UK INTRODUCES NEW "CORPORATE INTEREST RESTRICTION" RULES

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From 1 April 2017, new "interest barrier" rules will apply to corporates to restrict UK tax relief for interest and some other financing expenses. The rules are based on (but to some extent go beyond) the OECD/G20's Base Erosion and Profit Shifting (BEPS) project recommendations.

Before the introduction of these rules, corporates could generally expect to see full UK tax relief for interest on commercially motivated third party debt and, under transfer pricing rules, "arm's length" interest on related party debt. This marks a significant change in UK tax law and the tax assumptions that investors and financiers should apply in modelling new and, in the main, existing debt-funded transactions.

INFRASTRUCTURE AND OTHER HIGHLY LEVERAGED INDUSTRIES

Since the Government announced its intention to introduce the new rules, there has been some understandable apprehension from highly leveraged industries, such as infrastructure and real estate; but there may be some solace for those companies that can elect into the "public benefit infrastructure exemption" (the PBIE). Details on eligibility for, and the effect of, the PBIE are set out below.

THE RULES ARE LIVE FROM 1 APRIL 2017 BUT ARE NOT FINAL

The rules have been subject to intensive and welcome consultation with advisers and industry, but they are not in final form. So, taxpayers will (until the rules are finalised) be borrowing and lending without certainty on the tax impact and, therefore, the true cost of debt. That uncertainty is an unfortunate side effect for taxpayers of the introduction of a complicated set of rules in such short order. The lack of certainty may to some extent – but not entirely – be mitigated by modelling appropriate sensitivities.

KEY POINTS

Draft legislation is available for the new rules and this runs to over 150 pages. Clearly, the sheer volume of new legislation will mean complexity.

In summary, a group's net interest for a period will be restricted to:

- 30% of "tax EBITDA" (which, essentially, is accounting EBITDA adjusted for certain non-taxable and non-deductible items), capped at the net interest in the consolidated profit and loss account (the Fixed Ratio Rule);
- if higher and an appropriate election is made, the "group" percentage (net third party interest over group EBITDA, up to 100%) of tax EBITDA, capped at the net interest (adjusted for equity-like debt) in the consolidated profit and loss account (the Group Ratio Rule). This is intended to enable businesses operating in the UK to obtain relief for interest in line with their activities – but it may not always allow full relief for third party interest, even in an entirely UK group. And it does not deal well with circumstances in which debt markets permit higher gearing for the same business type inside than outside the UK; and
- if higher, a de minimis of £2m.

WHAT IS "RELATED PARTY DEBT"?

"Related party debt" is a key concept in the Group Ratio Rule (above) and the PBIE (below). Related parties include, broadly:

- consolidated entities;
- entities connected under the transfer pricing rules; and
- entities where one has a 25% investment in the other or a third entity has a 25% investment in both (not including investments by normal commercial loans, e.g. bank loans).

There are also far-reaching provisions that make parties related where they "act together" (joint venturers beware!).

Note that the related party concept is significantly wider than under transfer pricing rules.

Debt guaranteed by a related party can also be related party debt. There are exclusions in the context of the Group Ratio Rule, such as where the guarantee is from another group member. That is, apparently, because an entity may be able to borrow excessively (more than it could on its own) due to a guarantee.
Helpfully, where unrelated parties hold at least 50% of a class of debt issued by a company, debt of the same class held by a related party is not related party debt.

WHAT IS "NET INTEREST"?

"Net interest" is, essentially, the aggregate of loan relationship and certain (e.g. interest rate, FX and RPI/CPI-linked) derivative credits and debits (excluding FX gains/loss and impairments).

CARRIED FORWARD INTEREST ALLOWANCE AND CAPACITY

Generally, unused interest allowance can be carried forward up to five years; and disallowed interest expense can be carried forward (under these rules and not as carried forward losses) indefinitely. This should help to smooth out some tax EBITDA fluctuations. But there are significant complexities to be considered where companies move between groups.

NO COMPENSATING ADJUSTMENT

Unlike the UK's transfer pricing rules, there are no "compensating adjustments" available – a UK lender's interest income will not escape tax purely because relief for the borrower's interest expense is restricted under these rules.

OTHER UK TAX RULES, E.G. TRANSFER PRICING

The UK has other rules that can restrict or defer relief for interest, such as transfer pricing and the unallowable purpose rule – those will continue in force (except the worldwide debt cap, a modified form of which is in effect included within these new rules). The new interest barrier rules will need to be applied after those other rules.

PUBLIC BENEFIT INFRASTRUCTURE EXEMPTION

In recognition that certain public services are often provided by using infrastructure that is funded using private capital (and so not at the cost of the Exchequer), the new rules include a targeted exemption – the PBIE.

ELIGIBILITY FOR THE PBIE

A company is, broadly, eligible for the PBIE (a "qualifying infrastructure company") if:

- its income all, or all but an "insignificant proportion" of its income, derives from "qualifying infrastructure activities" (or shares/debt in a qualifying infrastructure company);
- the value of its assets, or all but an "insignificant proportion" of the value of its assets, derives from "public infrastructure assets" provided by that company or used in the course of a "qualifying infrastructure activity" carried on by the company or an associate (or shares/debt in a qualifying infrastructure company);
- it is fully taxed in the UK; and
- it makes a PBIE election.

The income and assets tests are complicated.

"Insignificant proportion" is not defined. Draft tax authority guidance should be available on this shortly, but unless the Government changes tack there will be no safe harbours. On the one hand, that creates some uncertainty; but, on the other, it may be beneficial in avoiding "technical fails" that might arise should a fact pattern fall marginally below a defined percentage proportion.

"Qualifying infrastructure activities" are the provision (including construction and operation) of public infrastructure assets or other activities that are ancillary to or facilitate the qualifying activity. It may be that "ancillary" and/or "facilitates" can be interpreted widely enough to cover activities that make a qualifying activity economically viable – and, if so, that may provide some comfort where it is unclear that the income/asset in question is insignificant. The UK tax authority should respond to applications for clearance on what constitutes "ancillary" or what "facilitates" where there is uncertainty, which could be welcome where an investor is relying on the PBIE to finance a project.

"Public infrastructure assets" are tangible assets forming part of the UK's (or the UK continental shelf's) infrastructure, which meet a public benefit test, have a useful economic life of at least 10 years and are on the group's balance sheet. This should encompass an array of infrastructure, including thermal, renewable and nuclear energy generation, water, gas and electricity transmission, and port and airport operators.

EFFECT OF PBIE ELECTION

Where a company successfully makes a PBIE election, interest payable to unrelated third parties under limited recourse loans will be excluded from the group's calculation of net interest expense and so generally should be treated as deductible. The company's tax EBITDA will also not count in the group's calculation. Again, related party debt is widely defined, but here debt guaranteed by a related party is not deemed to be related party debt.

Guarantees are still, however, significant. In order to qualify for the PBIE, the creditor's recourse must in general be limited to qualifying infrastructure income and assets which, without more, would not include a guarantee from a company that itself is not a qualifying infrastructure company. But, a guarantee is ignored in assessing whether the creditor's recourse is so limited if it:

- was entered into before 1 April 2017;
- is provided by a non-related party (which is helpful for wrapped bonds); or
- is a performance guarantee of goods/services obligations from a related party of the provider and the guarantor is not on the hook for more than the provider's fees (as is commonly the case for parent company guarantees of construction or operation and maintenance contracts).

Downstream parent guarantees from non-qualifying companies used to facilitate the enforcement of a share pledge are not ignored – but it ought to be possible to structure around that issue under the PBIE.

THE PBIE ELECTION HAS A FIVE-YEAR "LOCK-IN"

The PBIE election is generally irrevocable for five years. Given that it saves non- related party debt only, companies will need to consider whether they might refinance with related party debt in that time – if so, they might be better off not making an election.

If an election is revoked, it cannot be remade for five years.

IS THE PBIE BANKABLE?

The conditions for the PBIE and what can be exempted under it are involved – so taxpayers and their financiers relying on it will want robust advice and appropriate future-proofing.

TAKEAWAY POINTS

1. The interest barrier rules will apply from 1 April to new and (generally unless grandfathered) existing interest. Investors and financiers should therefore model appropriate tax assumptions for new projects and revisit existing projects to evaluate whether a restructuring is appropriate.
2. Generally, it will be appropriate to model the Fixed Ratio Rule. Interest on shareholder debt could be used to “top up” to 30% of tax EBITDA, but would be restricted thereafter. Analysing the extent to which and time it takes restrictions to unwind (perhaps as senior debt amortises) is likely to be important in understanding the overall impact of these changes.
3. Where relying on the PBIE, investors and financiers will need robust advice and future-proofing. Investors will also need to consider the consequences of the five-year lock-in in the context of their future plans.
4. Related party debt is frequently used as a mechanism to move cash out of companies with negative distributable reserves – both to service debt and to repatriate cash to equity investors (which is key to achieving their IRR). Given that, shareholder debt could therefore still have a role to play on investments. Some careful structuring may, however, be required to repatriate cash without tax leakage (which could arise if relief for interest expense on a related party loan used solely to repatriate cash was restricted but interest income for the creditor was taxed after applying transfer pricing rules).
5. These rules need to be considered together with the impact of the UK’s new loss restriction rules – which are also live from 1 April 2017 and prevent losses from being carried forward against more than 50% of a group’s profits (subject to a £5m de minimis).