SP 4/00 Annex

Finance costs

Broad approach of the legislation

1. This statement provides guidance on the implementation of paragraphs 61 to 63. These require that where a single company or members of a group include an excessive deduction for finance costs in computing profits outside the tonnage tax ring-fence, then additional taxable profits should be brought into account to reflect the excess. The rules will apply to all tonnage tax companies or groups that carry on non-tonnage tax activities and incur finance costs that are deductible for the purposes of corporation tax.

2. A simple example of a situation where an additional charge would normally arise is a diversified group that funds its shipping subsidiaries through equity and its non- shipping subsidiaries through debt.

3. The legislation does not include detailed rules prescribing exactly how the calculation of the additional profits should be carried out. Instead, companies and groups may choose an appropriate methodology for this calculation to ensure a just and reasonable result when their own circumstances are taken into account.

4. This guidance assumes that a tonnage tax group is involved, although the principles can be adapted for a single company, as shown in example G below. Where a group operates under a group arrangement as described in paragraphs (17) to (21) above, HM Revenue and Customs will accept that these calculations should be carried out by the representative company and not by every tonnage tax company in the group. However, any resulting adjustment should be allocated to all the tonnage tax companies, as required by paragraph 62(5).

Computational principles

5. The calculation of the excess finance costs for an accounting period will involve the following stages:

   (i) Determine the total UK-deductible finance costs of the tonnage tax group that are taken into account in computing profits arising outside the ring-fence (after any statutory disallowances including transfer-pricing adjustments). Intra-group finance costs with a corresponding direct receipt chargeable to UK corporation tax (outside the ring fence) in the same accounting period elsewhere in the group do not need to be counted for this purpose.

   (ii) Determine the total UK-deductible finance costs of the tonnage tax group, as if there were no tonnage tax election in place. This could be approximated by the amount determined in (i) above, plus finance costs charged in the calculation of relevant shipping profits. Intra-group finance costs with a corresponding contemporaneous UK taxable receipt that were not counted under (i) above should again be ignored here.

   (iii) Determine the proportionate amount of the costs calculated in (ii) that cannot be regarded as being incurred so as to give rise, directly or indirectly, to relevant shipping profits. This should be done on a just and reasonable basis having regard to the underlying funding and the generation of relevant shipping profits. Further guidance is given below.
   (iv) Calculate the excess of (i) over (iii), if any.

   (v) Allocate this excess to the tonnage tax companies in proportion to their tonnage tax profits.

6. Stages (i) to (iv) can be represented by the following formulae, which are used to facilitate the examples below:

   E = A - (F x B)
   IF (F x B) > A THEN E = 0

where:

E is the excess finance costs to be allocated to the tonnage tax companies.

A is the group finance costs that can be taken into account outside the ring-fence (before the application of paragraph 62).

B is the group finance costs determined as if there were no tonnage tax election in place.

F is a just and reasonable fraction.

7. Where there are non-coterminous accounting periods, then the periods should be matched using any just and reasonable method.

Definition of finance costs

8. Finance costs are defined at paragraph 63. All of the costs arising from debt financing should be included and HM Revenue and Customs will expect this provision to be interpreted very broadly. It could include off-balance sheet methods of financing. However, finance costs will not normally include costs incurred through the late payment of debts, such as interest paid to trade suppliers or interest on late payments of corporation tax/PAYE/VAT.

Determining the just and reasonable fraction (F)

9. It is not possible to specify a single universally applicable formula for determining F, as different groups will have different operational and financial circumstances. Each group will therefore have to devise its own methodology. A group may wish to discuss this with its tax office as part of the clearance procedure.

10. In devising an appropriate methodology, HM Revenue and Customs will generally expect the following considerations to be taken into account:

    i) The calculations must observe the principle of fungibility. This means that individual items of finance should not be linked with individual activities or individual assets. Instead the financing should be viewed as funding the totality of all the tonnage tax and non-tonnage tax activities of the group's UK companies and those of its overseas subsidiaries.

    ii) Any consideration of tonnage tax activities must include the activities of overseas shipping companies whose dividends would ordinarily be relevant shipping profits under paragraph 49 (and thus subject to UK corporation tax solely under the tonnage tax regime). This is the case irrespective of whether any such dividends are paid during the accounting period under review. This approach is necessary to avoid distortionary tax effects that could otherwise be caused as a result of the group’s commercial decisions as to where debt is to be located. See examples I and J below.

    iii) If the funding requirements of a business differ from activity to activity the calculation of F should take this into account. Shipping is generally a capital-intensive activity due to the high costs of the assets and would be expected to require greater funding than many other activities.

    iv) The existence of and circumstances surrounding intra-group financing across the ring-fence should be taken into account in considering the nature of the activities outside the ring fence and in arriving at the adjustment required.

    v) A group that utilises complex international funding structures must take these fully into account in determining whether or not a proposed methodology produces a just and reasonable result.

11. The methodology chosen must be used consistently from period to period, unless group circumstances change so that this would no longer produce a just and reasonable result.

Examples

12. The examples below are designed to demonstrate how a just and reasonable result might be reached. They are not exhaustive and are necessarily simplified.

A. A tonnage group carries out wholly qualifying shipping operations and all income and expenses (including £100 finance costs) are accounted for within the tonnage tax ring-fence.

In this situation there are no activities outside the ring-fence and therefore neither paragraph 61 nor paragraph 62 applies.

B. The same situation as A, except that the £100 finance costs are borne outside the tonnage tax ring-fence, and the group now has £100 of interest income outside the ring-fence. This interest income is negligible when compared to the rest of the group's activities and therefore any funding used to support the interest bearing deposit will also be negligible.

This means that F is 0% so E is 100. The net result is taxable income outside the ring- fence of £100.

C. The same situation as **B**, except now the £100 of interest income is material to the group, representing 10% of its total income.

It might now be reasonable to regard some of the debt as funding the interest bearing deposit, and therefore **F** increases to (say) 10% and **E** reduces to 90.

D. The same situation as **C**, except the £100 of interest income now represents 10% of the group's total profits but only a negligible proportion of its total income.

A just and reasonable view might be that the funding applicable to the interest bearing deposit is negligible compared to the funding for the business as a whole, giving the result that **F** is 0% and **E** is 100.

E. A tonnage tax group contains two UK companies, one of which is a tonnage tax company carrying out wholly qualifying shipping operations and the other of which is not a tonnage tax company. Both businesses are of similar size with similar funding requirements and therefore it is appropriate for **F** to be 50%. Each company incurs £100 finance costs, of which the tonnage tax company's are inside the ring fence.

In this situation **A** = 100 and **B** = 200. This means that **E** = 0 and no adjustment is required.

F. The same situation as **E**, except that the tonnage tax company is now wholly equity funded and all the finance costs have been charged in the non-tonnage tax company.

Now **A** = 200, **B** = 200, **F** = 50%, and therefore **E** = 100.

G.The same situation as **F**, except that the tonnage tax group is a single company with two divisions. The finance costs are charged equally inside and outside the ring-fence. There is already an equal sharing of finance costs on either side of the ring-fence, so **E** = 0.

H. A tonnage tax company decides to increase its borrowings at the same time as it acquires a non-tonnage tax company. Finance costs are £100. Before this borrowing, the group was entirely equity funded. The two businesses are of similar size and with similar funding requirements. The group takes the full £100 into account in computing its profits outside the ring fence.

> The principle of fungibility means that the finance costs must be regarded as relating to both businesses. Thus, **F** = 50%, and **A** = 100, **B** = 100 and therefore **E** = 50.

I. A tonnage tax group consists of three companies: one is a tonnage tax company carrying out wholly qualifying shipping operations, another is an overseas company qualifying to pay dividends under the provisions of paragraph 49 and the other is a UK non-shipping company. All three businesses are of similar size and with similar funding requirements. Finance costs of £900 are all taken into account in computing the profits of the non-shipping company. Non-tonnage tax activities account for one third of the group.

> The paragraph 49 company counts as tonnage tax for this purpose therefore **F** = 33%. This means that **A** = 900, **B** = 900 and **E** = 600.

J. The same situation as **I**, except that the finance costs are charged £375 in each UK company and £150 overseas.

> This means that A = 375, **B** = 750 and **F** = 33% giving **E** = 125. It can be seen that this gives a net UK deduction of 250/750 outside the ring-fence, which is proportionately the same as the 300/900 in example **I**. This satisfies the principal at 10(ii) and takes proper account of the fact that overseas debt reduces the extent of the group's UK source financing requirement.

K. The same situation as **J**, except that the non-shipping company is now an overseas company.

> This means that **A** = 0, **B** = 375 and **E** = 0 (**E** cannot be negative).

L. The same situation as **J**, except that additional finance costs of £150 are paid by the non- tonnage tax company to the tonnage tax company.

> The interest does not constitute trading income and is therefore taxed outside the ring- fence. **A** still = 375 (as the additional costs can be ignored), **B** still = 750 and **F** = 33% giving **E** = 125 (as in **J**).

M. The same situation as **L**, except that the additional finance costs of £150 are paid by the non- tonnage tax UK company to the overseas shipping subsidiary.

> **A** = 525 (the additional costs are now brought into account), **B** = 900 and **F** = 33% giving **E** = 225.

N. Mrs X controls a group of UK non-tonnage tax companies that are funded primarily by debt. Her husband controls a group of tonnage tax companies that are funded primarily by equity.

> The debt and finance costs in the Mrs X companies must be taken account of in the paragraph 62 calculations.

O. A tonnage tax group incurs UK finance costs of £100 outside the ring-fence. **F** is determined at 2/3 which means that **E** = 33.3. The group enters into a financing arrangement whereby equity is invested in a subsidiary in a low tax regime and funds loaned back from this subsidiary to a tonnage tax company.

> There are no additional commercial activities created by this transaction and prima facie, **F** remains at 2/3. Interest paid by the tonnage tax company to the overseas finance company increases **B** but has no impact on **A**, thus reducing **E**. The main benefit of this arrangement to the group is to avoid an additional tax charge. HM Revenue and Customs would view this as not being a just and reasonable result and would expect a further adjustment to be made.