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UK Corporate Interest Restriction rules – keeping pace with change

Adam Blakemore and Catherine Richardson reflect on the development of, and practical considerations associated with, the existing legislation, and provide guidance on some of the aspects that may be subject to further amendments.

Finance (No. 2) Act 2017 has finally delivered the long-promised but perhaps not long-awaited corporate interest restrictions rules to be included in a new Part 10 and Schedule 7A of Taxation (International and Other Provisions) Act 2010.[1]

The UK corporate interest restriction rules represent a significant departure from previously stated government policy on interest deductibility[2] and despite only having received Royal Assent on 16 November 2017, the rules will broadly take effect from 1 April 2017. As such, groups should give both early and detailed consideration to the potential application of the rules to their operations. With the legislation now largely in force, it is timely to reflect on the provisions as enacted, the changes that have been made to the legislation since first being published as well as highlighting those aspects of the rules which are still to be finalised. This article considers each of these topics in turn after first providing a brief overview of the development of the corporate interest restriction rules in the UK.

Development of the UK's corporate interest restriction rules

The UK's corporate interest restriction rules sit within the international context of both Action 4 of the OECD's Base Erosion and Profit Shifting (BEPS) project and the EU's Anti-Tax Avoidance Directive.[3] The UK corporate interest restriction rules are similarly aimed at *"combating attempts by multinational national enterprises and other companies to obtain excessive tax relief for net interest and similar financing costs"*[4].

The UK legislation currently runs to nearly 160 pages with another 489 pages of HMRC draft guidance. It is therefore not surprising that this reflects the culmination of efforts that started when the UK government first flagged its intention to introduce rules to limit the deductibility of corporate interest in a joint HM Treasury and HMRC consultation document published in October 2015. Iterations of draft legislation were published in December 2016, January 2017, March 2017, July 2017 and September 2017 with the legislation being enacted in December 2017. This was interspersed with a series of public consultations, the Chancellor of the Exchequer's Budget speeches and the publication of the UK's Business Tax Road Map in March 2016, together with the publication of draft legislation in March 2017.

As with a significant number of other provisions, the corporate interest restriction rules originally included in Finance Bill 2017 were removed following the announcement of the 2017 General Election in order that such measures could be subject to appropriate parliamentary scrutiny and a simplified Finance Bill 2017 could be passed. The draft legislation was re-introduced in what is now Finance (No. 2) Act 2017, having received Royal Assent on 16 November 2017.

UK corporate interest restriction legislation

The discussion draft on BEPS Action 4 published in December 2014 identified the erosion of the tax base *"through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments."* Supranational, international and domestic efforts have been focused on addressing this concern. In the context of the UK corporate interest restriction legislation, the HMRC guidance (at paragraph CFM95110) notes that the UK rules are aimed at restricting a group's *"deductions for interest expense and other financing costs to an amount which is commensurate with [a group's] activities taxed in the UK…"*. The legislation is both dense and technical, and will require a number of new calculations to be undertaken and compared in order for entities to determine the extent to which the rules will apply.

Turning to the general operation of the corporate interest restriction rules, a worldwide group's deductible net tax-interest expense for a period of account for UK taxation purposes will broadly be limited to the lesser of: (i) the interest allowance under the "fixed ratio" method or the "group ratio" method; and (ii) the amount determined under the modified debt cap. This is subject to a *de minimis* amount, such that groups with less than £2 million of net tax-interest expense should not be within the scope of the new rules. The "worldwide group" for these purposes is defined in the legislation as being the "ultimate parent" and its consolidated subsidiaries, each of which is determined under IAS principles but subject to various overriding rules.

The "fixed ratio" method limits a group's deductible net tax-interest expense to 30 per cent of the group's "aggregate tax-EBITDA" or, if lower, the fixed ratio debt cap of the group. The "group ratio" limits a group's deductible net tax-interest expense to the lower of the group ratio percentage of the "aggregate tax-EBITDA" and the group ratio debt cap of the group. The modified debt cap provisions are intended to limit net tax-interest to a worldwide group's net external interest expense and replace the worldwide debt cap rules introduced into the UK tax code in Finance Act 2009.

Once the net tax-interest expense and interest capacity of the worldwide group have been calculated for a period of account, the group is required to allocate such disallowance of deductions to individual UK group members. This is subject to further rules which permit restricted interest (i.e. net tax-interest expense which has been disallowed) to be carried forward indefinitely and unused interest allowance can be carried forward for up to five years.

Although any detailed discussion of the mechanical operation of the new rules is beyond the scope of this article, there are also specific rules for particular companies and businesses in particular industries and sectors (including but not limited to public infrastructure, banking companies, securitisation companies, investment managers, and groups in the oil and gas, REIT, insurance and shipping industries). These adjustments to the operation of the corporate interest restriction regime are helpful and reflect higher levels of leverage usually required to operate in particular sectors or that these companies are already subject to a specific tax regime which requires amendments in order that the relevant rules interact without adversely affecting the group.

The legislation is supplemented by HMRC guidance, which was first published on 31 March 2017 and revised on 4 August 2017. In addition to a large number of clarificatory and/or technical amendments, the revised guidance includes substantive new sections in relation to the "alternative calculation", joint ventures, property and real estate investment trusts, leasing and the carry-forward rules.

Helpful changes

A number of changes have been made to the corporate interest restriction legislation since it was first introduced. The most wide-reaching change relates to the ability of a group to now carry forward any excess debt cap indefinitely and enable a group to increase its debt cap amount in a later period. Previously the amount calculated under the modified debt cap was determined by reference to the "adjusted net group-interest expense" (ANGIE) under the fixed ratio rule or the "qualifying net group-interest expense" (QNGIE) under the group ratio rule. This calculation has since been revised to be called the "fixed ratio debt cap" (under the fixed ratio rule) being the ANGIE amount plus the excess debt cap of the group that was generated in the immediately preceding period of account of the group, or the "group ratio debt cap" (under the group ratio rule) being the QNGIE amount plus the "the excess debt cap of the group generated in the generating period". This change will be useful where the disallowance in a particular period is not limited by the debt cap but rather by the aggregate tax-EBITDA amount of the group (under either of the fixed ratio rule or the group ratio rule). Groups with limited aggregate tax-EBITDA, such as start-ups or businesses with earnings volatility will therefore benefit from this amendment.

Changes have also been made to the definition of the "related party" concept. Expenses on "related party" debt reduce the QNGIE amount to ensure that related party debt does not inflate the group's interest deductibility. Unfortunately, earlier drafting created a situation whereby a lender could be regarded as a "related party" simply as a result of its ordinary lending activities or alternatively, third party debt could be excluded from the group ratio calculation simply because a parent had guaranteed its subsidiary's third-party borrowing. The revised legislation as enacted makes provision to exclude "normal commercial loans" from creating a related party relationship in a number of different circumstances (including lending and guarantee arrangements), which will be helpful in ensuring that limits on interest deductibility are more aligned with the reality of a group's financing arrangements.

Further amendments are also proposed in relation to the public infrastructure rules so as to not deem a transferee of a business or part of a business of a qualifying infrastructure company (QIC) has having made a QIC election and to also permit companies to be regarded as a QIC or as carrying on a "qualifying infrastructure activity" where it has an insignificant amount of non-taxable income in the relevant period. This latter change is expected to benefit groups in the construction phase of infrastructure developments.

Still outstanding

Despite calls to delay the introduction of the UK's corporate interest restriction rules and having only received Royal

Assent on 16 November 2017, the legislation will apply in respect of periods of account starting on or after 1 April 2017, with provision for deemed notional periods where a period of account would otherwise straddle this date. However, there are still a number of aspects of the regime which are not yet finalised.

Perhaps most notably, the HMRC guidance remains issued in draft form and was still open to public consultation until 31 October 2017. HMRC has stated that the draft guidance will be updated as necessary in light of comments received. However, as the rules have already come into effect, there is a careful balance to be struck between amending the guidance in a way which provides greater clarity and creating further uncertainty for taxpayers. This is particularly important for groups which are required to take action before the end of the first relevant period, such as infrastructure groups that are required to make "qualifying infrastructure company" elections.

In addition, the legislation is already subject to proposed amendments, which are in turn subject to further amendments. Clause 24 and Schedule 8 of Finance (No. 2) Bill 2017-19 (Finance Bill 2018) propose a number of amendments to the rules. Interestingly, the relevant explanatory note describes these amendments as simply comprising "technical amendments". Some of these amendments are due to take effect from 1 April 2017 (when the rules commenced) but many of these amendments are due to take effect from, broadly, 1 January 2018. This will potentially require a further set of calculations in respect of the first relevant period for groups where they are within the scope of the relevant amendments.

Finance Bill 2018 proposed a number of amendments in relation to the public infrastructure rules. In particular, the date by which an infrastructure company must have made a QIC election is to be amended to be the last day of the accounting period where the election first applies (originally the election was to apply from the beginning of the relevant accounting period).

Finance Bill 2018 also proposed changes so as to ensure that the subsidiaries of a managed company should not be regarded as members of the same worldwide group as the asset manager. This is a welcome change that should ensure that the carrying on of investment management does not cause otherwise unrelated businesses to be grouped together.

Furthermore, additional amendments were proposed to Finance Bill 2018. For example, where Finance Bill 2018 proposed to extend the definition of a "non-consolidated subsidiary" to include subsidiaries which are being held as an asset as being "held for sale" (within the meaning of IAS) (and in addition to the current rules which include investments in such subsidiaries which are measured at fair value), it was also proposed[5] to include subsidiaries "held for distribution to owners" (also within the meaning of IAS). Although Finance Bill 2018 received Royal Assent (including this amendment) on 15 March 2018, it is hoped that the Government will endeavour to finalise any further amendments as soon as possible.

Finally, it is also worth noting that the UK corporate interest restriction rules are still subject to ongoing consultation in relation to the repeal of section 53 of the Finance Act 2011 (which disregards changes in lease accounting standards) and the introduction of IFRS 16 Leases (which will bring about a change in lease accounting standards by removing the distinction between operating leases and finance leases in some circumstances – terms which are used within the rules). The consultation paper proposes three solutions but invites further suggestions which do not introduce "additional legislative complexity or would be significantly more administratively burdensome".

This consultation period was open to comment until 28 February 2018 with any amendments expected to be introduced in Finance Bill 2018-19 to take effect from 1 January 2019. Given that IFRS 16 Leases is to apply from 1 January 2019 with early adoption permitted, it will be important that this timetable is adhered to.

Practical considerations

Generally, the UK corporate interest restriction rules have effect in relation to periods of account of worldwide groups that begin on or after 1 April 2017. As such, groups would be well advised to give consideration to the potential applicability of the rules if they have not already done so. A number of restructuring themes are likely to be explored by group treasurers in conjunction with the introduction of the corporate interest restriction legislation. Groups might consider creating headroom under the rules through the migration of existing external debt outside the UK, or through the importation of loan assets into the UK to increase income proportional to the existing UK interest burden of the group. Such restructuring will need to be undertaken with great care owing to the inclusion of a regime anti-avoidance rule (RAAR) in the legislation (although the RAAR is relaxed in the context of "commercial restructuring arrangements" which are considered in HMRC guidance, albeit not in great detail). The practical consequences of a group falling within an interest restriction situation will also need to be modelled with care, including the context of forcing covenant breaches or even mandatory redemptions under financing instruments. For groups that can establish that they are not within the corporate interest restriction rules on account of being within the *de minimis* threshold, this will ease the compliance burden although a certain amount of work will still be required in order to make even this determination.

Even if a group is not within the scope of the regime initially, the group may still benefit from filing an abbreviated interest restriction return where the group has an unused interest allowance. Where a group has an unused interest allowance, this can only be carried-

forward in respect of periods in which an interest restriction return has been filed. Accordingly, a group should consider filing an abbreviated return, which can subsequently be amended to a full return within 36 months after the end of a period of account.

In order to file an interest restriction return (full or abbreviated), a "reporting company" must have been "appointed". A group may appoint a "reporting company" within six months after the end of the relevant period of account or 31 March 2018 if such time would otherwise end earlier. Where a group has not appointed a "reporting company", HMRC will have the powers to do so. The "reporting company" must notify each UK company within the group and the ultimate parent of the reporting company's appointment as soon as possible after its appointment in respect of the first period of account and will also be responsible for the filing of an "interest restriction return", which will detail how interest deductibility restrictions are allocated between group members. Groups considering filing an (abbreviated) interest restriction return should be aware that the "reporting company" may need to be appointed as early as 31 March 2018 with any return potentially due as early as 30 June 2018.

For groups within the UK rules, consideration should be given to the various elections which may be required to be made. Groups determining interest capacity under the group ratio rule will need to elect into this method and potentially make further related elections in the case of joint ventures (under the group ratio (blended) election) or in respect of chargeable gains (under the group-EBITDA (chargeable gains) election). Such elections are made in the interest restriction return of the group.

Groups which expect to be within the public infrastructure exemption should undertake the required analysis to make this determination as soon as possible. As noted above, a QIC election must currently be made before the beginning of the accounting period for which it is to have effect although Finance Bill 2018 provides for this to be amended to be the end of such accounting period. It should also be noted that a QIC election will apply for five years after which it can be revoked, however, another QIC election cannot be made for five years.

More generally, groups within the scope of the rules should ensure they are alive to the relevant compliance obligations so as to avoid being subject to the various penalties which may be imposed for failure to meet deadlines or for the filing of inaccurate returns.

As with many recent substantial developments in UK taxation law, the corporate interest restriction regime will impose a significant and ongoing compliance obligation on groups which ultimately do not fall within its scope, let alone those that do. Groups will need to continue to monitor legislative amendments as well as revisions to the guidance. Further amendments will inevitably be required to the rules. Whilst such amendments should improve the application of the rules, the government should endeavour to ensure that groups are not adversely affected as a result of subsequent changes.

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Endnotes

1. See section 20 and Schedule 5 of Finance (No. 2) Act 2017.
2. See in this regard, HM Treasury's policy paper, 'The Corporate Tax Road Map' (2010) at paragraph 3.7 in which it is noted that the "UK's current interest rules, which do not significantly restrict relief for interest, are considered by businesses as a competitive advantage and it is the Government's view that this advantage outweighs potential benefits from moving towards a more territorial system for interest.".
3. Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market [2016] OJ L193/1.
4. See HMRC draft guidance at paragraph CFM95120.
5. See Notices of amendment, Public Bill Committee (9 January 2018).

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