HERBERT
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TAX DEDUCTIBILITY OF CORPORATE INTEREST EXPENSE

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Legal Briefings

CONSULTATION OVERVIEW

4 August 2016 will mark the closing date for responses to the second consultation document published by HM Treasury and HM Revenue & Customs (HMRC) on 12 May 2016 on the detailed policy design and implementation of the proposal to limit the tax deductibility of corporate interest expense. The new rules are currently expected to be introduced from 1 April 2017.

The consultation document outlines 46 questions, summarises the result of the previous consultation (published on 22 October 2015) and gives a number of examples of how the new rules will operate in practice.

The UK's proposals follow on from the OECD report of 5 October 2015 which recommended an approach to the design of rules to prevent base erosion through the use of interest expense. The UK's response in introducing a restriction on the tax deductibility of corporate interest expense is stated to be consistent with the OECD recommendations.

PROPOSED NEW RULES

The UK's proposed new rules can be summarised as follows:

Intention: the intention of the new rules is to align the tax deductibility of interest with income that is subject to tax in the UK. The limitations on deductibility will therefore be based on a company's Tax-EBITDA.

A new Fixed Ratio Rule: this is the primary rule limiting a group's UK tax deduction for net interest expense to 30% of its UK EBITDA.

A Group Ratio Rule: this is based on the net interest to EBITDA ratio for the worldwide group (as recommended in the OECD report) and will allow groups that are highly leveraged for commercial reasons to obtain deductions in excess of the Fixed Ratio Rule.

Modified Debt Cap Rules: there will no longer be a need for the Worldwide Debt Cap regime and the existing legislation will be repealed. Similar rules will be introduced such that group net UK interest deductions cannot exceed the global net third party expense of the group.

De minimis exclusion: all groups will be able to deduct net UK interest expense up to £2m annually.

Carry Forward Rules: the restricted interest may be carried forward indefinitely and spare interest capacity may be carried forward for 3 years.

Targeted Anti-Avoidance Rules: the structural rules will be backed up with targeted anti-avoidance rules which are under review and additional rules may be added.

Public Benefit Project Exclusion (PBPE): the Government's intention is that the new rules do not impede the provision of private finance for public benefit infrastructure in the UK where there are no material risks of BEPS. A project would need to meet certain conditions in order to fall within the PBPE.

Banking and insurance sectors: the Government will develop bespoke rules to prevent BEPS involving interest in the banking and insurance sectors.

Other sectors: Other sectors given particular mention are the oil and gas sector, securitisation companies, authorised investment funds, investment trust companies, collective investment vehicles, the real estate sector and charities. In many cases Government continues to consult on the impact of the new rules for these sectors.

Commencement: The rules are expected to apply from 1 April 2017. Where the actual period of account for the group straddles this date, the current intention is that the rules will apply on the basis that the group prepares accounts for two notional periods of account, with the first one ending on 31 March 2017 and the second commencing on 1 April 2017.

HERBERT SMITH FREEHILLS SUMMARY COMMENTS

Whilst the concept underlying the introduction of these measures may, at first sight, seem simple, the consultation document itself highlights many areas of complexity and uncertainty. This is inherent in introducing such fundamental changes to any system, but this consultation process in particular continues to feel rather rushed. As was seen in the much slower (over three years) and more measured process around the introduction of the statutory residence test, sweeping changes take time to get right. However the Exchequer is expecting to raise approximately £1bn per annum from these changes by the end of 2021, so it is perhaps understandable in the current climate that there is pressure to expedite the legislative process.

As the first draft of the legislation is only likely to be published (at the earliest) towards the end of 2016, this does not give much time before the 1 April 2017 start date for business to adapt to the new regime. This measure also needs to be viewed in the wider context of the other major corporate tax reforms currently expected to be introduced next year, including the new loss relief rules. Businesses certainly have a significant amount of tax related change to prepare for and adapt to over the next 12 months.

Alongside the short legislative timescale, the proposed lack of grandfathering rules for existing debt, with the possible exception of public benefit infrastructure projects, increases the immediate impact of these measures. The comments in the latest consultation that grandfathering measures would be "distortive" are hard to reconcile with the fact that many new tax measures are accompanied by grandfathering – presumably on the basis that any distortive effect is seen as the "lesser evil" compared to the perceived unfairness and instability caused by changing tax rules in a way that could, at the extremes, make existing commercial ventures (entered into in good faith based on the longstanding rules as then existed) uneconomic.

Given that the proposals represent such a fundamental change to the long established interest deduction rules, and in particular in the likely absence of grandfathering, it is unsurprising that lobbying continues from many in "capital intensive" industries for exemptions or relaxations to the new rules. Whilst an exemption for public benefit infrastructure projects is welcome, the scope of this is currently highly uncertain, and further clarity will be needed to ensure that those investing in such projects have sufficient certainty to allow long term decisions to be made. The treatment of other sectors and industries also remains uncertain; whilst the consultation recognises the challenges in these industries (for example oil and gas), the fact remains that details of how the new rules will impact on many sectors, including those most likely to be caught by the new rules, remains an area where significant further work is still needed.

The fundamental changes to the interest deduction rules will also result in new commercial issues for borrower and lender groups, where new "market" positions will need to quickly develop. For example the proposal to allow borrower groups, where interest deductions are restricted, to decide how to allocate their interest deductions amongst group members will likely have knock on effects on the terms of any financing. Lenders will likely be keen to maximise deductions within any borrower group or sub group, to the possible detriment of non borrower entities within a group. That will likely pose real issues where third party debt is taken from different lenders at multiple levels and/or within multiple ring fenced sub-groups.

Having noted the challenges for business posed by the speed of introduction of these new rules, it will be interesting to see what impact the recent "Brexit" vote has on the legislative timetable for both this and a number of other expected tax measures. In particular will Parliament and the Government, faced with the enormous challenges of negotiating the terms of Brexit with the EU, enacting domestic legislation to cater for Brexit, and at the same time entering into negotiations with the UK's trading partners, be left with sufficient time and resource for the implementation of the BEPS related measures (including the corporate interest rules covered in this briefing) in accordance with the current timetable?

More detail and commentary with respect to the mechanics of the proposed new rules and their likely impact is in our full briefing which can be found here.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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