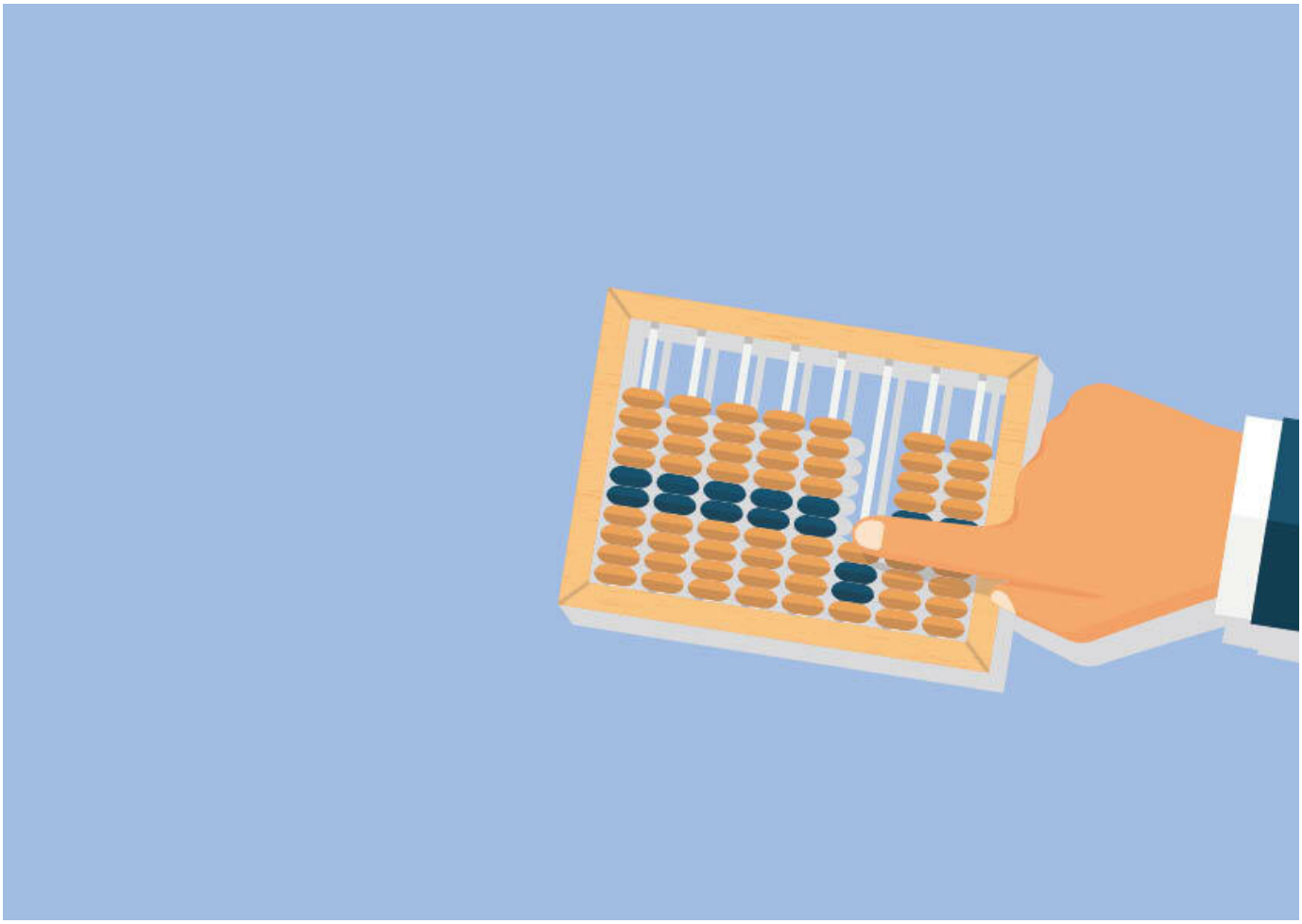
Adding up the interest

Large Corporate



01 January 2017

Bill Dodwell provides guidance on what the new rules on corporate interest will mean for large companies

On 5 December 2016, following extensive consultation, the Government released a response document setting out its decisions on new rules for corporate interest deductibility. This implements Action 4 of the G20/OECD Base Erosion and Profit Shifting (BEPS) project. The new rules will take effect from 1 April 2017 and are expected to raise over £1 billion annually – something like 5% of large company corporation tax.

All groups will be able to deduct £2 million of net interest expense. Amounts over this will be restricted to the lower of 30% of tax-based earnings before interest and tax depreciation (called tax-EBITDA) and the worldwide group's net interest expense (the Fixed Ratio rule). If worldwide net interest expense is higher than the Fixed Ratio, the group may elect to deduct an amount equal to the group's net-accounting interest to accounting EBITDA ratio (the Group Ratio rule).

The rules will include limited provisions to protect investment in infrastructure that has a public benefit, including specified grandfathering applicable to PFI companies only. There will be no special provisions for banking and insurance groups but there will be special rules for oil companies and REITS. The draft bill published on 5 December includes the core provisions of the restriction, whilst the remaining provisions, including definitions relating to the Group Ratio rule and rules for particular industries and issues, are expected to be published by the end of January 2017.

The government has included relieving provisions recommended by the G20/OECD so disallowed interest may be carried forward indefinitely and excess capacity to use finance costs may be carried forward for five years. Groups affected will need to consider the deferred tax implications of carrying forward interest and must satisfy the requirements for carrying forward deferred tax assets.

Applying the rules in practice

A group will be subject to interest restrictions if its 'aggregate net tax-interest expense' is greater than its 'interest capacity'. A group's interest capacity is calculated as being its current year 'interest allowance' plus any brought forward interest allowance amounts. The interest allowance is calculated either under the Fixed Ratio or (by election) under the Group Ratio.

Groups that are subject to an interest restriction will have a 'total disallowed amount' (equal to the excess of the group's aggregate net tax-interest expense over its interest capacity). Any disallowed amount may be carried forward and 'reactivated' in future periods provided there is sufficient interest capacity in those periods.

Once a disallowed amount has been calculated, a group may – with the consent of individual companies – determine how that amount should be allocated between

group members (alternatively the allocation is made on a pro-rata basis). The group must file an interest restriction schedule within 12 months of the year-end. The disallowed amount may only be allocated to group companies within the charge to UK corporation tax that have a net interest expense (and only to the extent of their net interest expense). Unlike the worldwide debt cap, the allocations may not be made to companies with a gross interest expense but net interest income overall.

The existing Worldwide Debt Cap will be repealed, but to prevent groups with little third party interest claiming excessive deductions under the Fixed Ratio Rule, a Modified Debt Cap will be included to limit deductions to the net interest expense of the worldwide group. This concern was raised by the OECD Working Group, although not included in the final BEPS Action.

The Group Ratio is calculated using accounting rules and many responses noted that accounting/tax mismatches could mean that this limited tax deductions even for wholly third party debt.

Accordingly, the rules will allow for the accounting measure to exclude fair value movements on derivatives and on capital assets. Group may also opt to recognise pension costs on a paid basis; the cost of employee share options on exercise; adjustments to the calculation of gains on asset disposal in line with the tax basis; and optional recognition of amounts from changes in accounting policy. The Group Ratio will be limited to 100% of the tax-EBITDA. The definition of a worldwide group is based on International Accounting Standards rather than UK tax definitions. The accounts used for calculating the group ratio are those under the GAAP of the parent company, provided it is IAS (or not materially different) or drawn up under UK, Canadian, Chinese, Indian, Japanese, South Korean or US GAAP.

Since the rules apply from 1 April, many companies will need to calculate interest limits for part of an accounting period. This is to be done on a time basis, although the usual just and reasonable allocation may be used.

Any credits or debits in respect of a change of accounting policy or transitional adjustment where the change occurred before 1 April 2017 are to be ignored. This means that transitional adjustments on the move to new UK GAAP should not affect the interest calculations.

These are major changes to the UK tax system and there is very limited time for large groups to get to grips with the detail of the changes.