MAY 2016
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AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

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A PUBLICATION FROM THE BDO UK/US TAX DESK

SUBJECT

THE UK GOVERNMENT RELEASES CONSULTATION ON POLICY DESIGN AND IMPLEMENTATION OF CORPORATE INTEREST DEDUCTIBILITY LEGISLATION

SUMMARY

On May 12, 2016, the UK government released a detailed consultation document in respect of its proposed implementation of the G20/OECD Base Erosion and Profit Shifting ("BEPS") Final Report on Action Item 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments ("BEPS Action Item 4"). The UK government had previously announced its intention to introduce a restriction on the tax deductibility of corporate interest consistent with the recommendations in BEPS Action Item 4. Responses to the consultation are requested from stakeholders by August 4, 2016, after which the draft legislation is expected to be issued in November 2016 for final consultation, prior to enactment with effect from April 1, 2017.

DETAILS

The UK will introduce a restriction on the tax deductibility of corporate interest that is consistent with the recommendations in BEPS Action Item 4, which will take effect on April 1, 2017. The following offers an overview of the proposed changes, including the fixed ratio rule, the group ratio rule, the repeal of the worldwide debt cap, and a *de minimis* allowance.

Fixed ratio rule

A fixed ratio rule will be introduced that limits corporation tax deductions for net interest expense to 30 percent of taxable earnings before interest, tax, depreciation and amortization ("EBITDA"). This applies to third party and related party net interest expense, and is tested on an aggregate UK group basis (including UK permanent establishments).

CONTACT:

ROBERT PEDERSEN, Partner and International Tax Practice Leader
(212) 885-8398 / rpedersen@bdo.com

JOE CALIANNO, Partner and International Technical Tax Practice Leader, National Tax Office
(202) 904-2402 / jcalianno@bdo.com

INGRID GARDNER, Managing Director UK/US Tax Desk
212-885-8268 / igardner@bdo.com

SCOTT HENDON, Partner
(214) 665-0750 / shendon@bdo.com

VEENA PARRIKAR, Principal, Transfer Pricing
(408) 352-3534 / vparrikar@bdo.com

MONIKA LOVING, Partner
(404) 979-7188 / mloving@bdo.com

CHIP MORGAN, Partner
(310) 557-7517 / cmorgan@bdo.com

BRAD RODE, Partner
(312) 233-1869 / brode@bdo.com

WILLIAM F. ROTH III, Partner, National Tax Office
(616) 776-3761 / wfroth@bdo.com

JERRY SEADE, Principal
(713) 986-3108 / jseade@bdo.com

Net interest expense of a UK group is comprised of loan relationship debits and credits; debits and credits arising from derivative contracts; finance income/costs arising from certain leases; debt factoring income and costs; guarantee fees paid/received; and income or expenses under certain service concession arrangements treated as finance assets or liabilities. The amounts subject to the cap are the taxable amounts after the application of other UK rules that relate to financing income and expenses, including transfer pricing, unallowable purpose and anti-hybrid restrictions.

EBITDA for the fixed ratio calculation will be measured by reference to amounts taxable and deductible for corporation tax purposes i.e., profits chargeable to corporation tax excluding net interest, tax depreciation (capital allowances), tax amortization, relief for losses of other taxable periods and group relief (loss sharing).

Any net interest in excess of the 30 percent cap will not be deductible in the testing period, and the group decides how much restricted interest to allocate to each UK group company. Such restricted interest will be carried forward indefinitely and treated as interest expense of future periods where it should be deductible subject to sufficient capacity.

Any excess capacity can also be carried forward to future periods, but this carry forward is restricted to three years, after which the excess capacity expires.

Group ratio rule

It is recognized that some groups have relatively high borrowing levels for sound commercial reasons and in those cases, a 30 percent limitation may not allow full relief for third-party interest expense. Therefore, an optional group ratio rule based on the net interest to EBITDA ratio for the worldwide group will also be implemented.

The group ratio is defined as net qualifying interest expense over group EBITDA and will be calculated using, broadly, accounting numbers for the worldwide group. The resulting ratio will be applied to the same tax EBITDA that is used for the fixed ratio limitation calculation to ascertain allowable net interest.

Repeal of world-wide debt cap

The current worldwide debt cap rules will be repealed, but rules with a similar effect will be integrated into the new interest restriction rules. In general, the application of this modified debt cap rule will mean that a group's net interest deduction in the United Kingdom cannot exceed the consolidated worldwide group's net interest expense.

De minimis

A *de minimis* allowance of GBP 2 million per annum is included in the rules. This means that all UK groups should be able to deduct up to GBP 2 million of net interest expense, regardless of the outcome of the application of the fixed or group ratio rules, and the application of the modified debt cap rule.

BDO INSIGHTS

- While the consultation document sets out the United Kingdom's proposals in terms of the detailed design of the proposed legislation implementing BEPS Action Item 4, further work is required around some of the detailed mechanics of the rules and application to certain specific regimes. In particular, the UK government continues to consult further on the application of the proposed rules to profits arising from the Oil and Gas Ring Fence Corporation Tax regime and the banking and insurance sectors. The expectation is that draft legislation will be issued in November 2016 for final consultation, prior to enactment with effect from April 1, 2017.

- Groups currently deducting interest expenses in the United Kingdom should consider the potential impact of the proposed rules now to ensure that they understand any impact on the group's effective tax rate.

- For further information or a discussion about the impact of the proposed new rules on your particular circumstances, please contact Ingrid Gardner or your usual BDO tax advisor.