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LATE PAID INTEREST - CORPORATE INTEREST RESTRICTION AND LOSS RELIEF

The UK's new corporate interest restriction takes effect from 1 April 2017. Companies with rolled up interest carried forward under the 'late paid interest' rules should carefully consider payment timing.

Outline of the restriction rule

The rule 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.

Commencement

Depending on a company's year-end, the corporate interest restriction may apply from part-way through a period.

This results in the need to calculate a notional split period to apply the new rule to the period after 1 April.

The starting point for allocating amounts to the split periods is a time apportionment, which will make sense for many profit and interest items. Where time apportionment would not give a just and reasonable basis, a just and reasonable apportionment is used.

This is likely to be relevant for late paid interest, as well as any significant one-off items of income or expense (such as break costs on derivatives), which may be allocated entirely to a specific date.

Impact on late paid interest

Two aspects of the corporate interest restriction will potentially cause difficulty for groups with accrued but unpaid interest that falls within the late paid interest rules:

- High interest deductions in a year, eg if interest from several periods is paid* at once, will be more likely to exceed 30% of tax-EBITDA
- The cap at the group's interest per accounts could cause a restriction on late paid interest if all of the group's interest is otherwise tax deductible in the UK.

These factors are most relevant to interest accruing before 1 April 2017 due to carry forward allowances. Some groups may find that rolled-up interest needs to be paid before 1 April 2017 (or within 12 months of the end of the period in which it accrued) to access deductions.

Following 1 April, interest payments for some groups could benefit from planning to maximise use of the de minimis allowance.

Loss relief rules

New loss relief rules will also apply from 1 April 2017, again with split period relief. These will introduce both greater flexibility for the use of losses arising after 1 April, no-longer requiring streaming, but also where a group's taxable profits exceed £5m, a restriction of relief so that only 50% of that excess can be sheltered by losses brought forward.

These new loss rules may need to be taken into account when considering whether to pay interest before or after 1 April 2017.

** Payment for these purposes includes interest that is cash paid or satisfied through the issue of payment in kind notes / funding bonds*

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Illustration of application

The following examples assume that the group in question has £20m of interest accrued and unpaid from periods ending 31 December 2016 or before:

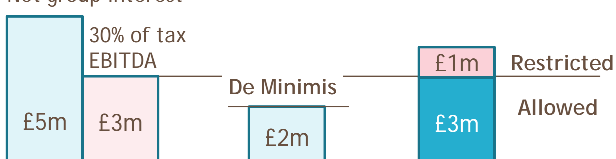
1) Imminent restriction

In this example we assume the company has a steady level of taxable profit and interest expense:

- Interest per accounts £5m
- UK tax deductible interest (before new rule) £4m
- Taxable profit (before interest and CAs) £10m

Fixed Ratio - lower of:

Net group interest



Maximum annual deduction with new rule: £3m
Interest restriction per annum if interest paid in year: £1m

In this case, the company will able to deduct less than the full amount of interest accruing each year. Therefore, any rolled up interest not paid before 1 April 2017 will likely never be deductible.

If all brought forward interest is paid before 1 April, the company would make a loss. The just and reasonable apportionment would assign this loss entirely to the pre-1 April 2017 (more restrictive) loss relief rules - which could result in losses becoming 'trapped'.

2) Continuing allowance

A company with greater headroom has more flexibility:

- Interest per accounts £4m
- UK tax deductible interest (before new rule) £3m
- Taxable profit (before interest and CAs) £15m

Fixed Ratio - lower of:

30% of tax EBITDA

Net group interest

Surplus allowance £1m

Maximum annual deduction with new rule: £4m
Surplus interest allowance: £1m

Surplus allowances can be carried forward up to five years and/or used to reactivate previously restricted interest.

The company could choose to pay £1m of old accrued interest per year after 1 April 2017 to maintain deductions and avoid a pre 1 April 2017 loss.

As shown in the examples, not all companies with late paid interest will be affected equally by the introduction of the corporate interest restriction. It is vital to understanding the dynamics of the various new rules effective from April 2017 before making decisions regarding payment of interest.

Wider considerations

As with any payment of interest, there will potentially be other factors to take into account:

- Valuation of payment in kind notes
- Any withholding tax applying on the interest payment could affect the net tax impact of payments
- Hybrid mismatch rules apply from 1 January 2017, potentially disallowing all deductions where hybrid instruments or entities are involved in the structure.

Potential changes to legislation

It is possible that the corporate interest restriction may yet change how it takes late paid interest into account, for instance considering interest expenses before the late paid interest rules are applied. We hope this will be clarified when the updated Finance Bill 2017 is published on 20 March 2017.

Your next steps

If your group has interest restricted under late paid interest rules, carefully consider whether payments are needed ahead of 1 April 2017.

BDO is on-hand to provide guidance, support and advise to you.

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