Corporate tax issues amid rising interest rates

Key Issues in the current economic environment

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What we'll be covering

- Corporate Interest Restriction rules
- Other corporate tax adjustments
  - Connected company and participation rules
  - Deemed releases for companies in financial difficulty
  - Unallowable purpose rules
  - Anti-hybrid rules
- Withholding tax

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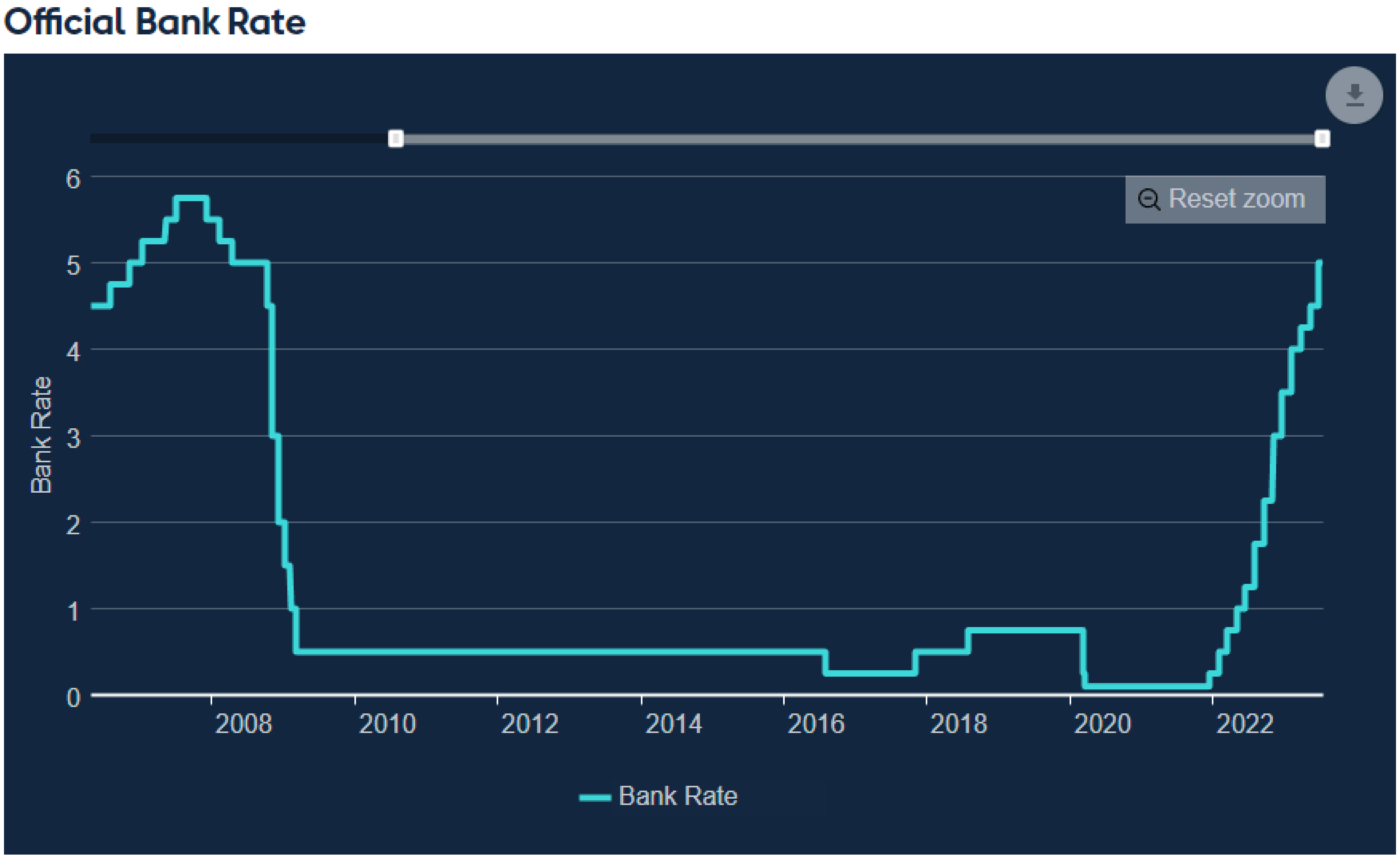
Changes in the Bank of England bank rate



HMRC interest rates have also increased

- HMRC interest rates for overdue corporation tax have increased:
  - 7.5% after normal 9-month date (4% overpaid)
  - 6% underpaid quarterly instalment payments for ‘large’ and ‘very large’ companies (4.75% overpaid)
- CTSA interest deductible/taxable but other types of HMRC interest (VAT and PAYE are disallowed)
- One-off large gains and s455 CTA 2010 loans to participators can bring companies into quarterly instalment regimes

Treatment of corporate debt generally

- Loan relationship rules
- Very different to rules for individuals
- Debits/credits are usually based on amounts included in GAAP compliant accounts (capital v revenue distinction ignored)
- Statutory exceptions to these rules include:
  - Transfer pricing/distribution treatment
  - Connected company debt
  - Late paid interest - participators
  - UK anti-hybrid rules
  - **Corporate interest restriction**

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Corporate Interest Restriction: overview

- **From 1 April 2017**, the Corporate Interest Restriction **(CIR)** can limit the amount of interest a company/group can deduct from its taxable profits if the **UK net interest expense is over £2m**
- ‘Interest’ covers a wide range of transactions. **CIR applies <u>after</u> other restrictions on interest deductibility**
- Calculations are carried out at group level and restrictions applied afterwards to UK companies
- Finance Act 2023 (FA 2023) – Minor changes to rules

CIR: key steps (1)

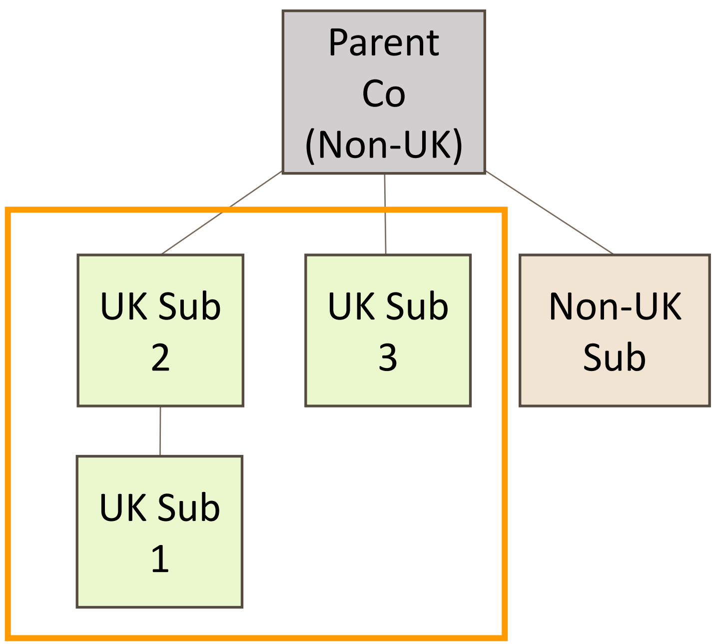
Step 1: Identify the worldwide group and its consolidated subsidiaries

- Ultimate parent and all its consolidated subsidiaries
- Can comprise of companies resident only in the UK and 'single-group' UK companies
- Company is not treated as a consolidated subsidiary where investment is measured using fair value accounting in its parent (investment fund structures)
- UK companies now include non-resident landlord companies from 1 April 2020 which are in the charge to UK corporation tax **(CT)**

CIR: key steps (2)

Step 2: Calculate the Aggregate Net Tax Interest Expense **(ANTIE)** of the UK group companies. This is the tax interest expense less tax interest income.

Exclude: FX, impairment losses + adjust for double tax relief (DTR)



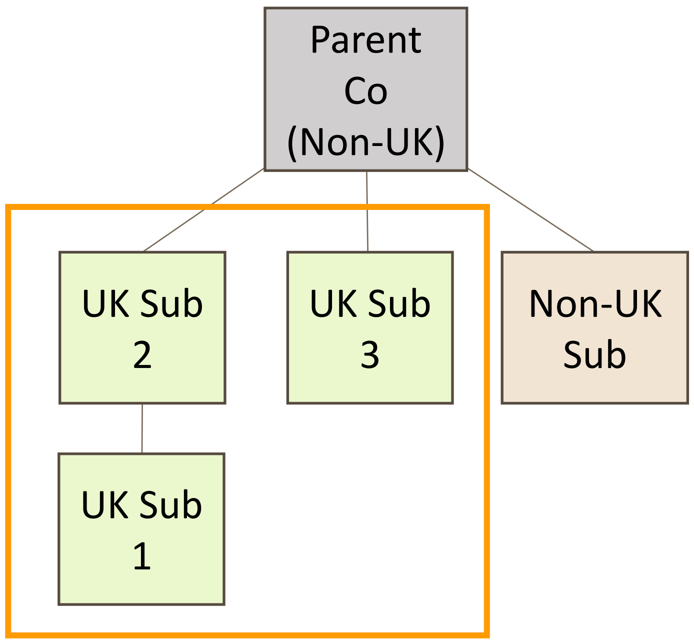
ANTIE (Subs 1, 2 and 3):

	£
Net tax interest income of UK companies	**500k**
(Net tax interest expense of UK companies)	**(4.5m)**
ANTIE > £2m	**4m**

Restriction may be required as > £2m

CIR: key steps (3)

Step 3: Calculate the Tax EBITDA for <u>each</u> company in CT and add together to give the Aggregate Tax EBITDA. EBITDA is calculated using UK tax principles



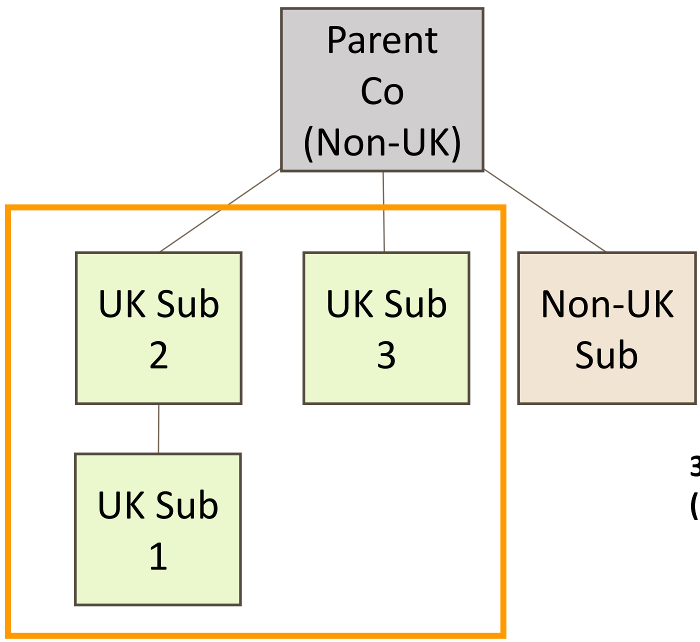
<u>Example: Sub 1</u>

	£
Taxable profits <u>not PBT</u>	**X**
<u>Deduct:</u>	
Interest receivable	**(X)**
Group relief surrendered	**(X)**
Income sheltered by DTR (DTR grossed up)	**(X)**
<u>Add:</u>	
Interest expense	**X**
Capital allowances	**X**
Tax losses brought forward/Group relief claimed	**<u>X</u>**
Tax EBITDA UK Sub 1	

Other adjustments may be required!

CIR: key steps (4)

Step 4 – Calculate the Interest Allowance **(IA)** <u>for the Group</u> for the accounting period



Basic interest allowance (BIA)

Standard basis : Fixed rate method (FRM) - 30% rule

GROUP DEDUCTION IS LOWER OF

- **30% x UK Tax EBITDA (Step 3)**
- **Adjusted net interest expense of worldwide Group (ANGIE) + excess debt cap**
  - **Measure of group's external funding**

<u>Election</u> : Group ratio method (GRM)

GROUP DEDUCTION IS LOWER OF

- **Group ratio x UK Tax EBITDA (Step 3)**
- **Qualifying Net Group Interest Expense (QNGIE) + excess debt cap**
  - **Measure of group's external funding (excludes related party)**

IA = BIA + ANTII

ANTII = Aggregate net tax interest income of UK companies (relevant to c/fwd)

CIR: key steps (4 - continued)

- **30% rule: Calculate the Net Group Interest Expense (NGIE) and the Adjusted Net Group Interest Expense (ANGIE)**
- Based on the consolidated profit and loss (worldwide accounts):

  The sum of all relevant expense amounts

  Less

  The sum of all relevant income amounts
- ANGIE is then calculated by making certain upwards and downwards adjustments (**capitalised interest** at point of capitalisation, **equity treated as debt… s413 TIOPA**)

CIR: key steps (4 - continued)

Group ratio method: Calculate the Group Ratio Restriction

1. Calculate the Qualifying Net Group Interest Expense **(QNGIE)** for all companies in the worldwide group
2. **Based on the ANGIE** but with certain exclusions including:
   - Loans from major shareholders
   - Related parties
3. Calculate the Group Ratio Percentage **(GRP)** by dividing QNGIE by Group-EBITDA as a %.
4. Multiply UK tax-EBITDA by the GRP
5. Elect if % is greater than 30% subject to QNGIE + EDC

CIR: key steps (5-7)

Step 5: Calculate the Interest Capacity **(IC)**

IC =**Higher of** £2m and Total Interest Allowance **(TIA)**

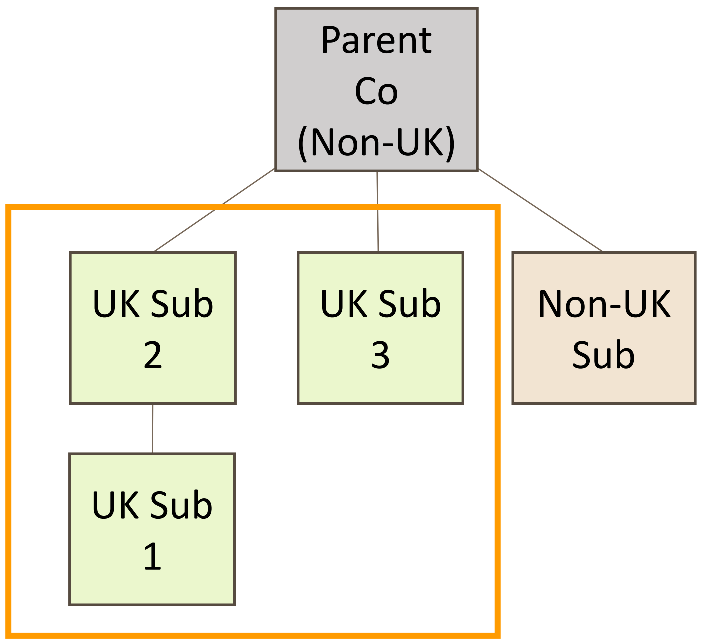
TIA = IA + B/fwd IA (IA from the last 5 years)

Step 6: Calculate the disallowed interest

Step 7: Allocate the disallowed amount to companies with net UK interest expense

Corporate Interest Restriction Steps – Key Steps

Step 6 – Calculate the disallowed interest



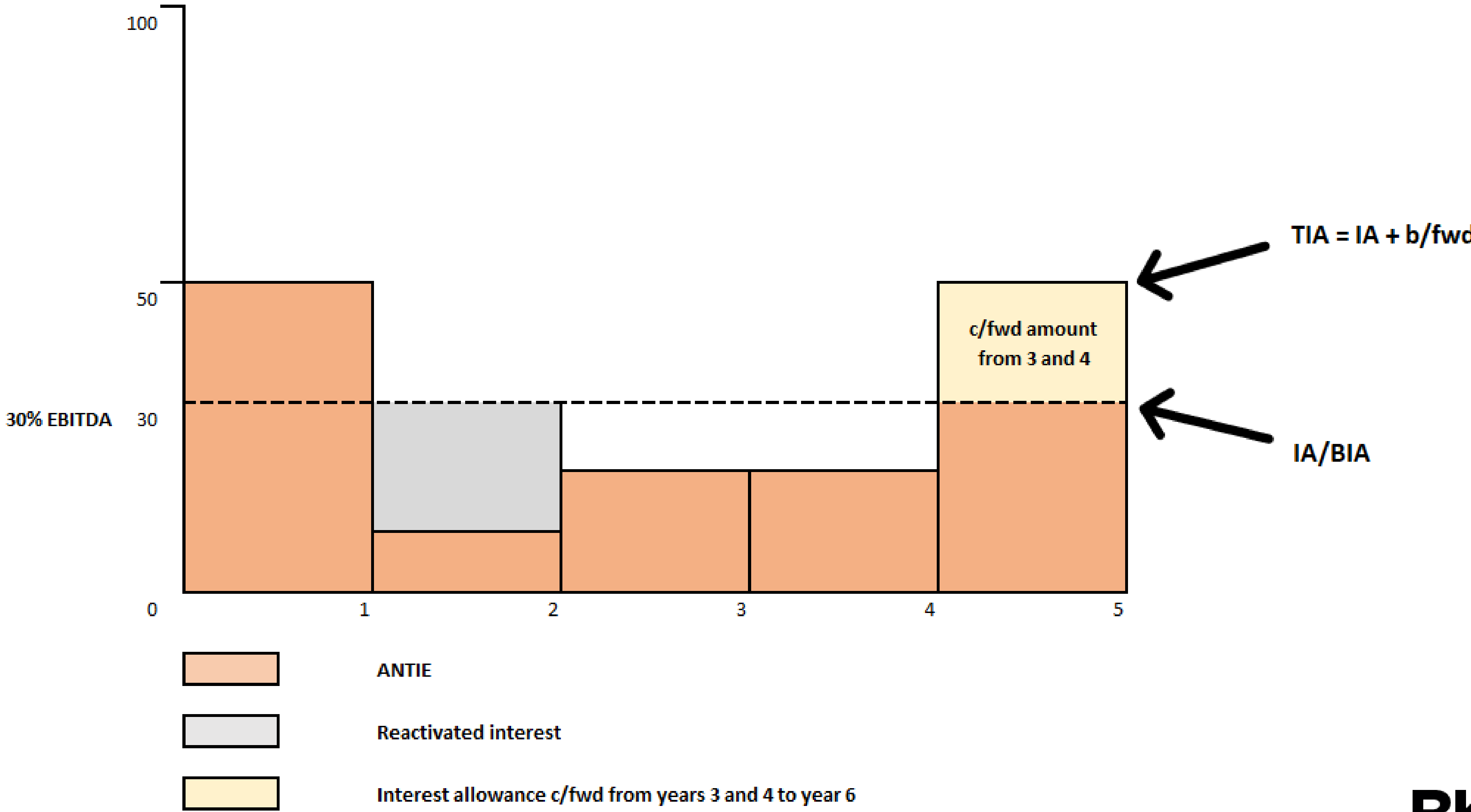
Different levels of ANTIE compared

	2021 £m	2021 £m
ANTIE (See Step 2)	4.00	2.50
Less: BIA/IA (See Step 4)	(3.00)	(3.00)
Less b/fwd unused (last 5 years)	0.00	0.00
Interest disallowed/(unused)	1.00	(0.50)

- £3m is the IC for 2021
- This is the maximum deduction and £4m is therefore 'restricted' by £1m in column 1
- The £1m is allocated to UK companies with net interest expense (can't allocate to companies with net interest income)

- The £500k unused capacity in 2021 could be carried forward for 5 years
- Can't 'bank' unused disallowance if IC = £2m de minimis

CIR Reactivation: Unused IA



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CIR Reactivation: Excess Debt Cap (EDC)

31 December 2021

ANTIE = £25m

30% x Tax EBITDA = £20m

ANGIE = £30m

EDC = £30m - £20m = £10m

31 December 2022

ANTIE = £25m

30% x Tax EBITDA = £23m

ANGIE = £21m

EDC = £0m
EDC b/fwd = £5m

*IC=IA=BIA for simplicity

Assume FRM used for both years

31 December 2021

Step 4 - BIA

Lower of

30% x Tax EBITDA = £20m	ANGIE + EDC b/fwd
£20m	£30m + nil (EDC)

Step 6 - Disallowed amount

ANTIE - (IA + Bfwd IA)*: £25m - £20m = £5m

Step 7 - Allocate the disallowed amount

Step 8 - EDC Carried forward

Lower of

ANGIE	£30m	Step 6 disallowed	£5m
30% x Tax EBITDA	-£20m	2020 c/fwd	£0
	£10m		£5m

31 December 2022

Step 4 - BIA

Lower of

30% x Tax EBITDA = £23m	ANGIE + EDC b/fwd
£23m	£26m (£21m + £5m)

BUT £21m if no EDC

Step 6 - Disallowed amount

ANTIE - (IA + Bfwd IA): £25m - £23m = £2m

Step 7 - Allocate the disallowed amount

Step 8 - EDC Carried forward

Lower of

ANGIE+ EDC	£26m	Step 6 disallowed	£2m
30% x Tax EBITDA	-£23m	EDC 2021 c/fwd	£5m
	£3m		£7m

CIR steps: recommendations [1/2]

Allocation of disallowance after all the group calculations

/ Unless a group complies with various administrative aspects, disallowance must be allocated pro-rata across companies with net interest expense

/ Allocate to companies with losses brought forward

/ Allocate to companies that might be in a position to access the disallowance in a future period – difficult to predict!

CIR steps: recommendations [2/2]

Possible elections

- GRM (compare FRM with GRM)
- Interest allowance (alternative calculation) election
- JV election (when using the GRM)

Public infrastructure election

- Will not be relevant to all companies
- 'Qualifying infrastructure company' (includes some UK property businesses)
- Watch out if there is related party debt
- Timing of election is also important

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Administration [1/2]

- If a group is within the CIR rules, a reporting company must usually be appointed within 12 months of the end of the period of account to which it relates. The notice must specify the first period of account to which it relates
- Include details of ‘consenting companies’
- An Interest Restriction Return (IRR) must then be submitted to HMRC
- The filing deadline for an IRR is generally 12 months from the end of the period of account of the worldwide group
- The return may be either a full IRR or an abbreviated IRR. A reporting company may elect to submit an abbreviated IRR if the group is not subject to interest restrictions for a period of account

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Administration [2/2]

- A revised IRR must be submitted within 36 months of the end of the period of account to which it relates or three months after the appointment of the reporting company if later. These time limits are subject to extension for the submission of a full IRR in place of an abbreviated IRR (5 years). Submission of full IRRs allows the group to access any unused interest allowance in a later period
- **It may be advantageous for a single company that is likely to be affected by the corporate interest restriction provisions to appoint itself as reporting company for its group (of which it is inevitably the ultimate parent) and submit an IRR. This enables it to benefit from reactivations of previously restricted tax-interest and to access unused interest allowance in a later period, processes that require the submission of a full interest restriction return**

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Other corporate tax adjustments

Tests of connection: Loan relationships

/ A variety of special rules apply as the legislation treats debt as quasi-equity

- Two companies are connected where at any time in an accounting period:

  (a) one of the companies controls the other, or
  (b) both are under common control by the same person

  Relevant to impairments, late paid interest and deemed releases

- Major interest – 40% test (extend late paid interest, 12-month rule)
- Participation (extend late paid interest, 12-month rule)

Impairment relief – connected parties

- The debtor (borrower) does not include the amount which is released, even if the creditor (lender) is not in the UK
- The creditor may not claim relief for any impairment
- Exceptions:
  - Creditor is in insolvency proceedings – expense is allowable
  - Debtor issues shares to creditor in full settlement and companies become connected. Any expense is allowable for the creditor. There is no income for the debtor.

Connection: deemed release [1/3]

Release does not take place in legal or accountancy terms but does for CT purposes:

a) Where a company is or becomes connected with the debtor and acquires an impaired debt of the debtor. Debtor recognises an amount of income in relation to a deemed release (s361 CTA 2009)

b) Where a company already holds impaired debt of an unconnected company and companies become connected (s362 CTA 2009)

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Connection: deemed release [2/3]

Release does not take place in legal or accountancy terms but does for CT purposes:

s361 CTA 2009

Newgrosh Ltd (NL) has a bank loan of £10m but likely to default

NL's parent, Kanczula Ltd (KL) acquires the loan for £8m. The bank will have a loss of £2m. As NL and KL are connected, NL has a deemed release of £2m

Income will not be taxed if:

- **Debt for equity exception:** KL issues shares to the bank
- **Corporate rescue exception:** Loan acquired at arm's length, debt released in 60 days and reasonable to assume borrower would have been insolvent in 12 months

PS What if s361 bites and the debt is subsequently fully repaid?

Connection – deemed release [3/3]

Release does not take place in legal or accountancy terms but does for CT purposes:

s362 CTA 2009

Borrower company, Finchley Ltd (FL) owes £500k to an unrelated company Tally Ho Ltd (THL). FL is struggling and THL impairs the carrying value of the debt to £200k, claiming £300k of tax relief.

THL thinks it can turn FL around and buys the shares

There is a deemed release in FL of £300k

Exception: Corporate rescue exemption if the loans is waived within 60 days of the acquisition, and FL is in financial difficulty.

Unallowable purpose rules

- Care required when a company takes out a loan
- ‘Unallowable purpose’ rules restrict deductibility if obtaining UK tax deductions is a main purpose of the borrower being party to loan
- HMRC has had some success through the courts and has updated their guidance and created uncertainty
- HMRC guidance has just been updated and includes some key examples (CFM38000, in particular CFM38190)
    - Lending because of a family connection *Example 17*
- Case law continuing to evolve

Anti-hybrid rules

- Another set of rules which requires an understanding of the wider structure
- Applicable to all expenses but lending structures are particularly vulnerable
- Prevent companies taking advantage of arrangements to obtain a **double deduction** for an expense or to obtain a **deduction with no corresponding income item**
    - **Financial instruments**
    - **Hybrid entities**
    - **Dual resident companies**
    - **Arrangements involving branches/permanent establishments**
- New CT600B (also for controlled foreign companies)

Withholding tax (WHT)

- Income tax at source (20%) is broadly payable on loans to individual participators (including overseas) and overseas entities
- ‘Yearly’ interest
- Can include the issue of shares in consideration for amounts owed
- Double tax treaties can reduce the income tax paid overseas to below 20%. **Agreement is required** (loan by loan, or lender obtains a treaty passport)
- **Exceptions:** Deeply discounted securities, quoted Eurobonds, Qualifying Private Placement rules

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Thank you and questions

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