The corporate interest restriction: don't get caught out!

Large Corporate

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The corporate interest restriction rules have been in force since 2017, but uncertainties and unexpected outcomes can be eye-wateringly costly.

Key Points

What is the issue?

The basic rule under the corporate interest restriction is that, across a corporate group, deductions for UK interest expenses are limited to 30% of the group's UK earnings before interest, taxation, depreciation and amortisation – or the total finance expense of the group, if lower.

What does it mean for me?

Without further provision, this would severely impact many businesses that are highly geared for commercial reasons. Fortunately, certain elections are available that can, in some circumstances, mitigate restrictions – but the calculations can be complex, requiring group information which overseas parent entities may be reluctant to share, and great care must be taken to ensure such elections are validly made.

What can I take away?

The complexity of the regime is compounded by HMRC's strict approach toapplying the administrative rules, so businesses with UK interest and other financing costs exceeding £2 million should consider obtaining specialist advice to avoid being caught out.

Initially a response to the financial crises of 2008 and the high profile tax planning arrangements implemented by some of the world's largest multinationals, the OECD and G20's base erosion and profit shifting (BEPS) project resulted in radical changes to the corporation tax system in the UK and other countries. Amongst other measures, country-by-country reporting, the hybrid and other mismatches rules, and the 'Pillar Two' global minimum tax rate all originated in the BEPS project.

It is sometimes forgotten that the corporate interest restriction regime is a BEPS measure and, in terms of the number of taxpayers significantly affected, it is arguably the most consequential for UK companies. Unlike country-by-country reporting and Pillar Two, corporate interest restriction can affect businesses of any size, and unlike hybrid and other mismatches, there is no immunity for those that do not use unusual entities or instruments.

Although corporate interest restriction took effect in 2017, the scope and complexity of the legislation means that surprises and uncertainties continue to arise. A particularly topical issue relates to the administrative requirements, which can cause as much difficulty as the computational rules. Below we give an overview of the regime and outline why it is so important to pay attention to the details.

The basic rule

In the BEPS Action 4 report, the OECD/G20 recommended that jurisdictions impose a cap on deductions for interest and amounts economically equivalent to interest, which should be set at between 10% and 30% of earnings before interest, taxation, depreciation and amortisation (EBITDA).

In implementing that recommendation via the corporate interest restriction legislation, the UK stuck to the more generous end of the range. Deductions for interest and similar financing costs ('tax-interest') are, by default, capped at 30% of tax-adjusted EBITDA (tax-EBITDA). This cap applies at group level, so for any group the aggregate net UK tax deduction in respect of tax-interest across all companies cannot exceed 30% of aggregate UK tax-EBITDA. This is referred to as the 'fixed ratio' rule.

The Action 4 report acknowledged that countries may wish to include an appropriate de minimis level of interest expenditure to reduce compliance costs for smaller entities. The UK set its deminimis amount at £2 million, meaning that groups with less than £2million of UK aggregate net tax-interest expense (ANTIE) are not required to take any action to comply with the regime.

In some respects, however, the UK'gold-plated' the OECD/G20's recommendations. For example, the Action 4 report recommended that only expenses under derivative contracts related to borrowings should be included in tax-interest, but the UK has drafted its rules so that they can restrict deductions in respect of derivatives related to currency movements and price indices as well.

Perhaps the most significant respect in which the UK's corporate interest restriction legislation goes further than recommended by the Action 4 report relates to the incorporation of 'debt cap' provisions. Prior to the introduction of corporate interest restiction, the UK had introduced legislation designed to ensure that multinational groups could not avoid UK tax by using internal lending that left UK entities more highly geared than the group as a whole. This legislation was repealed when corporate interest restriction was introduced; however, to ensure that the new regime achieves the policy goals of the old one, an additional debt cap test was added to the fixed ratio rule. This means that the restrictions will also arise to the extent that ANTIE exceeds the total net finance cost shown in the group accounts, after certain adjustments are made (this is referred to as 'aggregate net group-interest expense', or ANGIE).

To address timing differences, the corporate interest restriction rules allow certain amounts to be carried forward and utilised in later periods. The carry forward rules allow a deduction for previously restricted interest if the company is a member of a group with headroom for deductions in a later period (subject to anti-avoidance rules relating to changes of ownership of companies with tax attributes). This is known as an ‘interest reactivation’. Furthermore, unused headroom for interest deductions can be carried forward by the group and used to deduct interest that would otherwise be restricted in a later period. However, as a group attribute, unused headroom will be lost if the group ceases to exist (which it normally will do, for example, if the group is sold).

Elections

Limiting interest deductions to 30% of tax-EBITDA is a blunt tool that, without further provision, would cause serious problems for businesses that are highly geared for commercial reasons that have nothing to do with tax planning. To help those businesses manage the impact of corporate interest restriction there are two notable elections that can be made:

- the group ratio election; and
- the qualifying infrastructure company election.

The group ratio election is made at group level and provides an alternative tothe fixed ratio, whereby deductions for UK interest expenses can exceed 30% of tax-EBITDA if that is consistent with the capital structure of the group as a whole. The principle is that, if the consolidated accounts show third party finance costs equal to, say, 50% of EBITDA, then UK group companies should be able to deduct tax-interest expenses of up to 50%of tax-EBITDA. However, the calculations are often challenging in practice, particularly where the UK entities have limited information about the wider group and overseas head offices are reluctant to share.

If the election is made, an alternative cap is calculated based on qualifying net-group interest expense (QNGIE) as a proportion of group-EBITDA. QNGIE is ANGIE after further adjustments to strip out related party interest expenses and similar amounts, and group-EBITDA is, broadly, the EBITDA of the group as derived from its consolidated accounts.

A qualifying infrastructure company election is made at the level of the individual company and can only be made by those engaged in infrastructure activities, as defined (the tests are tightly drawn, but can include property rental activities). The effect of the election is that interest payable by the company tothird parties or other qualifying infrastructure companies will not generally be subject to restriction.

However, in calculating the tax-EBITDA of the group, the tax-EBITDA of a qualifying infrastructure company is assumed to be nil, and access to the £2 million de minimis is more complicated for groups that include a qualifying infrastructure company. This means that groups which include both qualifying infrastructure companies and other, non-qualifying companies may find making the election results in a greater restriction. Care should therefore be taken, not least because the election, once made, cannot be revoked for five years.

In addition, there are other elections that may be relevant to some companies, to ensure that the rules operate as intended and smooth anomalies between accounting and tax rules. These include, for example:

- elections that change technical aspects of the calculation of the group ratio, to address circumstances where the difference between the tax treatment of amounts in ANTIE and tax-EBITDA and the accounting treatment of those amounts in ANGIE and group-EBITDA depresses the group ratio;
- an election to ensure interest capitalised by property development companies is treated appropriately;
- elections affecting the treatment of non-consolidated investments and interests in partnerships; and
- elections governing the period for which group accounts are treated as drawn up when consolidated accounts are not, in fact, drawn up under acceptable accounting standards.

Administrative requirements

A fundamental principle of UK corporation tax is that a company is charged to tax based on the profits and gains it makes as a solus entity – there is no consolidation for tax purposes. Consequently, each company in a group is responsible for its own tax return, which must include a self-assessment of the tax that is due.

Without further provision, this would not sit easily with a regime like corporate interest restriction, which is based on complex calculations that are affected by the data of every company in the group. If those calculations result in arestriction on the deductibility of interest expenses for UK tax purposes, the restriction must be allocated amongst the UK companies.

To facilitate this process, the corporate interest restriction regime includes administrative provisions in Taxation (International and Other Provisions) Act 2010 Sch 7A (the main computational provisions are in Part 10 of that Act). The administrative provisions allow (but, importantly, do notrequire) a group to submit an interest restriction return. Certain group-level elections – most notably the group ratio election – must be included in an interest restriction return, which should also include a calculation of any interest restriction or spare capacity for the period, and an allocation of any restriction or reactivation that arises.

In order to submit an interest restriction return, the group must appoint a reporting company. The appointment must be authorised by at least 50% of the UK companies in the group, and must be submitted to HMRC, via commercial software or an online form, within one year of the end of the period of account of the group (which will normally be the period for which the ultimate parent of the worldwide group prepares financial statements). The appointment has effect until it is revoked or until the group ceases to exist.

If a group does not appoint a reporting company in the required timeframe, then HMRC can, at its discretion, appoint a reporting company on the group’s behalf. However, such an appointment will typically only have effect for one period. In the absence of an appointment, the group must apply the fixed ratio rule to calculate any interest restrictions that arise, and each company in the group must disallow its pro rata share of any such restriction.

If a reporting company appointment is in place for a particular period of account of a group, that company must submit an interest restriction return within one year of the end of the period, which can be amended at any time up to three years after the end of the period. There is an exception for periods in which the group is not subject to restrictions (and has elected to prepare an abbreviated return that does not include detailed calculations). In that circumstance, the window for filing an amended interest restriction return is extended to five years.

Given that an interest restriction return can be amended after the normal two-year deadline for amending a company tax return, the administrative rules include special provisions to allow any necessary amendments to such returns that arise from an amended interest restriction return to be made after the normal deadline has passed.

Note that qualifying infrastructure company elections are made by the relevant company directly to HMRC, outside of the interest restriction return. The election must be made before the end of the first accounting period in relation to which it is to have effect.

Problem areas

Corporate interest restriction is increasingly an area of specialism in larger firms, and with good reason. There are countless examples of situations in which the rules, despite their detail and complexity, produce unexpected or uncertain outcomes. Three technical areas that the authors have recently had to consider relate to share disposals, hedging instruments, and merger accounting – but that is the tip of the iceberg. For the purposes of this article, it is perhaps useful to focus on one very topical issue concerning the administrative requirements outlined above.

For a lot of businesses, the ability to make a group ratio election will be key to managing the impact of corporate interest restriction – overall tax liabilities can increase by many millions if the fixed ratio is used. However, to make a group ratio election (or other potentially beneficial elections, or carry forward spare capacity for deductions) the reporting company must submit an interest restriction return.

This means that, unless HMRC’s discretion is relied on (as explained below, this would be unwise), a valid reporting company appointment must bemade before the tight deadline of one year after the end of the period of account of the group.

To illustrate how problematic this can be, here is a non-exhaustive list of things that can go wrong:

- failure to correctly identify the period of account of the worldwide group: for example, due to a change in ownership of the ultimate parent part way through its accounting period;

- failure to correctly identify the extent of the group: for example, where the ultimate parent is located overseas and does not share full information with its UK subsidiaries;
- errors in accounts that significantly impact interest expense or EBITDA that are identified after the deadline has passed; and
- misunderstandings between groups and their advisers, or mistaken assumptions about what has happened in the past.

All of this means that innocent errors can be incredibly costly, and businesses and advisers should take great care toensure that they have met all the necessary administrative requirements. The difficulties are compounded by a change in HMRC's approach that was first outlined in Agent Update 109, published in the summer of 2023. Prior to that time, HMRC would generally appoint a reporting company for a period if asked to do so, but now it says that it will only make such an appointment 'where there is a risk that tax is at stake'. In practice, this seems to mean that HMRC will typically refuse to appoint a reporting company if the submission of an interest restriction return would enable the group to make beneficial elections that reduce the amount of interest disallowed.

It is reasonable to ask whether it is appropriate in an advanced tax system for minor failures in relation to complicated administrative provisions with short deadlines to impact tax liabilities so dramatically and irreversibly. Whilst deadlines are necessary for the tax system to function properly, it would arguably be more proportionate if the deadline for appointing a reporting company were aligned with the three-year deadline for amending an interest restriction return.

Summing up

The technical intricacy of the corporate interest restriction rules and the fact that they operate based on the accounts and tax computations of the group as a whole, rather than at individual entity level, means that they are unlike anything thathas gone before them in the UK corporation tax code. Furthermore, the regime is still relatively young, so it is perhaps unavoidable that technical uncertainties and unexpected outcomes will arise from time to time. However, the resulting challenges for taxpayers and advisers are compounded by a complex set of administrative provisions that HMRC is applying very strictly.

The impact of the rules can be dramatic, but in some of the more extreme cases, elections can mitigate large disallowances, provided they are validly made. Consequently, business that could be affected – all of those that have, or may at some point have, UK interest and other financing expenses in excess of £2 million – should ensure that appropriate care and attention is given to complying with the administrative requirements, and consider obtaining specialist advice.