TAX DEDUCTIBILITY OF CORPORATE INTEREST EXPENSE

Speedread: The 2016 Budget announced, and the UK government is currently consulting on, the biggest change in UK tax this century. Up until 1 April 2017, a tax deduction for interest costs of up to 100% of UK profits is (very broadly) available provided it can be shown that some third party lender would be prepared to lend that loan. For example, if a third party lender would be prepared to advance senior and mezzanine loans on a 1:1 interest cover ratio basis, all taxable UK profits could be washed away and no UK tax would be payable. **From 1 April 2017, an artificial limit is to be introduced so that tax deductions for interest will be capped at 30% of earnings.** If interest costs exceed 30% of earnings, additional UK tax will now be payable. This applies to all existing and future loans to UK businesses without grandfathering/ transitional rules. **The only dispensation is that if the worldwide group interest expense from third party lenders is already above 30% of worldwide earnings (ie the group is already highly geared) then this higher percentage may be applied instead, which might save some clients.** A £2m de minimis and public benefit project exclusion also apply, the latter being narrowly drawn and expected to be of little benefit in practice. **Interest rates for loans still need to be determined as arm's length in order to comply with transfer pricing and other requirements (including access to treaty benefits), as these existing requirements will be applied in priority.**

The change has fundamental implications for how attractive leverage in the UK is going forwards. It is no longer an easy answer to "*how do I manage my UK tax liability?*". This affects all highly leveraged businesses in the UK on their existing operations, how they finance future corporate acquisitions, how they finance development or infrastructure etc. By way of a simple example, an existing UK business has interest of £8m pa on senior and mezzanine terms and income barely covering that of £8.1m pa. The current tax is 20% on £100,000 so, £20,000. From 1 April 2017, a tax deduction will only be available for £2.4m of interest (30%) and tax payable at 19% on £5.7m giving a tax liability of £1.083m. In the real world, a £100,000 commercial profit has been made but in the tax world, the UK business is down £983,000 after the taxman takes his cut. This obviously reduces the ability of UK businesses to service interest and how much lenders will be prepared to lend in future.

The new rules, which are currently subject to consultation, will affect all our sector clients but particularly highly leveraged sectors such as real estate, infrastructure and private equity and anyone lending to them. UK groups and lenders financing the same should review existing and proposed *arrangements now, and factor the potential application of the new rules into cashflows. However, given the proposals remain subject to consultation, factoring their impact with certainty, is extremely difficult.*

The following text summarises the technical provisions of what is proposed but also explains the practical implications for UK businesses affected by this. The expected operation of the new rules (other than, for simplicity, the public benefit project exclusion) are set out in the flowchart at the end of this publication.

WHAT ARE THE ORIGINS OF THESE NEW RULES?

The Organisation of Economic Co-operation and Development (**OECD**) launched an action plan to drive out aggressive tax planning involving base erosion and profit shifting. As part of that action plan, the OECD published a recommended approach for limiting base erosion involving interest deductions and other financial payments. Following an initial consultation on the OECD recommendations, the 2016 Budget set the key policy design features for a restriction on the tax deductibility of corporate interest expense. The key policy features are elaborated on by a further consultation launched on 12 May 2016, with the detailed design of the rules being subject to the outcome of that consultation. Further OECD reports are expected in July 2016 on the design and operation of the group ratio rule and the application of the restrictions to the banking and insurance sectors.

DO THE NEWS RULES JUST APPLY TO INTEREST?

The new rules are to apply to interest on all forms of debt, payments economically equivalent to interest, and expenses incurred in connection with the raising of finance on a net (or consolidated) basis. This is referred to as net tax-interest.

The new rules are widely drawn and will restrict deductions for intra-group (shareholder) and third party debt and, for example, guarantee fees, swap payments and the finance cost element of payments under certain leases. The new rules are only applied after the arm's length interest rate is determined in order to comply with transfer pricing and other requirements (including access to treaty benefits), as well as current anti-avoidance legislation.

AT WHAT LEVEL DO THE NEW RULES APPLY?

The new rules are to apply to restrict deductions for net tax-interest expense at a UK group level. The UK group will include all companies that are within the charge to UK corporation tax (including permanent establishments) and that are consolidated on a line-by-line basis into the accounts of the ultimate parent. The ultimate parent must be a company or similar entity. Companies that are not part of such a group are to apply the rules in an equivalent way based on the company's own position.

Large groups should seek to confirm the composition of their existing UK group(s) to determine the potential impact of these new rules. An individual or partnership (generally) would not be the ultimate parent of a UK group. The new rules may not currently apply to non-resident property owners (who do pay UK tax on property income), but this has been identified as an issue (shortcoming really) in the consultation and we expect such property owners to be included in due course.

HOW WILL THE DE MINIMIS OPERATE?

The £2m net tax-interest expense de minimis is to operate as a threshold and exclusion. It will not, however, increase interest capacity or create spare capacity to carry forward.

All UK groups should be able to deduct at least £2m net tax-interest expense per year. Whilst the UK government comments that the de minimis should exclude 95% of groups, it is unlikely to assist highly leveraged sectors. Anti-avoidance rules are to apply to prevent groups manipulating the use of multiple de minimis amounts.

WHAT IS THE FIXED RATIO RULE?

The 30% profits cap is to be introduced by way of a Fixed Ratio Rule. This rule provides for an interest limit of 30% of the UK group's tax-EBITDA (based on profits chargeable to corporation tax with an add-back for interest deductions, capital allowances and amortisation of intangible fixed assets) for a period. If there is an excess over that interest limit, the UK group may choose to apply the Group Ratio Rule. The interest limit may also be reduced by the modified Debt Cap.

The 30% Fixed Ratio Rule operates very much as a blunt tool. The 30% Fixed Ratio is not particularly high (although at the maximum of the OECD recommendations) and means some UK groups could be paying a lot more UK tax in future.

WHAT IS THE MODIFIED DEBT CAP?

The modified Debt Cap is to restrict the interest limit to the global net adjusted group-interest expense for a period. The items included are to be based on the consolidated accounts of the group and mirror net tax-interest (including related party interest) but on a global basis and subject to adjustments. Capitalised interest and profits on the release or restructuring of debt are to be included, and amounts representing dividends on preference shares excluded.

The modified Debt Cap is designed to prevent UK groups with little net external debt gearing up to the Fixed Ratio interest limit in the UK ie international groups using high leverage in the UK simply to reduce UK tax whilst the rest of the global group is lowly geared.

WHAT IS THE GROUP RATIO RULE?

The worldwide group dispensation is to be introduced by way of a Group Ratio Rule which UK groups may choose to apply instead of the Fixed Ratio Rule. This rule provides for an interest limit of the UK group tax-EBITDA multiplied by the group ratio. The group ratio is:

$$\frac{\text{Net qualifying worldwide group-interest expense}}{\text{Worldwide group - EBITDA}}$$

This Group Ratio interest limit may also be reduced by the modified Debt Cap, but this is unlikely to apply in practice.

The Group Ratio Rule is a failsafe measure to soften the blow of the changes on UK subsidiaries of large highly geared groups. If a group's worldwide interest ratio is high, its UK subsidiaries can choose that ratio rather than the 30% Fixed Ratio. However, only external debt counts, not shareholder, and the UK government has highlighted concerns regarding its potential abuse. A further report is expected from the OECD regarding its design and operation.

What is the net qualifying worldwide group-interest expense and worldwide group-EBITDA?

The items included in net qualifying worldwide group-interest expense are to be based on the consolidated accounts of the group and mirror net tax-interest but on a worldwide basis, and subject to certain exclusions. Interest arising on debt instruments which would not ordinarily attract relief for interest in the UK (eg profit participating loans and perpetual debt) or which have equity like features, are excluded. Interest payments on related party debt, compound instruments and hybrid debt are also to be excluded. Worldwide group-EBITDA is to be based on the worldwide group's pre-tax accounting profit with an add-back for interest deductions, depreciation and amortisation of the worldwide group.

HOW ARE THE RESTRICTIONS APPLIED?

If and to the extent that the net tax-interest expense of the UK group exceeds interest capacity for a period, being the higher of:

- the interest limit (ie the result of the Fixed Ratio Rule or Group Ratio Rule) plus any spare capacity carried forward; and
- £2m,

the UK group is to be subject to an interest restriction.

Taxable Income	£8,000,000
= EBITDA	£8,000,000
x Fixed Ratio	30%
= Maximum deduction (30% x £8m)	£2,400,000
Restricted Interest (£6m - £2.4m)	£3,600,000

Example: A UK property owning group has rental income of £8m pa. The group acquired the property for £100m and borrowed £80m (LTV of 80%) at a blended

Taxable Income	£1,000,000,000
= EBITDA	£1,000,000,000
= Group Ratio (£400m/£1bn)	40%
= Maximum deduction (40% x £8m)	£3,200,000
Restricted Interest (£6m - £3.2m)	£2,800,000

rate of 7.5% pa. The group therefore has external interest expense of £6m pa.

The worldwide group has net third party interest expense of £400m pa and operating profits of £1bn.

The UK group can choose which companies in its group suffer the interest restriction (up to their respective net tax -interest expense) and restricted expense can be carried forward indefinitely.

If the net tax-interest expense of the UK group is less than the interest limit, spare capacity can be carried forward for three years.

The ability to select companies to suffer interest restrictions, the carry forward of restricted interest and the carry forward of spare capacity are designed to address volatility. Unfortunately the new rules do not permit carry back of restricted interest or spare capacity. The ability to select group companies to suffer interest restrictions will create issues for lenders. Lenders will *not want their borrowers/obligors suffering all interest restrictions, with the remaining group companies suffering no (or little) restriction. Loans will need to counteract this going forwards.*

WHAT IS THE PUBLIC BENEFIT PROJECT EXCLUSION?

The PBPE is to apply where public benefit services are provided as part of a long term infrastructure project where project revenues are subject to UK corporation tax and the majority of revenues are generated from the provision of public benefit services. This exclusion is designed to protect highly geared projects of national importance (where gearing is high because the UK government is the credit risk). Groups electing to apply the PBPE, would exclude from their interest restriction calculations interest expense from third party loans used to fund project assets.

Despite responses to the UK government's first consultation criticising the PBPE as too narrowly drawn, this still remains the case. The PBPE would only seem relevant to PFI, not infrastructure more generally. For example, it would not seem to apply to windfarms or biomass plants.

WHEN WILL THE NEW RULES APPLY?

Whilst the new rules are to apply from 1 April 2017, the detailed design of the rules remain subject to consultation (which closes on 4 August 2016). The OECD has also announced that further discussion reports are to be issued. No transitional rules or grandfathering is expected to be applicable for existing debt.

The new rules will apply to existing and future debt from 1 April 2017 despite the new rules remaining subject to consultation, further OECD reports remaining outstanding and no draft legislation having been published. For borrowers with an income profile barely matching interest costs, the new rules may lead to insolvency, subject to the de minimis and Group Ratio Rule maybe helping. Cashflows drawn up for current and new debt should reflect potential restrictions.

HOW WILL THE NEW RULES AFFECT BUSINESS?

The new rules will be relevant to the terms on which lenders are willing to provide finance. The disallowance of interest deductions will increase the cost of borrowing and therefore the ability of borrowers to service debt. This will be relevant to the terms on which lenders are willing to advance debt. Subject to the de minimis and Group Ratio Rule, a lender cannot (even if it would be willing to) lend 100% of operating income and expect the borrower to pay no tax. There will be tax payable because of the 30% EBITDA restriction. Borrowers cannot use shareholder loans to eliminate the UK tax line altogether either - some UK tax will have to be paid.

Real estate market

The application of the new restrictions to real estate investment trusts, property approved investment funds and corporate non-resident landlords (which are liable to UK income tax rather than UK corporation tax), remain subject to the outcome of the current consultation.

Property owning companies are generally highly leveraged (for good commercial reasons ie because of the nature of the underlying assets) and are likely to be badly affected. Whereas debt funds have been willing to advance mezzanine and junior debt at high levels of loan to value (with an associated interest cost) on the basis of the underlying assets, the new rules are likely to make this a lot more expensive for borrowers. If the new rules are extended to apply to non-resident landlords, consideration should be given to claiming other reliefs that may be available, such as, sovereign immunity or using REITs. The days when non-UK pension funds could eliminate all their UK tax on property investments in the UK using debt (internal or external) are probably about to end, and such funds will pay a lot more UK tax in future.

Securitisation market

Companies within the UK securitisation regime are required to have a retained profit of nil or greater. In the case of securitisations over interest-bearing or financial assets, the components of retained profit should constitute tax-interest. It follows that such securitisation companies should not be in a net interest expense position and should therefore not be subject to the new restrictions.

Whilst such companies should hopefully not be affected by the new rules, the application of the new rules to similar companies outside this tightly drawn regime is unclear and subject to consultation.

Private equity

Private equity funds are generally structured as collective investment vehicles.

Provided such vehicles recognise subsidiaries at fair value rather than consolidating shareholdings on a line-by-line basis as is usual in the PE world, investments should form their own UK group and any restriction should be calculated at the investment group level. This would enable each UK sub-group to maximise the benefit of the £2m de minimis. In practice though, PE houses *will find smaller investments more tax efficient ie with interest costs up to just the £2m de minimis.* Bigger *takeovers of major companies will typically involve more than £2m of interest costs to finance them and could be significantly less tax efficient or attractive as a result.*

Banking and insurance activities

To the extent that banking and insurance groups are net interest recipients, the new rules would not generally apply. However, this might not always be the case due to impairment losses, unexpected changes in maturity curves, or if investment banking groups generate significant non-interest income.

Against the regulatory backdrop applicable to these sectors, the current consultation proposes the targeting of the new rules to non-banking and insurance companies within a group or the introduction of supplementary targeted anti-avoidance rules. The application of the restrictions in these sectors is also subject to the further OECD reports.

If the new rules or, indeed, the application of existing transfer pricing or other requirements affecting interest deductibility are of particular interest to you, our tax team would be happy to discuss this with you in further detail.

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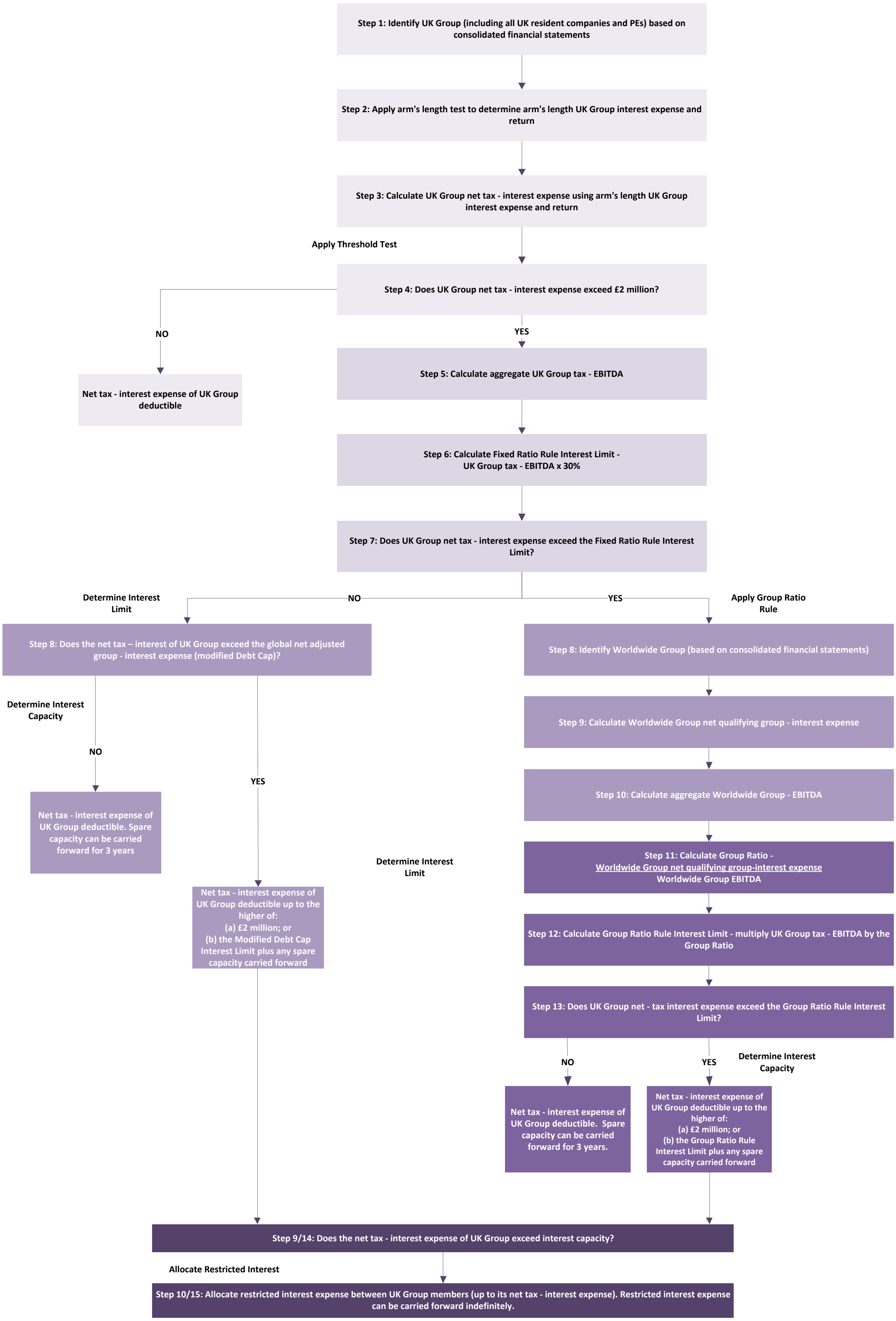
Step 1: Identify UK Group (including all UK resident companies and PEs) based on consolidated financial statements
Step 2: Apply arm's length test to determine arm's length UK Group interest expense and return
Step 3: Calculate UK Group net tax - interest expense using arm's length UK Group interest expense and return
Apply Threshold Test
Step 4: Does UK Group net tax - interest expense exceed £2 million?
NO
Net tax - interest expense of UK Group deductible
YES
Step 5: Calculate aggregate UK Group tax - EBITDA
Step 6: Calculate Fixed Ratio Rule Interest Limit - UK Group tax - EBITDA x 30%
Step 7: Does UK Group net tax - interest expense exceed the Fixed Ratio Rule Interest Limit?
Determine Interest Limit
NO
YES
Apply Group Ratio Rule
Step 8: Does the net tax – interest of UK Group exceed the global net adjusted group - interest expense (modified Debt Cap)?
Step 8: Identify Worldwide Group (based on consolidated financial statements)
Determine Interest Capacity
NO
Net tax - interest expense of UK Group deductible. Spare capacity can be carried forward for 3 years
YES
Net tax - interest expense of UK Group deductible up to the higher of: (a) £2 million; or (b) the Modified Debt Cap Interest Limit plus any spare capacity carried forward
Step 9: Calculate Worldwide Group net qualifying group - interest expense
Step 10: Calculate aggregate Worldwide Group - EBITDA
Determine Interest Limit
Step 11: Calculate Group Ratio - Worldwide Group net qualifying group-interest expense / Worldwide Group EBITDA
Step 12: Calculate Group Ratio Rule Interest Limit - multiply UK Group tax - EBITDA by the Group Ratio
Step 13: Does UK Group net - tax interest expense exceed the Group Ratio Rule Interest Limit?
NO
YES
Determine Interest Capacity
Net tax - interest expense of UK Group deductible. Spare capacity can be carried forward for 3 years.
Net tax - interest expense of UK Group deductible up to the higher of: (a) £2 million; or (b) the Group Ratio Rule Interest Limit plus any spare capacity carried forward
Step 9/14: Does the net tax - interest expense of UK Group exceed interest capacity?
Allocate Restricted Interest
Step 10/15: Allocate restricted interest expense between UK Group members (up to its net tax - interest expense). Restricted interest expense can be carried forward indefinitely.