

# TAX DEDUCTIBILITY OF CORPORATE INTEREST: FURTHER CLARITY

July 2016



Following the recommendations of the OECD's 'Base Erosion and Profit Shifting' project on interest expense (Action 4), the proposed UK interest limitation takes further shape with the launch of the UK Government's second consultation

## The coming storm

The potential impact of the interest limitation rule is becoming increasingly clear and, for many groups, it will be very significant. The UK Government anticipates it will raise them approximately £1bn of additional tax a year. This is a significant amount in the context of total corporation tax receipts of £43bn in 2014/15 and the relatively narrow tax base to which the rule will apply.

The new rule applies from 1 April 2017 but it is expected that draft legislation will only be available from December 2016 with enactment taking place in June 2017. This gives limited time for groups to plan for the introduction of the rules. Therefore, groups should start considering the impact now based on what we currently understand of the shape of the rules. Engaging stakeholders and lenders in early stage discussions on the potential impact of the rules and developing appropriate remedial action plans where necessary will be critical over the coming months.

## What will the rule look like?

The main aspects of the rule have been known for some time - it will allow the higher of:

- **De minimis:** £2m net interest
- **Fixed Ratio:** 30% of 'tax-EBITDA'
- **Group Ratio:** Group's ratio of interest to EBITDA (excluding related party interest)

Interest under the Fixed Ratio and Group Ratio tests will be limited to the overall interest of the 'group'.

The definition of 'group' will be based on accounting principles in the same way as the existing Worldwide Debt Cap. In most cases this will mean each portfolio group is a standalone 'group'.

UK tax-adjusted figures will be aggregated before applying the tests (ie there will be a single £2m de minimis per group), before allocating any disallowance to companies. The flow-chart overleaf illustrates how these measures will apply.

## How close are we to the 'final' rule?

The second consultation gives a great deal of new information on how each part of the rule could apply (depending on responses). It closes on 4 August 2016 and aside from potential changes to the stance taken, the main unresolved areas are:

- A potential restriction to the Group Ratio test
- Details of carry-forward amounts and their usage
- Related party definition (excluding shareholder interest from the Group Ratio, but not the cap based on overall group interest)
- The scope and effect of the public benefit exemption
- Detail of anti-avoidance rules
- Availability of double tax relief.

## How will this interact with other rules?

The new rule will apply after other tax adjustments. The starting position for calculating tax-EBITDA is a company's Profit Chargeable to Corporation Tax after almost all tax adjustments - the main exception being R&D relief. Interest, capital allowances and intangible fixed asset allowances are added back.

The net interest expense figure is net of interest income and calculated after other rules such as transfer pricing (including thin capitalisation), and the unallowable purpose and anti-hybrid rules.

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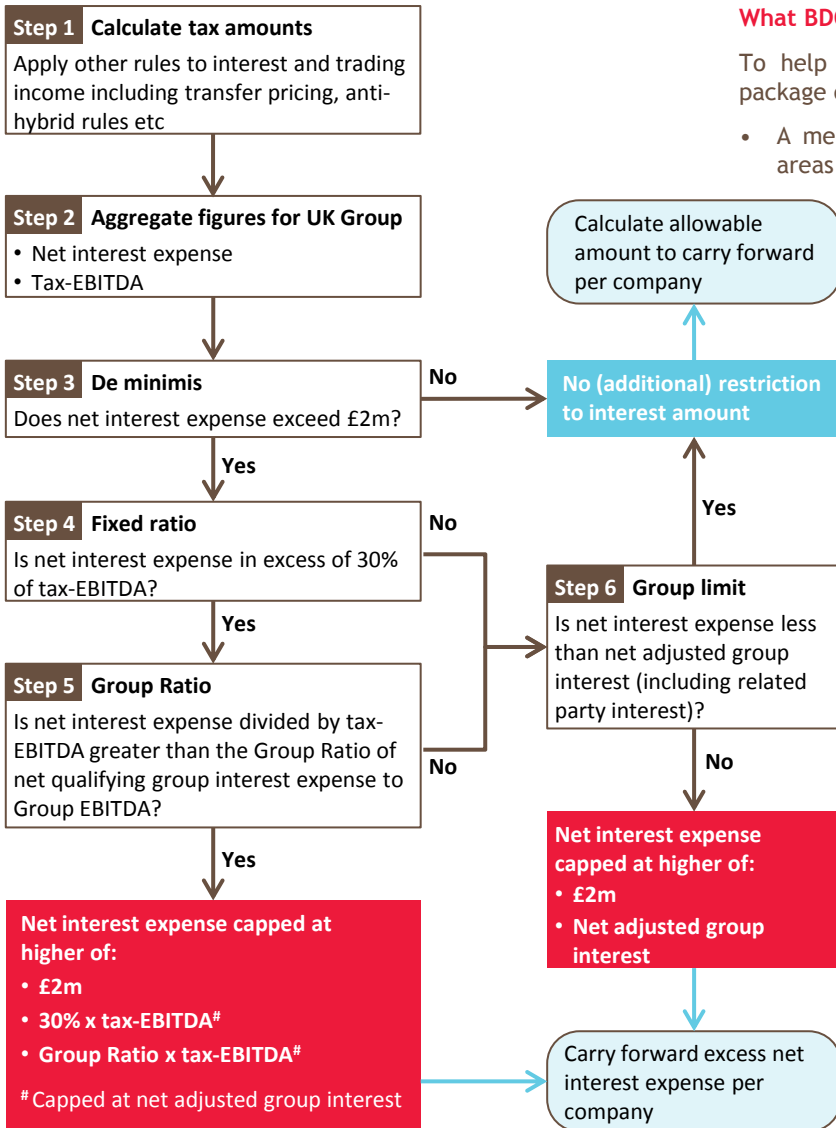
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Having an Advance Thin Capitalisation Agreement ('ATCA') will still, therefore, be relevant to many. Late paid interest originally accruing before 1 April 2017 is likely to be excluded from the new rule even if paid and deductible after that date.

### Impact on private equity backed businesses

Private Equity acquisition structures typically feature significant leverage, both from independent lenders and from funds. The Group Ratio rule is likely to provide relief for bank loans, however care will be needed for UK groups that have non-UK subsidiaries or other non-taxed income.

The exclusion of related party interest from the Group Ratio rule may result in a restriction to the level of the Fixed Ratio (30% of tax-EBITDA), or de minimis, unless the application of transfer pricing rules has already restricted the interest deduction to less than that level. Going forward, analysis of this restriction will need to be included in relation to M&A activity, restructurings and refinancing, changes in group profitability and expansion outside the UK, as well as for annual compliance.



While the new restriction will be applied after transfer pricing adjustments, it will be relevant in determining the level of potential exposure to transfer pricing rules and may cause groups to reconsider whether to seek an ATCA.

### Mezzanine and unitranche loans

The definition of 'related party' in the context of the Group Ratio test is currently set to be very broad. The intent is to include all investors eg PE funds and management shareholders. The 'acting together' tests discussed in the consultation document are likely to be narrower than the test of the same name used in the transfer pricing rules (which typically brings bank interest within scope, albeit generally with no restriction).

Specific comment is being sought on how 'innocent' lending arrangements can be identified and distinguished from investor loans, especially in cases where the lender has a small equity interest. We are engaged in the consultation, both directly and with the BVCA, and would appreciate input from any groups potentially affected by this.

### What BDO can do for you

To help you prepare for the new rule, BDO is offering a package of support, comprising:

- A meeting to talk through the new rule and explain any areas that are likely to have an important impact for you
- Undertaking initial calculations based on forecast or prior year results to determine whether a restriction is likely, what that means to you and how to respond
- Help preparing a message to stakeholders.

If a significant restriction appears likely under the new rule, we can help investigate changes to your group's financing structure to identify options to mitigate the impact.

The most natural solution in many cases is to push-down debt to non-UK subsidiaries. This is implied by the OECD's recommendations to be a positive step, aligning expenses with substance; however, many countries may still treat this as avoidance and care must be exercised.

## Your next steps

For help and advice on the impact on your business and your options going forward, please get in touch with your usual BDO adviser or contact our team overleaf.



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