fixed ratio, beyond referring to the range of 10% to 30% proposed by the OECD and noting the factors identified by the OECD report as being relevant to selecting an appropriate figure. Interestingly, these include the local interest rate environment and the size of the relevant group, both of which suggest the ratio may potentially vary over time.

Notwithstanding that the risk of base erosion and profit shifting is greatest for multinational groups, the consultation solicits views on whether the cap should be general, applying to UK domestic groups and standalone companies as well. It notes that to do otherwise may risk breaching the EU treaty freedoms of establishment and movement of capital (which, famously, can negative domestic tax rules in EU member states which are discriminatory) and could harm the UK economy.

The Group Ratio Rule

The OECD report recommends that the fixed ratio rule is applied in tandem with and qualified by a "**group ratio rule**," which would allow any proposed cap to take into account different leveraging norms in different sectors. The inclusion of a group ratio rule is left to the discretion of the implementing country; however, such a rule is likely to be very important to highly-geared sectors such as real estate. A rule of this type would help to reassure companies that the target of the cap is profit shifting between jurisdictions, and not debt financing in general.

A group ratio rule would allow interest deductions up to the ratio of the worldwide consolidated group, where this exceeds the fixed ratio calculated only by reference to the UK sub-group. It is proposed that the group ratio in respect of a worldwide consolidated group would be calculated as the group's net third-party interest expense

against group EBITDA. The UK consultation also notes an alternative "equity escape" rule adopted by Germany which performs a similar function.

The consultation paper points out that a group ratio rule would add extra complexity to the operation of any cap, and the presence of any such rule may be a factor in selecting a lower value for the fixed ratio rule within the 10% to 30% OECD range. Further work on the group ratio rule is to be concluded by the OECD in 2016.

Carve-outs and Exemptions

The effect of the introduction of the cap is proposed to be moderated by certain carve outs and similar provisions:

- *Banking and insurance groups* – Both the OECD report and the UK consultation note that the fixed ratio rule is not likely to be appropriate in the context of regulated banking and insurance groups, as these are likely to be net lenders with net interest income rather than overall net interest expense. The use of EBITDA as a measure for the cap is also unlikely to be appropriate where borrowing and lending is the core business of a financial group. The OECD therefore recommends that banking and insurance groups (but not treasury companies, captive insurance companies or other non-regulated quasi-banking entities) should be excluded from any general fixed ratio rule, and instead subject to a different regime, guidelines on which are to be published in 2016.
- *Addressing earnings volatility* – In order to smooth the effect of earnings volatility, the OECD report proposes allowing EBITDA to be averaged over several years and/or allowing the carry forward and carry back of disallowed interest and unused interest capacity (subject to potential restrictions, for instance, relating to how long or to what extent such amounts can be carried back or forward). The UK consultation indicates that the Government is leaning towards the latter as a simpler solution. As noted above, this approach may be of limited comfort to a borrower in the year that it experiences an unusually low level of EBITDA due to business difficulties and, therefore, obtains lower tax deductions.
- *De minimis* – The UK consultation notes that, if the cap did only apply to a group with more than £1 million of net UK interest expense in a year, this would exclude over 90% of UK companies. The consultation paper does not go so far as to say that £1 million is their proposed *de minimis* threshold, but presumably this is the implication. Whatever level of threshold is selected, it is anticipated that any groups would be permitted to deduct at least the threshold amount regardless of the operation of the cap.
- *Public benefit project exemption* – The OECD report recommends that the financing of long-term public benefit projects, which generally poses a lower risk of avoidance, should be eligible for an exemption from the deductibility cap provided that it meets certain conditions, restated in the UK consultation. The conditions include the project being commissioned by a public sector body (even if it is carried out by a private operator), the financing for the project having recourse only to the project assets and income – guarantees from other companies in the operator's group would not be permitted – and a UK nexus for the operator and the project assets, income and expenses. The proposed exemption would need to conform with EU rules on State aid (which prevent unjustified beneficial tax treatment for specific entities or sectors).

Implementation

It is anticipated that the fixed ratio rule would replace the WWDC, but would operate in tandem with other existing UK interest deductibility rules on transfer pricing and anti-avoidance, and new measures relating to hybrid instruments. While the fixed ratio rule is intended to apply generally, the OECD report notes the potential need for targeted rules, particularly to preclude any attempt to avoid or structure around the requirements of the fixed ratio rule. The UK Government has not expressed a view in the consultation paper on which risks should be targeted specifically.

The consultation paper states that if the deductibility cap is introduced, it is unlikely that this will be before 1 April 2017, in order to strike a balance between protecting the UK tax base and allowing businesses sufficient time to adapt to the new rules. It also states that the UK Government would expect grandfathering of existing loans only in exceptional circumstances, albeit that views are solicited on whether there would be particular cases where transitional rules would be necessary to prevent unfair or unintended consequences.

Further Considerations on Potential Impact

Using 2009-2013 average figures provided by the OECD report, it is estimated that 17-38% of multinational groups and 19-45% of other companies would be affected by the international adoption of their proposed rule (depending on where the fixed ratio is set in the proposed range of 10-30%, and excluding companies with negative EBITDA). This weighting away from multinationals may perhaps follow from the fact that, all other things being equal, they would usually already ensure that borrowing costs are incurred in the jurisdictions where the highest profits are anticipated. In other words, those jurisdictions are more likely to have higher levels of EBITDA, and therefore are more likely to fare better under a fixed ratio rule based on EBITDA.

However, the OECD figures do indicate that a significant number of companies will need to review their existing financing arrangements to ensure that they do not fall foul of any new regime. In particular, the private equity industry will be following the consultation closely, given that financial models for their acquisitions will have assumed predictable, consistent deductions for interest payments on acquisition finance. It is possible that a group ratio rule would provide something of an answer here, if each investee (as opposed to the private equity fund itself) forms its own separate group for these purposes.

Even if a fixed ratio formula (which looks at the position of the UK sub-group) is implemented in tandem with a group ratio rule (applying a similar formula by reference to the worldwide consolidated group), the deductibility cap will likely be a factor in the continued attractiveness of the UK as a holding company jurisdiction. The specific ratio that is eventually introduced will be of particular interest. That said, past experience in other jurisdictions may indicate that in practice a deductibility cap will not make all the difference. Interestingly, the OECD report indicates that small cap multinationals are more likely to be affected than large cap multinationals, the implication being that different factors will weigh differently when each type of enterprise considers whether to maintain its UK headquarters or to invert into the UK.

In general, it does seem likely that the proposed cap would result in an increase in the potential cost of funds for UK borrowing, particularly in the leveraged acquisition sector. As discussed above, given the possibility of increased tax leakage for borrowers dependent on future EBITDA, and an increased focus for lenders on clear business

projections from the borrower, this may lead to a period of uncertainty in the finance sector until the rules are finalised and bed down.

Given the previous position that acquisition finance drawn in the UK would generally be deductible, the proposed cap may also have knock on consequences for the economics of UK M&A activity funded by debt.

Lessons from Other Jurisdictions

A number of European jurisdictions have operated a similar cap for many years. In particular, a similar measure was introduced in Germany in 2008, limiting interest deductions to 30% of EBITDA, subject to certain exemptions including an "equity escape" rule which performs a similar function to the group ratio rule. France introduced a measure in 2012 limiting interest deductions to 75% of net interest expenses. Both Germany and France apply a *de minimis* exemption from the cap where net interest expense is no more than €3 million.

Despite initial concerns that a cap could lead to a reduction in leveraged acquisitions when the rules were first proposed, in practice, there has been little substantive effect in these jurisdictions on the overall behaviour of borrowers. Significantly, although the tax effect of debt finance is more contingent on future performance than was previously the case, in most cases this has not changed the overall case for borrowing in order to grow the business when this is commercially appropriate.

Other jurisdictions, such as Australia, Italy, Japan and Spain, already have similar rules. The US currently has rules that generally limit deductions for interest paid to multinational affiliates to approximately 50% of EBITDA, but there have been proposals that would bring these current rules in line with the approach recommended in the OECD report.

Conclusion

The detailed mechanics have not been spelled out at this stage, but it is clear that the UK Government intends to introduce a UK tax deductibility cap for corporate financing expenses in some shape or form in accordance with OECD BEPS recommendations.

Multinationals, borrowers and financial institutions with a UK presence, or which operate in the UK market, should consider reviewing their structures with the proposed deductibility cap in mind. Shearman & Sterling's Global Tax Practice has extensive experience in guiding clients through the changing tax landscape and with similar deductibility caps worldwide. If you have any questions about the UK proposals, please do not hesitate to approach any of the authors or your usual Shearman contact.

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