Practice guide

Restrictions on tax deductibility of loan interest

Speed read

This practice guide, by LexisNexis®PSL Tax with additional practitioner comment, provides a checklist of the key anti-avoidance rules that may apply to restrict the tax deductibility of loan interest for a corporate borrower within the charge to UK corporation tax.

There are a number of anti-avoidance rules that may apply to restrict the tax deductibility of loan interest for a corporate borrower within the charge to UK corporation tax. They are:

- the loan relationships regime anti-avoidance rule (RAAR);
- the unallowable purposes rule;
- the rules recharacterising interest as a distribution;
- the corporate interest restriction;
- the transfer pricing rules;
- the hybrid and other mismatches rules;
- non-market loans; and
- the general anti-abuse rule.

For this purpose, it is assumed that the borrower and the lender are unconnected parties acting at arm's length in respect of a bilateral or syndicated loan.

Outside the scope of this practice guide are the tax considerations relevant to:

- non-corporate borrowers, such as individuals;
- repealed provisions, such as the old worldwide debt cap rules (that were in TIOPA 2010 Part 7); the arbitrage rules that were found in TIOPA 2010 Part 6; CTA 2009 s 443 (that used to apply where the 'sole or main benefit that might be expected to accrue' to the borrower from the loan was a reduction in the borrower's tax liability by bringing a debit into account); and the late interest rules for connected party debt alternative finance arrangements;
- loans where the borrower and the lender are connected, often referred to as connected party debt: further anti-avoidance rules apply in these circumstances, including, with effect from 19 March 2014, the rule cancelling the tax effect of avoidance schemes involving an intra-group transfer of all or a significant part of a group company's corporate profits (for this purpose, applying the wide meaning of 'group' applicable to the patent box regime). If tax avoidance is a main purpose of the arrangements, this rule could restrict a borrower's tax deduction for interest paid to another group company because the rule requires the transferor's profits to be calculated for corporation tax purposes as if the profit transfer had not occurred; and
- loans provided in the context of management buy-outs involving private equity investors and/or shareholder loans.

Interest deductibility

In principle, interest incurred by a UK corporate borrower is, under the loan relationships rules, deductible in calculating taxable profits (CTA 2009 ss 296, 297, 300, 301, 306A–308, 463A–463I).

Trading vs non-trading loan relationships

Under the loan relationships rules, income and expenses (i.e. credits and debits) in respect of a loan are treated as:

- receipts and expenses of a trade where the loan is held by a company for the purposes of a trade and therefore form part of that company's trading profits or losses (CTA 2009 s 297); or
- non-trading loan relationship credits and debits in respect of a loan that is held otherwise than for the purposes of a trade and therefore form part of non-trading loan relationship profits or deficits (another word for losses) (CTA 2009 ss 299–301).

Action for the borrower

The general principle that interest expense is tax deductible is subject to various anti-avoidance rules that may apply to restrict deductions. As the deductibility of interest is one of the main benefits of loan financing, it is prudent for a borrower to consider these anti-avoidance rules before borrowing money so that it can address up-front any risk that the interest may not be deductible. For instance, the borrower could decide not to proceed with the borrowing at all (if, for instance, it has alternative means of obtaining the funds, such as from a rights issue) or to structure the borrowing in a more beneficial way. Restructuring a borrowing transaction that has already been entered into is likely to cost the borrower more, both in terms of time and money and may still result in some or all of the interest expense not being deductible for tax purposes.

Loan relationships RAAR

In relation to arrangements entered into on or after 18 November 2015, a tax deduction for interest (or other debits) may be denied (or a taxable receipt may be implied) in order to counteract any loan-related tax advantages (the advantage(s) may relate to quantum or timing) arising from relevant avoidance arrangements (see CTA 2009 ss 455B–455D; F(No. 2)A 2015, Sch 7 Part 1 para 51 and Part 6 para 111 and HMRC's *Corporate Finance Manual* at CFM35910–CFM39530, CFM39560).

An arrangement (which is widely defined to include any agreement, understanding, scheme, transaction or series of transactions, whether or not legally enforceable) is a relevant avoidance arrangement if a main purpose of the arrangement is to enable a company to obtain a loan-related tax advantage, unless obtaining the tax advantage can 'reasonably be regarded as consistent with any principles on which the provisions [of the loan relationships rules] that are relevant to the arrangements are based (whether expressed or implied) and the policy objectives of those provisions' (CTA 2009 s 455C(2), (3)–(4); CFM39520–CFM39550).

The RAAR looks at whether obtaining a loan-related tax advantage is a main purpose of the arrangement (i.e. 'the purposes at which the arrangements were aimed'): it is not necessary for any particular party to the arrangement to have a tax avoidance purpose but '[i]f any of the parties entered into the arrangements for tax avoidance purposes, then it is likely that seeking a tax advantage will have been at least one of the purposes of the arrangements' (CTA 2009 s 455C(3)).

Determining what the purposes of particular arrangements might be, and whether they amount to main purposes, are questions of fact to be determined in the light of the evidence available (CTA 2009 s 455C(3); CFM39520).

The tax advantage that the RAAR counteracts (i.e. a loan-related tax advantage) must be related to the loan relationship in question and must be a tax advantage under the loan relationships rules: 'Arrangements that seek to obtain a tax advantage not realised by way of [loan relationship] credits or

Practitioner view: Unallowable purposes – ascertaining purpose

The critical element of the unallowable purposes test in CTA 2009 s 441 is ascertaining the company's purpose. It is the company's subjective purpose which matters (*Travel Document Service* [2018] STC 723). 'Subjective' in this context means the actual intention of the company in entering the loan relationship, not what an observer might objectively discern from the evidence. That subjective purpose is determined by reference to the board of directors of the company, although it may be necessary to also consider the purpose of the shareholders (particularly a parent company: *JTI* [2022] UK FTT 166)). In some situations, it might be relevant to consider the influence of an external third party, such as an adviser (*Iliffe News* [2012] UKFTT 696 and *AH Field* [2012] UKFTT 104). Put simply, the focus is on the 'decision makers' (*Kwik-Fit* [2022] UKUT 314, para 97). All of the facts need to be considered, but it is also necessary to look beyond the stated motives and intentions of the board members of the company. The facts need to be viewed realistically; if direct evidence is insufficient, a court can draw inferences from those facts as to the company's purpose.

A company's purpose will be determined at the creation of a loan, but can also evolve through the lifecycle of the loan. Transactions which take place in a group, such as loan assignments or new companies being created, and the refinancing or restructuring of a loan are points at which the courts have identified that a company's original purpose regarding a loan relationship can change (*Fidex* [2016] STC 1920, and also CFM 38150).

The mere knowledge that a tax consequence will follow from being party to a loan relationship (such as the availability of deductions for interest costs) does not equate to a company having a tax avoidance purpose (*Versteegh* [2013] UKFTT 642 and *Kwik-Fit*). Unfortunately, in some transactions there is a risk that this principle can become obscured in practice. The inter-linking of steps in a transaction can make it difficult in practice to view tax consequences in isolation. A typical situation is where a proposed corporate restructuring has a complex series of inter-linked steps to achieve a commercial aim, but some of the steps may relate to the tax architecture of the restructuring. It is prudent to attempt to establish if the commercial purpose can be achieved without including the tax sensitive steps. Directors may well want to know that the transaction can be entered into without creating a manifest tax disadvantage for their company, but advice needs to be communicated carefully to ensure it cannot later be interpreted as demonstrating that the company's main purpose was seeking a tax advantage in eliminating all the tax frictions which are present.

> The mere knowledge that a tax consequence will follow from being party to a loan relationship does not equate to a company having a tax avoidance purpose ... Unfortunately, there is a risk that this principle can become obscured in practice

Clear contemporary documentation is always going to be important in evidencing the company's purpose at the critical points in a loan relationship's lifecycle. This can include board minutes and board resolutions, but the intentions of the board of directors can also be memorialised in emails and memorandums. While a company's purpose will be derived from a consideration of all the evidence and drawing of inferences (*Kwik-Fit* [2022] UKUT 314, at para 102), direct contemporary evidence is likely to be hard to ignore.

How a transaction is presented, particularly where documentary presentations are circulated between the company and its financial advisers, is another point to observe carefully. While not generally the preserve of tax advisers, presentations at risk and investment committee stages may be important in assessing a company's purpose. How a company's board describes a transaction to an investor can be relevant, not least because the company's communication with third parties might be used to infer the company's intention in the proposed transaction.

Adam Blakemore,
partner at Cadwalader, Wickersham & Taft

debits are not within the scope of these provisions' (CTA 2009 s 455C(5); CFM39530).

The legislation provides a non-exhaustive list of examples of results that may indicate that the result(s) (i.e. the tax advantage(s)) are not consistent with the policy or principles of the provisions of the loan relationships rules that are relevant to the arrangements. It is a question of fact whether or not the tax advantage(s) arising from the arrangements are excluded from the RAAR for being consistent with the policy or principles of the legislation (CTA 2009 s 455D; CFM39540–CF39550).

There has not yet been a judicial decision on the application or interpretation of the RAAR.

Unallowable purposes

A tax deduction is denied in respect of an accounting period to the extent that the interest (or other expense for which tax relief is being claimed) is, on a just and reasonable basis, attributable to an unallowable purpose or intention, i.e. a purpose which is not among the business or other commercial purposes of the company. An unallowable purpose includes (but is not limited to):

- a main purpose of securing a tax advantage for that company, or for any other person; and
- any business or other commercial purposes to the extent they relate to activities of the company that are not within the charge to corporation tax (CTA 2009 ss 441, 442; CFM38140).

The unallowable purposes rule can apply even if the tax advantage does not arise directly from the loan relationship in question. It is sufficient if a main purpose of the company in being (or remaining) a party to the loan relationship, or entering into a related transaction in respect of it, is to secure a tax advantage for the company itself or for any other person.

In addition, as can be seen from the facts and the decision of the FTT and then the Upper Tribunal (UT) in *Kwik-Fit*, accelerating the use of existing losses to shelter newly acquired income arising as a result of a debt restructuring can amount to a tax advantage and fall foul of the unallowable purposes rule (*Kwik-Fit Group Ltd v HMRC* [2022] UKUT 314 (TCC)).

The unallowable purpose rule works on an accounting period by accounting period basis. Therefore, a UK corporate borrower should consider whether or not this provision applies at any time throughout the life of a loan, as well as when entering into any related transactions, such as any disposal or acquisition (or anything which equates in substance to a disposal or acquisition) of rights or liabilities under the loan. The purposes for entering into a loan may differ from those of continuing to be party to that loan, which may also vary over time. This is why a company's loan may fall into the unallowable purposes rule in some accounting periods and outside it in others (CTA 2009 ss 441, 442; CFM38120, CFM38170).

Even if a company has a commercial purpose as well as an unallowable purpose, all its debits in the affected accounting period (or accounting periods) may still be disallowed if they are found to be wholly attributable to the unallowable purpose, as happened in *Fidex* [2016] EWCA Civ 385 and *Blackrock* [2022] UKUT 199 (TCC).

> As can be seen from *Kwik-Fit*, accelerating the use of existing losses to shelter newly acquired income arising as a result of a debt restructuring can amount to a tax advantage and fall foul of the unallowable purposes rule

Given the subjective nature of a purpose and that the burden of proof rests with the appellant taxpayer to demonstrate that, on the balance of probabilities, it did not (or does not) have an unallowable purpose (the burden of proof point being confirmed in *Oxford Instruments* [2019] UKFTT 254 (TC) at para 96 and *JTI Acquisition* [2022] UKFTT 166 (TC) at para 119, companies should document and evidence the commercial rationale for entering into, remaining party to and/or restructuring transactions involving loans (or other instruments) which could be subject to an unallowable purposes test.

Broadly, the unallowable purposes rule should not deny a tax deduction for interest expense provided that:

- there is commercial justification for the borrowing, i.e. the borrower actually needs the money;
- the borrowing arrangements are on commercial terms and do not include any ancillary provisions that are there simply to generate tax advantages;
- the purpose of the borrowing is to fund the borrower's activities that fall within the scope of UK corporation tax; and
- any tax advantage (such as a tax deduction for interest expense) is not a main purpose of the borrowing. (see CFM38190)

The unallowable purposes provision is likely to apply to a borrower in cases where:

- it enters into or retains a borrowing for artificial, tax-driven arrangements;
- it retains a loan that it no longer needs for its commercial or business purposes – including where a UK tax resident company no longer requires the loan for its business within the scope of UK corporation tax, for instance, where it retains the loan for the activities of its non-UK permanent establishment which benefits from a valid foreign branch exemption;
- it refinances an existing (commercially justifiable) borrowing purely to obtain a tax advantage; or
- it uses the loan to fund activities from which the company involved cannot (or does not expect to) make a pre-tax profit.

HMRC's guidance provides helpful examples of when it considers that the unallowable purposes provision is or is not likely to apply (CFM38180, CFM38190).

However, HMRC's approach in *JTI Acquisition Company (2011) Ltd v HMRC* [2022] UKFTT 166 (TC) appears to contrast with its own guidance at CFM38180 (on when the unallowable purposes rule will not normally apply) which states that 'double dipping' (i.e. tax relief being available in another jurisdiction as well as the UK) should not engage the unallowable purpose rule provided that the structure does not have a 'non-commercial feature' and/or relief might be available more than once in the UK in respect of the true economic cost of the borrowing. In *JTI Acquisition*, the FTT agreed with HMRC and disallowed all the debits for being attributable to an unallowable purpose where the arrangements involved a new UK company being established in a global group to acquire shares in a company from a third-party vendor, borrowing from its parent to do so and securing a tax advantage in that the debits from the borrowing resulted in a relief from tax for other UK group companies by means of group relief.

The decision of the UT in *Blackrock* [2022] UKUT 199 (TCC) and the FTT decision in *JTI Acquisition* raise a concern that structuring a commercial transaction efficiently with tax in mind may be sufficient for the unallowable purposes rules to apply and disallow tax relief for (some but maybe even all) interest (and/or other debits) on a loan even if that loan funds the commercial transaction.

Recharacterisation of interest as a distribution

Interest is not deductible if it is recharacterised as a distribution. This is because a distribution is not tax deductible for the payer (CTA 2009 s 1305; CTM15150).

Interest expense incurred in respect of a bilateral or syndicated loan where the borrower and the lender or lenders are unconnected parties acting at arm's length should generally not be recharacterised as a distribution unless the loan has equity-like features, such as an interest rate that increases if the borrower's financial position improves.

Most commonly, interest on a loan could be recharacterised to the extent that it:

- represents more than a reasonable commercial return for the use of (broadly) the principal amount of the loan (such securities/loans are referred to in the legislation as non-commercial securities), i.e. to the extent that the interest is excessive (CTA 2010 s 1000(1)E; CTA 2010 ss 1001, 1005–1014; CTM15502); or
- is results dependent (securities/loans that are results dependent are referred to in the legislation as special securities), i.e. dependent on the results of all or part of the borrower's business or assets (CTA 2010 s 1000(1)F; CTA 2010 ss 1001, 1015(4); CTM15520).

Standard calculation of interest

In a syndicated loan or a large commercial bilateral loan, it is common for the interest rate to be a floating rate that fluctuates throughout the term of the loan. In such cases, the

Practitioner view: The rules recharacterising interest as a distribution – practical issues

When considering the recharacterisation of interest as a non-deductible distribution, there are a number of practical points to watch for.

In respect of non-commercial securities, the determination of whether the return to the lender represents a reasonable commercial return is considered solely from the perspective of the lender and only whether the return is commercially reasonable by reference to the principal secured (CTM15502). As such, it is important that the risk analysis is undertaken by reference to the lender, and particularly the risk that the lender will not receive part or all of the principal (CTM15502).

When considering the recharacterisation of interest as a non-deductible distribution, there are a number of practical points to watch for

In addition, the commercial reasonableness of the interest rate is determined when the loan was made. As such, the relevant time for determining the commercial reasonableness of the interest rate in respect of 'replacement securities' (i.e. new securities issued on the same terms as previously issued securities) will be at the time of issuance of such new securities. The impact of this is particularly important at times when there is movement in base rates, which flows through to risk-free reference rates.

There are also practical considerations in respect of the special securities rules.

CTA 2010 s 1032 was introduced as an anti-avoidance measure to prevent what may be predominantly interest being recharacterised as a distribution and thus being received without being subject to UK corporation tax (CTM15530). However, in practice, CTA 2010 s 1032 can also be particularly useful in establishing the deductibility of interest paid on profit-participating subordinated securities in structured finance transactions. Where residual profits are distributed in accordance with a 'waterfall', the interest would likely be regarded as dependent on the results of the company's business and thus the securities would fall to be characterised as 'special securities'. However, where the recipient is within the charge to UK corporation tax, the interest shall not be recharacterised as a distribution to the extent that the return does not exceed a reasonable commercial return. This can be a useful provision to rely on in circumstances where the company is not within a special taxation regime, such as the Taxation of Securitisation Companies Regulations, SI 2006/3296. Section 1032 does not require there to have been avoidance present in order to be applied (CTM15530).

Exclusions from the results dependent securities provisions also apply in the case of hybrid capital instruments (under CTA 2009 s 420A(4)) and alternative finance arrangements (under CTA 2010 s 1019).

Catherine Richardson,
partner at Cadwalader, Wickersham & Taft

interest rate is often set for an interest period and includes the following components:

- a risk-free reference rate, such as the sterling overnight index average (SONIA) compounded in arrears or term SONIA: SONIA is a backward-looking rate since it is based on actual transactions and reflects the average of the interest rates that banks pay to borrow sterling overnight on an unsecured basis from other financial institutions and other institutional investors;
- the margin: this compensates the lender for the risks and costs of lending (which, in investment grade borrowings, tends to be a set percentage rate per year and in leveraged borrowings, tends to be a margin ratchet (margin ratchets are discussed further below)); and
- mandatory cost: this is the way in which the lender recoups costs associated with lending, such as any regulatory costs incurred by it in making the loan, and is normally factored into the margin.

The interest rate in some facility agreements also includes a credit adjustment spread (CAS). Broadly, the CAS is the difference between interest based on SONIA and interest based on LIBOR. LIBOR included a credit element to reflect the cost and risk to banks of lending over a period. SONIA, which is an overnight rate, carries lower risk for lenders, which is why it is referred to as a risk-free rate or RFR. Consequently, an interest rate based on SONIA tends to be lower. Therefore, most existing LIBOR-based loans that were amended to SONIA-based loans included a CAS to ensure a fair conversion of existing loans. However, even new SONIA-based loans sometimes include a CAS to ensure that the amount of interest received remains what it would have been had the interest rate been based on LIBOR without the lender having to increase the margin for that (which may be less popular with borrowers).

The London inter-bank offered rate (LIBOR) was discontinued on 31 December 2021 and replaced with SONIA.

Practical impact for loans of the rule recharacterising excessive interest as a distribution

In the context of a bilateral or syndicated loan, it is unlikely that the interest would be excessive having regard to the principal amount of the loan where:

- there is no discount or premium element that might affect how much is treated as the principal amount of the loan (or principal secured);
- the interest rate is based on:
  - a reference rate such as SONIA, which is a variable rate for inter-bank lending which closely tracks the actual cost of inter-bank borrowing, and the margin and, if relevant, the CAS, to reflect arm's length terms; or
  - a fixed interest rate that represented a market rate at the time the loan was entered into since what is a reasonable rate is determined at the time the loan is made and is not revisited – so, for instance, a fixed interest rate of 5% on a loan between unconnected third parties that was commercially reasonable when the loan was made could not become excessive just because interest rates subsequently drop (even if they drop significantly) while the loan is still outstanding (CTM15502); and
  - the lender and the borrower are unconnected parties acting at arm's length.

Where existing loans are amended to respond to interest benchmark reforms, such as replacing LIBOR with SONIA, HMRC states in its guidance that such amendments should normally only vary the existing agreement (rather than create a new loan agreement) and 'will not themselves constitute a material change' for the purposes of the analysis of whether interest is excessive or not. If the LIBOR-based interest was not excessive, the SONIA-based interest that replaces it should also not be excessive, and therefore not be a reason for the interest to be recharacterised as a distribution (see HMRC's *Guidance on the taxation implications for businesses from the withdrawal of LIBOR and other benchmark rate reform*).

Practical impact for loans of the rule recharacterising results-dependent interest as a distribution

In loan agreements where the margin is a fixed percentage throughout the term of the loan, the interest should not be results-dependent as usually none of the other components that make up the interest rate varies by reference to the financial position of the borrower or its group.

Where the margin is not a fixed percentage and it increases or reduces to any extent based on the results of all or part of the borrower's business or assets, there is a risk that the interest may be results-dependent.

There is an exception in cases where there is an inverse relationship between the interest rate and the results of the borrower's business so that if the borrower's business results increase, the interest rate decreases and vice versa. It is therefore important to understand how the margin interacts with the borrower's results or assets (CTA 2010 s 1017).

In ratchet loans, which use a margin ratchet (used in leveraged financing) the margin is determined by a ratio of debt to adjusted earnings (usually EBITDA, i.e. earnings before interest, taxes, depreciation and amortisation) and the margin rate depends on the level of that ratio. The ratchets tend to be inverse so that:

- the margin decreases (and in turn reduces the interest rate on the loan) when the ratio of the borrower's net debt to adjusted earnings improves: the decrease in the interest rate recognises that the borrower's improved financial situation has increased its creditworthiness and so reduced the lender's risk; or
- the margin increases (and in turn increases the interest rate on the loan) when the ratio of the borrower's net debt to adjusted earnings deteriorates: the increase in the interest rate recognises that the borrower's worsening financial situation has reduced its creditworthiness and so increased the lender's risk.

HMRC's guidance specifically confirms HMRC's view that these inverse ratchets are covered by this exception so the interest does not need to be recharacterized (CTM15525).

In particular, in its *Company Taxation Manual* at CTM15525, HMRC states that where the advance of a ratchet loan constitutes a commercial transaction between unconnected parties at arm's length and such a ratio is an accepted indicator of risk:

- 'the use of a ratio of borrowings to profits (such as EBITDA) in the interest rate terms will be acceptable as a measure of "results" for the purposes of [CTA 2010 s 1017] so that [recharacterisation under CTA 2010 s 1015(4)] will not apply'; and
- that this analysis applies even if the margin ratchet is to be adjusted by reference to the results of a group of companies that includes not just the borrower or its subsidiary companies, but also its parent and any other intermediate and subsidiary companies.

There are also a number of circumstances in which distribution treatment in respect of results-dependent interest (and in respect of other types of special securities) does not apply. Consequently, the risk that results-dependent interest will be recharacterised as a distribution only exists where:

- the lender is a company that is not chargeable to UK corporation tax;
- the lender is not a company; or
- the interest payments on the transaction exceed a reasonable commercial return, in which case the excessive interest would fall within CTA 2010 s 1000(1) para E. (See CTA 2010 s 1000(1)F(a)–(b); CTA 2010 s 1032.)

> Unlike the other rules that restrict tax relief for interest on a transactional basis, the CIR is a general, structural restriction

Corporate interest expense restriction (CIR)

The CIR rules, which took effect from 1 April 2017, limit the amount of interest expense and certain other financing costs that large businesses can deduct when calculating their profits subject to corporation tax. Unlike the other rules referred to in this practice note that restrict tax relief for interest on a transactional basis, the CIR is a general, structural restriction on tax relief. The CIR rules include:

- a de minimis allowance of £2m: deductions for net interest expense (i.e. interest expense less interest income) up to this amount annually will not be restricted by the rules;
- for net interest expense above the £2m allowance, net interest expense is disallowed by reference to the lower of two separate caps so that net interest expense in excess of the relevant cap will not be deductible. The two caps are:
  - a cap that limits deductions for net interest expense to a percentage of a group's UK 'tax EBITDA' – 30% is the default percentage pursuant to the fixed ratio method, but, where a group elects to apply the group ratio method of calculating interest allowance for the relevant period, this percentage may be higher if the group has a high level of external debt; and
  - a cap (referred to at consultation stage as a 'modified debt cap') which broadly replaces the worldwide debt cap rules (which were repealed with effect from 1 April 2017) and ensures that a group's UK interest deductions cannot exceed the total net interest expense of the worldwide group;
- rules allowing the carry forward of disallowed interest to be deducted against profits of future periods where there is 'spare' interest allowance in that future period and, subject to a five-year time limit, rules allowing the carry forward of unused interest allowance;
- an exemption for certain public benefit infrastructure projects; and
- provisions to prevent taxpayers circumventing the CIR rules.

(See TIOPA 2010 Part 10; F(No 2)A 2017 Sch 5 Part 4; CFM95000.)

Transfer pricing

Where the transfer pricing rules in TIOPA 2010 Part 4 apply to a loan, they deny the borrower a tax deduction for any part of the interest that exceeds an arm's length rate of interest or which relates to a loan or a portion of a loan that exceeds what would have been made on arm's length terms. This is because the terms, amount and availability of the debt will

Practitioner view: The corporate interest expense restriction – risk allocation implications

As stressed in the adjoining column, the CIR is a structural restriction on interest deductibility, which has to be considered regardless of the commercial underpinning of the relevant loan arrangements and their tax-related motivation (if any). This means that the CIR can restrict interest deductibility in a wide range of circumstances, depending upon factors such as the level of leverage within the borrower group (does its net group interest expense exceed the £2m annual de minimis?), the composition of the group's balance sheet (the more tax-interest income it receives, the better, since this will net down tax-interest expense and generally reduce potential restrictions under the regime) and whether the group can and wants to access exemptions from the regime such as the public benefit infrastructure exemption.

The application of the CIR may also have risk allocation implications in a transaction context

Although largely mechanical, the CIR rules are complex and potentially time-consuming to apply, relying on a number of regime-specific concepts that require calculation separately from other accounting and tax concepts, and it is therefore important for taxpayers to consider the impact of these rules carefully. This is particularly the case because the CIR rules apply by reference to the 'CIR group', which is defined by reference to IFRS consolidation standards and therefore has a very wide reach, potentially linking companies that would not consider themselves to be connected for other tax purposes and so may have no existing lines of communication/cooperation between them (which obviously renders it challenging to obtain the necessary information).

The application of the CIR may also have risk allocation implications in a transaction context, for example concerning an acquisition financing or other relevant transaction structure. For example, whilst lenders will generally be forced to accept the application of the CIR to members of what they perceive to be the 'borrower group', they will not usually want that application worsened by so-called cross contamination – i.e. the possibility that the CIR group (which, as noted above, can have a wide reach) extends beyond the borrower group, with the potential for interest disallowances to be allocated to members of the borrower group from entities outside it even in situations where the borrower group entities would not be subject to any such restriction on a standalone basis. For that reason, therefore, lenders may wish to restrict this type of allocation as a contractual matter (i.e. to ensure that borrower entities are not subject to any greater restriction than would have applied had the CIR rules applied only to the borrower group, or at least to ensure that any restrictions are proportionate to the relevant entities' share of the CIR group's aggregate tax-EBITDA or aggregate net tax-interest expense), which borrowers may correspondingly resist as it fetters their discretion to allocate any interest disallowances to the greatest overall benefit to the wider group and/or their investors.

(See also 'The CIR regime and acquisition finance' (M Mortimer & K Hunt), *Tax Journal*, 9 September 2022.)

Kitty Swanson, partner at Mayer Brown

be readjusted (for tax purposes) for both parties to what they would have been on an arm's length transaction (TIOPA 2010 s 147(3), (5)).

The UT's decision in *HMRC v BlackRock Holdco 5 LLC* [2022] UKUT 199 (TCC) highlights the importance of ensuring that an intra-group loan includes all the terms (not just the amount of the loan and the rate of interest) that would have been included in a loan between third parties acting on arm's length terms. In this case, various third party covenants that would have been included in an arm's length loan were not included in the intra-group loan. According to the UT, since an independent lender would not have made the loans without those covenants, there was no comparable arm's length transaction to the intra-group loan that had been made, so the loan would not have been made between independent entities and therefore no tax deduction for any of the debits was allowed.

In the context of a loan between unconnected parties, the transfer pricing rules should still be considered when a party connected to the UK corporate borrower provides a guarantee (whether it is a contractual or an implicit guarantee). A guarantee may enable a borrower to borrow more money and perhaps on preferable terms (such as a lower interest rate, less demanding covenants and/or a longer term) than it could have done in the absence of the guarantee. Any interest in excess of the interest that would have arisen in respect of the principal amount it could have borrowed on its own would not be deductible. Similarly, the deductibility of the expense of the guarantee is also at risk to the extent that it is not made on arm's length terms (TIOPA 2010 ss 147, 151–154; INTM413110–INTM413170)).

BlackRock highlights the importance of ensuring that an intra-group loan includes *all* the terms that would have been included in a loan between third parties acting on arm's length terms

The transfer pricing rules may also be relevant in cases where multiple lenders act together in relation to the financing arrangements of a company or a partnership, even if the borrower and the lenders are not connected. This is a broad extension of the transfer pricing provisions intended to apply in a private equity context but which may apply more widely. This rule tends to apply where the lenders are not seeking the best possible deal for themselves in respect of the lending because, for example, the lenders:

- already have an existing equity interest in the borrower; or
- as a result of, or at the same time as, providing the lending, will acquire or dispose of an equity interest in the borrower.

(See TIOPA 2010 ss 161–162; INTM413180, INTM519040, INTM519070.)

According to HMRC's guidance (at INTM413180), the concept of 'acting together':

> '... has a very wide meaning and it is not necessary for a loan provider to have an equity interest in the borrower for it to be within the scope of the legislation. However, where the loan is from a lender who is otherwise unconnected with the equity investors, in normal circumstances the risk that the terms are other than arm's length is likely to be low.'

In addition, HMRC's *International Manual* used to helpfully acknowledge at INTM461260 that the co-ordination of multiple lenders for the purposes of putting together a syndicated loan should not, of itself, make it likely that the results would differ from arm's length results. In other words, co-ordination by multiple lenders for the purposes of putting together a syndicated loan should not, therefore, mean that this 'acting together' extension of the transfer pricing rules would apply. INTM461260 was archived and removed from HMRC's *International Manual* in 2011, but can still be found on the National Archives website. A statement made in INTM522020 (which still forms part of HMRC's *International Manual*), however, suggests that HMRC still holds the same view (i.e. that syndication of itself does not bring a loan within the ambit of the transfer pricing rules) since it states:

> 'Syndicated loans are normally made by third-party lenders, although there may be guarantees from connected parties which bring the financing within the ambit of Part 4 of TIOPA [2010].'

Even if the act of syndication would, of itself, bring a syndicated loan within the scope of the 'acting together' extension to the UK transfer pricing rules, this alone should not mean that any adjustments would need to be made. Support for this is provided in INTM519070, where HMRC states that even in a private equity buyout situation where lenders may well be seen to be 'acting together' for the purposes of the transfer pricing rules, loans provided by third party senior or mezzanine lenders who have no other interest in the borrower or its business 'can normally be accepted as being at arm's length' so that no adjustments would need to be made under the transfer pricing rules (INTM519070, INTM519040).

Non-arm's-length related transactions: CTA 2009 s 444

In circumstances where the main transfer pricing rules in TIOPA 2010 Part 4 do not apply, regard should also be had to the specific loan relationship transfer pricing rule in CTA 2009 s 444 that applies to non-arm's-length related transactions, even if the parties are not connected. Although CTA 2009 s 444 does not apply to the initial setting up of a loan relationship (even if it has uncommercial terms from the outset), any adjustments required to be made under CTA 2009 s 444 can arise not only in respect of a related transaction but also in respect of all future debits and credits arising from that loan relationship. Detailed consideration of this rule is outside the scope of this practice note and, in any case, the rule is only likely to have a minimal impact on unconnected parties because the lack of connection makes it more likely that the parties will be able to show that they are independent and acting at arm's length (see CTA 2009 ss 444–445; CFM38400, CFM38410, CFM38420).

Additionally, if a loan falls within the scope of the transfer pricing rules (even if the terms of the debt are not adjusted under those rules), CTA 2009 s 444 does not need to be considered. On the other hand, the extension of this rule to SMEs will make transfer pricing a consideration for SME companies in relation to their financing transactions even where they are exempt from the main transfer pricing regime (CTA 2009 s 445; CFM38420).

Hybrid and other mismatches rules

Since 1 January 2017, the anti-hybrid and other mismatches rules have been in effect, having replaced the anti-arbitrage rules. The UK's rules to counteract tax advantages arising from hybrid and other mismatches are found in TIOPA 2010 Part 6A (having been introduced by FA 2016) (see TIOPA 2010 Part 6A; FA 2016 s 66, Sch 10; INTM550000).

The UK's hybrid rules combat abusive hybrid mismatch arrangements, broadly those:

- involving hybrid entities or hybrid financial instruments where, for example, a tax deduction is obtained by a borrower but there is no corresponding taxable income for the lender (such arrangements referred to as deduction/non-inclusion or D/NI mismatches); or
- where a hybrid arrangement gives rise to more than one tax deduction for the same payment (such arrangements referred to as double deduction or DD cases),

by denying a UK tax deduction (not only in intra-group transactions, but also in respect of third party arrangements that are found to be 'structured arrangements') or bringing an amount into charge in the UK.

The UK's hybrid legislation identifies eight standalone impermissible mismatches, together with the potential to import these mismatches into the UK where there is an overarching arrangement in place that links a UK corporation taxpayer to any of those types of mismatches (TIOPA 2010 Part 6A; INTM550000).

The UK's hybrid legislation identifies eight standalone impermissible mismatches

On-market loans

Where, on or after 1 April 2016:

- a corporate borrower recognises in its accounts a debt at a discount (i.e. less than the transaction price or the principal amount borrowed); and
- the lender is either not a corporate person or, if it is a corporate person, it is at any time in the relevant accounting period resident (or effectively managed) in a non-qualifying territory (a jurisdiction which has not been designated as a qualifying territory by HM Treasury and which has no double tax treaty (DTT) with the UK or, if there is a DTT with the UK, the DTT does not include a non-discrimination provision),

the non-market loans provision in CTA 2009 s 446A applies to deny the borrower a tax deduction for any part of the discount that is not recognised as a credit in the hands of the lender for the purposes of the loan relationships rules (see CTA 2009 s 446A; FA 2016 Sch 7 paras 2 and 12).

This provision is aimed at interest-free and other non-market loans that would, in the absence of this rule, give rise to asymmetrical tax treatment between the borrower and the lender.

General anti-abuse rule

A borrower's ability to obtain a deduction for interest incurred on a loan may be restricted by the general anti-abuse rule (GAAR) in FA 2013 Part 5. The GAAR applies:

- with effect from 17 July 2013 (the date of royal assent of FA 2013);

Practitioner view: Hybrid and other mismatch rules – double deduction issues

The UK's anti-hybrid rules should not really apply to ordinary arm's length borrowings between independent persons even if they do create relevant hybrid mismatches, for example, a deduction for the borrower but a non-inclusion of income for the lender. This is principally because, assuming the relevant arrangements are not designed or otherwise 'structured' to generate those mismatches, as would usually be the case, borrower and lender must generally be 'related' to each other or, depending upon the relevant provision, in the same 'control group' for the legislation to apply (see, for example, TIOPA 2010 s 259CA(6)(b) and s 259GA(7)(b)).

> The borrower and lender need not be connected in this way for the double deduction rules in Chapter 9 to apply

However, borrower and lender need not be connected in this way for the double deduction rules in TIOPA 2010 Part 6A Chapter 9 to apply. For example, a UK borrower company might be disregarded for applicable US tax purposes such that both it and US-based investors in it can, potentially, claim tax deductions for the interest that the UK borrower pays to its third-party lenders. In such circumstances, the double deduction rules in Chapter 9 may still apply to deny the UK borrower company a tax deduction for that interest provided, absent the above type of 'structured arrangement', that it and the US-based investors are in the same 'control group' (s 259IC(2)) (see also HMRC's *International Tax Manual* at ITM557200).

In addition, lenders that are otherwise unconnected with a borrower company because they have small ownership interests in the borrower group, viewed singly, might nevertheless be treated as 'related' or in the same 'control group' as it under the acting together component of the UK's anti-hybrid rules (s 259ND(6)), which are capable of aggregating those interests in certain cases.

Thankfully, therefore, it is often possible to circumnavigate these potential entry points into the UK's anti-hybrid rules, including because of valuable reforms that FA 2021 has recently made to those rules. For example, exclusions from the rules will now often be available if the lender whose ownership interest in the borrower might otherwise be aggregated with other lenders under the above acting together rules has a relatively small interest in that borrower, the relevant threshold being less than 10%, broadly speaking, for lenders that effectively lend to the borrower group via a 'transparent [investment] fund' (TIOPA Part 6A Chapter 13A) and 5% or less for other types of lender (s 259ND(7C) (see also 'UK loan structures: changes to the anti-hybrid rules' (M Mortimer & K Hunt), *Tax Journal*, 26 November 2021).

It is also possible to avoid the application of the above double deduction rules to arm's length borrowings if there is no double deduction in the first place (because, for example, a 'blocker' company in the corporate chain above the UK borrower company stops a tax deduction for interest being enjoyed both in the UK and the US) or if the UK borrower has sufficient 'dual inclusion income' to prevent that deduction being denied under those rules (s 259IC(4)).

Suffice to say, however, that substantial intellectual energy can be expended in reaching this conclusion, which, as mentioned, does not automatically follow just because lender and borrower are acting at arm's length.

Matthew Mortimer, partner at Mayer Brown

- to counteract (by making adjustments on a just and reasonable basis);
- tax advantages that would, ignoring the GAAR, arise from abusive tax arrangements.

  (See FA 2013 ss 206, 209, 215.)

It is important to note that:

- the double reasonableness test effectively limits what is abusive to any arrangement in respect of which it would be unreasonable to hold the view that the arrangement was reasonable (FA 2013, s 207(2));
- HMRC's GAAR guidance (which must be taken into consideration by a court or tribunal in considering the application of the GAAR to a specific case) acknowledges that it is acceptable for a taxpayer to have the freedom to choose how to fund an acquisition, i.e. whether to fund it by way of a share issue, a loan or existing reserves and that it is 'entirely reasonable for the company concerned to take these potential tax consequences into account in deciding what particular course of action it will take' (FA 2013 s 211(2); GAAR guidance, para C5.6.3); and
- one of the indicators of abusiveness is that the deduction or loss for tax purposes is significantly greater than the economic loss (FA 2013 s 207(4), (6); GAAR guidance, para C5.11)

Judged in that light, it should be possible to conclude that the GAAR should not apply to deny tax deductions for interest expense on a normal loan:

- entered into and retained for business purposes;
- that is neither tax motivated nor otherwise part of a tax avoidance scheme;
- that does not fall within any of the other anti-avoidance rules restricting deductibility of interest – if the loan isn't caught by other anti-avoidance rules, this would make it easier to conclude that the arrangement was reasonable, judged from a reasonable point of view, and therefore not abusive; and
- where the tax deduction does not exceed the true economic expense of the interest. ■

For related reading visit www.taxjournal.com

- How to handle unallowable purposes enquiries (H Buchanan & S Bond, 15.2.23)
- Purpose-based rules: have we hit BlackRock-bottom? (C Christofi, 18.8.22)
- The CIR regime and acquisition finance (M Mortimer & K Hunt, 9.9.22
- UK loan structures: changes to the anti-hybrid rules (M Mortimer & K Hunt, 26.11.21