

CORPORATE INTEREST RESTRICTION: PUBLIC BENEFIT INFRASTRUCTURE EXEMPTION

Real estate and construction



Entities subject to corporation tax face new restrictions for interest deductibility from April 2017 but some exemptions are available.

New corporate interest rules

The Government has been consulting on new corporation tax rules for the deductibility of interest payments (to OECD's Base Erosion and Profit Shifting project recommendations) and these have now reached the stage of draft legislation intended to take effect in April 2017.

In broad terms, the new rules will cap a deduction for the net interest expenditure of the UK companies in a group at the higher of:

- £2m (the 'de minimis' amount)
- The lower of 30% of 'tax-EBITDA' and the consolidated net interest expense of the worldwide group (the fixed ratio)
- The lower of a 'group' percentage of 'tax' EBITDA and the consolidated net interest expense of the worldwide group on third party debt (the group ratio).

In some circumstances, interest incurred and disallowed under these rules can be carried forward so that relief can be obtained in a later period.

Similarly, where the amounts allowed under the fixed ratio or group ratio exceeds the amount of interest incurred, the excess can be carried forward to facilitate additional deductions in a later period. Both these provisions are subject to complex qualifying rules.

Implications for UK property investment

In the real estate sector in particular, businesses are often subject to high amounts of debt and, in many normal commercial circumstances, the fixed ratio would result in significant disallowances of interest.

The group ratio offers some relief, in theory permitting deductions for interest on third party financing, but with potential uncertainty for groups with an international profile. To address this uncertainty, the Public Benefit Infrastructure Exemption (PBIE) is to be extended to real estate investment businesses.

PBIE conditions in real estate investment situations

Companies in a real estate investment group would be 'qualifying companies' able to elect for the exemption if they meet the following conditions:

- All of the company's profits and gains are fully chargeable to UK tax.
- The company, along with any other associated qualifying companies, does not have significantly more debt than other comparable companies in the group.
- The debt for which exemption is sought must be secured only on the 'qualifying exempt assets' or shares of the company or the qualifying assets or shares of other qualifying companies (the 'recourse' condition).
- Other than to an insignificant extent, the assets and income of the company must relate to qualifying activities.

Qualifying activities

The assets and income of the company must relate to qualifying activities. To be a 'qualifying exempt asset' it must be included on the balance sheet and must have, or have had, an expected economic life of at least 10 years.

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For a real estate investment group, qualifying activities are most likely to be:

- Holding UK property which is let, or which is to be let, to an unrelated party for a term of less than 50 years.
- Holding shares in qualifying companies (for example shares in a subsidiary letting property to an unrelated party).
- Making loans to qualifying companies (for example lending down to a subsidiary letting property to an unrelated party).

Implications of making election for the PBIE

Where the election for exemption is made, it has the following effects for tax purposes:

- Interest incurred on loans which meet the recourse condition and which is paid either to an unrelated party or to another qualifying company will be excluded from the interest restriction and will, therefore, be deductible.
- For the purposes of calculating the capacity of the rest of the group to claim a deduction for interest, the qualifying company is treated as having a tax-EBITDA of nil. Any interest income of the company is not included in the calculation of the net interest of the group.
- Interest reported in the financial statements relating to loans for which the interest is excluded from the restriction is not taken into account in calculating the consolidated group net interest cap to the deduction permitted under the fixed ratio and group ratio.
- For the purpose of calculating the interest deduction available to the rest of the group for interest incurred, the group will not be treated as having access to the 'de minimis' amount and so will be limited to either the fixed ratio or the group ratio.

Overall, this crystallises a full deduction for interest on loans meeting the recourse condition and excludes the PBIE qualifying company from the interest deductibility calculations for the group. This means that the presence of a PBIE qualifying company in a group cannot increase deductions available elsewhere in the group. In a group (which can include a singleton company) where all companies are PBIE qualifying companies, this would result in all related party interest being disallowed.

An extension to the exemption is permitted to 'grandfather' pre-existing debts, including related party debts (see below). However, this will not usually be available to real estate investment businesses.

Provisions are also included to ensure that making a PBIE election does not result in a group having higher restrictions than it would have without the exemption. This is achieved by effectively giving the lower restriction from two sets of calculations - the positions 'with' and 'without' the exemption. For example, if the group's overall net interest expense falls below the £2m de minimis, a full deduction will be ensured even if this includes related party interest not covered by the exemption.

Grandfathering

Loans from related party lenders will also be within the scope of the exemption if:

- The loan was entered into before 13 May 2016, and
- On 12 May 2016, at least 80% of future receipts for a 10 year period were highly predictable by reference to public contracts.

This may be the case where property such as a hospital is let to the NHS under a public contract which specifies the basis of rentals for the next 10 years.

How BDO can help you

The new rules are set out in over 130 pages of draft legislation and are complex. Even for businesses which could qualify for the PBIE, it may not necessarily be obvious which companies in the group will qualify and, in many cases, careful planning may be required to ensure that some of the technical requirements are not inadvertently breached.

BDO will be monitoring the continuing development of the rules up to enactment and can advise on how they might affect ongoing or prospective projects. We can prepare illustrative calculations based on historic actual figures or projected future figures to help businesses assess the impact of these new rules and plan new projects.

Next steps

To discuss how BDO NI could help you structure your real estate activities in the context of the new rules, please contact your usual BDO NI adviser or one of our team overleaf.



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