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Finance (No 2) Bill 2017: Revised draft legislation on corporate interest restriction

Finance (No 2) Bill 2017, published on 20 March 2017, contains the third iteration of the corporate interest restriction legislation, following initial publication on 5 December 2016 and revisions released on 26 January 2017. The operation of the rules remains broadly unchanged from the version published in January, although there are a number of significant changes, many of which were announced at Spring Budget 2017, and which are the result of comments received by HMRC and HM Treasury on the previous versions. The revisions are largely positive for taxpayers, albeit generally with added complexity.

Summary of the interest restriction rules

The corporate interest restriction rules are intended to limit the deductibility of finance costs (hereafter referred to, for simplicity, as interest expense) incurred in the UK, largely following the recommendations of the G20/OECD Base Erosion and Profit Shifting (BEPS) Project in its report into Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, first published in October 2015.

The rules operate to limit a group's interest expense to its interest capacity, an amount determined by calculating interest allowance, using either a fixed ratio or group ratio method, subject to a de minimis amount of £2 million.

- The fixed ratio method calculates interest allowance as 30% of tax-EBITDA – broadly taxable profits less interest and tax depreciation (capital allowances and amortisation of intangibles) – limited to a fixed ratio debt cap amount.
- Groups may instead elect to calculate their interest allowance by applying the group ratio to tax-EBITDA. The group ratio is the ratio of the group's qualifying net interest expense to group-EBITDA (both of which are accounting measures). This is also limited, this time to a group ratio debt cap amount.
- These rules form new Part 10 of the Taxation (International and Other Provisions) Act ('TIOPA') 2010, with the administrative provisions forming a separate Schedule 7A to the same Act. The rules apply from 1 April 2017, requiring groups with periods of account which straddle this date to deem two separate periods of account for the purposes of applying these rules.

Whilst we generally refer to the application of these rules to groups, they apply equally to standalone companies, although many of these are likely to be outside the scope of these rules as their net interest expense is less likely to exceed the £2 million de minimis amount. Any company or group with interest expense is likely to experience some degree of administrative burden to determine the application of these rules to their circumstances.

Deloitte comments

The revised legislation contains a number of amendments, although the fundamental structure of the rules has not changed. The amendments remove ambiguity and unintended consequences and, in some cases, are the result of industry representations. The majority of changes represent a relaxation in the rules and the removal of unintended consequences; however, there is a consequent increase in complexity.

The amendments permit 'excess debt cap' to be carried forward, in order to avoid the situation where companies with losses or low profits, carrying forward interest allowance due to a lack of current year tax-EBITDA, would be unable to deduct that interest in future years due to the operation of the debt cap. This is a welcome change. We believe that this works for groups with restrictions due to low profits followed by higher profits, but is of less assistance where a company is initially profitable and then makes losses/lower profits.

Clarification of the application of the anti-avoidance rule to certain interest payments made pre-1 April 2017 is also helpful, albeit the timing of this clarification could be challenging for groups who have not previously made payments due to uncertainty as to whether or not they would be affected by the rules.

Although the new draft of the rules provides welcome positive changes, there are still issues which remain, recognised by the introduction of a general power to make regulations to amend the rules for periods beginning on or after 1 April 2017, provided that those changes are made prior to 1 April 2018.

The legislation is now close to a final version, which fixes most of the known issues; however, with less than 10 days until the rules take effect, it is clear that the rules will continue to move after the commencement date to an extent, leaving some residual uncertainty.

Spring Budget 2017 announced changes

Companies with losses or low profits: impact of modified debt cap

The drafting of what are now called the fixed ratio and group ratio debt caps in the 26 January 2017 version of the corporate interest restriction legislation could operate to prevent UK companies from deducting disallowed interest carried forward in future periods in certain circumstances. The issue was most significant for UK-only groups with losses or small profits, who could be permanently prevented from deducting third party finance costs, due to the operation of the debt cap; however the problem was not solely limited to UK groups.

The issue arose where, in a year, a UK group makes losses (or small profits). As both the fixed ratio and the group ratio are calculated based on a percentage of tax-EBITDA, the interest allowance of a loss making group will be nil, or very low where there is minimal tax-EBITDA. As a result, interest expense in excess of the de minimis amount would be carried forward indefinitely, which is how the legislation is designed to operate. However, in future years, the interest capacity of the group would be restricted by the operation of the debt cap to the external finance costs of the group for the year. In these circumstances, it may never have been possible for groups to deduct the disallowed interest carried forward.

Recognising that the operation of the debt cap created such an issue, HMRC have amended the legislation so that the debt cap is now the sum of the net group-interest expense of the group for the period and the excess debt cap amount of the previous period. (Although the mechanism is broadly the same, there are differences in the calculation of net group-interest expense for the fixed and group ratios.)

This revised debt cap works to prevent the previous issue whereby disallowed interest expense may never have been accessible. The mechanism does not operate to provide a similar solution where a company makes significant profits in one year, followed by a number of years of low, or no, profits.

Guarantees by related parties: treated as related party debt

The definition of related party in the corporate interest restriction rules is relevant for both the group ratio and group ratio debt cap (which exclude related party debt expense) and for the public benefit infrastructure exemption (PBIE), which also excludes related party debt, except where that debt is subject to the limited grandfathering rules for loans entered into on or before 12 May 2016.

The previous draft of the legislation included a guarantee condition; a third party loan guaranteed by a related party was related party debt for the purposes of these rules. Having accepted that this would catch many commercial situations where third party debt is required to be guaranteed by group company, which was not the intention, HMRC have amended the rules.

The first change is a grandfathering of guarantees, indemnities and other financial assistance in relation to such loans provided prior to 1 April 2017.

Secondly, for the purposes of the group ratio rule and the group ratio debt cap, a loan will not be treated as having been made by related parties where a guarantee is made by a member of the debtor's group or where financial assistance is only provided in relation to shares in the ultimate parent entity, or loans to a member of the group, or where the financial assistance is a non-financial guarantee.

For the purposes of the PBIE, the rules operate differently. Third party debt is excluded from restriction provided certain conditions are met. Guarantees will not breach those conditions provided that they are provided before 1 April 2017, are not provided by a related party, or they relate only to qualifying infrastructure income/assets or performance guarantees.

Public benefit infrastructure exemption: comparison to non-qualifying group companies

One of the conditions for qualifying for the PBIE in the previous version of the rules was the comparative debt test, requiring a comparison of the total debt and assets of all qualifying infrastructure companies in the group to the total debt and assets of *'comparable'* group companies, i.e. group companies carrying out similar activities to the qualifying infrastructure companies within the group. The mechanism of the comparison could have resulted in qualifying infrastructure companies, in a group with no *'comparable'* companies, failing the test and not, therefore qualifying for the PBIE.

Following consultation, the comparative debt test has now been removed altogether; a welcome amendment, removing some of the complexity from the PBIE qualifying requirements.

Banking: dealing in financial instruments

The definition of tax-interest has been expanded to include both income and expenses of banking companies arising directly from dealing in financial instruments (including loan relationships, derivative contracts and shares and securities). This change was made in response to industry representations.

Insurance: option to calculate interest on amortised cost basis

The definition of the amortised cost basis for the purposes of the election to calculate interest on an amortised cost basis, as a practical alternative to fair value accounting, has been extended for insurance groups.

Other amendments

Derivative contracts

The corporate interest restriction rules include certain income and expenses from derivative contracts. This latest draft of the rules excludes income and expenses in respect of derivatives which hedge risks arising in the ordinary course of a trade. This change represents a significant simplification for many groups by removing debits and credits relating to derivatives which are unrelated to the financing of the group/company but are, instead, used to hedge risks associated with the group's/company's trade. For example, under previous drafts of the rules where a group had a foreign exchange forward contract which hedged a sale or purchase, it would have been necessary to strip out all non-foreign exchange gains and losses and include these in group interest. This amendment removes this onerous requirement.

Group ratio (blended) election – application to group ratio debt cap

The group ratio (blended) election enables consortia and joint ventures to benefit from a group ratio based on the group ratios of their consortia/joint venture members' groups. An amendment has been made to fix an issue with the way in which the debt cap restricted the group ratio when such an election had been made.

Public benefit infrastructure exemption

- The definition of 'infrastructure' for the purposes of the PBIE has been expanded to include oil pipelines, oil terminals or oil refineries. Oil and gas activities which fall within the ring fence are already outside the scope of the corporate interest restriction rules.
- Amendments have been made to mitigate the impact on a joint venture company where at least one of the joint venture member companies is a qualifying infrastructure company and at least one is not.
- A transitional provision applies, broadly for accounting periods beginning before 1 April 2018, enabling groups to not entirely fall outside the exemption where the infrastructure conditions are failed in that period, so long as the conditions are met for a period of at least three months including 1 April 2018.
- A new election introduces flexibility for groups by enabling them to consider the PBIE conditions for a number of specified qualifying companies together, and treat all such companies as falling outside of the exemption, if one of them ceases to satisfy the conditions.

Anti-avoidance

Making payments prior to 1 April 2017

The anti-avoidance rule within the corporate interest restriction legislation had created uncertainty, specifically related to the actions which could be taken prior to the commencement of the rules on 1 April 2017. Recognising this uncertainty, HMRC have taken steps to clarify that transactions, for example the payment of late-paid interest prior to the end of March 2017, which would bring an interest expense amount into account before the commencement of these rules and therefore prevent the amount becoming a tax-interest amount, would not be considered an avoidance arrangement.

Compliance and administration

Power to make regulations

The rules contain a number of powers for regulations to be made to amend these rules in the future. One such power relates to situations where accounting at group and company level is different, similar to the 'mismatch regulations' under the worldwide debt cap rules. The explanatory notes give examples of where these rules are intended to apply, including where loan relationships are accounted for at fair value at group level but at amortised cost at company level. It is hoped that this will apply to all similar issues, for example where fair value hedge accounting is ineffective at group level.

The rules also contain a general provision allowing consequential changes which are made prior to 1 April 2018 to take effect for accounting periods commencing on or after 1 April 2017.

These powers illustrate that it is highly likely that more changes will be made to these rules before they are finalised and that any groups with year ends after March 2017 may not know the full scope of the rules applicable to their 2017/18 period of account until that after period ends.

Elections

Group-EBITDA (chargeable gains) election

The capital (disposals) adjustment calculates gains and losses on disposal of capital assets, disregarding capital allowances, or any revaluation adjustments. For most disposals, this is likely to be the actual proceeds, less the cost of acquisition. A new, irrevocable, election, the group-EBITDA (chargeable gains) election, allows groups to calculate their capital gains and losses using tax principles instead, albeit ignoring the impact of the substantial shareholdings exemption or any double taxation relief. This election may be beneficial for groups with high value, long term assets, which benefit from significant indexation allowance to reduce the taxable value of their gains.

This election previously formed part of the interest allowance (alternative calculation) election; however, the nature of the election makes it more appropriately a standalone election.

Other changes

A number of other changes have been made, including:

- Finance costs which are recognised in equity of the group and the issuing company, and are tax deductible because they relate to pre-1 January 2016 debt or regulatory capital securities, will now be added to group-interest, removing a potential permanent disallowance;
- The election to fully consolidate investments in entities accounted for as joint ventures or associates has now been extended to cover subsidiaries accounted for at fair value in the consolidated accounts of the worldwide group (as originally proposed in the consultation document);
- Debt which becomes related party debt on a corporate rescue transaction, will not be treated as being between related parties for the purposes of the rules;
- An adjustment for tonnage tax companies to strip out tonnage tax profits from tax-EBITDA;
- A new grandfathering provision applies to finance leases between related parties entered into before 20 March 2017;
- An election enabling groups to change their deemed periods of account where, for example, no consolidated accounts are drawn up;
- Groups which have filed an abbreviated return will now be able to file a full return for that period (necessary to access brought forward interest allowance), within five years of the end of the period of account.

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