Analysis

Interest deductions and other financial payments

Speed read

Action 4 was one of the more keenly anticipated final reports, largely because of the sheer scope of companies affected by it. The way that the UK's tax regime deals with interest is relatively generous. There is no formulaic thin capitalisation rule, the costs of funding equity investments are deductible, and deeply subordinated (and therefore high interest) shareholder debt is compatible with our transfer pricing rules. These were all within the sights of Action 4. The proposed best practice is for a combined fixed ratio rule and a group ratio rule; however, the practicalities are questionable.

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What is Action 4 intended to prevent?

In short, Action 4 is intended to prevent excessive interest deductions, in relation to both outbound and inbound investments, that shift profits to low tax jurisdictions and give an unfair advantage to multinational corporations (MNCs) over domestic groups.

The perception has been that MNCs allocate their third party debt to high tax jurisdictions rather than low tax jurisdictions: if investment is made from a low tax jurisdiction into a high tax jurisdiction, then the third party acquisition debt is pushed down into the target; whereas if an investment is made from a high tax jurisdiction into a low tax jurisdiction, then the debt is retained at the level of the parent and the target is funded with equity. In both cases, the profits in the high tax jurisdiction are reduced.

A second concern has been the leveraging of operating companies in high tax jurisdictions with internal debt that is not fully funded by external debt (but rather by shareholder capital or retained earnings).

See figures 1, 2 and 3.

Figure 1

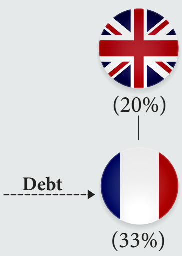


Figure 2

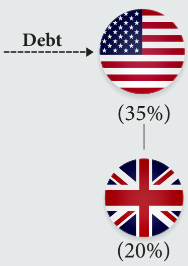
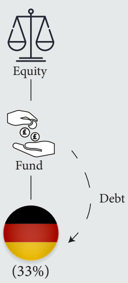


Figure 3



What are the final recommendations?

Space does not permit a lengthy description of the final recommendations (and I do not intend to cover the specific details for project finance, banks and insurers, or the TAARs). For most UK businesses, the key proposals will be:

- A fixed ratio rule applied at the single entity level (or, perhaps more sensibly, at the level of a sub-group in a particular jurisdiction): the fixed ratio rule would limit interest deductions to the extent that net interest exceeds a percentage (between 10% and 30%) of earnings before interest, taxes, depreciation, and amortisation (EBITDA).
- An optional worldwide group ratio rule: this would mitigate the fixed ratio rule (by allowing deductions of interest in excess of the fixed ratio) to the extent that the entity or sub-group's leverage ratio reflects the actual leverage of the overall group. The precise tests which might be used are still under consideration, but some form of consolidated group net interest: EBITDA ratio is favoured (possibly with a cushion of up to 10%).

It is worth pausing here to reflect on how this proposal would counter the concerns described above. First, EBITDA is to be measured using tax principles (taxable profits with an add-back for interest deductions, capital allowances and amortisation of intangible fixed assets). It follows that exempt dividend income will be excluded, and that the planning shown in figure 2 (debt funding equity investments) would be restricted.

Second, the combination of the fixed ratio rule and the group ratio rule restricts the ability of a group to leverage its operating entities in high-tax jurisdictions (whether through raising third party debt directly in that jurisdiction, or providing intra-group debt funding) in excess of the higher of the fixed ratio and the group's overall ratio.

As a minimum, the rules should apply to multinational groups (this is a slightly misleading term even if literally accurate, as it is defined to include any group with entities in more than one country). Application to purely domestic groups is optional, although within the EU we can expect it to be mandatory. Application to single entities will also be optional.

The fixed ratio rule

While simple, the fixed ratio rule is a blunt instrument, requiring each country to choose a single fixed ratio for all industries and sectors (somewhere in the 10% to 30% corridor). The rule is applied to each entity within a group, and compares its net tax deductible interest with its tax based EBITDA. The report acknowledges that, in some circumstances, EBIT (or even asset values) may be used instead of EBITDA. If the interest:EBITDA ratio exceeds the fixed ratio, then the excess interest is not deductible.

The level at which the fixed ratio is set will inevitably be arbitrary. For entirely commercial reasons, some industries and sectors, such as capital intensive manufacturing, real estate and infrastructure, are far more leveraged than others. There is nothing like a universally normal interest:EBITDA ratio. Bank lending criteria take into account a multitude of other factors: debt service coverage, asset coverage, cash flow volatility, industry specific factors, geopolitical factors, interest rates and currency to name a few. Even within an industry or sector, there are significant variations, particularly between young growing businesses funded by bank debt and mature and stable MNCs funded by equity, retained earnings and the cheaper capital markets.

Wherever the fixed ratio might be set, there will be sectors and industries, and participants within sectors and industries, that will fall on the wrong side of the line. This problem is compounded because the 10% to 30% corridor is low. The benchmark used was publicly traded MNCs – less than 38% of MNCs have a ratio in excess of 10%; and less than 13% have a ratio in excess of a 30%. This does not reflect the wider business community, particularly younger businesses in their organic growth phase reliant on bank funding.

The worldwide group ratio rule

The report to an extent acknowledges this and recommends a group ratio rule to reduce the impact of the fixed ratio rule. The tentative recommendation is to compare the finance charge recognised in group consolidated financial statements with group EBITDA. If that ratio is higher than the fixed ratio, then it replaces the fixed ratio as the benchmark for restricting interest deductions.

The combination of a fixed ratio rule and a group ratio rule may well create some interesting dynamics. First, while the fixed ratio rule goes some way to counter over-leverage within a group, the group ratio rule would accentuate the bias for external third party debt, rather than shareholder equity. Shifting debt around and over-leveraging within a group is a tax problem. Over-leveraging with third party debt on the other hand has economic consequences, making business vulnerable in times of economic stress. Another consequence may be that highly leveraged groups will be handed an advantage over the well-capitalised, when competing to purchase companies operating in a highly leveraged industry. Inevitably the well-capitalised bidder will need to factor in the inefficiencies of an acquisition caused by a low group ratio.

On the other hand, those groups with group ratios below the fixed ratio (such as publicly traded MNCs) would retain some flexibility to organise their internal and external funding arrangements to maximise tax relief for interest up to the fixed ratio. However, groups with high leverage would find themselves working within the straitjacket of the group ratio rule at every level of their structure.

The Treasury consultation

HM Treasury published a consultation paper on Action 4 on 12 October 2015. The Treasury are broadly supportive, describing the best practice recommendations as an 'appropriate response', but noting that it is unlikely that the rules would be implemented in the UK before 1 April 2017. There seems to be some support for applying the fixed ratio rule at the UK sub-group level rather than to each and every UK entity separately. Grandfathering of existing arrangements may be permitted, but only in exceptional circumstances.

The most interesting aspects of the paper are the comments made in respect of the group ratio rule. I can't help but think that the somewhat negative or at least ambivalent comments are a direct consequence of the UK's experiences with the similar rules in the worldwide debt cap regime; all have bemoaned their complexity, in particular those aspects aligning accounting concepts with tax concepts and identifying the worldwide group. The paper also warns of the additional debt bias that such a rule would create. On the plus side, the paper notes that the group ratio rule would allow groups that for commercial reasons are more highly leveraged to obtain more interest relief.

The group ratio rule proposed by the OECD would be particularly complicated to manage and arbitrary in its application. It is worth remembering that the group ratio rule would require each and every entity within the group to have the same interest: EBITDA ratio (albeit with an optional 10% buffer). This seems commercially unrealistic – and to the extent it is not achieved there will be double taxation and denials of relief for real interest costs.

A simple example

Take the case of a fairly simple group active in a single sector and funded by unsecured bank loans. The tax or finance director would have the unenviable task of estimating annually, or perhaps even more regularly, the expected interest costs and EBITDA of each member of the group, and of the group as a whole. The relative debt funding would then need to be adjusted to reflect those expectations. Company law would pose a constraint; draining equity through distributable reserves should be achievable to the extent available. Increasing and decreasing share capital is far more cumbersome.

There may also be the ability to carry forward or back denied interest deductions and excess EBITDA capacity. Admittedly, this will help, smoothing the volatility between accounting periods.

A more common example

Many groups do not reflect this simple example. A single MNC will usually operate across a multitude of different sectors and geographies: from capital intensive manufacturing to low capital consulting and professional services. A profitable services arm may need to borrow well in excess of its business needs to match the group average, while a manufacturing arm less. What does the services arm do with the excess? The manufacturing arm may not be able to reduce its third party funding to meet the group average. Infrastructure and long-term capital assets are often funded by bank loans raised directly by the part of the group that will own and use the assets. This is often a requirement of the banks to allow them to enforce security against the assets and the asset-owning subsidiary's shares should things go wrong.

Comment

We are left with a difficult choice between a simple but blunt fixed ratio rule, and a complicated and perhaps impractical group ratio rule. The first option feels unlikely; not least because it would prejudice business investing in the UK when compared with countries that do implement a group ratio or similar rule. I suspect we'll end up somewhere in between – the difficulty is in replacing it with something which is both sophisticated enough to cope with very different leverage requirements across sectors and geographies, but is sufficiently simple for clarity and to limit the compliance burden. I wouldn't be surprised if we ended up with something like Germany's 'equity escape' rule.

While it would be sensible for groups and funds to undertake some due diligence at this stage to prepare for how these rules might affect them, it seems to me to be too early to start restructuring.

There is clearly the opportunity to co-operate in the design of something fair and workable. The most important thing for now will be active and positive engagement in the consultation process. Examples from business or industry representative bodies of how these rules would affect them will inevitably be more helpful than theoretical responses (like this) from professional service firms. ■