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BEPS and Infrastructure

How borrowers can manage the new tax rules

Highly geared infrastructure companies may face higher tax charges as a result of the new Corporate Interest Restriction rules coming into force on 1 April 2017. This note sets out how KPMG's tax specialists can help companies work through and understand the impact of the changes.

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Background

For several years the OECD's Base Erosion and Profit Shifting (BEPS) project has been looking at how to prevent cross-border tax avoidance by multi-national groups of companies.

One of the OECD's main recommendations ('Action 4'), concerns the perceived excessive deduction of interest by highly-geared companies. The UK Government has resolved to adopt the recommendation and after several rounds of consultation has now published draft Corporate Interest Restriction ('CIR') legislation in Finance Bill 2017.

This will impose new limits on the amount of interest a company can claim as deductible, with effect from 1 April 2017. This will be in addition to the transfer pricing and thin capitalisation legislation, which remains in place.

A summary of the new rules follows, below.

How can KPMG help?

KPMG's Infrastructure Tax team, headed by Naz Klendjian, has managed the process by which The Infrastructure Forum has collated representations from within the infrastructure community, and made HM Treasury and HMRC aware of the consequences of the new legislation for infrastructure investment in the UK. We have a deep understanding of the new rules and are already advising clients on details.

We can support infrastructure investors to:

— Determine the most optimal of the three methods available to claim interest relief (the Fixed Ratio Rule (30% rule), the 'Group Ratio Rule' or the Public Benefit Infrastructure Exemption (see below).

— Establish whether project companies qualify for the Public Benefit Infrastructure Exemption, and whether it would be beneficial to elect for it to apply, and what permissible restructuring may be necessary to qualify.

— See whether interest on pre-May 2016 loans from shareholders for Public Benefit Infrastructure is exempted ('grandfathered') from the new legislation (and what permissible restructuring may be necessary).

— Apply for non-statutory business clearances from HMRC on specific fact patterns.

— Keep in contact with industry bodies, who are feeding comments to HMRC as the Finance Bill 2017 may be amended before it is finalised.

— Advise on the detail of the financing documents and guarantee arrangements for new investments and loans.

What are the main features of the new CIR rules?

The Fixed Ratio Rule (FRR) will limit the amount of deductible interest to 30% of EBITDA.

This simple rule is then supplemented by a raft of detailed rules. In brief:

— De minimis exemption – for all groups of companies, the first £2 million of interest is always deductible.

— Group Ratio Rule – this should enable a group of companies with a large amount of interest payable to banks and other unconnected lenders to treat all that external interest as deductible. It will not be possible for a group of companies to obtain tax relief for more interest than the amount of the net interest expense in the group accounts.

— Public Benefit Infrastructure Exemption – PPP, infrastructure and other 'public benefit' companies should be able to treat third party interest as deductible.

— Public benefit infrastructure – 'grandfathering' – interest on existing loans, including connected party loans, will likely remain deductible where at least 80% of revenues are "highly predictable" and derive from a public contract (which should cover many publicly 'auctioned' asset classes such as PPPs, OFTOs and CfDs, but not all companies covered by the Public Benefit Infrastructure Exemption).

— Interest above the deductible limits can be carried forward indefinitely to future periods, where there might be capacity.

— Where there is more interest capacity than there is interest, the excess capacity can be carried forward for up to five years.

Some terms

The final draft legislation uses an IFRS accounting definition of 'group'.

Interest is broadly anything accounted for as interest, e.g. finance lease interest. The rules will apply to the net interest expense in the accounts after the application of all other UK legislation that may restrict interest relief (e.g. transfer pricing).

EBITDA is earnings before interest, tax, depreciation and amortisation. The fixed ratio rule will apply to 'tax-EBITDA', which is accounting EBITDA adjusted for non-taxable and non-deductible items.

Third party debt does not generally include a loan from a shareholder, even a minority shareholder where there is a consortium of investors.

Public Benefit Infrastructure Exemption

There will be a Public Benefit Infrastructure Exemption (PBIE) for companies falling within the definition of 'qualifying infrastructure companies'. A qualifying company must elect into the PBIE. The election is irrevocable for five years. Companies would need to consider whether the election was beneficial.

To qualify, a company must satisfy tests on the nature of the infrastructure and the income earned from it.

Public benefit infrastructure includes utilities, oil & gas, transport assets, and health, education and waste treatment facilities, as well as buildings let (or sub-let) to non-related parties (under a lease of 50 years or less).

To qualify as public benefit infrastructure, an asset must either be provided to a public authority, or its use must be regulated by an 'infrastructure authority' (of which the legislation contains a long list).

HMRC recognise that some groups may need to reorganise certain aspects of their holding structures in order to access the exemption as intended. There are also rules for infrastructure investments held through joint ventures.

There will be a one-year transitional rule, so that any restructuring would not need to be rushed through.

How does the Public Benefit Infrastructure Exemption help?

Under the PBIE, a qualifying infrastructure company's interest payable to unrelated parties is treated as outside the scope of the CIR rules. This exemption would not generally apply to loans from shareholders, though a loan from a shareholder can be 'unrelated' if 50% of the same class of debt is held by non-shareholders.

For most Private Finance Initiative (PFI) and similar companies with publicly procured / sponsored revenue streams, interest on all loans made before 13 May 2016 will be outside the scope of the CIR rules, even loans from shareholders.

The PBIE should provide infrastructure lenders with greater certainty, and enable them to rely on the long-term tax assumptions at the outset of a public infrastructure investment.

What isn't covered by the PBIE?

For infrastructure companies which are not PFI companies, there may still be restrictions on the tax relief available for interest on loans from shareholders and certain types of guarantees may need to be reviewed going forwards to ensure they do not taint the 3rd party debt.

For PFI and similar companies, loans from shareholders made after 12 May 2016 are not covered by the PBIE.

What about companies owned by Government or charities?

If a company is owned by a charity, and borrows from that charity, then the CIR legislation should not apply to restrict the company's tax relief on interest on the loan from the charity.

If a company is owned by a Government department, or by a local authority or an NHS Trust, it is intended that the CIR legislation will not apply to restrict the company's tax relief on interest on the loan from the parent public sector body provided realising of profit is merely incidental to the making of the loan by the public sector body.

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