BEPS Action 4

Webinar

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With you today

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BEPS Action 4: Agenda

1. Overview of Action 4 proposals: OECD and UK
2. The UK proposals: Practical implications
3. Financing strategy following Action 4
4. Wrap up and questions

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Overview of Action 4

Action 4 - The (UK) headlines

What do we know?

— £2 million de minimis threshold

— Fixed Ratio Rule (‘FRR’) limits amount of deductible interest to 30% UK Tax EBITDA

— Group Ratio Rule (‘GRR’) – Based on Accounting EBITDA

— No general grandfathering

— Carry forward of disallowed interest expense (indefinitely) and/or unused interest capacity (three years only)

— Public benefit exemption – Limited and unclear focus

What do we still need clarity on?

— Further work underway in relation to FS sector

Action 4 - The bigger picture

	OECD recommendation	EU proposal	UK proposal
De minimis	Optional	€3,000,000	£2,000,000
FRR	Recommended corridor: 10% to 30%	30%	30%
GRR?	Optional	Yes	Yes
Carry forward of disallowed interest expense?	Optional	Yes – Indefinitely	Yes – Indefinitely
Carry forward of unused interest capacity?	Optional	Yes – 5 years	Yes – 3 years
Public Benefit Exemption?	Optional	Yes	Yes
Grandfathering	Silent	Yes	No
Implementation date	Silent	1 January 2024	1 April 2017

The road ahead for the UK - Indicative dates

April 2016
- High level policy consultation: done
- Business tax roadmap: done
- Detailed policy consultation: being drafted

Mid-May 2016
Detailed policy consultation: released 12 May

August 2016
Detailed policy consultation: industry responses due by 4 August

Aug-Nov 2016
Legislation drafting instructions to Parliamentary Counsel

December 2016
Detailed technical consultation: due for release

February 2017
Detailed technical consultation: industry responses due

1 April 2017
- New interest regime starts
- (Final legislation to be included in FB 2017 which will then follow the usual timeline to Royal Assent)

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In more detail: The UK proposal

The UK proposal

The Fixed Rate Ratio – FRR

— Definition of ‘group’: IFRS accounting concept

— 30% cap to be applied to the UK group ‘tax EBITDA’

— UK group: UK entities only

— ‘Tax interest’: Interest on all forms of debt, payments economically equivalent to interest, and expenses incurred in connection with the raising of finance.

— Exchange gains and losses

— Impairment losses

— FRR will apply from 1 April 2017 – Allocation required for accounting periods straddling this date

The UK proposal (cont.)

The Group Ratio Rule – GRR

— Optional

— GRR: Net qualifying group-interest expense to Group Accounting EBITDA

— The GRR is then applied to the Group UK Tax EBITDA

— The interest limit is capped at:

- The net qualifying group-interest expense OR;
- The global net adjusted group interest expense of the group (if the Modified Debt Cap Rule applies);

— The key difference in the calculation of the GRR to the FRR is the use of accounting figures for EBITDA and net qualifying group-interest expense for the worldwide group

— GRR will apply from 1 April 2017 – Allocation required for accounting periods straddling this date

The UK proposal (cont.)

Consideration of other tax rules

— The deductible tax interest will be calculated after the application of existing tax rules, including:

- Transfer pricing rules (the arm's length provision)
- Unallowable purpose rules
- Anti-hybrid rules
- Group mismatch rules and
- Distribution rules

— There is also a provision to account for the R&D and patent box tax regimes

The UK proposal (cont.)

The Modified Debt Cap Rule – MDCR

- Must be considered, unless de minimis threshold applies
- Restricts the group’s net UK tax-interest amounts (third party and related party) such that it cannot exceed the global net adjusted group-interest expense (third party and related party)
- Replaces the existing worldwide debt cap (‘WWDC’) legislation
- MDCR applies to accounting periods commencing on or after 1 April 2017 (i.e. NO allocation required for accounting periods straddling this date)

Timing example - December year end

1 April 2017

2017

Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec

Arm's length principle

Arm's length principle only | Apply FRR (compulsory) and GRR (if required)

Apply WWDC

For a December year end, 2017 would have to be treated as a split period with the current rules applying until 31 March 2017 and the new rules applying from 1 April 2017

2018

Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec

Arm's length principle

Apply FRR (compulsory) and GRR (if required)

Apply MDCR

The MDCR applies from periods *beginning on or after 1 April 2017,* so would apply to a December year end from 1 January 2018. The FRR and GRR will also apply for the whole of 2018.

The UK proposal

Public benefit project exemption – PBPE

— Excludes eligible projects from the rules

— Conditions for eligibility:

- Provide a benefit to the public under government policy
- Contractual obligation
- Minimum duration of 10 years (or a shorter rolling term which both the operator and the public body have the expectation of continuing indefinitely)
- All the project revenues are subject to UK corporation tax
- At least 80% of gross revenue generated from the project assets over the lifetime of the project is expected to arise from the provision of public benefit services

— A lot of uncertainty and lack of clarity on this key area of the consultation.

The UK proposal (cont.)

Specific industry considerations:

— Financial services – Banking and insurance activities

— Oil and gas

— Securitisation companies

— Authorised investment funds including tax elected funds

— Investment trust companies

— Collective investment vehicles

— Real estate sector

Tax deductibility of corporate interest expense - An update

— **£100 million UK tax EBITDA and £40 million UK net interest expense (£30 million third party and £10 million related party, assume all arm's length)**

— **£200 million group accounting EBITDA, £70 million group third party net interest expense (assumed all qualifying) and, global net adjusted group interest expense of £90 million**

Step 1 – Apply arm's length rules

Step 2 – Identify the UK Group

Step 3 – Is the arm's length net interest expense > £2 million? **£40 million**

No: No further analysis is required under new rules

Yes:

Step 4 – **Apply FRR –** 30% of UK Group tax EBITDA
£100m x 30%= £30m – All £10m related party interest would be disallowed

Step 5 – Is the arm's length net interest expense >30% of UK Group tax EBITDA?
Yes £40m > £30m

No: go to Step 7

Yes:

Step 6 – Apply optional GRR – Net qualifying group interest expense/Group EBITDA. Is this >30%?
GRR = £70m/£200m = 35% >30%

No: Interest relief is restricted to 30% of UK Group tax EBITDA subject to the MDCR and £2 million

Yes: Interest relief is restricted to the GRR subject to MDCR and the £2 million
35% x £100m = £35m

Step 7[*] – Apply the MDCR: Is group's UK net tax-interest amounts greater than the global net adjusted group-interest expense? **£35m < £90m**

No: Interest relief available – Higher of FRR or GRR with an absolute floor of £2 million, **£35 million**

Yes: Further restrict to the global net adjusted group-interest expense with an absolute floor of £2 million

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Practical considerations

The Group Ratio Rule ('GRR')

- The GRR is intended to provide relief for interest in excess of 30% of tax EBITDA where the wider Group is more highly leveraged with third party debt
- However, the benefit of the GRR is only realised to the extent that the Group's third party interest expense is 'matched' to where EBITDA arises
- Group's that raise third party debt finance in the UK based on the EBITDA of the whole Group and do not push that debt to overseas entities will not realise a benefit

Application of the GRR		
Fixed Ratio Rule ('FRR')	**Example 1**	**Example 2**
UK Tax EBITDA	290	150
Net interest expense	100	100
Fixed ratio cap (30% x EBITDA)	87	45
Interest allowed in period (FRR)	**87**	**45**
Interest disallowed in period (FRR)	13	55
Group Ratio Rule ('GRR')	**Example 1**	**Example 2**
Group Accounting EBITDA	300	500
Net interest expense	100	100
Group external interest: Accounting EBITDA ratio	33%	20%
Group ratio cap (GRR x UK Tax EBITDA)	96.7	30
Interest allowed in period (GRR)	**96.7**	**30**
Interest disallowed in period (GRR)	3.3	70

Tax versus Accounting definitions

- One of the intentions of the GRR was to ensure UK only Groups can still claim full relief for their third party interest expense
- However, application of Tax EBITDA and Accounting EBITDA will create timing mismatches
- Whilst these may be expected to reverse over time. Differences on initial adoption of the rules and the carry forward restrictions may mean this is not the case
- This could be resolved by allowing UK only Groups to elect to apply Tax EBITDA for the purposes of both the FRR and GRR tests

Tax EBITDA versus Accounting EBITDA		
Fixed Ratio Rule ('FRR')	**Example 1**	**Example 2**
UK Tax EBITDA	200	250
Net interest expense	100	100
Fixed ratio cap (30% x EBITDA)	60	75
Interest allowed in period (FRR)	**60**	**75**
Interest disallowed in period (FRR)	40	25
Group Ratio Rule ('GRR')	**Example 1**	**Example 2**
Group Accounting EBITDA	250	200
Net interest expense	100	100
Group external interest: Accounting EBITDA ratio	40%	50%
Group ratio cap (GRR x UK Tax EBITDA)	80	125
Interest allowed in period (GRR)	**80**	**100**
Interest disallowed in period (GRR)	20	-
Interest carried forward	20	-
Excess capacity carried forward	-	25[(a)]

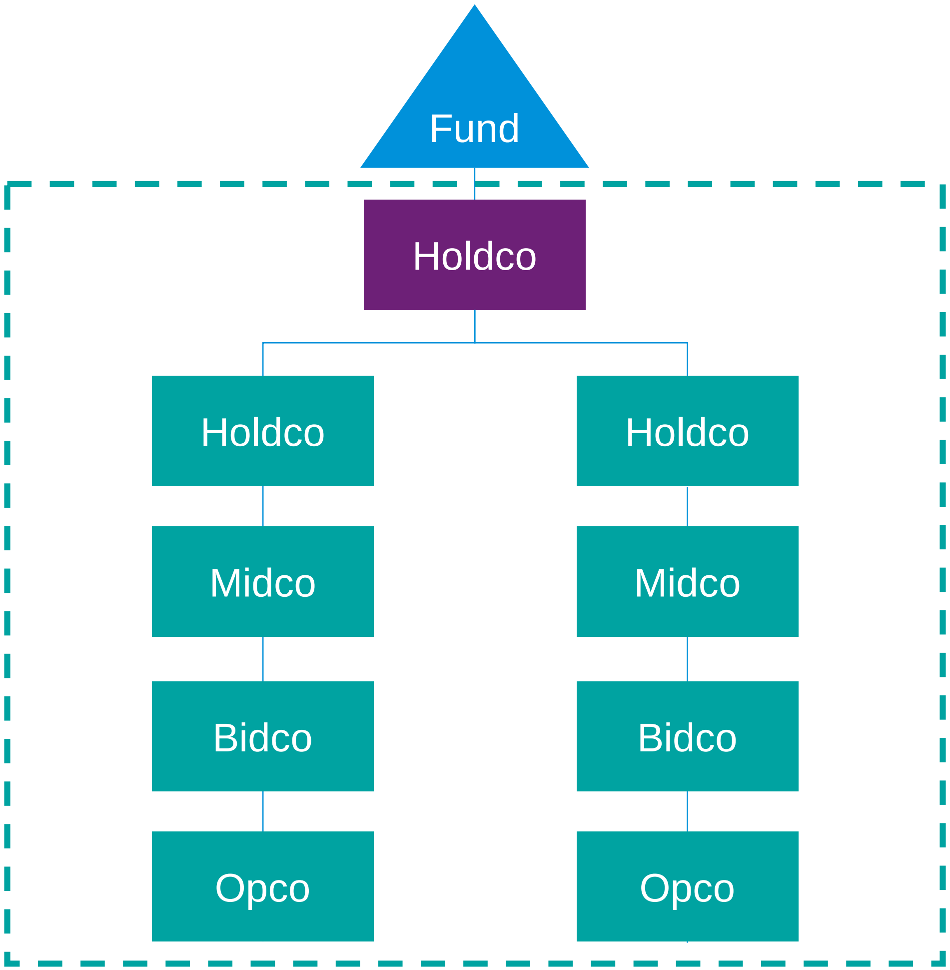
Note: (a) Excess capacity can only be carried forward three years.

Convertible loans

- Per the consultation the financing charge arising on convertible loans is excluded when calculating the GRR as 'not interest'
- However, under current UK rules where the convertible loan note has been issued to a third party a deduction would be available
- If tax EBITDA is the same as the group EBITDA then the exclusion of the finance charge arising from the convertible loan notes from the Group Ratio percentage would give rise to a disallowance in a group which only operates in the UK
- HMRC have encouraged representations on this

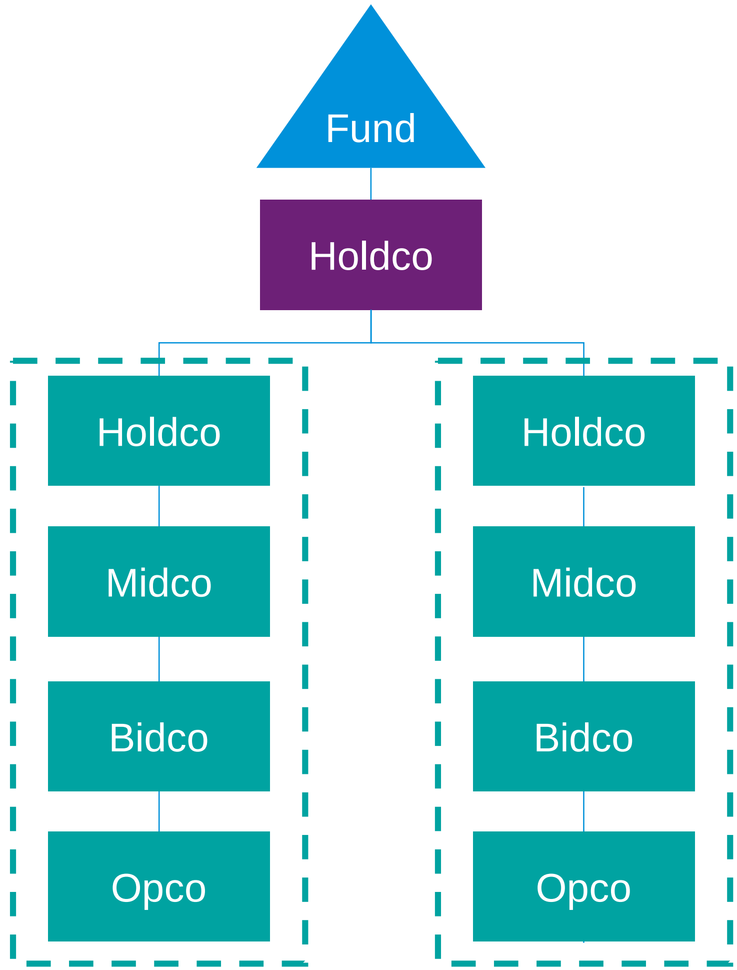
Convertible loans	
Fixed Ratio Rule ('FRR')	**£**
UK Tax EBITDA	250
Third party interest cost	100
Finance charge on third party convertible note	50
Net interest expense	**150**
Fixed ratio cap (30% x EBITDA)	75
Interest allowed in period (FRR)	**75**
Interest disallowed in period (FRR)	75
Group Ratio Rule ('GRR')	**£**
Group Accounting EBITDA	250
Third party interest cost	100
Finance charge on third party convertible note	-
Net interest expense	**100**
Group external interest: Accounting EBITDA ratio	40%
Group ratio cap (GRR x UK Tax EBITDA)	100
Interest allowed in period (GRR)	**100**
Interest disallowed in period (GRR)	50

Different levels of consolidation



No fair value accounting at Holdco level – 1 Group

Different levels of consolidation (cont.)



Fair value accounting at Holdco level – 2 separate Groups

Transitional adjustments

- When new GAAP accounting standards are adopted, transitional difference does not show up in the profit and losses account post transition. However, the tax rules pick up that transitional adjustment and, in certain circumstances, spread this over 10 years.
- Under the current proposals the amount which is being spread will be included in tax-interest but will not be included in the total group-interest (added back to arrive at group EBITDA), qualifying group interest (numerator in calculating the group ratio) and the adjusted group interest (relevant for modified debt cap).
- One answer would be to exclude the spreading amount from tax-interest because it does not originate in or relate to a period when the new rules apply.

Transitional adjustments	
Fixed Ratio Rule ('FRR')	**£**
UK Tax EBITDA	250
Third party interest cost	100
Transitional adjustment (100 spread over 10 years)	10
Net interest expense	**110**
Fixed ratio cap (30% x EBITDA)	75
Interest allowed in period (FRR)	**75**
Interest disallowed in period (FRR)	35
Group Ratio Rule ('GRR')	**£**
Group Accounting EBITDA	250
Third party interest cost	100
Transitional adjustment (nil for purposes of arriving at total group interest))	-
Net interest expense	**100**
Group external interest: Accounting EBITDA ratio	40%
Group ratio cap (GRR x UK Tax EBITDA)	100
Interest allowed in period (GRR)	**100**
Interest disallowed in period (GRR)	10

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Financing strategy following Action 4

Financing strategy following Action 4

Option 1 – Transfer pricing and Value Chain Analysis

- **A**: Revisit existing transfer pricing policies
- **B**: Reassess the Group's Value Chain

Outcome:

Potential increase in EBITDA in the UK which will increase interest deductions

Option 2 – Debt restructure

- Evaluate the opportunity to restructuring debt in the Group to align with economic activity

Outcome:

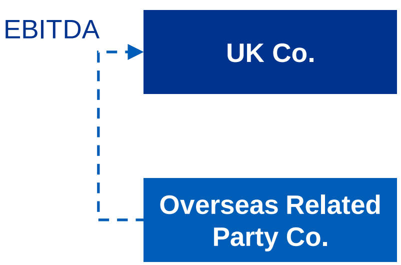
To maximise interest deductions in the UK and overseas

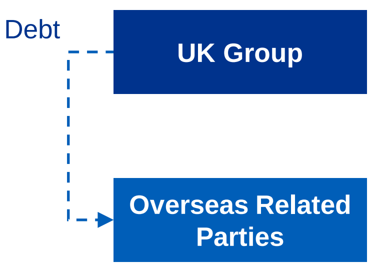
Option 3 – Refinancing

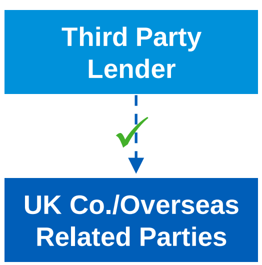
- Refinance related party debt with bank debt; or
- Increase overseas related parties' bank borrowings; or
- Reduce the interest rate on related party debt borrowed.

Outcome:

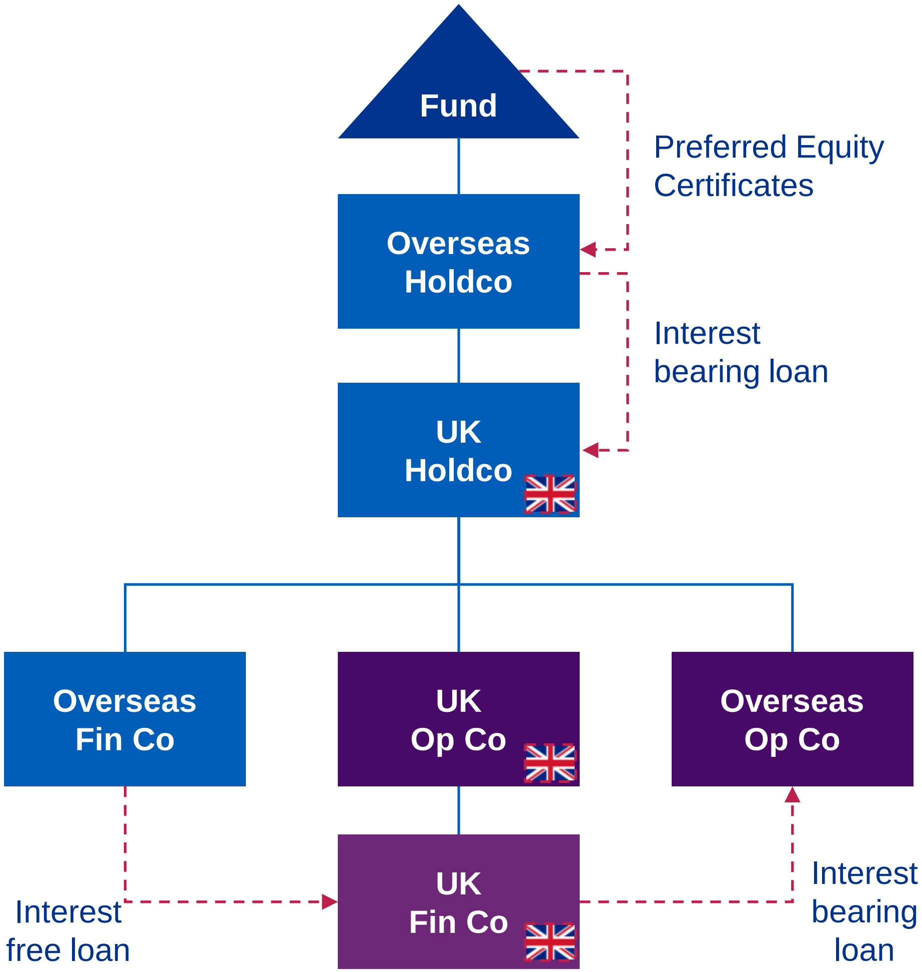
Potential benefit from further interest deductions from the GRR/less cash interest payments where reduction in interest rates





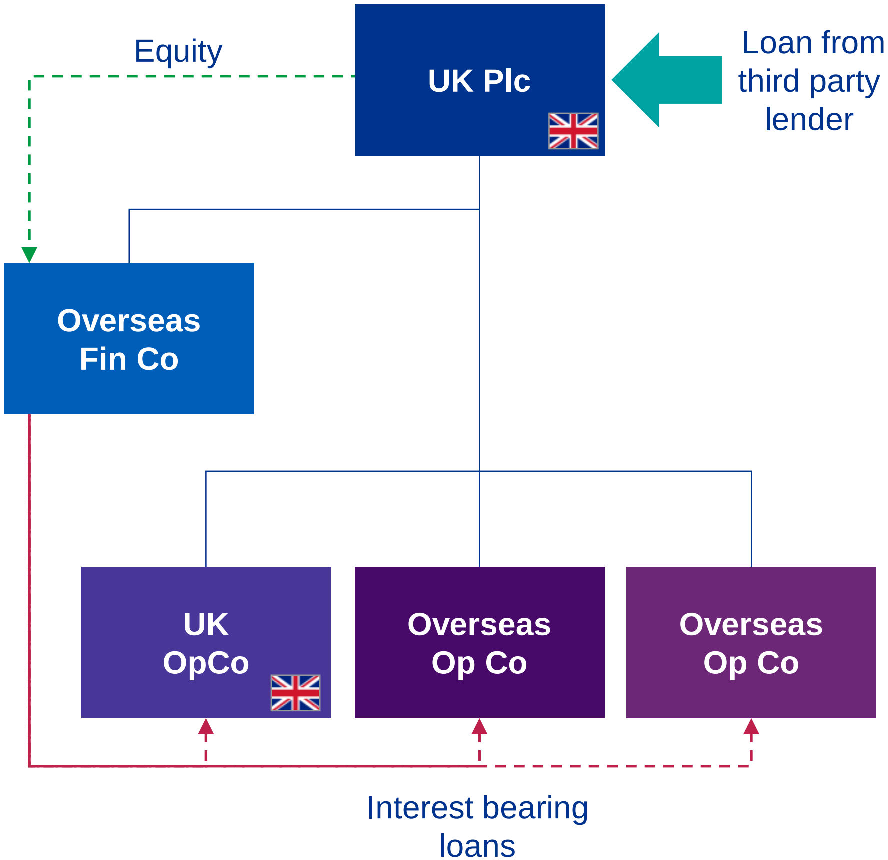


Impact on a typical inbound financing structure



- Action 2: Hybrid Mismatches
- Action 3: Effective CFC rules
- Action 4: Interest deductibility
- Action 6: Treaty abuse
- Action 8-10: Aligning Transfer Pricing Outcomes with Value Creation
- Action 13: Transfer Pricing Documentation and Country-by-Country Reporting

Impact on a typical outbound financing structure



- Action 3: Effective CFC rules
- Action 4: Interest deductibility
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- Action 8-10: Aligning Transfer Pricing Outcomes with Value Creation
- Action 13: Transfer Pricing Documentation and Country-by-Country Reporting

Conclusion...

Next steps

Understand the impact for your business

— Quantify the impact

— Identify any unexpected implications

Communicate with your stakeholders

— Within the business – e.g. Finance, Treasury and Board level

— Externally – Consider commentary in Annual Report/other communications

Respond to the Consultation document

— By 4 August 2016

— HMRC particularly interested in ‘real life’ examples

Consider options for refinancing

Thank you

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