

UK publishes updated draft legislation on interest restriction rules

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Executive summary

On 26 January 2017, the UK Government published updated draft legislation and explanatory notes on the proposed rules to restrict corporate interest deductions from 1 April 2017.

Although the draft legislation contains both promised provisions and amendments reflecting comments to date, there are still a number of anomalies and areas to be clarified. We will be meeting with HM Revenue & Customs (HMRC) to discuss both the draft legislation published in December and these new developments. There is a short window for taxpayers and advisors to comment on the new provisions - comments are due on the provisions issued in December by 1 February and on the additional provisions by 23 February - but even this will give HMRC little time to consider the comments before the Finance Bill is published in March.

In responding to the initial consultations and the December draft legislation, there has been wide-spread agreement among taxpayers that the timetable for implementation of the proposals should be deferred to allow the legislation to be fully discussed. This is particularly the case, given the acknowledgment by the Prime Minister recently that the UK's corporation tax rules may play a key role in the UK's attractiveness after Brexit.

However, to date HM Treasury has strongly resisted calls to put back the commencement date. As such, groups should expect the rules to enter into force from 1 April 2017, even if the fine detail of the legislation is not settled until committee stage or later. The rules are very complex and businesses will need to model their impact as soon as possible to fully appreciate their effect.

Detailed discussion

The updated legislation

The latest version of the proposed legislation expands upon the draft clauses published in December and now includes the majority of the elements that were missing from the original draft.

As a brief recap of the way the rules work, a group has a restriction of its UK net interest expenses based upon either:

- ▶ 30% of the group's UK taxable earnings before interest, tax, depreciation, and amortization (EBITDA), subject to a modified debt cap to restrict interest deductions to the group's external net interest expense, or
- ▶ A group ratio test, which allows groups to apply an overall group ratio to the UK's taxable EBITDA, again subject to a modified debt cap which in this case excludes related party interest

The new elements include:

- ▶ The definitions needed for the Group Ratio Rule, including optional rules for an alternative calculation more closely aligned with UK tax principles and dealing with associates and joint ventures (see below for further details)
- ▶ The Public Benefit Infrastructure Exemption, including the "grandfathering" of certain loans in existence before 13 May 2016 (see below for further details)
- ▶ Rules defining related parties, which also extend the definition to include unrelated parties that receive a guarantee from another group member or where there is a series of loan relationships where the ultimate lender is related
- ▶ Rules confirming the proposed treatments for particular industries, such as companies within the oil and gas ring fence, leasing, insurance and Real Estate Investment Trusts

- ▶ Rules to leave out of account, when calculating tax-EBITDA, the effect of tax incentives, such as the Patent Box, "above the line" research and development credits and reliefs for the creative industries
- ▶ Administrative rules dealing with enquiries, penalties and information powers available to HMRC (see below for further details)
- ▶ Changes to the UK's controlled foreign company (CFC) rules to allow the "matched income" provisions to continue to maintain their effect by bringing the relevant definitions directly into the CFC legislation from the soon to be repealed existing worldwide debt cap provisions

The revised draft also incorporates a number of changes reflecting some of the representations that have been made to date on the previously published draft legislation and consultation responses. These changes include:

- ▶ Providing the ability to revoke a Public Benefit Infrastructure Exemption election in certain scenarios
- ▶ Allowing groups with net tax-interest income for a period to add this to the interest allowance which might allow more brought forward interest expense amounts to be offset
- ▶ Preventing the targeted anti-avoidance rule from applying to certain "commercial restructuring arrangements," which includes restructuring that is consistent with the policy objectives of the legislation, as well as explicitly including scenarios where loan relationships previously held offshore are brought into the charge to corporation tax
- ▶ No longer specifying how much of the restriction is to be allocated to interest expense to which the Northern Ireland rate of corporation tax applies

The legislation has also been reformatted to allow it to be inserted as a new Part 10 to the *Taxation (International and Other Provisions) Act 2010* (TIOPA 2010), including renumbering the draft sections to be consistent with that Act.

As part of the reformatting, there has been some reordering of some of the provisions, as well as splitting out the administrative elements dealing with appointment of a reporting company and the interest restriction return, which will now be included in a new schedule to TIOPA 2010 (Schedule 7A), along with the newly published elements relating to enquiries, penalties and information powers.

Outstanding elements

Although the majority of the outstanding elements have now been covered, there are some areas impacting secondary legislation which are to follow.

These relate to:

- ▶ Interest distributions of Authorized Investment Funds and Investment Trusts
- ▶ The treatment of retained profit of a Securitization Company as an amount of tax-interest income
- ▶ Preventing the expense amounts on results-dependent securities from being excluded from qualifying net group-interest for Securitization Companies

Group Ratio Rule

The draft legislation now includes the definitions of "qualifying net group-interest" amounts and "group EBITDA" so that the group ratio can be calculated. The qualifying net group-interest takes the "adjusted net group-interest" calculated for applying the fixed ratio rule's modified debt cap and makes further adjustments to effectively eliminate related party interest and amounts on profit-dependent loans and equity notes.

Group EBITDA is broadly the profit before tax shown in the consolidated accounts adjusted for debits and credits in respect of interest, plant, property, equipment, intangible assets, goodwill and shares not held on trading account. Fair value movements on derivative contracts within the "disregard regulations" are intended to be brought into account in line with the items which they hedge.

The consultation response published on 5 December 2016 indicated that groups would be able to make a single, irrevocable election to align the calculation of group-interest and group-EBITDA more closely with the UK tax rules. This will be done by making an "interest allowance (alternative calculation) election," which must be made in the interest restriction return. This is broadly intended to allow groups to treat capitalized interest, gains or losses on the disposal of capital assets, pension contributions, employee share acquisitions and changes in accounting policy in line with the tax treatments for such items. This may be very complicated for multinationals to do in practice but may assist some largely domestic or simpler groups.

In addition, groups may make elections to include an appropriate proportion of non-consolidated investments (e.g., joint ventures) and exclude consolidated partnerships which do not have subsidiaries by treating them as accounted for under the equity method. The former election can be revoked but the election in relation to partnerships is irrevocable.

Public Benefit Infrastructure Exemption

The Public Benefit Infrastructure Exemption is broadly in line with the policy proposals included in the Government's consultation response in December, applying to assets forming part of the UK's infrastructure that meet the public benefit test, as well as buildings that are part of a UK property business and let on a short-term basis (less than 50 years) to unrelated parties. However, there are several key adjustments to the policy.

In particular, it is no longer proposed that the election into the exemption is irrevocable. Instead, a company may revoke an election after it has been in effect for a period of at least five years. However, once revoked, a company cannot elect into the exemption again until five years after the revocation took effect.

In addition, companies that have elected into the exemption will now only be excluded from the group's interest restriction calculation where they meet the requirements for the exemption throughout an accounting period (as opposed to always being excluded, which was proposed in the December consultation response). This can allow interest income and EBITDA to be taken into account, provided failing the conditions was not contrived (in which case the regime's anti-avoidance provisions are likely to be in point).

Enquiries, penalties and HMRC's information powers

Although certain administrative aspects relating to the interest restriction returns and some of the elections were included in the previous draft, further details are now provided. In particular, details have been published in respect of the enquiry process, the applicable penalties and HMRC's ability to obtain information from the group or third parties.

In relation to enquiries, HMRC will normally have the ability to raise an enquiry into an interest restriction return up to 39 months after the end of the period of account (although this may be extended, e.g., if a revised return is submitted).

Next Steps

The legislation is still due to take effect from 1 April 2017. Comments on the additions to the legislation are sought by 23 February 2017. It is not clear what changes HMRC will have time to include in the Finance Bill to be published shortly after the Budget on 8 March. It may be that changes have to be made in committee stage or later.

As HMRC recognizes, these proposals are “expected to have a significant impact on businesses.” Many will be subject to a restriction on their interest expenses and many more will have increased compliance costs in dealing with the new rules.

While the core principles of the rules are relatively straight forward, the legislation to achieve that is very complex with many adjustments required. Given this complexity and the very short time frame in which this legislation is being rushed through, it is likely that many issues will not come to light until the rules are applied in practice.

The rules are complex and will require a number of notifications and elections to be made, some of which are irrevocable.

Groups will need to carefully model the potential impact in order to assess which elections may be most beneficial and what actions to take, possibly including refinancing or restructuring in advance of the rules applying. Given the very limited time before the rules become operational, it is recommended that groups start reviewing and assessing the potential impact now. At the most practical level, groups may already need to factor calculations into quarterly installment payments.

Groups may also want to consider making further representations on the proposed rules, as it is still possible that changes will be made before the legislation is finalized.

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