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CORPORATE INTEREST RESTRICTION - THE BASIC RULE

Following the recommendations of the OECD's 'Base Erosion and Profit Shifting' project on interest expense (Action 4) and several consultations, the UK's general corporate interest restriction will come into effect in April 2017

The coming storm

The potential impact of the interest limitation rule is expected to be significant for some groups. The Government anticipates it will raise approximately £1bn of additional tax a year. This is a significant amount in the context of total corporation tax receipts of £43bn in 2014/15 and the relatively narrow tax base to which the rule will apply.

The new rule applies from 1 April 2017 so, although only draft legislation has been released, it is important that groups consider the impact now based on what we currently understand of the shape of the rules.

Engaging stakeholders and lenders in early stage discussions on the potential impact of the rules and developing appropriate remedial action plans where necessary will be critical over the coming months.

What will the rule look like?

The main aspects of the rule are now clear - it will apply to a 'group' (based on the requirement to prepare consolidated accounts) headed by a corporate entity.

It will allow the higher of:

- **De minimis:** £2m net interest
- **Fixed Ratio**: 30% of 'tax-EBITDA'
- **Group Ratio:** Group's ratio of third party interest to EBITDA, up to 100%

Interest under the Fixed Ratio test will be limited to the overall net interest expense of the 'group'.

The Group Ratio operates on interest from third parties, and is capped at the total net interest expense of the group excluding related party interest amounts.

UK tax-adjusted figures will be aggregated before applying the tests (ie there will be a single £2m de minimis per group), before allocating any disallowance to companies.

The flow-chart overleaf illustrates whether and how the measures result in a disallowance.

An election will be needed to select the Group Ratio, otherwise the Fixed Ratio will apply.

How will this interact with other rules?

The new rule will apply after other tax adjustments. The starting position for calculating tax-EBITDA is a company's profit chargeable to corporation tax after almost all tax adjustments - the main exception being R&D relief. Interest, capital allowances and intangible fixed asset allowances are added back.

The net interest expense figure is net of interest income and calculated after other rules such as transfer pricing (including thin capitalisation), and the unallowable purpose and anti-hybrid rules.

Having an Advance Thin Capitalisation Agreement (ATCA) will still, therefore, be relevant to many. Late paid interest originally accruing before 1 April 2017 will potentially be restricted if paid after 1 April 2017 and is not currently treated separately.

How final are the rules?

The legislation for the rules is in draft and may change further in the Finance Bill 2017 to be published on 20 March 2017.

Some change is hoped for in relation to the related party definition in particular.

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What BDO can do for you

To help you prepare for the new rule, BDO is offering a package of support, comprising:

- A meeting to talk through the new rule and explain any areas that are likely to have an important impact for you
- Undertaking initial calculations based on forecast or prior year results to determine whether a restriction is likely and what points to watch
- Help preparing your communications with stakeholders.

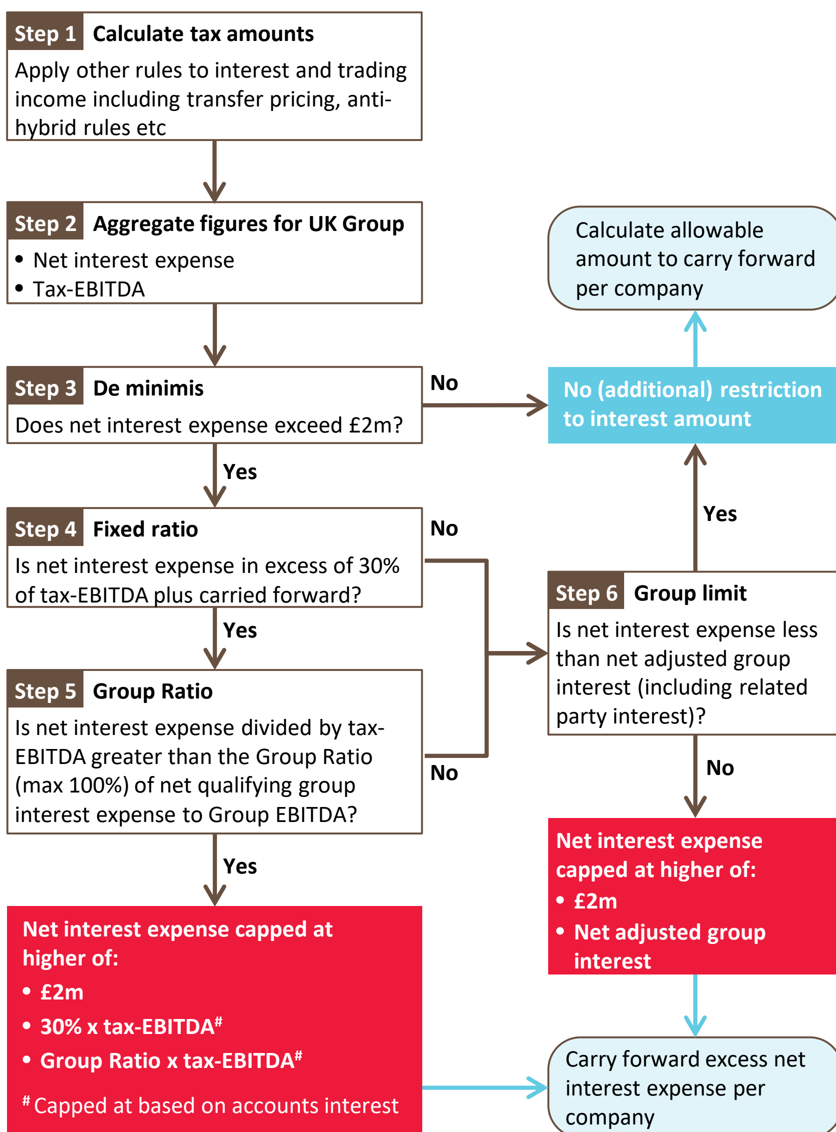
If a significant restriction appears likely under the new rule, we can help investigate changes to your group's financing structure to identify options to mitigate the impact.

The most natural solution in many cases is to push-down debt to overseas subsidiaries. This is implied by the OECD's recommendations to be a positive step, aligning expenses with substance; however, many countries may still treat this as avoidance and care must be exercised.

Going forward, analysis of this restriction will need to be included in relation to M&A activity, restructurings and refinancing, changes in group profitability and expansion overseas, as well as for annual compliance.

While the new restriction will be applied after transfer pricing, it will be relevant in determining the level of potential exposure from transfer pricing. Whether to engage in detailed analysis of borrowing capacity and debt pricing may be flavoured by whether, and how significantly, the new rule would restrict interest deductions.

We can help you establish an arm's length level of related party debt (and capacity for debt) and interest for the purpose of any planning and to support a tax filing position or ATCA application.



Your next steps

For help and advice on the impact on your business and your options going forward, please get in touch with your usual BDO adviser or contact our transfer pricing team overleaf.

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