Deloitte.

December 2016
United Kingdom

Finance Bill 2017: Draft legislation on Tax Deductibility of Corporate Interest Expense

On 5 December 2016, following extensive consultation, the government released its draft legislation on the new rules restricting the deductibility of corporate interest expense. The draft Finance Bill 2017 includes the core provisions, and will be updated by the end of January 2017 for some areas where additional work is needed, including additional group ratio rule definitions, some industry specific provisions and other points of detail such as available elections to limit mismatches between tax and accounting measures. The Government also published a summary of responses to the May 2016 consultation, setting out its decisions on all aspects of the new rules.

Summary

All groups will be able to deduct £2 million of net interest expense. Amounts over this will be restricted to the lower of 30% of tax-based earnings before interest and tax depreciation (called tax-EBITDA), and the worldwide group's net interest expense. If worldwide net interest expense is higher than the fixed ratio, the group may elect to deduct an amount based on the group's net accounting interest to accounting EBITDA ratio (the Group Ratio rule), again restricted to the worldwide group's net interest expense.

The rules will include provisions to protect investment in infrastructure that has a public benefit. There will be no special provisions for banking and insurance groups, but there will be for oil and gas companies and for REITs.

This forms part of the UK government's implementation of the G20/OECD Base Erosion and Profit Shifting (BEPS) project recommendations and is expected to raise over £1 billion annually, from the commencement date of 1 April 2017.

Deloitte comments

The broad framework of the draft legislation is consistent with the May 2016 consultation and is broadly based on the OECD's BEPS Action 4 paper. As the draft legislation is incomplete and it will therefore be difficult to fully understand the implications of the proposals for many groups until the rest of the draft law, including details of the operation of the group ratio and elections to reduce mismatches between tax and accounting measures, is published in early 2017. What is clear is that the rules will impose an additional compliance burden, to some extent, on all groups operating in the UK.

As anticipated, the government has retained the initially announced timing, re-affirming the UK's commitment to implement the BEPS project. Introducing the rules from a fixed date of 1 April 2017 imposes a burden on groups, as they will have to prepare notional consolidated financial statements under either IAS or one of the other acceptable GAAPs for periods ending 31 March 2017 and commencing 1 April 2017. The decision to repeal the existing worldwide debt cap rules and introduce the 'modified debt cap' with effect from 1 April 2017 provides some small mitigation to this burden.

Disallowed interest expenses can be carried forward indefinitely until they can be utilised in an accounting period where there is an excess interest allowance, unless the activity of the company ceases or becomes negligible, at which point any excess interest would lapse. The legislation operates by carrying forward disallowed interest on a company, rather than group, basis, which provides some flexibility for groups where companies join or leave the group.

The initial consultation document provided for a 3 year restriction on the carry forward of excess interest capacity. The draft legislation has increased this to 5 years. Whilst we welcome this extension we note that this restriction could still lead to permanent restrictions for groups with significant timing differences between accounting and taxable profits. The proposed election to exclude fair value movements on derivatives (and to mitigate certain other mismatches) should help to restrict this potential exposure; however the legislation for this has not yet been published and uncertainty therefore remains on important points such as whether losses inherent in derivative contracts as at 1 April 2017, which have not yet been deducted by companies, will be restricted under the rules.

Affected groups have been keenly anticipating details of the Public Benefit Infrastructure Exemption, now to be published in January. The government's consultation response states that the exemption will be wider than that initially proposed, which is welcome, although how beneficial it is will be down to the details of the definition. Electing into take the exemption is irrevocable and careful analysis will be needed as to whether companies would benefit, given the complete exclusion of interest income and tax-EBITDA for electing companies, whereas not all interest expense may be excluded.

Banking and insurance companies will not be excluded from the rules (which are likely to be positive for banks and insurers with net interest income); there will be flexibility for REITs and ring-fenced oil and gas activities will be excluded.

The inclusion of a targeted anti-avoidance provision is not unexpected. The provision will take effect where there are "relevant avoidance arrangements" which have a main purpose of securing a tax advantage. The tax advantage must be at least partly attributable to absolute and timing advantages arising under this draft legislation for restricting interest deductibility. The anti-avoidance provision appears to be very broad and it will be important that in practice the rule does not prevent groups from mitigating disallowances through 'house-keeping' actions, or indeed the alignment of taxable profits and interest expense through bringing taxable income into the UK.

Overall, the draft legislation contains the basic framework of the rules but some of the detail remains outstanding. Despite this, given the limited time until commencement, it is important for groups to model the potential impact of the restrictions, consider whether any action is required to mitigate unexpected impacts, and consider the processes which will be needed to collect the relevant information to satisfy the various compliance obligations, particularly for those groups which have not previously been within the scope of the worldwide debt cap. Modelling the impact will also need to take into account other legislative change; for example the impact of the hybrid mismatch provisions (commencing 1 January 2017) and the reform of loss utilisation (from 1 April 2017), where relevant.

General operation and scope

Effective from 1 April 2017, all groups will be able to deduct net interest expense of up to £2 million, but over this de minimis amount, deductions for interest expense will be restricted where a group's 'aggregate net tax-interest expense' exceeds its 'interest capacity'. Interest capacity is calculated as the group's current year 'interest allowance' plus any brought forward interest allowance amounts (which expire if not used within 5 years). The interest allowance is calculated by the application of either the fixed ratio or the group ratio.

The components of 'tax-interest' (the amounts which are potentially subject to restriction) are similar to those within the scope of the current worldwide debt cap rules, with the important addition of certain derivative amounts. The finance costs and income covered include: loan relationship debits and credits with certain exclusions; derivative contract debits and credits on specified 'in-scope' derivatives, again with certain exclusions; financing costs and income implicit in finance leases and debt factoring (and similar) arrangements; and guarantee fee income. Further detail on exclusions and derivatives is included below.

There appears to be no adjustment to deal with interest deductible on a paid basis which accrued before 1 April 2017 – i.e. such interest would be within scope (which is in accordance with expectations following the May consultation).

Fixed Ratio Rule

The fixed ratio has been drafted broadly in line with the proposals in the May 2016 consultation document. The tax deductible net interest expense will be restricted to 30% of tax-EBITDA, based on the aggregated amount of tax-EBITDA of each UK resident group company and UK permanent establishment, supplemented by any unexpired brought forward interest allowance.

Tax-EBITDA is the company's total profit or loss for corporation tax purposes, adjusted for tax interest, capital allowances, relevant intangible debits or credits (broadly, amortisation), non-allowable capital losses, brought forward losses and group relief from companies within the worldwide group. Group relief from non-group companies is not adjusted for, and there is an apparent inconsistency between the claimant company (where relief reduces tax-EBITDA) and surrendering company in a no-group situation.

The fixed ratio has also been drafted to include what was described in the consultation document as the "Modified Debt Cap". As such, the interest allowance under the fixed ratio will be the lower of:

(a) 30% of the aggregate tax-EBITDA of the group for the period; and

(b) the adjusted net group-interest expense of the group for the period.

The adjusted net group-interest expense for the period is broadly the total current year net interest expense of the worldwide group per the consolidated financial statements (in respect of prescriptively defined matters), adjusted for specific items such as capitalised interest (included) and preference share dividends (excluded).

The policy objective behind the modified debt cap is to prevent groups with little external borrowing gearing up to the fixed ratio rule limit in the UK. The government believes that this rule is required in order to sufficiently protect the UK Exchequer against BEPS risks and that it is consistent with the OECD recommendation that countries consider introducing rules to tackle specific BEPS risks that are not addressed by the fixed ratio and the group ratio.

Group Ratio Rule

As outlined in the consultations which preceded this draft legislation, the rules also permit groups to elect, for each period of account, to calculate their interest allowance under a group ratio. The draft legislation incudes the framework for the group ratio but some of the detailed definitions for the group ratio and its application, for example to joint ventures, will be published in January 2017.

Where groups elect to use the group ratio, they will calculate their interest allowance as the lower of:

(a) the group ratio percentage of the aggregate tax-EBITDA of the group for the period; and

(b) the qualifying net group-interest expense (as yet undefined) of the group for the period.

The group ratio is calculated as:

$$\frac{\text{qualifying net group-interest expense}}{\text{accounts-EBITDA}}$$

Accounts/Group-EBITDA is expected to be the group EBITDA from the consolidated financial statements. The group ratio is restricted to 100% of tax-EBITDA (see above), meaning that contrary to the May 2016 consultation paper, in loss-making years no relief would be available. Although acknowledging that this restriction may give rise to a permanent restriction for highly leveraged projects (where the restriction in loss-making years may never be reclaimed), the government considers this to be an acceptable risk when balanced against the complexity of other options to prevent the operation of the group ratio undermining the new rule. Relief may be available through the Public Benefit Infrastructure exemption (see below), where applicable.

The purpose of (b) above would appear to be to provide an equivalent of the modified debt cap for the group ratio. However, details of this definition are part of the package to be released in January 2017.

The Government's response to the consultation document also states that it intends to address some of the potential mismatches between 'tax interest' and 'group-interest', by allowing a once and for all election:

- excluding fair value movements on derivatives (but seemingly not loan relationships) in line with the operation of the Disregard Regulations;
- optional adjustments for capitalised interest on development property and other items of trading stock; and
- optional recognition of transitional adjustments resulting from changes in accounting policy.

In order to better align the group's accounting profits with the calculation of taxable profits, the government has also announced the intention to provide for adjustments to group-EBITDA, again under a once and for all election, including:

- exclusion of fair value movements on derivatives (but seemingly not loan relationships);
- exclusion of fair value movements on capital assets;
- optional recognition of pension costs on a paid basis;
- optional recognition of the cost of employee share options on exercise;
- optional adjustment to the calculation of gains on asset disposal in line with the tax basis; and
- optional recognition of amounts from changes in accounting policy.

Interest deductions and capacity carried forward

Once a disallowed amount has been calculated, a group may – with the consent of individual companies - determine how that amount should be allocated between group members (alternatively the allocation is made on a pro-rata basis). The group must file an interest restriction schedule within 12 months of the year-end. The disallowed amount may only be allocated to group companies within the charge to UK corporation tax that have a net interest expense (and only to the extent of their net interest expense). Unlike the worldwide debt cap, the allocations may not be made to companies with a gross interest expense but net interest income overall.

Disallowed tax-interest expense can be carried forward indefinitely to be used in subsequent accounting periods (to the extent that there is an excess interest allowance). If the activity of the company ceases or becomes negligible, any excess interest would lapse.

Disallowed amounts which have not lapsed are "reactivated" in subsequent periods provided there is sufficient interest capacity. Disallowed amounts are carried forward on an individual company basis and are treated as tax-interest of the current year in subsequent years when they are "reactivated".

In accounting periods where the interest allowance exceeds total current year tax-interest expense and brought forward disallowed tax-interest expenses, the excess interest capacity may be carried forward for 5 years; an increase on the three years initially proposed.

Relevant accounting standards

The worldwide group is determined in accordance with the definition of a group for International Accounting Standards ("IAS"). Alternative group definitions have not been permitted, in order to maintain consistency in the application of the rules. Subsidiaries will be excluded from the worldwide group where investments in them are required to be held at fair value through profit and loss under IAS.

However, for the purposes of calculating any of the accounts based amounts required by the rules, such as the "net group-interest expense", the relevant financial statements of the worldwide group will be the actual consolidated financial statements of the worldwide group's ultimate parent and subsidiaries. These accounts must be prepared in accordance with IAS (or not materially different from those prepared under IAS) or the GAAP of one of the following countries: UK, Canada, China, India, Japan, South Korea or USA.

References to amounts "recognised" in financial statements are references to amounts translated into sterling at the average rate of exchange for the period of account. This could lead to distortions where UK companies prepare their accounts (and therefore tax returns) in a currency other than sterling.

Other considerations

Derivative contracts

Certain derivative contracts are within the scope of the rules – namely, those whose underlying subject matter consists only of one or more of: interest rates; RPI or similar indices; currency; and loan relationships. Pure currency derivatives, such as forward contracts, will therefore be within scope, even if they have no function in financing the group, meaning that the interest differential ("forward points") element of pure currency contracts will need to be identified and included in the calculations.

There is an apparent exclusion of RPI derivatives from the group ratio measures, but this is presumed to be an omission which will be corrected.

One of the most significant issues arising from the consultation was the potential restriction (depending on the particular facts) of losses inherent in derivative contracts as at 1 April 2017, where such losses have not yet been deducted (e.g. interest rate swaps within the Disregard Regulations). The election to calculate the group ratio excluding derivative fair values, effectively applying Disregard Regulations principles, will hopefully resolve this, but uncertainty will remain until the law is published in January.

Foreign exchange

In accordance with the Government's response to the consultation, foreign exchange gains and losses in respect of principal amounts are excluded from the definition of tax interest. Foreign exchange differences wrapped up in interest amounts are expected to be included. It appears that the intention is to similarly exclude foreign exchange amounts from the definition of group interest for the purposes of the group ratio; however, there is some uncertainty in the drafting on this point.

Change of accounting policy and transitional adjustments

Any credits or debits in respect of a transitional adjustment on a change of accounting policy arising before April 2017 are to be ignored. It is unclear from the drafting whether this is limited to loan relationships, or also covers derivative contracts, which we believe to be the intention and is important as the significant transitional adjustments on a change of accounting policy (e.g. adoption of 'new' UK GAAP) have tended to arise on derivatives.

Related transactions

The draft legislation specifically excludes impairment losses (and reversals) on financial instruments. However, any other amounts arising in respect of "related transactions" would be included within tax interest and group interest. This will include in tax-interest both amounts which are commercially equivalent to interest, such as premiums on early redemption of loans, as well as amounts which relate to credit risk, such as credits from the release and substantial modification of loans which are not exempt (or would not be exempt for a UK company) under corporate rescue provisions.

Public Benefit Infrastructure Exemption

The draft legislation does not include details on the Public Benefit Infrastructure Exemption (expected to be published with the other outstanding clauses by the end of January 2017). The Government's response to the consultation process states the intention to introduce an exemption which is wider than that initially proposed in the consultation document.

The exemption is to apply by way of an irrevocable election on a company by company basis, and should exclude a "qualifying company" from the group's interest restriction calculations. To fall within these provisions, a qualifying company must undertake activities such as the provision, upgrade or maintenance of public benefit infrastructure, the undertaking of public benefit services, or integral services using infrastructure of a qualifying company (within the same worldwide group).

The definition of public benefit infrastructure is expected to cover (inter alia): water, gas and electricity transmission, distribution and supply; coal, gas, renewable and nuclear energy generation; port and airports; and the rail network – with a requirement that the infrastructure has an expected economic life of at least 10 years.

Qualifying companies will include those that only have operating income from qualifying activities, interest income or distributions from qualifying companies, such that a chain of holding companies that only receive interest income and distributions from a qualifying company would also be considered qualifying companies. Immaterial non-qualifying income or assets will not disqualify a company, but a company must not hold shares in non-qualifying companies.

Interest expense of qualifying companies will be excluded from the rules except for 'non-qualifying' interest, which includes most related party debt. All interest income and tax-EBITDA will be excluded, which means companies will need to carefully evaluate whether the election will be beneficial.

Interest expense in relation to related party financial instruments are not generally intended to be excluded by virtue of the

PBIE. However, for loans agreed pre 12 May 2016, there will be a very limited grandfathering provision (not expected to apply beyond some PFI businesses).

Banks and Insurance

There is no specific exclusion from the rules for banking and insurance groups. Many such groups will have net interest income and therefore should not generally be subject to restrictions.

The government has stated that they will monitor the situation to determine whether specific rules are required for ‘mixed’ groups which combine non-financial services businesses with a regulated bank or insurer.

Real Estate

The rules will provide flexibility for Real Estate Investment Trusts (‘REITs’) to apply the restrictions in such a way that they will not be forced to pay excessive distributions to maintain their REIT status. The introduction of an election to disregard the impact of fair value movements on property assets held as investments, which could distort the group ratio calculation and unduly restrict the ratio in a particular year, is also beneficial for the Real Estate sector.

The extension of the Public Benefit Infrastructure Exemption to property rental businesses generally is an interesting development, which opens up the possibility that interest on third party loans secured on UK investment properties may, where the security is limited to the asset or company, be outside of the rules. The publication of this legislation will determine the true application of this.

Controlled Foreign Companies

The government’s response to the consultation has confirmed that it has not changed its stance on the exclusion of interest chargeable under the Controlled Foreign Company (CFC) rules - the CFC charge is to be excluded on the basis that this is primarily an anti-avoidance measure.

Joint Ventures

The legislation applicable to joint ventures has yet to be released. The government has stated that its intention is to permit joint ventures to elect to use a “blended group ratio” based on the weighted average group ratios of their corporate investors. This is intended to address concerns raised during the consultation that joint ventures would suffer restrictions unfairly when third party debt is issued by an investor and the funds are on-lent to the joint venture.

Double tax relief

The draft legislation includes an exclusion from tax-interest and tax-EBITDA for any income upon which the UK corporation tax payable is reduced by a credit for foreign tax. The amount excluded is determined by dividing the foreign tax credit by the rate of corporation tax otherwise applicable.

No provisions will be included to disregard the effect of the interest restriction on the maximum amount of double tax relief available.

Patent Box

The government’s response to the consultation confirms that it does not intend the effect of the Patent Box incentives to be diminished, and as such will ensure that the effect of the Patent Box regime will be disregarded when applying the rules. This is a welcome change to the previous proposals, which were inconsistent with the proposals for other innovation tax reliefs. Excluding the Patent Box deduction from tax-EBITDA is consistent with the previously-stated policy objective of excluding the impact of different financing methods on the Patent Box benefit. Full details of this have yet to be released.

Administrative points

A worldwide group can elect to appoint an active UK member company as the group’s reporting body. If no reporting body is appointed, HMRC may appoint one. The reporting body is responsible for submitting the interest restriction return to HMRC within 12 months of the end of the group’s accounting period.

The interest restriction return must include details of all UK group companies, whether the group is subject to interest restrictions in the period, whether the group is subject to interest reactivations in the period and contain a statement of calculations and a statement of interest restrictions. The statement of calculations must contain details of the total disallowed amount for the period and whether the group has elected to use the group ratio to calculate its interest allowance for the period. The statement of allocated interest restrictions shows how the group’s restricted interest is allocated between the members of the group.

To the extent a company has notified its intention to be a consenting company to HMRC (i.e. to accept the nominated company as reporting body on its behalf) the reporting body has discretion as to how to allocate any interest disallowance to it. However, if a company is a non-consenting company any interest disallowance may only be allocated on a pro-rata basis. For groups which operate on a divisional basis, such that no one entity has visibility over the activities of all of the UK group companies, this pro-rata allocation may provide a sensible solution to the allocation of interest restrictions.

Broadly, the compliance requirements are similar to those under the current worldwide debt cap, but many more companies/groups will be in scope. There is an option to produce abbreviated statements for groups which do not suffer a restriction, but there will still be compliance requirements for all groups with UK operations.

Anti-avoidance

The draft legislation includes a targeted anti-avoidance rule which will apply where:

- arrangements are entered into with the main purpose, or one of the main purposes, being to obtain a tax advantage; and
- the tax advantage is attributable, wholly or partly, to absolute or timing advantages under the interest deductibility rules.

The result of any transactions being caught by this rules would be that the arrangements would be counteracted by just and reasonable adjustments to bring into account amounts left out of account, or leave out of account amounts brought in by the operation of these arrangements. Whilst the rule should only apply from 1 April 2017, it appears that arrangements entered into at any time can in theory be within scope.

The anti-avoidance is drafted broadly and it will be important, in practice that straightforward actions taken by groups to mitigate unintended and unexpected impacts are not affected, and also that action taken to align interest expenses to taxable profits – for example, the movement of taxable income into the UK – is also unaffected.

Timetable

The rules will come into force on 1 April 2017. For accounting periods that straddle 1 April 2017, there will be two notional accounting periods; one ending 31 March 2017 and the other beginning 1 April 2017. The apportionment of amounts between these two periods should be on a time basis, unless a just and reasonable apportionment is more appropriate.

In a change to the proposals of the consultation document, the existing worldwide debt cap provisions will be repealed with effect from 1 April 2017 and the modified debt cap will come into effect on that date, at the same time as the rest of the interest restriction rules.

Draft legislation on a number of provisions has yet to be published. The main areas outstanding include:

- Details of the Public Benefit Infrastructure Exemption;
- Detailed definitions forming part of the group ratio calculation;
- Elections to mitigate tax and accounting mismatches such as derivative fair values;
- Rules for particular industries, including oil and gas, REITs, leasing and Patent box;
- Definition of related parties and acting together, which will be particularly important for privately held groups; and
- Administrative rules relating to interest and penalties.

Updated legislation is expected by the end of January 2017 and is expected to cover all of the outstanding issues.

Contacts

Bill Dodwell
Tel: 020 7007 0848
Email: **bdodwell@deloitte.co.uk**

Jim Charlton
Tel: 020 7007 0629
Email: **jicharlton@deloitte.co.uk**

Ben Moseley
Tel: 0161 455 857
Email: **bmoseley@deloitte.co.uk**

Simon Cooper
Tel: 020 7007 0982
Email: **sjcooper@deloitte.co.uk**

Helen Chadwick
Tel: 0161 455 6034
Email: **hchadwick@deloitte.co.uk**

Mo Malhotra
Tel: 0191 202 5511
Email: **mmalhotra@deloitte.co.uk**