Analysis

Limitations on deductibility of corporate interest expense: where are we now?

Speed read

The corporate interest restriction is the latest addition to the list of potential limitations on the deductibility of corporate interest expense, following the introduction of the hybrid mismatch regime. The possible impact of the rules should be considered for any UK companies and groups claiming or modelling deductions in respect of interest costs, whether in the context of financing arrangements, mergers and acquisitions, joint ventures, or restructurings. However, notwithstanding these new regimes, the UK remains a comparatively attractive holding company jurisdiction.

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The corporate interest restriction (CIR), which followed hot on the heels of the hybrid mismatch regime, has introduced a significant new limitation on the deductibility of corporate interest expense. The CIR and hybrid mismatch regimes are the latest significant limitations on corporate interest expense deductibility, which can be added to the existing list. Now that the CIR has been in place for some months, this is a good time to take stock of the various restrictions on corporate interest deductibility, and the impact of these changes in the context of the UK's attractiveness as a holding company jurisdiction.

Corporate interest restriction

The CIR was finally enacted in F(No.2)A 2017, following a long period of consultation and a last minute legislative reshuffle. It was originally included in the Finance Bill 2017, but was then dropped from the Bill (together with a number of other provisions) in April 2017 ahead of the snap general election in May 2017, before being reintroduced later in the year. Since then, updated detailed HMRC guidance was published in February 2018, further technical amendments to the CIR were made in FA 2018, and a consultation has taken place (the outcome of which is currently pending) concerning further possible amendments in light of changes to the lease accounting standards.

The CIR regime, which is contained in TIOPA 2010 Part 10, is highly complex. In summary, the rules provide that the net interest expense of UK groups in excess of a £2m de minimis threshold is restricted pursuant to either the 'fixed ratio' percentage or, if higher and the group elects, the 'group ratio' percentage. Under the fixed ratio, the interest expense is restricted to an amount equal to 30% of aggregate tax-EBITDA. Under the group ratio, the interest expense is restricted to a percentage of aggregate tax-EBITDA, where that percentage is calculated as the worldwide group's qualifying net group interest expense over group-EBITDA). Both the fixed ratio and the group ratio are subject to the 'modified debt cap', which limits the deduction to the group's aggregate net interest expense after applying certain adjustments. The CIR regime, and in particular the modified debt cap, replaces the worldwide debt cap rules (WWDC), formerly in TIOPA 2010 Part 7, which operated to restrict deductions for UK companies with reference to the worldwide group's finance expense. Certain modifications to the rules apply in the case of particular businesses, including banking companies, securitisation companies, real estate investment trusts, oil and gas companies, insurance companies, and collective investment vehicles.

The regime also provides various carry forward concepts to flatten out volatility: disallowed tax-interest expense (a company attribute) for a period may be carried forward indefinitely and used in future periods where there is spare capacity; unused interest allowance (a group attribute) for a period may be carried forward for five years; and excess debt-cap can be carried forward into the next accounting period.

The rules have effect for periods of account of worldwide groups beginning on or after 1 April 2017, and CIR can potentially impact existing group structures and financing arrangements established prior to April 2017.

Determining whether, and the extent to which, the CIR rules will apply in a particular case will require a close examination of the particular group structure and financing arrangements. Ultimately, CIR should be considered for any UK companies and groups which are currently claiming, or anticipate claiming, deductions in respect of interest costs (or certain other categories of expense including debits in respect of derivatives, finance leases, and debt factoring).

The rules can, for example, have an impact on the modelling of long-term debt and some securitisation structures, effectively pushing out the period for which the financing is in place in order to achieve an equivalent economic return to that which would have applied had CIR not been applicable. Equally, there are structures where a UK holding company may be used as a leveraged finance vehicle holding debt investments, where it (or the wider UK group for the purposes of the group ratio) has significant interest income, which may in practice result in minimal or nil aggregate net tax-interest expense, and therefore no practical CIR impact. There is also the risk that CIR could engage a mandatory redemption provision in financing instruments if one of the triggers is that the issuer ceases to be entitled to a particular level of interest deductions, so a review of existing financing arrangements would be recommended.

Care should be taken in an M&A context where companies are leaving, or joining, a consolidated worldwide group for CIR purposes. For example, a buyer may wish to diligence the target company's existing CIR position and, where relevant, seek appropriate protections against the risk of the seller group allocating a CIR disallowance to the target company for a pre-closing period that has not already been factored into pricing. In a joint-venture context, where the corporate joint-venture entity (the JV) is not consolidated with the investors, there are specific elections that may be beneficial:

- an investor level election (the 'interest allowance (non-consolidated investment) election') which enables a proportion of the JV's interest and financing costs to be included within group-interest (and thereby increase the investor's group ratio); and

- a JV level election (the 'group ratio (blended) election') which allows the JV to access the aggregated (on a pro rata basis) blended group ratio profile of its investors.

Where relevant, it will be important to ensure that the joint venture agreement has sufficient co-operation and provision of information provisions to enable these elections to be considered and, where beneficial, made.

In a restructuring context, the impact of CIR may be a driver towards deleveraging the company rather than retaining shareholder debt. In the case of a partial debt release and conversion into equity in a distressed debtor scenario, the remaining debt is deemed not to become 'related party debt' (which could otherwise adversely impact the group ratio calculation), although this deeming rule applies only where the parties become related in the context of an actual release of debt and not a deemed release.

It is also worth noting that the CIR applies after application of the transfer pricing and hybrid mismatch rules, so it may be that by the time these rules have been applied the practical impact of the CIR may be reduced.

Hybrid mismatch regime

The hybrid mismatch regime, in TIOPA 2010 Part 6A, was introduced by FA 2016 with effect from 1 January 2017. These rules can deny UK interest deductions in situations involving mismatches arising from certain hybrid arrangements; for example, involving a hybrid entity, hybrid instrument, permanent establishment or dual resident company. Targeted scenarios, subject to some exceptions, include a 'deduction / non-inclusion' scenario (for example, interest payments by a UK subsidiary which is checked as disregarded for federal income tax purposes, to its US corporate parent), and a 'double deduction' scenario (for example, interest payments by the same UK subsidiary to a third party, where the UK subsidiary is checked as disregarded and owned by a US corporate parent).

In most cases, it should be fairly obvious if there is a hybridity question that needs to be considered. One area, however, which has given rise to some difficulties in practice concerns the possible application of the imported mismatch rules to plain vanilla loans. The particular concern is that an imported mismatch might arise where a non-UK lender, which is itself financed by a hybrid loan, has a greater than 50% investment in the third party borrower (i.e. a greater than 50% entitlement to a borrower's assets on a winding up, by virtue of the loan). The question is whether the hybrid rules could operate to deny interest deductibility for the borrower, even where the only hybrid element in the structure is above the level of the lender, and may not be known to borrower. HMRC has addressed this concern in HMRC's *International Tax Manual* at INTM559230, noting that the borrower will generally be able to conclude that the arrangement under which the funding is provided is not part of an 'over-arching arrangement' in the circumstances described, which include, in summary:

- a vanilla loan on normal commercial terms;
- no other connection between the lender and borrower; and
- the only reason why the lender and borrower may be considered to be in the same control group is that the lender has a 50% investment in the borrower by virtue of the loan.

In the context of the CIR, TIOPA 2010 s 464 reflects amendments that were made to the draft legislation to address a similar concern; namely, that vanilla third-party commercial lending should not fall within the meaning of related party debt (which is relevant to the calculation of qualifying net group-interest expense). In particular, s 464(1) specifies that the '25% investment' conditions are, where relevant, determined with reference to equity holders; and s 464(10) provides that s 464(7) is not to result in a person being regarded as having a 25% investment in another person merely as a result of their being parties to a normal commercial loan. Equivalent amendments could, in principle, be made to the meaning of '50% investment' in TIOPA 2010 s 259ND as applicable to s 259NB(1)(c) in the context of s 259KA, consistent with the approach already noted in INTM559230. We understand that this is not a change which HMRC currently considers is necessary to be made. As such, INTM559230 represents the final word on this point, at least for now, albeit taxpayers have the option to seek non-statutory clearance on any particular areas of concern.

Other limitations on deductibility of corporate interest expense

In addition to the CIR (which has replaced the WWDC), and the hybrid mismatch rules (which have replaced the tax arbitrage rules in TIOPA 2010 Part 6), a number of other interest limitation rules remain relevant and should continue to be borne in mind in any transaction where UK interest deductibility is relevant. These include:

- transfer pricing (TIOPA 2010 Part 4);
- the loan relationships unallowable purpose rule (CTA 2009 s 441) and targeted anti-avoidance rule (CTA 2009 s 455B);
- distribution treatment (CTA 2010 Part 23) in respect of, for example, results-dependent interest or interest payable on certain convertible loan notes;
- group mismatch schemes (CTA 2010 Part 21B);
- late paid interest (CTA 2009 Part 5 Chapter 8); and
- the general anti-avoidance rule (GAAR) (FA 2013 Part 5).

UK as a holding company jurisdiction

Notwithstanding the new limitations on corporate interest expense, the UK remains a comparatively attractive holding company jurisdiction. Of course, the UK is not alone in introducing a corporate interest restriction or hybrid mismatch regime, these being derived from the OECD's BEPS Actions 4 and 2, respectively. The combination of BEPS, the EU Anti-Tax Avoidance Directive (ATAD I) and amending directive (ATAD II) means that equivalent rules will shortly be introduced in EU and participating BEPS jurisdictions, to the extent such rules are not already in place. The recent US tax reform also introduced a form of corporate interest restriction in the US.

In many ways, the fact that the UK has already implemented these changes is a comparative advantage in that at least it has given practitioners and clients a head start in getting to grips with the new regimes, against the backdrop of detailed HMRC guidance having been published. By comparison, pursuant to ATAD I a corporate interest restriction will be introduced in Luxembourg, for example, with effect from 1 January 2019, although draft legislation remains to be published, which can make planning difficult.

The UK also provides a relatively generous form of participation exemption:

- an exemption from corporation tax on dividends received, provided the technical conditions are satisfied; and
- the substantial shareholding exemption (SSE) from gains on the disposal of qualifying interests in subsidiaries, for which the relaxations to the trading conditions introduced by F(No.2)A 2017 have provided welcome flexibility.

The UK does not impose withholding tax on dividends paid by UK companies, and while there is 20% withholding tax on 'UK source' interest and royalties, this may be reduced or eliminated pursuant to domestic exemptions, EU directives (at least pending the outcome of Brexit), and double tax treaties. The UK is not alone in having a controlled foreign company (CFC) regime (and ATAD I also includes a CFC regime), albeit the UK regime provides a helpful partial exemption for qualifying finance companies.

The increased international drive towards substance may also be favourable to the UK in terms of the location of relevant personnel, and the UK remains relatively generous in allowing tax deductions for interest expense on the financing of tax-exempt assets.

The UK has a wide treaty network, which makes it a good starting point for international holding structures, and while the introduction of the principal purpose test (PPT) will be a significant development, again this is not confined to the UK's treaties.

The UK also has one of the lowest headline corporate tax rates of the G20: currently a 19% rate, set to fall to 17% from 1 April 2020.

While developments surrounding Brexit, and the Labour party's tax policy in the event of a change of government (whether in connection with Brexit if an election is called, or at the next scheduled election in 2022) should continue to be monitored, for the time being the UK remains a comparatively attractive holding company jurisdiction, and the introduction in the UK of the CIR and hybrid mismatch regimes should not materially dampen that. ■

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- Hybrid mismatch arrangements: the UK's take on Action 2 (Jeanette Zaman, 28.1.16)
- Disregarded UK subsidiary companies and the hybrid mismatch regime (Nick Thornton & Will Gay, 20.4.17)
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