

Practice guide

How to handle the new corporate interest restriction

Speed read

The new corporate interest restriction (CIR) regime, which is expected to be enacted retrospectively with effect from 1 April 2017, represents a significant restriction on groups' ability to obtain UK tax relief for finance costs. It also poses significant practical challenges for UK groups, including in terms of: determining the scope of the CIR worldwide group; gathering and 'cleansing' all the data required in order to perform CIR calculations; making strategic decisions regarding elections, allocations and restructurings; and determining the impact on financial statements and tax instalments.



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Following the endorsement of the BEPS package of measures by G20 leaders and the OECD in 2015, the final updated Action 4 report (limiting base erosion involving interest deductions and other financial payments) was finalised in December 2016.

After a period of consultation, the government announced on 13 July 2017 that it intends to enact the new corporate interest restriction (CIR) regime in a Finance Bill after Parliament's summer recess, with a commencement date of 1 April 2017. This article is based on the draft Finance Bill legislation published on 8 September 2017 and the draft HMRC guidance published on 4 August 2017.

The CIR regime, which will also replace and extend the existing worldwide debt cap rules, introduces a complex overlay to the UK corporate tax code applicable to financing transactions. It also imposes a significant restriction on groups' ability to obtain UK tax relief for finance costs, which the government estimated (in December 2016) will yield almost £4bn of tax revenues over a four year period.

In particular, the CIR regime undermines the long-held assumptions that interest costs are deductible on plain vanilla (i) third party loans, and (ii) arm's length related party loans.

Overview of the CIR regime: the five key steps

Broadly speaking, there are five key steps required under the CIR regime:

1. **Determine the worldwide group, etc:** The CIR rules apply at the level of a 'worldwide group'. The first step is therefore to determine:
 - the scope of the worldwide group (and the UK corporation tax-paying companies within it);
 - the financial statements that are to be used by the group for CIR purposes; and
 - the group's period of account over which the CIR calculations are to be performed.
2. **Calculate the group's ANTIE:** The next step is to calculate the group's 'aggregate net tax-interest expense' (ANTIE) for the period of account, which is potentially susceptible to being disallowed for tax purposes under the CIR regime.
3. **Calculate the CIR disallowance (or reactivation):** The next step is to calculate how much of the group's ANTIE must be disallowed by the CIR rules. If the group's ANTIE is less than £2m (on an annualised basis), none of it will be disallowed. If the group's ANTIE is more than £2m, the amount to be disallowed will either be determined under the basic 'fixed ratio method' or an alternative 'group ratio method' if an election is made. In certain circumstances, it may also be possible for a group to 'reactivate' interest that has previously been disallowed. The core calculations required to determine the group's 'total disallowed amount' or 'interest reactivation cap' are summarised in figure 1.
4. **Allocate the disallowance:** Having calculated the total amount that must be disallowed (or reactivated) by the group, the next step is to allocate this disallowance (or reactivation) within the group; i.e. decide which corporation tax-paying companies in the group will have to disallow (or reactivate) relief for tax-interest expenses in their tax computations.
5. **Comply with administrative rules:** Finally, at least where the group expects to suffer a restriction under CIR, it will be necessary for the group to appoint a 'reporting company', file a special CIR 'interest restriction return' and comply with other administrative requirements.

Inputs derived from UK tax computations

Term	Meaning	Overview
ANTIE	Aggregate net tax-interest expense	The group's aggregate net deductible expense for UK tax purposes in respect of loans, derivatives and certain other finance transactions, subject to exclusions (e.g. in respect of foreign exchange movements, impairments and derivatives hedging trading risks unrelated to the capital structure).
ANTII	Aggregate net tax-interest income	Where the group has aggregate net taxable income (rather than a net deductible expense) in respect of the above matters.
Aggregate tax-EBITDA	Aggregate tax-EBITDA	The group's aggregate net taxable earnings for UK tax purposes, before taking into account tax-interest, tax depreciation (i.e. capital allowances and relief for capital expenditure on intangibles) and qualifying tax reliefs.

Inputs derived from group financial statements

Term	Meaning	Overview
NGIE	Net group-interest expense	The net finance cost recognised in P&L in the group's financial statements in respect of loans and other specified finance transactions.
ANGIE	Adjusted net group-interest expense	NGIE, but adjusted to align with UK tax principles in certain respects (e.g. excluding preference shares accounted for as a financial liability, which are non-deductible for UK tax).
QNGIE	Qualifying net group-interest expense	ANGIE, but stripping out expenses relating to transactions with related parties, results-dependent securities and equity notes.
Group-EBITDA	Group-EBITDA	Based on the group's overall profit before tax in its financial statements, before taking account of interest-like amounts and relief for capital expenditure, and subject to various adjustments.

Examples 1 and 2 provide high level examples illustrating the way that the CIR rules work.

The CIR regime undermines the long-held assumptions that interest costs are deductible on plain vanilla third party and arm's length related party loans

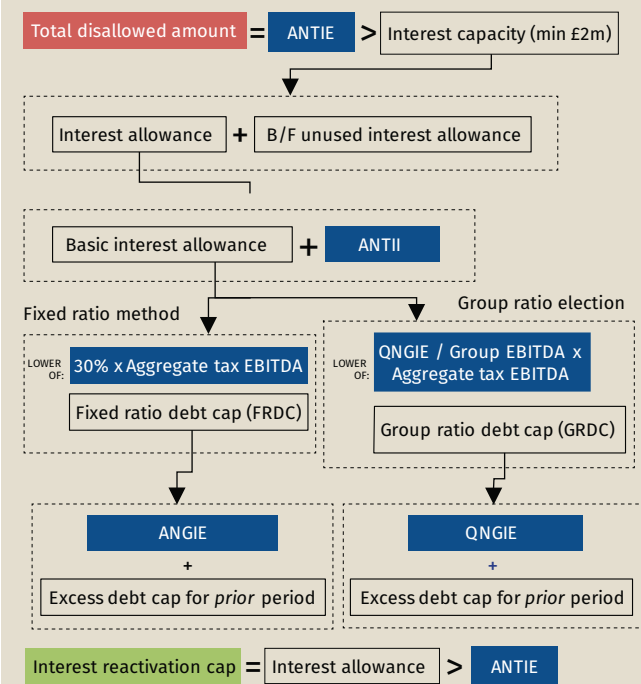
Determining the scope of the CIR group

A CIR 'worldwide group' is defined as an 'ultimate parent' and its 'consolidated subsidiaries'. Broadly speaking, this is determined by applying IAS principles, but subject to various overriding rules, one of which is that an entity may only qualify as an 'ultimate parent' if it is: (i) a company; or (ii) a non-corporate entity whose shares/interests are listed on a recognised stock exchange and are sufficiently widely held.

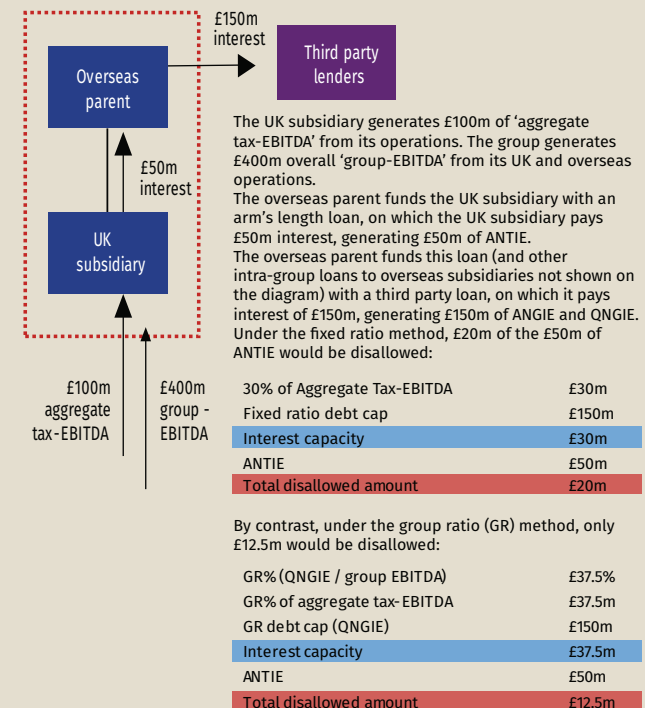
The following practical points flow from this:

- Determining whether particular entities do or don't form part of a wider CIR group can have a profound impact not only on the amount of interest costs that are potentially disallowed under the CIR regime, but on the extent to which the companies have control over the overall CIR process. If a particular sub-group forms its own self-standing worldwide group for CIR purposes, it will compute its interest disallowance by reference to its own interest and EBITDA metrics and will have sole autonomy over allocating any resulting disallowances or reactivations of interest within its sub-group. By contrast, if the sub-group forms part of a wider worldwide group, any disallowances or reactivations it suffers/enjoys may be determined by a reporting company elsewhere in the wider group.
- Two sub-groups in a very similar commercial position might end up in one scenario or the other, based on very fine points of difference in the precise ownership structure and IAS accounting analysis. (See example 3 which illustrates this.) The potential CIR implications

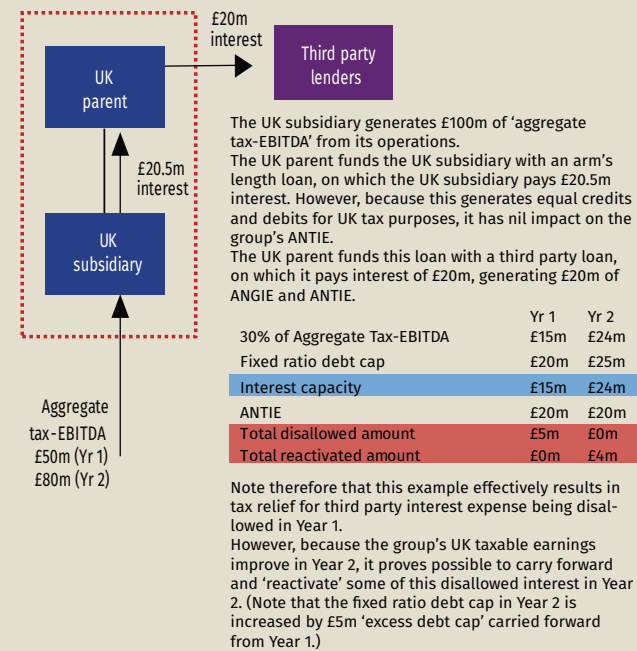
Figure 1: Overview of the core CIR calculations



Example 1: Fixed and group ratio methods



Note that: (i) if the overseas parent was wholly equity-funded (with no external debt), its ANGIE and QNGIE would be £zero and all but £2m of the £50m of ANTIE would be disallowed; (ii) if the UK subsidiary was a holding company, which simply earned £100m of exempt dividends, the group's 'aggregate tax-EBITDA' would be £zero and all but £2m of the £50m of ANTIE would be disallowed; and (iii) if all £150m of the group's external borrowing derived from related party lenders, QNGIE would be £zero and it would therefore not be worthwhile making a group ratio election.

Example 2: Disallowance and reactivation

should therefore be considered when analysing new ownership structures.

- Note that although the basic CIR rules operate by reference to the results of members of the worldwide group, the rules also contain elections that can effectively allow CIR groups to either:
 - proportionately consolidate interests in non-consolidated entities; or
 - de-consolidate interests in consolidated partnerships, for CIR purposes. This can lead to some potential blurring of lines, in terms of the way the CIR calculations apply to the group once it has been identified.

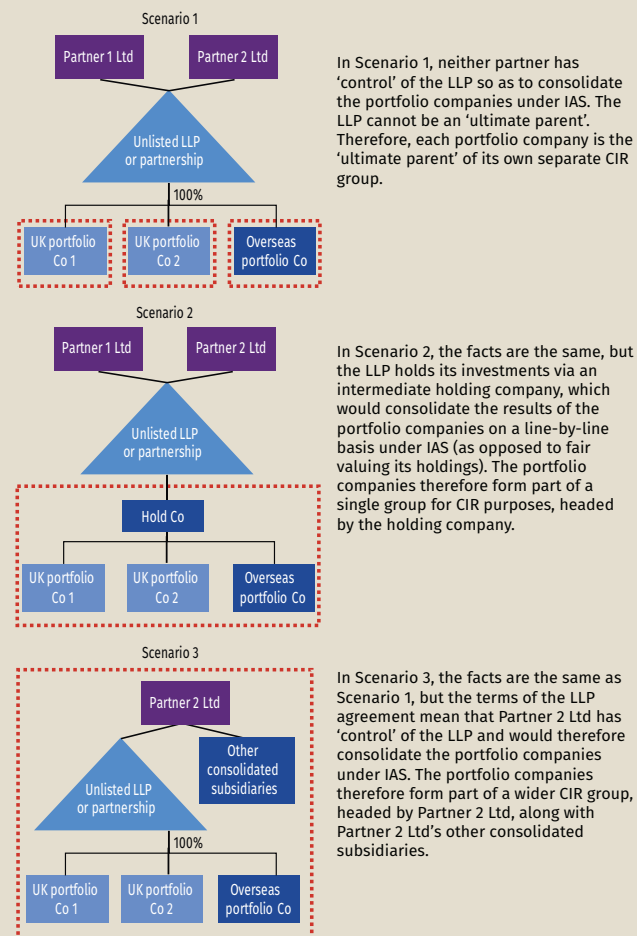
Determining whether particular entities do or don't form part of a wider CIR group can have a profound impact on the amount of interest costs potentially disallowed under CIR

Gathering and 'cleansing' data required to perform the CIR calculations

Having identified the scope of the worldwide group, one of the key challenges that all groups will face is gathering and 'cleansing' all the data required in order to calculate the 'UK tax inputs' (i.e. the group's ANTE and aggregate tax-EBITDA) and 'group accounts inputs' (i.e. ANGLE, QNGIE and group-EBITDA), which are required in order to perform the CIR calculations.

Performing this exercise is likely to give rise to many practical and technical issues, for example, in connection with:

- coordinating the gathering of (what is often 'non-standard') information from (what may often be) semi-autonomous sub-groups;
- identifying specific amounts required to be extracted from tax computations or group accounts, in circumstances where the computations or accounts may categorise items in a way that is different to the categorisation applied for CIR purposes. Groups need to prepare for the fact that this will not simply involve 'lifting and shifting' relevant amounts from the computations and accounts, but will require a significant amount of analysis by a tax professional in order to 'cleanse' the data to ensure the correct amounts are being used for CIR purposes; and
- adjusting the basic amounts extracted from the tax computations or group accounts to reflect the detailed technical adjustments required by the CIR rules. For example, where derivative contracts are accounted for at fair value in the group accounts and are acting as a hedge on a group basis, then the figures extracted from the group accounts for the purposes of calculating the 'group accounts inputs' *must* be adjusted to reflect the amounts that would be recognised (on an authorised accrual basis) if the UK tax disregard regulations (SI 2004/3256) were to apply. Where a group has a large number of derivative contracts in different jurisdictions, this is likely to represent a significant compliance burden in itself (in terms of identifying what derivatives are in place, how they are accounted for in the group accounts, whether they meet the relevant conditions to be subjected to the disregards regulations override and, if so, the impact of re-computing amounts in respect of them on an authorised accruals basis).

Example 3: CIR grouping

Determining whether debt is treated as 'related party' debt

Given that finance amounts arising from related party transactions are excluded in calculating QNGIE (see above), it will be crucial for groups to determine to what extent any counterparties to the group's financing transactions qualify as 'related parties'.

Broadly speaking, the CIR rules provide that two parties will be 'related' where:

- their financial results would be consolidated under the Companies Act 2006 test;
- one person participates in the management, control or capital of the other (or a third person participates in the management, control or capital of both persons); or
- one person has a 25% investment in the other (or a third person has a 25% investment in both of them).

Complicated definitions will need to be worked through in order to apply each of these tests. It may also be necessary to amalgamate rights of connected persons and partners when applying the '25% investment test'. (This is likely to result in investors in an unlisted partnership holding vehicle being treated as 'related' to the underlying CIR group in many cases, even if they would otherwise not qualify as such under the three basic tests outlined above.)

Furthermore, the rules also contain:

- certain deeming rules that can deem loans to be related party loans where they otherwise would not be. For example, in certain scenarios, where:
 - a third party loan is guaranteed by a related party of the borrower (see example 4); or
 - shareholders that would otherwise not qualify as related parties lend to the group pro rata to their shareholdings;
- then interest costs on the relevant loan can be deemed to be related party interest costs (so they are excluded in calculating the group's QNGIE); and
- certain exceptions that can treat loans as not being related party loans where they otherwise would be, for example, in certain scenarios where:
 - a third party lender only becomes related as a result of a partial debt-for-equity swap forming part of a 'corporate rescue'; or
 - shareholders qualifying as related parties take up part of a syndicated debt issue on the same terms as third party lenders.

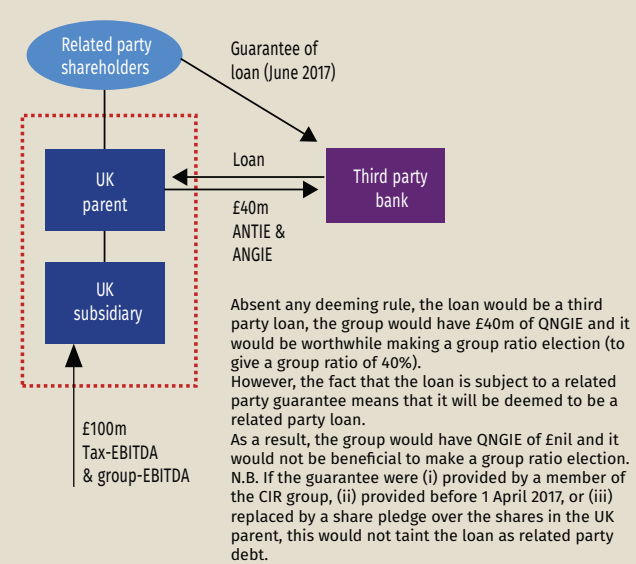
Groups will need to take great care to properly determine the status of lenders and borrowers in light of the above rules, and consider to what extent it might be beneficial to restructure the way that the group finances its activities going forward. The combination of the extensive attribution rules and the special deeming provision for shareholder loans is likely to mean that most shareholder debt is treated as 'related party' debt for purposes of the CIR regime. This is likely to incentivise highly geared groups to consider refinancing shareholder debt with third party debt or equity.

Mismatches in calculation of UK and group inputs, carry forwards and elections

Where there is a mismatch between the way any particular interest-like expense item is recognised for the purposes of UK tax and in the group accounts, this can lead to a disproportionate disallowance of interest under the CIR rules.

To the extent any mismatch is just a timing one, it might get smoothed out over a number of years via the ability to carry forward: (i) disallowed interest and excess debt cap

Example 4: Related parties



indefinitely; and (ii) excess interest allowance for up to five years (subject to various exceptions).

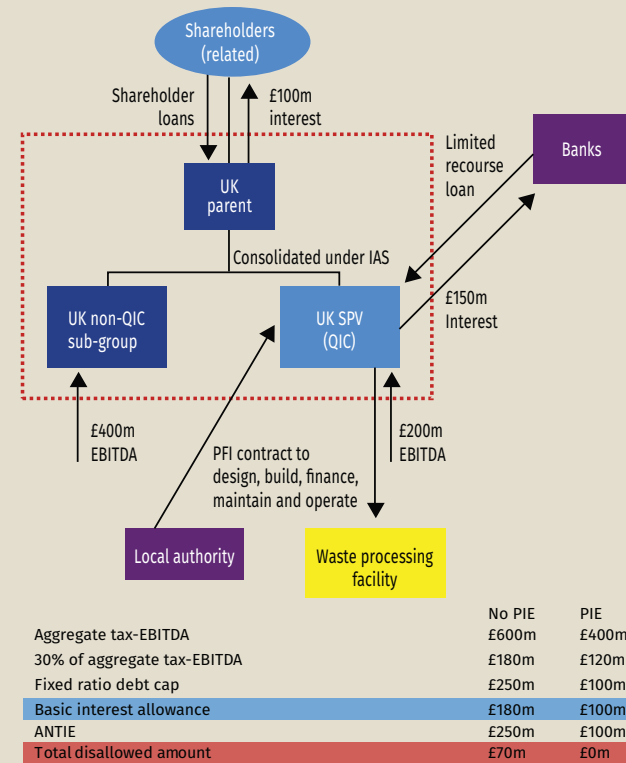
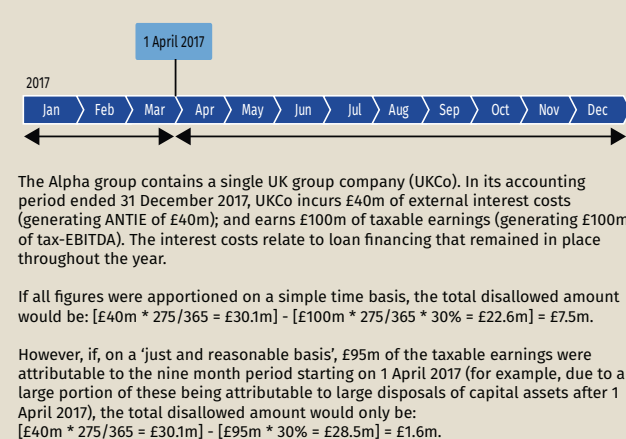
However, some mismatches might be permanent (as opposed to simply timing mismatches); some timing mismatches might not be cured by the carry forward rules (e.g. where the mismatch extends beyond the five year carry forward period for excess interest allowance); and some timing mismatches might essentially be rendered permanent for CIR purposes, e.g. by virtue of the relevant interest expense being recognised in the group accounts before the CIR rules commence but for UK tax purposes after the CIR rules commence.

The government has listened to representations regarding a number of potential scenarios where mismatches may arise. It has responded by introducing various provisions in the draft rules allowing certain mismatches to be 'fixed' by the group (or relevant UK companies in the group) making an election. (For example, the 'interest allowance (alternative calculation) election' allows the group to align the calculations of amounts recognised in the group accounts in respect of capitalised interest, employer pension contributions, employee share schemes and changes in accounting policy with the way these items are recognised for UK tax purposes.)

Furthermore, the CIR rules contain various other elections that might mitigate the quantum of any disallowance of interest costs. (For example, the group ratio (blended) election can allow a group to access a higher group ratio percentage by 'piggy-backing' off its investors' group ratios.)

Companies involved in the provision of qualifying public infrastructure or the short-term letting of property will also want to consider whether to elect into the special 'public infrastructure' regime. This, broadly speaking, allows such companies' interest expenses on limited recourse third party debt (and some limited grandfathered related party debt) to be excluded in calculating the group's ANTIE (and ANGIE/QNGIE) at the cost of its interest income amounts and EBITDA being disregarded in calculating the group's ANTIE, aggregate tax-EBITDA and group-EBITDA. (See example 5, overleaf, for an illustration of how this may be beneficial to a group.)

In total, there are over 15 different elections within the

Example 5: Public infrastructure exemption**Example 6: Apportionment**

CIR regime, all with their own detailed conditions and operative effect. Some of these elections can be altered period by period, some are irrevocable and others can only be revoked after a specific period. Failure to consider these in detail could result in a group suffering a much higher disallowance than it need do. Therefore, it will be important for groups to carefully model the potential impact of these elections (where relevant, over a number of periods) and consider whether the relevant conditions can be met on an ongoing basis.

Commencement and apportionments

In the first year of application of the new CIR rules, it will be necessary for groups with a period of account straddling the 1 April 2017 start date (and containing UK tax-paying

companies with accounting periods straddling that date) to apportion the UK tax inputs and group accounts inputs between notional periods ending 31 March 2017 and starting 1 April 2017.

What approach is taken to this exercise may have a significant impact on the CIR disallowance for the first period. (See example 6, which illustrates this.)

Going forward, apportionments of a UK group company's tax-interest and tax-EBITDA will also be required where: (i) the company has a different accounting period to the group's period of account; or (ii) the company joins or leaves the group midway through the group's period of account.

Allocating the disallowance (or reactivation) and interaction with the wider CT position

In most cases, once the group has calculated the total amount that it needs to either disallow or 'reactivate' under the CIR rules, it will have full discretion regarding:

- how to allocate the disallowance or reactivation between group companies that have net tax-interest expense or carried forward disallowed amounts, as relevant; and
- what specific type of tax-interest expenses (e.g. trading loan relationship debits, non-trading derivative contract debits) are disallowed or reactivated within a particular company.

The decisions made by groups as to how these choices are managed (and what elections are made affecting the prior quantum of disallowance or reactivation under the CIR rules – see above) may therefore have a significant impact on the group's overall corporation tax liability for a period and will need to be carefully managed.

One additional factor here is how the various choices made under the CIR rules might interact with the group's position under the revised regime for carried forward losses, which is also expected to apply from 1 April 2017. For example, when deciding how to allocate a CIR disallowance between group companies, the group may choose to disallow interest in companies that would otherwise generate a loss in the period (which would be carried forward and subject to the new 50% restriction when utilised). This is likely to add a further layer of complexity onto an already complicated year end compliance process.

Furthermore, the new restrictions on relief for interest and losses is likely to encourage UK groups to place renewed emphasis on ensuring that they are taking full advantage of alternative tax reliefs available to them; for example, in relation to R&D and the patent box.

Complying with the administrative requirements

Far from simplifying the compliance associated with assessing interest deductibility, there are a myriad of new definitions, concepts and potential optional elections to get to grips with, and the enactment of the CIR provisions in the UK will create a further layer of complex calculations and formal reporting requirements. And this, therefore, is likely to significantly increase the compliance burden placed on groups.

In most cases, groups will need to appoint a 'reporting company', which will submit an interest restriction return (IRR) for each period of account, calculating the overall disallowance (or reactivation) of interest expenses and allocating this between UK corporation tax-paying group companies.

Where a group reasonably estimates that its ANTIE is less than £2m per annum in a period of account (so that the group is exempt from any CIR disallowance on that basis), HMRC's draft guidance intimates that the group need not appoint a reporting company or file an IRR (i.e. a 'nil return' will be acceptable in such a scenario).

Where a group reasonably estimates that it has ANTIE of more than £2m per annum, but that none of this interest expense will be subject to restriction under the CIR rules (because it is less than the group's CIR interest capacity for the period), it may elect to submit an 'abbreviated return', simply confirming that the group is not subject to interest restriction for the period and including details of the composition of the worldwide group, without having to provide full CIR calculations.

Since disallowed interest, unused interest allowance and excess debt cap amounts are each carried forward, groups will need to monitor the rules over multiple periods, rather than looking at each period in isolation.

(See figure 2 for an overview of CIR compliance.)

Determining the impact on quarterly payments

Larger groups will need to factor in the potential impact of CIR on their quarterly instalment payments of corporation tax prior to the year-end compliance cycle.

Analysing the accounting impact

Groups will need to assess the potential impact of CIR on their full or half year accounts.

The point at which the new rules will be 'substantively enacted' for IFRS and UK GAAP purposes or 'enacted' for US GAAP will depend on how swiftly the Finance Bill proceeds through Parliament.

Prior to that date, groups that expect the CIR rules to have a material impact may wish to consider making a disclosure.

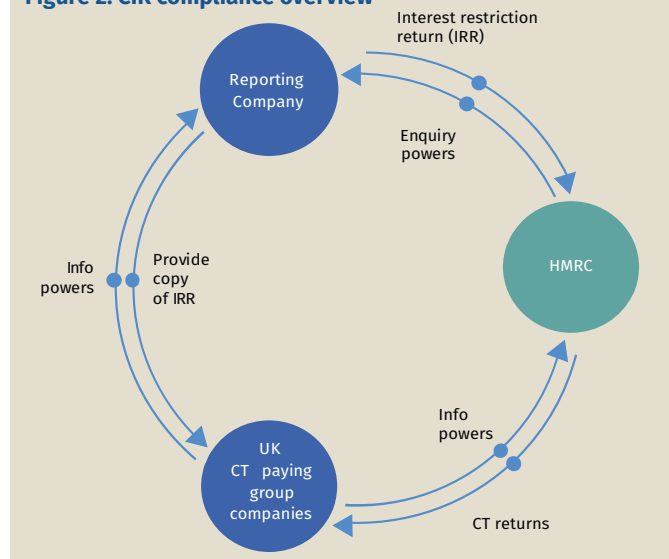
Once the CIR have been (substantially) enacted:

- To the extent the CIR rules restrict the deductibility of interest or use of losses, this may obviously give rise to an increase in cash tax.
- The extent to which this would also give rise to an increase in the group's effective tax rate would depend on the extent to which a deferred tax asset (DTA) is recognised for any interest that is disallowed and carried forward for potential reactivation under the CIR rules.
- This is uncharted territory and the approach adopted by different audit firms may vary in practice. The analysis is likely to involve considering both: the probability of the group having excess interest allowance in future periods permitting disallowed interest to be reactivated; and if so, the probability of the group having taxable profits to utilise any reactivated deductions.
- However, the precise circumstances in which a DTA can be recognised (and, if so, in what amount) and the evidence needed to substantiate these conclusions, will need to be discussed with the group's auditors.

Considering potential restructuring transactions

In light of the potential restriction on UK deductibility of interest costs imposed by the new CIR rules (and the potential restriction on overseas deductibility imposed by equivalent overseas rules implementing BEPS Action 4), groups may wish to consider restructuring options; for example:

Figure 2: CIR compliance overview



- pushing down existing external UK debt costs overseas;
- transferring loan assets to the UK;
- refinancing shareholder debt with third party debt (or replacing it with equity); and
- reviewing the transfer pricing of intra-group transactions.

Far from simplifying the compliance associated with assessing interest deductibility, the CIR provisions will create a further layer of complex calculations and formal reporting requirements

In considering potential restructuring options, groups will need to take care to ensure that the proposed transactions do not fall foul of the regime anti-avoidance rule (RAAR), which can counteract UK tax advantages arising from arrangements with a main purpose of achieving a better result under the CIR rules than would otherwise apply. In some cases, groups may be able to rely on specific transitional exemptions from the RAAR that have been included in the draft rules.

Final thoughts

This new legislation goes beyond the original remit of the BEPS project introduced by the OECD in 2013 and will result in some UK groups suffering a restriction on arm's length third party interest. Whilst we have sought to provide a practical guide to the latest version of the draft legislation and guidance, taxpayers and advisers should not underestimate the complexity that lies ahead. ■



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► Interest barrier update (Helen Lethaby & Jill Gatehouse, 7.9.17)

► BEPS: Interest deductions and other financial payments (Charles Yorke, 29.10.15)