Introduction

As part of the United Kingdom’s ongoing commitment to the OECD’s Base Erosion and Profit Shifting (BEPS) initiatives, the Finance Bill 2017 introduced draft legislation containing rules to restrict the amount of interest expense that companies can deduct with effect from 1 April 2017. The most recent amendments to the draft legislation were published on 26 January however there are likely to be further refinements prior to the rules coming into force.

What do the new rules look like?

Broadly, the restrictions will allow all groups to deduct up to £2million of “aggregate net tax-interest expense”. This is defined as the sum of each group entity’s “net tax interest expense”, being tax interest expense less tax interest income.

Beyond the £2million de-minimis, the rules allow for a deduction of net tax-interest expense at a percentage of ‘Tax EBITDA’, capped at the consolidated net interest expense of the group. The percentage is the higher of:

• The ‘Fixed Ratio’ percentage - 30%
• The ‘Group Ratio’ percentage - net group interest expense / group EBITDA

‘Tax EBITDA’ represents Profit Chargeable to Corporation Tax after taking into account most tax adjustments, with the exception of R&D and other qualifying tax reliefs (eg creative industries reliefs). Interest, capital allowances and intangible fixed asset allowances are added back.

The draft rules repeal and replace certain provisions relating to the worldwide debt cap legislation which, for groups defined as large, currently restrict corporation tax relief for interest and other finance expenses by reference to the group’s consolidated finance costs.

Who will be affected?

The legislation potentially impacts all UK companies or UK permanent establishments, regardless of size, which claim corporation tax relief for interest and other finance expenses, although many smaller companies will fall below the £2million de-minimis threshold. It does not apply to limited liability partnerships. The rules apply in addition to transfer pricing but they have the potential to be significantly more restrictive.

In particular, where the group overall has no external interest expense the total UK deduction across the group could be restricted to £2million regardless of how much debt could have been raised at arm’s length. Highly leveraged groups are likely to have to rely on the Group Ratio percentage if net interest expense exceeds 30% of Tax EBITDA. The intention of the Group Ratio is to allow interest on external debt where it relates to UK taxable income, making it likely that a deduction should be secured for senior interest. This may not provide assistance for shareholder loans however.

How is any disallowance calculated?

All groups will have an “interest capacity” of at least £2million per annum. The “interest capacity” for a group is calculated as being the group’s current year “interest allowance” plus any brought forward unused interest allowance from the previous years. Unused interest allowance can be carried forward for a maximum of five years.

The interest allowance in a given year is calculated either using the “Fixed Ratio” or “Group Ratio” percentages, as noted above. Where a group’s “aggregate net tax-interest expense” exceeds its “interest capacity”, the excess is not allowable as a deduction for the group.

Any disallowed amounts are carried forward indefinitely to be used in subsequent accounting periods. If and when there is a future accounting period where there is excess interest capacity, these brought forward amounts will be reactivated and treated as tax interest in the year in which the excess arises.

A simplified application of the rules is illustrated in the flow-chart overleaf.

How is the disallowance allocated within the group?

If in a given period there is a disallowance, then a group may, with the authority of each individual company, allocate the disallowance between the UK tax resident group members in the most beneficial manner. This is subject to the restriction that the disallowance allocated to any individual group member cannot exceed the net interest expense of that group member.

If no allocation is made by the group then the allocation will be made on a pro-rata basis.

Next steps?

The above is a high level summary of the key aspects of the rules – certain exemptions (for example, the Public Benefit Infrastructure Exemption) and anti-avoidance also apply.

The detailed rules, including the definitions of the various terms, are complex and accordingly groups should review these in the context of their financing structures to determine whether significant restrictions are likely.

We can assist you with your compliance obligations under the new rules and investigate restructuring options to help mitigate the impact.

Please turn over
1. Identify the Worldwide Group
The ultimate parent and its consolidated subsidiaries as per IFRS.

2. Aggregate figures for:
- Tax EBITDA
- Net tax-interest expense
- Group EBITDA
- Net group interest expense

3. £2million de-minimis
Does aggregate net tax-interest expense exceed £2m?

4. Fixed ratio
Is net tax-interest expense >30% of tax-EBITDA?

5. Group ratio
Is [Net group interest expense]/[Group EBITDA] >30%?

6. Modified debt cap
Is net tax-interest expense less than adjusted net group interest expense?

Net tax-interest expense capped at higher of:
- £2million
- Group ratio x Tax EBITDA*

* Capped at qualifying net group interest expense

No restriction to interest amount

Yes

Net tax-interest expense capped at higher of:
- £2m
- Net group interest expense

NO