The "world-wide debt cap" – a fundamental change to the tax deductibility of finance costs in the UK

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Since 2007, HM Revenue & Customs ("HMRC") has been consulting with business on reforms to the "taxation of foreign profits" in the UK. The result of this consultation is one of the most fundamental changes to the UK corporation tax system in recent memory. Unfortunately, despite what may be suggested by the title of the consultation, it is not only multinational groups who will be affected – even wholly UK groups could see significant changes in the tax deductibility of their financing costs and, at the very least, will face an increased tax compliance burden.

As a result, it will become even more important that good communication channels are maintained between the tax and treasury departments in large corporate groups, and in particular, it will also be crucial for treasurers to discuss potential changes in their group's financing profile with their tax colleagues in advance of implementation.

Background

HMRC's consultation on the "taxation of foreign profits" has resulted in proposed legislative changes in a number of international tax areas, including the subject of this article: the introduction of a restriction on the deductibility of finance costs in the UK – the so-called "world-wide debt cap" (referred to as the "debt cap" hereafter).

For many years, the UK has been relatively generous in terms of the deductibility of finance costs incurred by UK tax resident companies, with HMRC preferring to release specific anti-avoidance rules to target transactions which are seen as erosive to the UK tax base. There are general restrictions on interest deductibility, including in particular:

- transfer pricing rules, to prevent not only excessive interest rates but also excessive lending (on an 'arm's length' comparable basis); and
- "unallowable purposes" rules, to disallow deductions for finance costs incurred for "tax avoidance" purposes.

However, there have been no hard and fast quantitative restrictions on the amount of interest that a UK company can deduct. The debt cap imposes such restrictions – providing, broadly, that the total finance cost deductions in UK tax resident companies in a group must not exceed the worldwide consolidated group's gross finance costs.

HMRC see this as generous, in that a multinational group can in theory still inject the full amount of its external debt into the UK and claim finance cost deductions (subject to the existing limitations imposed by transfer pricing requirements etc); however the method of calculation will result in increased computational complexity for the majority of large groups based or operating in the UK.

The debt cap may also encourage behaviours that would ordinarily be seen as contrary to good commercial practice, although such instances are likely to be rare. More on this later.

In broad summary, the landscape is changing in terms of interest deductibility in the UK and the need for treasurers to maintain a dialogue with their tax colleagues has increased. Group treasurers need to be aware that a change to the financing profile of the group could impact the UK group's tax cost, effective tax rate and compliance burden.

Please note that the following is based on the draft law contained in the Finance Bill 2009 at 26 June 2009. Although substantial further changes are considered unlikely, certain regulations to accompany the rules have yet to be laid and it is essential that the final legislation is analysed before concluding as to the likely effect of the rules on your group or on a transaction.

The below is also necessarily summarised – the debt cap legislation is extensive and complex and therefore must be checked in detail in relation to any specific group or transaction.

Detail

The debt cap rules are contained in Schedule 15 to the Finance Bill 2009, as released on 30 April 2009. Several amendments and additions have been introduced at the Public Bill Committee review stage. The provisions will become law on obtaining Royal Assent (likely to be late July 2009), and will apply for groups' periods of account beginning on or after 1 January 2010.

Purpose

The purpose of the rules is to restrict UK tax deductions for financing costs to the amount of the consolidated group's gross external financing costs, to prevent groups from eroding the UK tax base via interest (or other finance) expense, where the consolidated group as a whole does not suffer an equivalent cost to external lenders.

The precise target area of the rules can be considered to be relatively narrow, principally being:

Non-UK parented groups injecting debt into their UK sub-group, in excess of the group's total external debt (even though the UK sub-group may be realistically leveraged on a stand-alone basis).

UK parented groups lending cash from overseas jurisdictions (typically low taxed) to the UK, again reducing the UK tax base.

The rules include a "gateway test" which aims to filter out groups that are not the policy target of the legislation. However, many groups will be unable to pass the gateway test simply because of UK-UK intra-group loan balances, as discussed further below. For groups that can not pass the gateway test, there may be cash tax, financial reporting and/or tax compliance considerations.

Scope

The rules apply to a "group" of companies (based on the accounting definition) that is "large" in accordance with EU definitions (the "worldwide group"). Broadly, this means that the group as a whole either employs 250 or more people or, if not, has an annual turnover of at least £50 million and an annual balance sheet total of £43 million or more.

The rules restrict the financing cost deductions of UK resident "Relevant Group Companies", defined as either the "Ultimate Parent" of the worldwide group (in many groups, the top company in the corporate structure) or broadly 75% subsidiaries of the Ultimate Parent. Where there is a disallowance of financing deductions of Relevant Group Companies, it is possible to exempt from tax the financing income of those companies and any other UK resident companies that are within the accounting consolidated group (broadly, UK resident 51% subsidiaries).

So in most cases we are dealing with the UK tax resident 75% subsidiaries of the parent of the consolidated group, plus that parent company if it is UK resident. Groups with more complex structures, e.g. involving stapled stock, partnerships or companies without share capital, will need to consider the scoping provisions in more detail. For simplicity, we will refer to the Relevant Group Companies as "the UK companies" and the worldwide group as "the consolidated group" hereafter.

The debt cap rules apply by reference to the period of account of the consolidated financial statements of the consolidated group. The consolidated financial statements are required to be drawn up under International Accounting Standards ("IAS") or in accordance with one of the generally accepted accounting principles ("GAAPs") of one of the following countries: UK, US, Canada, People's Republic of China, India (for periods of account beginning on or after 1 April 2011), Japan and the Republic of Korea.

Gateway test

The debt cap only applies where the "UK Net Debt" exceeds 75% of the "Worldwide Gross Debt" of the group for a period of account. This is referred to as the gateway test.

The "Worldwide Gross Debt" is the average of the "relevant liabilities" in the consolidated group balance sheet at the start and end of the period of account. Relevant liabilities include:

- Borrowings (overdraft, short-term debt and long-term debt).
- Finance lease liabilities.

The "UK Net Debt" is the total average of the net debt at the start and end of the period of account of UK companies that have net debt. Net debt is defined as "relevant liabilities" (as listed above) less "relevant assets". Relevant assets include:

- Cash and cash equivalents.
- Amounts loaned (overdraft, short-term debt and long-term debt).
- Net investments in finance leases.
- UK or non-UK Government securities.

Relevant assets and relevant liabilities must generally be translated into sterling at the spot exchange rate on the balance sheet dates. This will make it difficult for many groups to obtain certainty on the gateway position before the end of the year in question, although clearly for some groups the level of headroom may mean this is not a major concern.

If the net debt of a UK company is less than £3m (including where net debt is negative, i.e. net assets), the company is not included in the determination of UK Net Debt. For example, this means that only the liability side of a stand-alone UK-UK balance is taken into account if the lender was not debt-financed itself. The effect of this is that many groups that might expect to pass the gateway test on a "total UK net debt" basis will in fact fail, as a result of these intra-group balances. (Note that companies which are dormant throughout the relevant period of account will be treated as having a net debt of nil).

Practical implications

Consequently, many groups are looking to minimise UK-UK balances before the first period in which the debt cap rules will apply. However, such exercises should be undertaken in consultation with your tax colleagues as there may be other tax issues to consider and you would also need to bear in mind the targeted anti-avoidance rule ("TAAR") that applies to catch companies that enter into "schemes" in order to pass the gateway test – see below for more details on the TAAR.

Disallowance of deductions and income exemption

If the gateway test is failed, the debt cap needs to be considered. This provides that where the "Tested Expense Amount" exceeds the "Available Amount", the excess (the "Total Disallowed Amount") is applied as a restriction on the group's finance deductions. However, the group's finance income may be exempted up to the level of the disallowance.

For many groups (e.g. wholly UK groups) this will mean there is no net disallowance of deductions; however the compliance burden of the full rules will be significant, so wherever possible it would be expected that groups will generally look to pass the gateway test.

The Available Amount is the gross financing cost in the consolidated financial statements for the period in question, excluding dividends on preference shares accounted for as debt.

The Tested Expense Amount is essentially the total UK tax deductions for net financing costs of those UK companies that have net financing costs of at least £0.5 million. Similar to the gateway test, this means that UK companies with net financing income will not reduce the Tested Expense Amount, so groups with UK-UK balances may find that they have a net disallowance.

If there is a disallowance of deductions, the group is able to exempt financing income up to the lower of the Total Disallowed Amount and the Tested Income Amount. The Tested Income Amount is the net financing income of those UK companies that have net financing income of at least £0.5 million. There is also an exemption for income from EEA-resident group subsidiaries where a tax deduction is denied in the relevant EEA country.

The Available Amount and Tested Expense Amount are closely defined, which could lead to mismatches where a financing cost is included in one but not the other. Areas where complexities could arise include foreign exchange movements on loan balances and fair value movements on both debt and derivatives.

Practical implications

So what do the debt cap rules mean in practice? Financing costs on external UK debt should be deductible, as the impact on the total tax deductions (Tested Expense Amount) should in most cases equal the impact on the accounting cost (Available Amount). Financing costs on external overseas debt essentially provide headroom for UK tax deductions on intra-group debt from overseas group companies.

Although UK-UK intra-group debt can give rise to a disallowance of deductions, there should be an equal exemption of income so these balances should have no net effect.

This means that, in isolation, the debt cap rules might in some circumstances provide an incentive to maintain both debt and cash in the overall group rather than paying down external debt. Commercially, of course, this may be unattractive but nevertheless, it would be wise to consult with your tax colleagues before paying down external debt.

The “foreign profits” rules may also mean that the most tax-efficient way of returning funds from overseas subsidiaries may now be via dividends. Historically, many groups have returned funds via “upstream loans” as the financing cost incurred by the UK parent meant that the UK tax base was decreased rather than the parent suffering additional UK tax on dividends which carried insufficient ‘double tax relief’ (relief for tax suffered locally on the foreign subsidiary’s profits).

An exemption from corporation tax for dividends, introduced as part of the reform package, coupled with the debt cap restrictions which could affect deductions on upstream loans, means that returning funds via dividends may be the most tax efficient route for many groups. However, before paying such dividends, the position should be checked with your tax colleagues to ensure that the exemption applies and there are no other tax inefficiencies.

Exclusions for financial services and certain other companies

Qualifying financial services groups are excluded from the debt cap rules: they do not even need to pass the gateway test. Qualifying financial services groups are those that derive all or substantially all of their UK trading income or worldwide trading income from qualifying activities, which are essentially: lending activities, insurance activities and relevant dealing in financial instruments. The trading income is usually the gross income from qualifying activities, but includes net income where the treatment under GAAP (restricted to IAS when considering the group’s worldwide trading income) is to disclose income net.

This exclusion is certainly very useful for groups that can fall within it; however there is no partial exclusion for financial sub-groups of a non-financial group.

There are special rules for companies with North Sea oil activities or real estate investment trust (“REIT”) ring-fenced businesses, and for tonnage tax companies.

Elections for group treasury companies and short-term debt

The rules permit certain companies to elect that the financing expense and financing income of that company are not taken into account in the full debt cap calculation, if the company meets the definition of a “Group Treasury Company”. For most groups this is unlikely to be advantageous as group financing companies usually make an overall profit on their activities, so excluding this overall profit will reduce a group’s capacity for income exemption. However, in certain circumstances the exemption could assist in reducing the compliance burden (albeit assessing the application of the Group Treasury Company provisions is a burden in itself) and (particularly in multi-national groups) could prevent tax inefficiencies from arising.

Companies can also elect for intra-group short-term debt to be excluded from the full debt cap rules. Again this can help to reduce the group’s tax compliance burden (again subject to the burden of assessing whether the debt constitutes ‘short term debt’ as defined) by excluding, for example, short term UK-UK balances from the scope of the debt cap; it could also be particularly beneficial if the short term debt was between a UK borrower and a non-UK group lender, such that the Tested Expense Amount would be reduced.

Broadly, a short term debt will be one which is required to be settled, or is settled, within 12 months of creation. However, as would be expected, there is anti-avoidance to prevent (for example) what is in substance a long-term debt from being structured as several short term instruments. For some groups it may be worth navigating the detail in order to remove short-term debt from the debt cap calculation; although such a review may be a considerable exercise as it will also require a review of the documentation and terms of these financing arrangements.

Targeted Anti-Avoidance Rules ("TAARs")

There are TAARs within the debt cap rules to prevent the effect of the following:

- Schemes designed to pass the gateway test.
- Schemes designed to reduce a net disallowance under the full rules.
- Schemes designed to reduce income under the EEA exemption.
- A change of consolidated group accounting date to defer the effect of the rules.
- Schemes designed to characterise a long-term debt as short-term debt.

These are all widely drafted and depend on there being a "main purpose" of achieving the stated mischief. The scope of the first three TAARs listed above is narrowed by the permission of certain "excluded schemes" specified in Regulations – at the time of writing these excluded schemes had not been defined. This definition will be critical in ensuring that the TAARs are closely targeted and do not catch wholly commercial arrangements or reorganisations to prevent unintended inefficiencies as a result of the debt cap.

Conclusion

Overall, the introduction of the debt cap rules, and the wider foreign profits reforms, marks a significant shift in the landscape for UK corporation tax and will require treasurers to work with their tax colleagues, to ensure that an optimal balance is achieved for the group between funding and cash considerations on the one hand and tax on the other.

Prior to the introduction of the debt cap many groups will be reviewing their projected position and attempting where possible to pass the gateway test, subject to the TAARs.

Steps that could improve a group's position under the debt cap (subject to the TAARs) may include:

Repaying, or otherwise removing, loans to UK companies from overseas group companies.

- **Reducing UK intra-group loan balances**

Identifying short-term debt and documenting financial arrangements and terms appropriately.

Reorganising to take advantage of the exemption for Group Treasury Companies (although the definition of Group Treasury Company means that it will often be difficult to do so).

Consider whether the exemption for income from EEA resident borrowers could be of use.

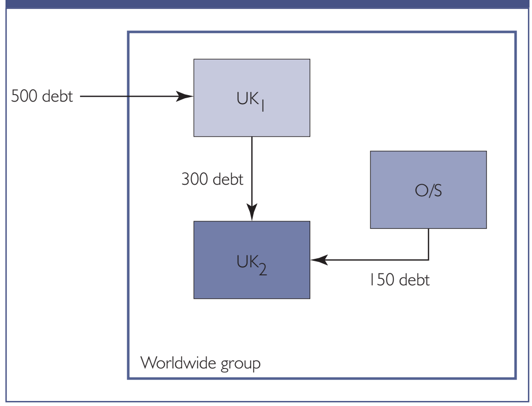
It is recommended that treasurers discuss with their tax colleagues prior to undertaking any actions, including those listed below, in relation to the group's financing position, to assess the relative commercial and tax costs and benefits and to ensure that the group is not disadvantaged overall:

- Raising debt – whether in the UK or overseas.
- Repaying external overseas debt.
- Increasing intra-group debt to UK companies.
- Increasing UK-UK debt.

Examples

These examples illustrate a key outcome of the debt cap rules - that UK intra-group borrowings must be supported

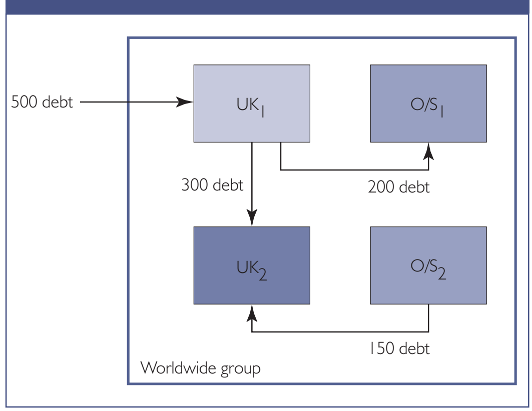
External debt in UK and intra-group overseas debt into UK



by the same level of external debt if the interest on that debt is to be deductible.

The following examples show that the UK financing costs

External debt in UK and intra-group overseas debt into UK & lending from UK



arising on any unsupported intra-group debt into the UK from overseas are not deductible. (The examples assume, for simplicity, that the interest rates attaching to the various debts are equal).

The level of gearing of the UK sub-group means the gateway test is not passed. Under the debt cap rules, interest on an amount equal to the unsupported intra-group overseas debt of 150 is not deductible, as the Tested Expense Amount (financing deductions on UK1's net debt of 200 + UK2's net debt of 450) exceeds the Available Amount (financing deductions on UK1's external debt of 500). The level of gearing of the UK sub-group means the gateway test is not passed. Under the debt cap rules, interest deductions in UK2 are fully available, as UK1's net debt is now zero – the Tested Expense Amount (financing deductions on UK2's net debt of 450) is less than the Available Amount (financing deductions on UK1's external debt of 500).

The level of gearing of the UK sub-group means the gateway test is not passed. Under the debt cap rules, interest on an amount equal to the unsupported intra-group overseas debt of 50 is not deductible.

External debt int overseas is less than intra-group overseas debt into UK