United Kingdom

UK Consultation: Tax Deductibility of Corporate Interest Expense

On 5 October 2015 the OECD Secretariat published thirteen papers and an Explanatory Statement outlining consensus Actions under the Base Erosion and Profit Shifting ('BEPS') Project, including a Final Report on Action 4 in relation to Limiting Base Erosion Involving Interest Deductions and Other Financial Payments. On 22 October 2015 HM Treasury released a Consultation Document on the UK implementation of the Final Report's recommendations.

Deloitte Comments and Business Next Steps

The Consultation Document mainly consists of a summary of the 'best practice' approach outlined in the Final Report.

The UK Government has not yet formed a view on many of the policy choices open to it, and the open consultation represents a genuine opportunity for business to influence the outcome. The government acknowledges that a move to a structural interest limitation would be a major new approach in UK tax policy. The government expects to announce the direction of travel in its forthcoming Business Tax Roadmap, due to be delivered with the annual Budget, in March 2016.

The suggestion that the new rules could be applied to the aggregated Tax EBITDA of all group companies within the UK could be a helpful approach. It would deal with many of the issues identified in the Action 4 Final Report, such as loss-making individual entities and holding companies with substantial non-taxable dividend income. However, it is by no means certain that such a UK sub-grouping would be permitted under EU Law.

The Consultation Document appears to favour the carry-forward of disallowed interest (but not the carry-back of such interest, nor the carry forward of excess capacity) as a means of addressing volatility in Tax EBITDA. This would not necessarily be an effective solution to the potential disallowance of groups' external funding costs, depending on how and when this excess could be utilised. It also does not recognise some of the limits on using attributes within a group, given the UK's approach to group taxation.

The recommendations for grandfathering of existing debt set out in the Action 4 Final Report are important. The Consultation Document suggests that grandfathering would be allowed by exception. We understand that this means that HM Revenue & Customs would look at requests on a case-by-case basis. Further, references to existing debt would be taken to mean debt issued before the UK legislative process to adopt the new rules reaches an agreed point (and not debt issued before the Action 4 Final Report was published).

Introduction

The Consultation Document confirms that the Government wants to continue with its strategy to deliver the most competitive corporate tax system in the G20, but is determined to tackle avoidance and aggressive tax planning in the UK and, in order to meet the Final Report's recommendations, needs to introduce a new general rule for restricting interest. Responses to the questions will be considered in the development of a future 'business tax roadmap, expected in the March 2016 Budget.

UK implementation of the OECD best practice recommendations on interest expense

Fixed ratio rule

The Final Report recommends a 'fixed ratio rule' to limit an entity's net deductions for interest – whether due to third parties, related parties, or group companies - to a percentage of the entity's taxable earnings before interest, taxes, depreciation and amortisation ('Tax EBITDA'). The percentage restriction should be set at a single benchmark fixed ratio of between 10%-30% of Tax EBITDA.

The Consultation Document considers how a fixed rule might operate, and specifically refers to the possibility of applying the fixed ratio to the aggregated Tax EBITDA of all UK companies in the same group (the 'UK sub-group'). This approach would require the calculation of an overall disallowance for the UK sub-group, with either a mechanical allocation of a non-deductible amount or an allocation which allows taxpayers an element of choice, such as is currently the case under the existing UK Worldwide Debt Cap ('WWDC') rules.

The Final Report set out a number of criteria which should determine the level of the benchmark fixed ratio for each jurisdiction, and the Consultation Document calls for evidence to determine where the UK's benchmark ratio should be set.

Group ratio rule

A group ratio rule can be, but is not mandated to be, introduced in combination with the fixed ratio rule, to permit groups to deduct interest in excess of the amount allowed under the fixed ratio, up to the level of their external borrowings. The OECD is carrying out further work in respect of the recommendations for the group ratio and this is expected to be completed in 2016.

The Consultation Document asks whether respondents believe that the UK should adopt a group ratio rule alongside a fixed ratio rule. It also makes it clear that related party interest will be excluded from benefiting from any group ratio rule.

Timing and Transition

The UK Government recognises the need to allow businesses sufficient time to adapt to new rules, and therefore confirms that it is unlikely that new rules would take effect before 1 April 2017.

Transitional rules would primarily be restricted to interest on third party loans entered into before the rules were announced. The grandfathering of existing loans is only expected to be available in exceptional circumstances, and the Consultation Document asks for views on what those circumstances might be.

Interaction with other restrictions on tax relief for interest

The paper clarifies that any new restriction would operate after the UK's transfer pricing and other anti-avoidance rules (including proposed anti-hybrid rules). Any new restriction would either replace the WWDC rules, or the WWDC rules would need to be amended to fit with the new approach.

Other points of interest

The Consultation Document asks for views on various other matters, including:

- The most appropriate definition of 'interest' and how foreign exchange movements should be treated.
- A **de minimis threshold** of up to £1m of interest expense. It is estimated that this would exclude over 90% of companies in the UK from the rules.
- An exclusion for Small and Medium Sized entities.
- How best to address volatility in earnings, with the Consultation Document seeming to favour the **carry-forward of disallowed interest** (but not the carry-back of such interest, nor the carry forward of excess capacity).

- An option to exclude from the fixed ratio rule interest expense incurred on third party loans linked specifically to **projects which deliver a public benefit**.
- Specific rules will be required to address issues raised by the banking and insurance sectors.

Next steps

The deadline for responses to the UK consultation document is 14 January 2016.

Deloitte EMEA Dbriefs Webcast

Deloitte's Dbriefs webcast programme for Europe, the Middle East and Africa will include a discussion on Action 4, including the UK implementation of its recommendations on 27 October 2015 at 12pm (BST). For further details and to register for the webcast please visit www.emeadbriefs.com.

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