



HM Treasury



HM Revenue
& Customs

Tax deductibility of corporate interest expense:

consultation on detailed policy
design and implementation



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Foreword

The 'Business tax roadmap' published at Budget 2016 set out the government's plans for business taxes to 2020 and beyond. We are cutting corporation tax to 17% in 2020, supporting investment and ensuring the UK has by far the lowest rate in the G20. Alongside this, we are taking action to address aggressive tax planning by large multinational groups. Our principle remains clear – taxes should be low, but must be paid.

Following the publication of the outputs from the G20-Organisation of Economic Co-operation and Development (OECD) Base Erosion and Profit Shifting (BEPS) project in October 2015 and the endorsement by G20 leaders in November 2015, the government has set out plans for taking forward this work.

The government announced that new rules on interest deductibility will be introduced from April 2017 in line with the recommendations set out in the OECD report and taking into account the responses to the initial consultation that closed in January 2016. Due to the importance of this issue, we are publishing this next document now to seek views from all stakeholders on the detailed design of the new rules.



David Gauke MP

Financial Secretary to the Treasury

1 Introduction

1.1 Following consultation, the government announced at Budget 2016 that new rules for addressing BEPS through interest expenses will be introduced from 1 April 2017 in line with the OECD recommendations. The new rules will limit the tax relief that large multinational enterprises can claim for their interest expenses.

1.2 The government is leading the way in implementing the G20 and OECD recommendations to ensure that profits are taxed in line with activities in the UK. Where large multinational enterprises are over-leveraging in the UK to fund activities elsewhere in their worldwide group, or are claiming relief more than once, the government will act to counter aggressive tax planning and level the playing field, so that multinationals can no longer arrange their interest expenses to eliminate UK taxable profits.

1.3 The government will cap the amount of relief for interest to 30% of taxable earnings before interest, depreciation and amortisation (EBITDA) in the UK, or based on the net interest to EBITDA ratio for the worldwide group. To ensure the rules are targeted where the greatest risk lies, the rules will include a de minimis threshold of £2 million net UK interest expense per annum and provisions for public benefit infrastructure. The government will continue to work with the OECD to develop appropriate rules for groups in the banking and insurance sectors.

1.4 These rules will apply to all amounts of interest, other financing costs which are economically equivalent to interest, and expenses incurred in connection with the raising of finance. References in this document to interest should be read to also include these other amounts.

2 Parameters of consultation

Previous consultation

2.1 On 5 October 2015, the OECD published a recommended approach for limiting base erosion involving interest deductions and other financial payments, which was endorsed by G20 leaders. On 22 October 2015, the UK government launched a consultation, seeking views on the OECD proposals in a UK context. That consultation closed on 14 January 2016 and was used to inform the decisions announced at Budget 2016 and the proposals contained in this document. The government received 163 formal responses to the consultation from 5 individuals and 158 organisations. These responses are summarised in Annex B. A list of those who responded is provided in Annex C. The government is grateful to all those who contributed their views during the consultation process.

Scope of this consultation

2.2 Following initial consultation on the OECD recommendations, Budget 2016 and the 'Business tax roadmap' set the key policy design features for a restriction on the tax deductibility of corporate interest expense as set out in Chapter 3 of this document. This consultation seeks stakeholder input on the detailed design of the new rules as set out in this document to inform the drafting of the legislation for Finance Bill 2017.

How to respond

2.3 Please send response by email to: BEPSinterestconsultation@hmtreasury.gsi.gov.uk

Deadline for responses

2.4 4 August 2016

Summary of the Budget

3 2016 announcement

3.1 Subject to existing rules, businesses get tax relief in the UK for interest they incur on borrowing. Some multinational groups borrow more in the UK than they need for their UK activities, for example because the funds are used for activities in other countries which are not taxed by the UK, but the tax deduction for the interest reduces UK taxable profits. Groups might also enter into arrangements to claim further tax relief in the other country as well as in the UK, effectively obtaining a double deduction for the same interest expense. This creates competitive distortions, for example between groups operating internationally and those operating solely or mainly in the domestic market. These arrangements can readily be created within a group with the effect that intra-group interest far exceeds interest paid to third parties.

3.2 Under Action 4 of the BEPS project, the OECD has recommended an approach to the design of rules to prevent base erosion through the use of interest expense. The government believes the rules set out in the OECD report are an appropriate response to the BEPS issues identified, and has decided to introduce a restriction on the tax deductibility of corporate interest expense consistent with the OECD recommendations. **The new rules will apply from 1 April 2017** (see Chapter 11). This further demonstrates the government's commitment to align the location of taxable profits with the location of economic activity, which is in line with the UK's more territorial approach to corporate taxation.

3.3 The UK will be introducing a **Fixed Ratio Rule limiting a group's UK tax deductions for net interest expense to 30% of its UK EBITDA**. This approach is consistent with the approach in several other countries and international best practice. A level of 30% remains sufficient to cover the commercial interest costs arising from UK economic activity for most businesses. The rules will apply on a group-by-group rather than a company-by-company basis.

3.4 Recognising that some groups may have high external gearing for genuine commercial purposes, the UK will also be implementing a **Group Ratio Rule based on the net interest to EBITDA ratio for the worldwide group** as recommended in the OECD report. This should enable businesses operating in the UK to continue to obtain deductions for interest commensurate with their activities.

3.5 There will be a **group de minimis threshold. All groups will be able to deduct net UK interest expense up to £2 million**. This will target the rules at large businesses where the greatest BEPS risks lie, and minimise the compliance burden for smaller groups. It is estimated that this threshold will exclude 95% of groups from the rules.

3.6 The government intends to introduce rules to ensure that the restriction does not impede the provision of private finance for certain public infrastructure in the UK where there are no material risks of BEPS. It will also introduce rules to ensure that timing differences including volatility in earnings or interest do not result in an unwarranted permanent restriction.

3.7 Taking into account further engagement with the OECD and the responses to this consultation, the government will develop **rules to prevent BEPS involving interest in the banking and insurance sectors**.

3.8 There will no longer be a need for a separate **Debt Cap** regime and the existing legislation will be repealed. Rules with similar effect will be integrated into the new interest restriction rules, such that a group's net UK interest deductions cannot exceed the global net third party expense of the group. This modified cap will strengthen the new rules and help counter BEPS in groups with low gearing.

4 Overview of the proposed interest restriction rules

4.1 This chapter sets out an overview of the main elements of the proposed new rules, with signposts to parts of the document where those rules are defined in detail.

Scope of the rules

4.2 The new rules apply to all amounts of interest, other financing costs which are economically equivalent to interest, and expenses incurred in connection with the raising of finance. At the heart of the proposed rules is a UK tax measure of this concept, **tax-interest** (defined in paragraph 5.18). These are the amounts to which the rules apply and that are potentially restricted.

4.3 The rules also require a global accounts-based measure of the same concept, referred to as **total group-interest** (defined in paragraph 6.14). Other references to interest in this document should be read to also include all financing costs which are economically equivalent to interest, and expenses incurred in connection with the raising of finance.

4.4 The interest restriction rules generally apply after all other rules which determine the taxable profit or loss of a company for a period, but before most rules governing loss relief (see paragraph 4.26).

Application to groups

4.5 The new rules will apply on a group-wide basis. The **group** will include all companies that are or would be consolidated on a line-by-line basis into the accounts of the ultimate parent company. Companies that are not part of such a group will apply the rules in an equivalent way based on the company's own position (see paragraph 5.6).

De minimis exclusion

4.6 There is a de minimis allowance of £2 million per annum which means that groups with net interest expense below this are unaffected by the rules.

4.7 Most groups (and standalone companies which are not part of a group) will readily conclude without the need for any computation that they do not have net tax-interest expense in excess of £2 million, and that they are unaffected by these rules.

4.8 Groups that are not excluded by the de minimis rule can nevertheless always deduct at least £2 million of net tax-interest expense per annum, whatever the outcome of the Fixed and Group Ratio Rules. Beyond this, the de minimis threshold has no further impact on the rules (see paragraph 5.52).

Fixed Ratio Rule

4.9 Subject to the modified Debt Cap rules, deductions for net tax-interest expense are not restricted to the extent they do not exceed 30% of the group's **tax-EBITDA**. If there is an excess the group may apply the Group Ratio Rule, which may reduce or eliminate the excess. The excess may also be reduced or eliminated by utilising any **spare capacity** brought forward (see paragraphs 5.46 to 5.51). There is a **restriction** equal to any remaining excess, which is given effect by reducing deductions for specific items of tax-interest expense chosen by the group. This

determines in which companies the **restricted interest** is carried forward to be treated as an interest expense in future periods (see paragraph 5.43).

Modified Debt Cap rule

4.10 In addition to introducing the Fixed and Group Ratio Rules, the government wants to retain the existing protection offered by the Debt Cap. So that businesses do not have to apply two sets of rules, the existing Debt Cap legislation will be repealed. Rules with similar effect will be integrated into the new interest restriction rules, such that a group's net **tax-interest** amounts in the UK cannot exceed the global net **adjusted group-interest** expense of the group. This modified Debt Cap Rule will strengthen the new rules and help counter BEPS in groups with low gearing, as it will stop some groups with little net external debt gearing up to the Fixed Ratio Rule limit in UK. Any restriction arising from the modified Debt Cap will be treated in the same way as a restriction under the Fixed Ratio Rule (see paragraphs 5.55 to 5.58).

Group Ratio Rule

4.11 The Group Ratio Rule (see Chapter 6), will only be relevant for a small proportion of groups, and its use will be optional. It will allow groups that are highly leveraged for commercial reasons to obtain a higher level of net interest deductions, up to a limit in line with the group's overall position.

4.12 The rule will use most of the same mechanics as the Fixed Ratio Rule, but the **interest limit** of tax-EBITDA multiplied by 30% will be replaced by **tax-EBITDA** multiplied by the **group ratio**.

4.13 The group ratio will be defined as:

$$\frac{\text{Net qualifying group-interest expense}}{\text{Group-EBITDA}}$$

4.14 These amounts will be calculated using accounting figures for the worldwide group. The interest limit will be capped at the net qualifying group-interest expense. This is also the limit under the Group Ratio Rule if the group-EBITDA is zero or less.

4.15 To prevent groups being able to use debt instruments that would not ordinarily attract interest relief in the UK or which have equity-like features to inflate the group ratio, interest arising on such instruments is excluded from the definition of qualifying group-interest. Interest arising on loans from related parties is also excluded, and rules are proposed to treat shareholders that are acting together to secure greater control or influence over the group as related parties (see paragraphs 6.40 to 6.47).

4.16 In some cases, where group-EBITDA is unexpectedly small, the group ratio could be very large, reaching many hundred percent. Similarly, where group-EBITDA is negative, it is proposed that the Group Ratio Rule will permit deductions for tax-interest up to the amount of the whole of the net qualifying group-interest expense. This could give rise to excessive amounts of capacity, which could be used to permit deduction of substantial amounts of restricted interest brought forward. Alternatively, the capacity could be carried forward to allow excessive interest expense to be deducted in the following 3 years. Paragraph 6.9 sets out two options to address this risk.

Public Benefit Infrastructure

4.17 The provision of public benefit services often involves a long-term project benefitting from private finance to provide or upgrade, maintain and operate the necessary infrastructure. Projects are often structured so that income and operating expenditure have little volatility, and in consequence it may be both highly geared and generate only a small profit margin over the

cost of finance. It is possible that the current project arrangements would become unviable if the tax treatment of interest expense is changed.

4.18 Such projects do not present a BEPS risk provided that all the project revenues are subject to UK taxation, and to the extent that the financing is provided by third parties (with no equity interest), is used only for the project, and does not exceed the operator's costs of providing or upgrading the infrastructure. As announced at Budget 2016, the government wants to ensure that the restriction does not impede the provision of private finance in such cases.

4.19 In most cases it is expected that the third party interest expense of such projects will be deductible under the Fixed Ratio Rule or the Group Ratio Rule. Where the project gives rise to a finance asset, for example in accordance with IFRIC 12, the resulting finance income will be regarded as tax-interest and therefore netted off interest expenses when applying the interest restriction rules.

4.20 In addition, Chapter 7 sets out a proposal for a Public Benefit Project Exclusion (PBPE), based on the optional recommendation in the OECD's report. Groups electing to apply the PBPE would identify eligible projects, and would then exclude the eligible tax-interest expense, as well as any tax-interest income and tax-EBITDA connected with those projects, from their interest restriction calculation.

4.21 It is proposed that the PBPE would apply where a public body contractually obliges an operator to provide public benefit services, or licenses the operator and thereby regulates, directly or indirectly, the pricing of such services. Public benefit services are considered to be those which it is public policy to provide for the benefit of the public. The PBPE would only apply to interest payable to third parties. Further conditions for the PBPE are set out in Chapter 7.

4.22 Provision for grandfathering of existing loans or projects would only be made if there is evidence that any adverse impacts of the new rules connected to infrastructure finance would be systemic and could not be mitigated in other ways, and if rules can be designed to limit distortions and preserve the impact of the new rules in tackling BEPS.

Interaction with specific regimes

4.23 Profits from the exploitation of oil and gas in the UK and on the UK continental shelf are subject to a special regime known as Ring Fence Corporation Tax (RFCT), which imposes a higher tax burden than the normal corporation tax regime. It includes rules to prevent taxable profits from oil and gas extraction being reduced by excessive interest payments. Budget 2016 confirmed that the new interest restriction rules will not adversely affect existing commercial arrangements within the ring-fence. Paragraph 8.2 sets out two options intended to ensure that the new interest restriction rules are effective outside the ring-fence. Under both options, any restriction of interest deductibility would only be applied to activities outside the ring-fence.

4.24 The government is continuing to engage with businesses, regulators, the OECD and other countries participating in the BEPS project to understand the extent to which the Fixed and Group Ratio Rules' application to groups with banking and insurance activities could leave interest-related BEPS risks unaddressed. It is considering whether bespoke or modified rules should be introduced for groups engaged in these types of activities. It is envisaged that these rules would have effect from 1 April 2017 and two such options are outlined in paragraphs 8.26 to 8.44.

4.25 The interest restriction will not reduce or increase the value of Research & Development (R&D) allowances. This will be achieved by ensuring that the actual amount of R&D expenditure, but no enhancement, is included in tax-EBITDA. In contrast with R&D allowances, which are based only on expenditure, the Patent Box is intended to apply a lower effective tax rate to

profits falling within the regime. Therefore, the additional deductions in respect of Patent Box profits will be included in the calculation of tax-EBITDA. This will ensure consistent application of the interest restriction and prevent groups that are highly leveraged in the UK getting tax relief at the full Corporation Tax rate for interest on borrowings that are used to generate income that is subject to reduced taxation (see paragraphs 8.45 to 8.48).

4.26 The interest restriction will be designed to work in conjunction with the reforms to loss relief which will become effective on the same date. In broad terms, the interest restriction rules will apply first, and the reformed loss relief rules will apply to the resulting profits and losses. Losses relating to interest expense that arise before 1 April 2017 will not be subject to the interest restriction but will be included within carried forward losses. Interest arising on or after 1 April 2017 that is restricted will be carried forward as interest and subject to interest restriction rules in subsequent periods, but not treated as a carried forward loss. It is possible, though not common, that interest deductible after the interest restriction rules have applied will give rise to or increase a loss. In this case the loss will be subject to the loss relief rules (see paragraphs 9.41 to 9.42).

Targeted rules

4.27 The proposals set out in this consultation are for structural rules backed up with targeted anti-avoidance rules, as described in Chapter 10. The government is continuing to review whether additional targeted rules are necessary to apply to particular situations in which deductions for interest would not be restricted under the proposed rules but do give rise to BEPS.

5 Fixed Ratio Rule

5.1 The key aspect of the interest restriction is that under the Fixed Ratio Rule, **tax-interest** for the group will be limited to:

$$30\% \times \text{tax-EBITDA}$$

5.2 Where relevant, this will need to be calculated for a **period of account**, and will be based on the aggregated amount of tax-EBITDA across the **group**. This requires the group to sum the tax-EBITDA of each UK resident member company and UK Permanent Establishment (PE). The tax-EBITDA of a company or PE can be negative, but the group's tax-EBITDA is subject to a floor of zero.

5.3 If the group's net tax-interest expense exceeds its interest capacity, there is an **interest restriction** equal to the excess. The group must decide how much of any **interest restriction** will be allocated to each group company. Amounts of interest restriction can only be allocated to companies to the extent they have net tax-interest expense.

5.4 In addition, the rules will contain provisions to address timing differences that can arise between interest expenses incurred and the earnings generated using the borrowed funds.

- The **restricted interest** is carried forward indefinitely and may be treated as a deductible interest expense in a subsequent period if there is sufficient interest capacity in that period
- Where a group has **spare capacity** for a period it can carry this forward and use it as additional interest capacity in subsequent periods until it expires after 3 years

5.5 The main operation of the Fixed Ratio Rule is supplemented by the following additional aspects:

- There is a **de minimis allowance** of £2 million per annum which means that groups with net interest expense below this are unaffected by the rules
- The rules limit interest relief to the net adjusted group-interest expense (this is the **modified Debt Cap rule**)

Definition of Group

5.6 A single definition of group is used for all aspects of the rules.

5.7 In particular, the interest restriction rules will apply on a group, rather than company-by-company, basis. There will therefore be a single calculation of the amount of interest relief available for the group based on the aggregated amounts of net tax-interest and tax-EBITDA across all the companies in the group that are within the charge to UK corporation tax. In addition, the group ratio calculation also looks at the group position, but for this it requires all members of the worldwide group to be considered.

5.8 In line with the OECD report, it is proposed that for the purposes of these rules, the group should be based on the accountancy concept of a group as used for the purposes of preparing consolidated accounts. This should typically enable the required financial information to be prepared easily using the group's consolidation system. It also ensures that the group ratio cannot easily be manipulated through the location of activities and debt in different parts of the worldwide group.

5.9 The group will comprise the ultimate parent and all entities that are consolidated on a line by line basis in the parent's consolidated financial statements (excluding, for example, associates

and joint venture companies). The ultimate parent would generally be the top company in a holding structure, so would be based on the highest level of consolidation.

5.10 In line with the current Debt Cap regime, the ultimate parent must be a company or similar entity. A group cannot be headed by an individual. It would not generally be able to be headed by a non-corporate entity such as a UK or foreign partnership, taken to include Limited Liability Partnerships. It would not be able to be headed by a public body (see paragraphs 9.37 to 9.40). There will be an exception in that a parent can be a non-corporate entity which is listed on a recognised stock exchange and where no participator owns more than 10% of the entity.

5.11 It is proposed that the definition of the group should be based on International Financial Reporting Standards (IFRS) concepts only, to prevent issues with different accounting standards resulting in different entities being included within the group.

5.12 This approach is very similar to the way the Debt Cap regime currently operates, where the group is defined in s338 and s339 of the Taxation (International and Other Provisions) Act (TIOPA) 2010. The key difference is that where a subsidiary is accounted for as an investment at fair value and not consolidated on a line-by-line basis, it would be excluded from the investor's group and would instead form its own group, following the OECD's recommendation. The current approach under the Debt Cap regime would include all of the subsidiaries within the investor's group.

5.13 Specific rules will be included to address "stapled stock" at the top of the group and dual listed groups in line with the current Debt Cap regime.

Question 1: Does the use of IFRS concepts cause practical difficulties for groups accounting under other accounting frameworks (e.g. UK Generally Accepted Accounting Principles (GAAP) or US GAAP)? Could the use of a range of acceptable accounting frameworks to define the group give rise to difficulties in identifying the members of the group? What would be the main consequences of relaxing the definition in this way?

Periods of account

5.14 The interest restriction calculations should be performed by reference to the group's period of account. The starting point will be the period of account of the ultimate parent for the group, and so follows a similar approach to that taken in the current Debt Cap regime. This will be the period for which the group's consolidated accounts are made up.

5.15 Where the ultimate parent does not produce consolidated accounts, it is proposed to use the period for which it produces its own non-consolidated accounts. Where there are no such accounts drawn up for more than 18 months, a period of 12 months from the end of the last period will be used. The calendar year will be used if there is no other reference for fixing the period to use.

5.16 Where group membership is stable and all companies have the same period of account then calculations should be straightforward. However, where companies leave and join the group, or have differing periods of account, amounts for those companies will need to be adjusted before being allocated to periods of account for the group. The proposed rules follow the approach in the current Debt Cap rules, which requires that the amount be reduced by such proportion as is just and reasonable (including, where appropriate, to nil). This would apply both for aggregating the amounts of tax-interest and for the amounts of tax-EBITDA.

5.17 Provision will be included for reworking the figures in corporation tax computations and returns, when they depend on interest restriction calculations that cannot be finalised by the relevant filing deadlines.

Question 2: Is it reasonable to take the proposed approach to the periods for making interest restriction calculations? What changes or alternatives to that approach, if any, should be adopted?

Tax-interest

5.18 In line with the recommendations of the OECD report, it is proposed that the interest restriction rule should apply to interest on all forms of debt, payments economically equivalent to interest, and expenses incurred in connection with the raising of finance. In this document, amounts falling into any of these categories are referred to as **tax-interest**.

5.19 As the rules are intended to limit the amount of tax relief that UK companies can obtain for these amounts, tax-interest is defined by reference to tax concepts and measured by reference to the relevant tax rules. The net tax-interest expense will equal the **financing expense amount** less the **financing income amount**.

5.20 The financing expense amount will comprise:

- loan relationship debits (which typically includes guarantee fees paid)
- derivative contract debits (on interest, currency and debt contracts)
- financing cost implicit in the payments under certain leases
- financing cost recognised under a structured finance arrangement falling within Chapter 2 of Part 16 Corporation Tax Act (CTA) 2010 (which typically includes financing costs on debtor factoring and a service concession arrangement that is accounted for as a finance liability)

5.21 The financing income amounts will comprise:

- loan relationship credits
- derivative contract credits (on interest, currency and debt contracts)
- financing income implicit in amounts received under certain leases
- financing income receivable on debt factoring or any similar transaction
- guarantee fees received
- the financing income implicit in amounts received under a service concession arrangement that is accounted for as a financial asset

5.22 The amounts within tax-interest will be those that are taxable or deductible after the application of rules such as:

- transfer pricing rules
- unallowable purpose rules
- anti-hybrid rules
- group mismatch rules
- distribution rules

5.23 Other tax rules will also operate to determine the amount of tax-interest. For example, it would include amounts attributed to a corporate partner where a partnership borrows or lends money; and would exclude amounts relating to an exempt foreign branch. It would also include amounts of capitalised interest which fall within section 320 Corporation Tax Act (CTA) 2009.

5.24 This broad approach is in line with the current Debt Cap regime which defines 'financing expense amounts' and 'financing income amounts' in sections 313 and 314 TIOPA 2010 respectively. However, there are specific amounts which would now be included within the scope of the rules, particularly in respect of impairment losses, related transactions and derivative contracts. See below for further details.

Question 3: Do you agree that these are the right amounts to be included with the scope of tax-interest? Are there any other amounts that should be included within the scope of tax-interest, or any amounts which should be excluded? If so, please explain the reasons why?

Exchange gains and losses

5.25 Amounts of exchange gains and losses on principal amounts will be excluded from tax-interest. In many cases these amounts will be hedging the operating activities of the company. Rather than seek to distinguish which amounts are hedging trading operations (potentially in different group companies) all exchange movements are excluded.

5.26 Exchange gains and losses will be calculated by reference to movements in spot exchange rates in line with existing tax rules (see section 475 CTA 2009). If groups enter into arrangements to artificially convert interest expense into exchange losses, these would be countered by the anti-avoidance rules.

5.27 Exchange gains and losses in respect of retranslation of interest and other financing amounts will be included within tax-interest.

Question 4: Do you agree with the proposed treatment of exchange gains and losses? Do you foresee any unintended consequences from this approach? If so, please explain, and suggest an alternative.

Impairment losses

5.28 Impairment losses will be included in tax-interest to the extent that they arise on loan relationships or finance lease receivables. This reflects the nature of these items as part of the return on the lending of money. Impairment losses on ordinary trade debtors and other non-lending money debts will be excluded.

Question 5: Do you agree with the proposed treatment of impairment losses? Do you foresee any unintended consequences from this approach? If so, please explain, and suggest an alternative.

Related transactions

5.29 Profits and losses from related transactions, as defined in section 304 CTA 2009, such as break costs on the early termination of loans, will be included within tax-interest. This reflects the nature of these items as part of the cost of borrowing or part of the profit from the lending of money. Including these amounts will ensure that there is no distortion in the rules where, for example, a business makes a profit or incurs a loss on refinancing existing debt, reflecting differences between the terms of the existing loan and the new market interest rates at which it can borrow.

5.30 A business could incur a large profit or loss in one period, whereas the corresponding cost (or benefit) materialises in the new interest rate over a number of years. The rules for timing differences should address this.

Question 6: Do you agree with the proposed treatment of related transactions? Do you foresee any unintended consequences from this approach? If so, please explain, and suggest an alternative.

Tax-EBITDA

5.31 As the intention of the new rules is to align the tax deductibility of interest with income that is subject to tax in the UK, tax-EBITDA will be measured by reference to amounts taxable and deductible for corporation tax purposes. A company's tax-EBITDA will equal the aggregate of the amounts brought into account for the year which do not comprise 'interest', 'depreciation' or 'amortisation'. This can be either a positive or a negative amount.

5.32 Tax-EBITDA will therefore be based on profits chargeable to corporation tax (and equivalent amount of current year losses) excluding:

- tax-interest (as defined above)
- tax-depreciation (as defined below)
- tax-amortisation (as defined below)
- relief for losses brought forward or carried back (including trading losses, non-trading loan relationship deficits, non-trading intangible losses and excess management expenses)
- amounts of group relief claimed or surrendered between companies in the same group (as defined for these rules)

5.33 Other adjustments will also be made, as described in this document.

Question 7: Are there any other amounts that should be included with the definition of tax-EBITDA, or any more items which should be excluded? If so, please explain the reasons why?

Tax-depreciation

5.34 The amounts excluded in respect of depreciation will consist of claimed capital allowances (including balancing allowances) less balancing charges. See also comments below in relation to leasing contracts.

Tax-amortisation

5.35 The amounts excluded in respect of amortisation will include amounts which are deductible under the rules for intangible fixed assets at sections 729 (accounting basis) and 730 (fixed rate basis) of CTA 2009, reflecting the cases where the intangible fixed asset is capitalised in the company's accounts. Where there is a realisation, revaluation or other reversal of previous accounting debits, these credit amounts would also be excluded from tax-EBITDA to the extent that they represent amounts where relief has previously been given under the above sections.

Question 8: Do you agree with the proposed treatment for tax-depreciation and tax-amortisation?

Tax losses brought forward and carried back

5.36 Tax-EBITDA will be calculated on a current-year basis, without any account being taken of losses brought forward or carried back. This avoids the need to trace an analysis of losses between EBITDA, interest, depreciation and amortisation.

5.37 There is a risk that this could inflate the interest capacity of the business over a number of years. For example, a business with £100 million of EBITDA in each of two years will have total interest capacity for the two-year period of £60 million under the Fixed Ratio Rule (30% of £200 million). However, a business with a loss of £100 million in year 1 and a profit of £300 million in year 2 will have total interest capacity of £90 million under the Fixed Ratio Rule (30% of £300 million).

5.38 To eliminate this risk, provisions could be introduced requiring groups to carry forward negative amounts of tax-EBITDA to future periods. However, at this stage, it is considered that this would add unnecessary additional complexity to the rules. The risk is already limited by difficulties in artificially manipulating the timing of taxable profits, potential limitations under the proposed reforms to carried forward loss relief and by the anti-avoidance rules (see Chapter 10). However, the need for rules requiring negative tax-EBITDA to be carried forward will be kept under review.

Group relief (including consortium relief)

5.39 Tax-EBITDA will be calculated without taking account of amounts of group relief (which includes consortium relief) claimed from companies that are within the same group for the purpose of these rules. This ensures that amounts are included within the aggregated tax-EBITDA figure once and only once.

5.40 Amounts of group relief claimed for losses from outside of the group (for the purpose of these rules) should be deducted from the tax-EBITDA figure. This is to ensure that group relief claims cannot be used to reduce the amount of taxable profits of the group without it also reducing the amount of the aggregated tax-EBITDA figure. To avoid the need to analyse such amounts of group relief between EBITDA, interest, depreciation or amortisation, the full amount of the group relief claimed will be deducted from tax-EBITDA.

Question 9: Do you agree that the proposed treatment of different types of loss relief will be fair and effective while minimising the need to analyse and trace loss amounts? If not, please suggest an alternative, providing an explanation of why you find it preferable.

Chargeable gains and allowable losses

5.41 It is considered that net chargeable gains should be included within tax-EBITDA as they represent part of the taxable profits arising from the assets of the business.

5.42 Allowable capital losses are more restricted in their use than revenue losses and can only be used against chargeable gains of the current or later period. As a result, it could be overly restrictive for groups to be required to deduct unused capital losses in calculating tax-EBITDA in the period in which they arise. Allowable losses would be taken into account at the time they are utilised. Consequently, tax-EBITDA will include any net chargeable gains (after the deduction of allowable losses). This means that the calculation of tax-EBITDA is based on the amount of the gain that is actually giving rise to a potential tax liability in the year. This provides protection for the Exchequer where groups have significant amounts of existing allowable losses.

Question 10: Do you agree with the proposed treatment of chargeable gains and allowable capital losses? If not, please suggest an alternative, providing an explanation of why you find it preferable.

Carry forward of restricted interest

5.43 If a group's net tax-interest expense exceeds its interest capacity, there is an interest restriction equal to the excess.

5.44 Groups will be able to choose how to allocate any interest restriction between the individual companies of that group, subject to certain limitations. The amount of restriction allocated to a company will be limited to its net tax-interest expense. The allocation will give effect to any interest disallowance in-year, and it will determine in which company this restricted interest is carried forward.

5.45 Restricted interest will be carried forward indefinitely. It will be deductible in subsequent periods, as if it were an amount of interest of that period, subject to there being sufficient capacity available under the interest restriction rules in that later period.

Carry forward of spare capacity

5.46 It is proposed that where a group has spare capacity in one year, it may allocate that capacity at its discretion to group companies to be carried forward. However, the amount of spare capacity allocated to a company will not be allowed to exceed the spare capacity within that company calculated as a stand-alone company.

5.47 Spare capacity will be calculated by subtracting the net tax-interest expense from the interest limit. Net tax-interest income does not create additional spare capacity. So where there is net tax-interest income the spare capacity will equal the interest limit. Spare capacity carried forward will be added to the capacity of the next period.

5.48 If spare capacity could be carried forward indefinitely, then it could build up to very large amounts. This tax attribute could have a large potential real value if it could be used to absorb otherwise unrelieved interest expenses. The government recognises the desirability for spare capacity to be allowed to be carried forward, but is wary of creating a potentially very valuable tax attribute which could lead to distortions in commercial behaviour.

5.49 The government therefore proposes to allow spare capacity to be carried forward for 3 years.

5.50 To prevent abuse, the government is considering including rules for restricted interest and spare capacity, similar to the loss-buying rules proposed as part of the carried forward loss reform but adapted as necessary.

5.51 The government is not proposing to allow any carry back of restricted interest or spare capacity. A carry back would involve additional complexity and the issues around timing differences can be largely dealt with using carry forward rules.

Question 11: Given the proposed reform of losses, does carrying forward restricted interest to be treated as an interest expense of a later period give companies sufficient flexibility?

Question 12: Does the 3 year limit on the carry forward of spare capacity provide sufficient flexibility for addressing short term fluctuations in levels of tax-interest and tax-EBITDA?

Question 13: Are there common circumstances where the proposals will substantially fail to deal with problems around timing differences?

De minimis allowance

5.52 Budget 2016 confirmed there will be a de minimis group threshold of £2 million net UK interest expense. This will target the rules at large businesses where the greatest BEPS risks lie, and minimise the compliance burden for smaller groups. The threshold is estimated to exclude 95% of groups from the rules. All groups will be able to deduct up to £2 million of net interest expense per year (pro-rated where necessary). This will override the modified Debt Cap Rule going forwards so that the £2 million de minimis amount will always be available.

5.53 Where a group already has more than £2 million of interest capacity, the de minimis threshold will not enhance it further. Where a group has less than £2 million net interest expense, the de minimis threshold will not give rise to any spare capacity to carry forward.

Example 5.A

A group has net interest expense of £1.8 million, current-year interest limit of £1 million and spare capacity brought forward of £0.5 million. The capacity brought forward is added to the in-year interest limit to give a total available capacity of £1.5 million. This capacity is wholly consumed and would still leave £0.3 million of interest restricted, except that the de minimis rule will allow the full £1.8 million of net interest expense to be deducted. There is no restricted interest or capacity remaining to carry forward.

5.54 The government will ensure the anti-avoidance provisions (see Chapter 10) prevent groups using artificial structures to take advantage of multiple de minimis amounts.

Replacement of the current Debt Cap regime

5.55 Budget 2016 confirmed there will no longer be a need for a separate Debt Cap regime and the existing legislation will be repealed. Rules with similar effect will be integrated into the new interest restriction rules, such that a group's net UK tax-interest amounts cannot exceed the global net adjusted group-interest expense of the group. This modified Debt Cap Rule will strengthen the new rules and help counter BEPS in groups with low gearing, as it will stop groups with little net external debt gearing up to the Fixed Ratio Rule limit in UK.

5.56 So in addition to tax-interest being limited to the higher of the results of the Fixed Ratio Rule and the Group Ratio Rule, the amount of tax-interest will also be limited under a modified Debt Cap rule. This will provide a limit based on the net total group-interest expense, although net tax-interest expense of up to £2 million per annum would remain deductible for all groups.

5.57 The amount of the adjusted group-interest limit will be calculated in a similar way to how it will be calculated for the Group Ratio Rule. In particular, it will be based on the net finance cost of the group. It will also include amounts of capitalised interest and exclude amounts of dividends payable under redeemable preference shares. However, there will be no additional restriction of amounts that are included within total group-interest. For example, in contrast to the measure of interest used for the calculation of the group ratio (see paragraphs 6.29 to 6.47), amounts due to related parties would not be excluded.

5.58 The mechanics of this rule will be fully incorporated with the main rules. So, for example, an amount of restricted interest would be available to be carried forward and used in a future period where there is sufficient interest capacity.

Question 14: Does the proposed modification of the Debt Cap rule balance the objectives of maintaining effective Exchequer protection in this area, aligning the mechanics with the interest restriction rules and ensuring that the relevant figures are readily available from the group's consolidated financial statements?

6 Group Ratio Rule

6.1 Recognising that some groups may have high external gearing for genuine commercial purposes, the government announced at Budget 2016 that the new rules will include a Group Ratio Rule based on the net interest to EBITDA ratio for the worldwide group, as recommended in the OECD report. This should enable businesses operating in the UK to continue to obtain deductions for interest expenses commensurate with their activities, in line with the worldwide group's financial position.

6.2 The Group Ratio Rule builds on to the mechanism of the Fixed Ratio Rule as follows.

Group ratio

6.3 The group ratio will be defined as:

$$\frac{\text{Net qualifying group-interest expense}}{\text{Group-EBITDA}}$$

6.4 These amounts will be calculated using the accounting figures for the worldwide group. Where the group is in a net qualifying group-interest income position, the amount of net qualifying group-interest expense will be taken to be zero. A simple example of the calculation of the group ratio is shown in example 1 in Annex D.

6.5 Where a group chooses to apply the Group Ratio Rule it uses the group ratio, as calculated above, in place of the 30% in the operation of the Fixed Ratio Rule. However, the amount available under the Group Ratio Rule is capped at the amount of net qualifying group-interest expense.

6.6 It follows from the definition of the group ratio that if the group-EBITDA is small relative to the group-interest expense (for example, due to trading difficulties or as the group looks to expand) the group ratio will be very large.

Example 6.A

A group has net qualifying group-interest expense of £100 million and group-EBITDA of £5 million. The group ratio would be 2000%.

If the group has tax-EBITDA in the UK of £10 million, the interest limit is calculated as 2000% of £10 million, being £200 million, but capped at the net qualifying group-interest expense of £100 million.

6.7 The group ratio is undefined if group-EBITDA is zero or less. In that case the interest limit under the Group Ratio Rule will be the amount of net qualifying group-interest expense. This prevents a cliff edge in the outcome of the Group Ratio Rule as group-EBITDA decreases through zero and becomes negative.

6.8 In most circumstances the Group Ratio Rule will provide an interest limit that reflects both the group's external borrowing and its UK activity. However, in some circumstances it does not provide an effective cap. If the group ratio is very large, or if the Group Ratio Rule results in an interest limit equal to the net qualifying group-interest expense, the resulting interest capacity can sometimes be excessive compared to UK activity. This capacity, could be used to permit deduction of substantial amounts of restricted interest brought forward. Alternatively the

capacity could be carried forward to allow excessive interest expense to be deducted in the following 3 years.

6.9 To address this risk, the government is considering the merits of two separate approaches.

Option 1: The Group Ratio Rule should only be available for groups to utilise current year financing costs. It would not allow groups to access restricted interest brought forward, nor would it be able to create spare capacity to be carried forward for later years. This would mean that the groups operating in highly leveraged sectors would not have the full benefit of the rules to address timing differences between the UK ratio and group ratio.

Option 2: The Group Ratio Rule should operate in all cases so that the interest limit is capped at a fixed percentage of tax-EBITDA. This percentage would be set higher than 30% but less than 100%. Below the percentage cap, groups would have the full benefit of the rules to address timing differences. However, it could result in financing costs being restricted and therefore carried forward when the tax-EBITDA is low or negative (e.g. during the construction phase of a project).

Question 15: Which of these two approaches do you consider to be the most appropriate way to address the risks arising from very high group ratios or negative group-EBITDA, and why? How should the percentage cap be set under the second approach? Are there other approaches which would better address this situation?

Obtaining financial information

6.10 It is proposed that financial statements prepared in accordance with a particular accounting framework are acceptable if they are drawn up in accordance with IFRS, UK GAAP or accounting standards of Canada, China, India, Japan, South Korea or the USA. This is in line with the current Debt Cap regime.

6.11 The current Debt Cap regimes also contains a 'broadly comparable' limb (ss347 (4)-(6) TIOPA 2010) which allows other accounting frameworks to be used where the relevant figure are aligned with IFRS methodology. However, it does not appear that this limb is widely used, and it would not be straightforward to modify it to fit with the calculation of the group ratio. We are therefore considering whether this element should be retained.

Question 16: Are there specific cases where the removal of the 'broadly comparable' limb contained in the current Debt Cap regime would give rise to particularly difficult outcomes? If so, please suggest how this extension should be modified to allow the calculation of the group ratio.

6.12 Where no consolidated financial statements are drawn up for the worldwide group in respect of a period, or if financial statements are drawn up, but are not in accordance with one of the acceptable list of accounting frameworks listed above, the rule would apply as if financial statements had been drawn up in accordance with IFRS. In these circumstances the group would have to calculate the relevant numbers under IFRS: those that are needed for the modified Debt Cap Rule and, where it is being used, for the Group Ratio Rule.

6.13 In the event of a merger or demerger of a worldwide group which results in a change in the ultimate parent, the group ratio will be calculated separately on the assumption that two separate sets of accounts were prepared for the pre and post transaction periods.

Definition of total group-interest

6.14 Total group-interest represents the amounts of interest-like amounts recognised as amounts of profit or loss in the group's financial statements. This is the amount which is added back to the group's profit for the period in calculating group-EBITDA (see below).

6.15 It is proposed that total group-interest is defined in a similar way to the definition of the Available Amount in the current Debt Cap rules (section 332 TIOPA 2010) in that the definition will set out the nature of items to be included, and that these are then measured by reference to the amounts recognised in the worldwide group's financial statements. As a starting point, this should be based on the amounts recognised in profit or loss, and so would not include amounts in other comprehensive income or which are recognised directly in equity.

6.16 The items to be included would mirror those within the concept of tax-Interest, although without regard to their tax treatment under any overseas tax system, and so would be wider than the definition in the current Debt Cap rules. It would, though, exclude amounts of exchange gains and losses.

6.17 The expense amounts included within total group-interest would be the amounts recognised in the financial statements of the group in respect of:

- interest payable on borrowings
- losses on borrowing and related transactions
- expenses ancillary to borrowing
- the financing expense implicit in payments made under finance leases
- the financing expense relating to debt factoring
- the financing expense implicit in payments made under a service concession arrangement that is accounted for as a financial liability

6.18 The income amounts included within total group-interest would be the amounts recognised in the financial statements of the group in respect of:

- interest receivable on borrowings
- profits on borrowing and related transactions
- the financing income implicit in payments made under finance leases
- the financing income relating to debt factoring
- the financing income implicit in payments made under a service concession arrangement that is accounted for as a financial asset

6.19 Ancillary expenses are expenses incurred directly in bringing borrowing into existence or altering its terms, or in making payments in respect of borrowing, including abortive financing costs.

6.20 In line with the definition of tax-interest, amounts of exchange gains and losses would be excluded from the definition of total group-interest. In addition, the definition would not include any expected return or financing expense in respect of pension assets and liabilities, or the unwinding of discounts on accounting provisions. All these amounts would therefore be included within group-EBITDA.

6.21 In line with regulations made in respect of the current Debt Cap rules, qualifying group-interest would also include the following amounts:

- interest payable in respect of relevant non-lending relationships
- alternative financing costs under alternative finance arrangements
- manufactured interest treated as a loan relationship
- finance charges treated as interest payable under a debtor repo or debtor quasi-repos
- finance charges under structured finance arrangements treated as interest payable

Question 17: Are there any further items of profit or loss which should be included within the definition of total qualifying group-interest?

Adjusted group-interest: Adjustments to amounts in profit or loss

6.22 For the purpose of the modified Debt Cap Rule, certain adjustments to total group-interest are needed to align with the UK tax rules. These are as follows:

Capitalised interest

6.23 Where the group capitalises interest as part of the cost of an asset, it is proposed that this amount should be included in qualifying group-interest. This replicates the effect of s320 CTA 2009. It should be noted that no conditions would be attached to this, so it would include all capitalised interest irrespective of the nature of the asset or its tax treatment.

Cancellation of debt income where group is in distress

6.24 Where debt is released or restructured as part of a corporate rescue of the group, it is proposed that any profit in respect of the release or restructure should be excluded from the amounts of adjusted group-interest. This would be in line with the provisions in sections 322 and 323A of CTA 2009. This would include any income arising from a bona fide debt-to-equity swap.

Timing differences

6.25 It is not proposed that special provision is included for addressing differences for when financing costs can be deducted for tax as opposed to when they are recognised in the group accounts. These generally arise in respect of loans with related parties. In addition, the rules to address timing differences detailed in Chapter 5 should relieve most potential difficulties.

Other items

6.26 See Chapter 9 for further detail of the calculation of tax-Interest in respect of changes of accounting policy.

Preference shares

6.27 No amount is to be included in adjusted-group-interest to the extent that the amount represents dividends in respect of preference shares. This mirrors the restriction in the current Debt Cap rules at section 332(2) TIOPA 2010.

6.28 This is illustrated in example 5 in Annex D.

Question 18: Are there any other amounts that should be included with the definition of adjusted group-interest, or any more items which should be excluded? If so, please explain the reasons why?

Qualifying group-interest: Restrictions on deductibility

6.29 The Group Ratio Rule allows groups which are highly leveraged for commercial reasons to obtain a higher level of deduction for their financing costs, in line with the group's overall position. However, to prevent groups being able to use debt instruments that would not ordinarily attract interest relief in the UK being used to inflate the group ratio, only certain amounts of adjusted group-interest (referred to as qualifying group-interest) would be taken into account when calculating the group ratio.

6.30 Where groups use vanilla debt instruments from third parties, they should be entitled to tax relief for a proportion of finance cost on these instruments. Where, however, groups use more exotic instruments, such as those with debt and equity characteristics, the group ratio should not benefit from the associated financing costs.

6.31 The following restrictions will not affect the operation of the modified Debt Cap Rule.

Related Party Interest

6.32 No amount of expense is to be included in qualifying group-interest to the extent that the amount arises in respect of a financing transaction with a related party. See below for what would constitute a related party.

Profit participation loans

6.33 Financing costs in respect of results-dependent debt will likewise be excluded from qualifying group-interest.

6.34 Results-dependent debt would be defined in line with section 1015(4) CTA 2010 as debt where the consideration given by the borrower for the use of the debt is to any extent dependent on the results of the business of the group or on any part of the group's business.

Perpetual debt

6.35 It is proposed that financing costs in respect of perpetual debt will be excluded from qualifying group-interest.

6.36 Perpetual debt would be defined in line with s1015(6) as debt where, in broad terms, the debt has no redemption date, or the latest date for redemption falls more than 50 years after the inception of the debt.

6.37 Loans that are repayable on notice by the lender would not fall to be perpetual debt, because they contain terms capable of giving rise to a particular date by which the lender can require repayment.

Compound instruments and hybrid debt

6.38 It is proposed that financing costs in respect of compound instruments or other hybrid debt will be excluded from qualifying group-interest.

6.39 Excluded instrument would include those which are accounted for as a compound instrument under accounting standards, and instruments which contain embedded derivatives that are not closely related to the host contract under accounting standards.

Question 19: Are there any other amounts that should be included with the definition of qualifying group-interest, or any more items which should be excluded? If so, please explain the reasons why?

Related parties

6.40 As noted above, financing costs to related parties will be disregarded in calculating qualifying group-interest. This means financing costs due by a group to related parties will not increase a group's ability to recognise tax effective deductions for financing costs in excess of the 30% limit provided for by the Fixed Ratio Rule.

6.41 The OECD recommendations on related party definition are focused on identifying a "significant relationship" between individuals or entities who do not come within the definition of group. An entity (B) will be related to another (A) where:

- B has effective control of A, or a third person has effective control of both A and B
- B has a 25% or greater investment in A, or a third person has a 25% or greater investment in both A and B
- A and B are associated enterprises under Article 9 of the OECD Model Tax Convention

6.42 It is proposed that this test be adopted in the UK regime, including the OECD recommendation that the interests of two or more persons should be aggregated when testing the 25% threshold if they are acting together in respect of their equity investments or voting rights.

Acting together

6.43 It is proposed that all the OECD recommendations on when two persons will be acting together are captured in the UK approach. Two persons will therefore be acting together where:

- a. they are members of the same family
- b. one regularly acts in accordance with the wishes of the other in respect of ownership or control of their investment
- c. they have entered into an arrangement that has material impact on the value or control of any such investment
- d. they each directly or indirectly hold debt in the underlying entity in proportion to their voting rights or equity interests, or
- e. the ownership or control of any such rights or interests is managed by the same person or group of persons

6.44 In line with the OECD proposals and the hybrids rules, it is proposed that collective investment vehicles under common management will not be caught by limb (e) where the investment manager can show that the schemes are not co-ordinated for the purpose of influencing the conduct of the affairs of the underlying entity.

6.45 In addition, the government proposes that two or more entities will also be considered to be acting together where they collaborate in a more general sense in relation to the making or holding of an equity investment in a company. This would cover situations where otherwise economically independent persons "club together" or form a consortium to acquire an asset which does not necessarily meet any of the specific situations described above but where the investors' interests are sufficiently aligned that they enter into the arrangements on the assumption that they will act together to secure greater control or influence. While the individual members of such a club may hold below 25%, by virtue of their membership of that group they have the sort of significant relationship which should be captured by the concept of related party, in line with the OECD recommendations.

Example 6.B: Acting together

To give a simple example, a group of 5 investors come together to take control of a UK utility group. Each investor takes a stake which falls below 25% when looked at in isolation. The parties enter into a relatively standard form investment agreement with drag and tag rights but this does not materially impact on the value of their stakes. To reflect different risk-reward appetites and their individual tax treatment the investors also split their investments between debt and equity in differing proportions. While such a structure may not meet any of limbs (a) to (e) above, each of the 5 investors is acting together to secure control and influence over the underlying group. That level of control by the “club” would permit the investors to undertake BEPS via the interest payments on the shareholder debt.

The government believes that whether such investors are to be regarded as related parties should not depend on the nature of their legal investment agreement or whether they decide to take equity and debt in the same proportions. The concept of “related party” will therefore identify situations like those described above where a club or consortium of investors act together in relation to the making or holding of equity investments to secure greater control or influence over a group.

The concept of related party will also catch arrangements where, in economic substance, a related party advances debt. This could involve back to back lending through a third party, or where the group’s borrowing from a third party is guaranteed by a related party.

Other considerations

6.46 The concept of related party will not apply in respect of loans made by public bodies (see paragraphs 9.37 to 9.40 for what would constitute a public body) with a primary objective of supporting the provision of goods or services for public, community or social benefit rather than to obtain a financial return.

6.47 The government is aware that some providers of subordinated finance may take a relatively small equity exposure to the groups they lend to. Where this exposure is small, it is not expected that they will be “acting together with other shareholders to secure greater control or influence” over the group. However, if there is a danger that such lenders could come within the concept of related party on the above proposals the government is prepared to consider this issue further.

Question 20: Do you agree that the proposed definition of related party will be effective in preventing equity investors inflating the group ratio by investing using debt instruments? Please identify situations where this definition would prevent the Group Ratio Rule from taking into account interest payable to lenders that invest for a fixed return and without seeking influence over the borrower?

Definition of group-EBITDA

6.48 The amount of group-EBITDA would be defined specifically for the operation of the Group Ratio Rule (and therefore could differ from a business’ calculation of its consolidated EBITDA for other purposes).

6.49 It is proposed that group-EBITDA should be calculated as follows:

- The starting point is to take the group’s profit or loss before tax for the period, including income from portfolio investments, its share of profit (or loss) from associates or joint ventures and any profit or loss in respect of subsidiaries held at fair value.

- Amounts of total group-interest should be added back or deducted, to remove these items from the figure. (To ensure that the correct amounts are added back, the total group-interest figure used should be before any restriction in the qualifying amounts and before the inclusion of capitalised interest.)
- Amounts of group-depreciation and group-amortisation should be added back to remove these items from the figure.

Group-depreciation

6.50 It is proposed that amounts of depreciation recognised in the group accounts in respect of capital expenditure on tangible assets should be added back in calculating group-EBITDA. In addition to amounts described as 'depreciation', it is envisaged that group-depreciation should also include impairment losses in respect of capital expenditure on tangible assets. Likewise it should also include gains or losses arising from the disposal of such assets to the extent that the disposal proceeds do not exceed the original cost of the asset.

6.51 As a result, deferred revenue expenditure (e.g. depreciation expensed in respect of expenditure which would be viewed as revenue in nature for UK tax purposes) would not be added back (see example 4 in Annex D).

6.52 Where a group recognises an asset under a finance lease, the associated depreciation charge would be added back in line with the proposed treatment of leases under the Fixed Ratio Rule (see below).

6.53 Group-depreciation would not include any amounts in respect of assets held by associates, joint ventures or other non-group entities.

Group-amortisation

6.54 It is proposed that amounts of amortisation recognised in the group accounts in respect of a capital expenditure on intangible assets should be added back in calculating group-EBITDA. In addition to amounts described as 'amortisation', it is envisaged that group-amortisation should also include impairment losses in respect of capital expenditure on intangible assets. Likewise it should also include gains or losses arising from the disposal of such assets to the extent that the disposal proceeds do not exceed the original cost of the asset.

6.55 The definition of intangible asset would mirror that in Part 8 of CTA 2009, and would include goodwill. It would not include share investments in associates, joint ventures or other non-group entities, including any intangible assets recognised by such non-group entities.

Profit or loss from a disposal of a subsidiary or part of a business

6.56 Where a group recognises a profit or loss from the disposal of a subsidiary or part of a business then this profit or loss should generally be included within group-EBITDA. This is irrespective of whether the item is included within discontinued operations. However, where the disposal includes tangible assets or intangible assets then potentially part of the profit or loss may need to be attributed to those assets. The approach will depend on whether there is an overall profit or loss from the transaction.

6.57 Where there is a profit on the disposal and under the transaction the group disposes of such assets where they have previously been depreciated, amortised, or impaired (i.e. where amounts have previously arisen in respect of group-depreciation or group-amortisation) then part of the profit may be attributed to those assets and deducted from group-EBITDA. The group will need to demonstrate that the value of those assets at the time of the disposal exceeded the net book value of the assets immediately prior to disposal.

Example 6.C

XYZ plc makes a disposal of a subsidiary on which it recognises a gain of £40 million. This includes tangible assets with net book value before the disposal of £10 million but it is assessed they have a market value of £15 million. When calculating group-EBITDA an amount of £5 million is therefore deducted.

6.58 Where a group recognises a loss from the disposal, part of the loss should be attributed to any tangible or intangible assets being disposed of as part of the transaction. This attribution should be based on the full amount of the net book values of such assets immediately prior to disposal, unless (and to the extent) it can be shown those assets have value at the time of the disposal.

Example 6.D

XYZ plc makes a disposal of a subsidiary on which it recognises a loss of £60 million. This includes the derecognition of £50 million of purchased goodwill. The group is not able to demonstrate that the goodwill has any value at the time of the disposal. So in calculating group-EBITDA an amount of £50 million should be added back.

Non-recurring items

6.59 It is not proposed that there would be any further add-back for non-recurring items. There would be no separate add-back for disposals of a subsidiary or part of a business. Amounts would be excluded to the extent it is attributable to tangible fixed assets or intangible fixed assets.

Discontinued operations

6.60 Companies preparing accounts under IFRS are required to present a single figure on the face of the income statement for the post-tax profit from discontinued operations, although they are permitted to show additional detail if they choose. No distinction is proposed between continuing and discontinued operations. The calculation of tax-EBITDA will be based on all amounts included within profit or loss for the period.

Other items

6.61 There are a number of areas where the tax treatment of particular items can depart from the accounting treatment - for example, pension costs and the costs of employee share options. It is not proposed that adjustments to group-EBITDA will be made for these book-to-tax differences.

6.62 See Chapter 9 for further detail of the calculation of group-EBITDA in respect of:

- Leasing
- Derivatives
- Investment in non-group entities
- Changes of accounting policy

Question 21: Are there any other amounts that should be included with the definition of group-EBITDA, or any more items which should be excluded? If so, please explain the reasons why?

7 Public benefit infrastructure

7.1 The 'Business tax road map' at Budget 2016 set out the government's intention to ensure that the restriction does not impede the provision of private finance for public benefit infrastructure in the UK where there are no material risks of BEPS.

7.2 It is recognised that public benefit services are often provided using infrastructure which is funded using private finance. In such cases, an entity (the operator, which may consist of one or more special purpose companies) typically undertakes a long-term project to provide or upgrade, maintain and operate the infrastructure. Often the project is structured so that income and operating expenditure have little volatility, and in consequence it may be both highly geared and generate only a small profit margin over the cost of finance. Because of this, it is possible that the current project arrangements would become unviable if the tax treatment of interest expense is changed.

7.3 Such projects do not present a BEPS risk provided that all the project revenues are subject to UK taxation, and to the extent that the financing is provided by third parties (with no equity interest), is used only for the project, and does not exceed the operator's costs of providing or upgrading the infrastructure.

7.4 In most cases it is expected that the third party interest expense of such projects will be deductible under the Fixed Ratio Rule or the Group Ratio Rule. The Group Ratio Rule will be particularly helpful where the project is undertaken by a special purpose company or small group of companies that is not consolidated into the financial accounts of any of its investors, so that the project itself is treated as a group for the Group Ratio Rule. Where the project gives rise to a finance asset, for example in accordance with IFRIC 12, the resulting finance income will be regarded as tax-interest and therefore netted off interest expenses in applying the interest restriction rules.

Question 22: Bearing in mind the Fixed Ratio Rule permitting net interest deductions of up to 30% of tax-EBITDA, the Group Ratio Rule, the £2 million de minimis amount, rules permitting the carry forward of restricted interest and excess capacity, and the inclusion in tax-interest of income accounted for as finance income, please describe the key features of situations involving the financing of public benefit infrastructure where a specific exclusion will be necessary to prevent interest restrictions arising in cases where there is no BEPS.

Potential Public Benefit Project Exclusion

7.5 The OECD Action 4 Report includes an option for a PBPE. Subject to any changes needed to tightly focus an exclusion on arrangements identified in this consultation as needing a PBPE to prevent an unwarranted interest restriction, the government's suggested approach for a PBPE is set out below.

7.6 Groups electing to apply the PBPE would identify eligible projects, and would then exclude the eligible tax-interest expense, as well as any tax-interest income and tax-EBITDA connected with those projects, from their interest restriction calculation.

Eligibility of a project

7.7 Eligibility of a project is dependent on meeting the following conditions:

- An arrangement (the project) is entered into by a company, or small group of companies (collectively, the “operator”, which may be part of a larger group) to provide public benefit services, i.e. services which it is government policy to provide for the benefit of the public
- A public body, as defined in paragraphs 9.37 to 9.40, contractually obliges the operator to provide those services, or licenses the operator and thereby regulates, directly or indirectly, the pricing of the services
- The project involves provision or upgrade, maintenance and operation of infrastructure (the project assets) on a long term basis, and must have a duration of at least 10 years, or a shorter rolling term which both the operator and the relevant public body have the expectation of continuing indefinitely. The public body is able to restrict the operator’s practical ability to sell or pledge the project assets throughout this period
- All the project revenues are subject to UK corporation tax
- At least 80% of gross revenue generated from the project assets over the lifetime of the project is expected to arise from the provision of public benefit services

Eligibility of interest expense for exclusion

7.8 In order to be eligible for exclusion from the interest restriction calculation, interest expense must be payable by the operator or a related party on loans (eligible loans) meeting the following conditions:

- The lender is not a related party, as defined in Chapter 6
- The total amount of an operator’s eligible loans does not exceed the arm’s length cost of acquiring, constructing or enhancing the project assets plus any associated interest
- Other than incidental lending to unrelated parties (such as a bank deposit), none of the funds from the eligible loans are used other than for the project assets
- Eligible loans are made on the strength of forecastable project cash flows and project assets. The eligible loans have terms commensurate with the duration of the project (where finite), and the lenders’ recourse is materially limited to project assets and cash flows from the project. This could include security over shares and debt in an operator company, as long as all its material assets are directly related to the project. The project may benefit from other forms of security, including guarantees from public bodies, but any such security must be strictly limited and not have the effect of giving lenders full recourse from assets and cash flows outside the project
- Where the operator is part of a larger group, the project does not have a materially greater ratio of third-party debt to asset values than other projects undertaken by the same group, after adjusting for differences in risks, maturities and expected cash flows

Question 23: Are there any situations involving the financing of public benefit infrastructure where interest restrictions could arise in the absence of BEPS despite a PBPE with the above conditions? If so, please provide details and suggest how the proposals could be changed to prevent undue restrictions occurring.

Potential grandfathering for existing loans or projects

7.9 The government does not favour grandfathering other than in exceptional circumstances as it would introduce distortions between market participants and reduce the effectiveness of the new rules. However, it recognises that limited grandfathering may be necessary to protect the financial viability (taking into account debt covenants) of existing UK infrastructure projects. The risk premium attached to financing for new projects could increase if the new rules lead to defaults on existing loan covenants or a widespread inability of existing infrastructure projects to make scheduled payments to service or repay debt. Provision for grandfathering would only be made if there is evidence that any adverse impacts of the new rules connected to infrastructure finance would be systemic and could not be mitigated in other ways, and if rules can be designed to limit distortions and preserve the impact of the new rules in tackling BEPS.

Question 24: Are there any situations where interest restrictions would arise connected with public benefit infrastructure despite the provisions outlined in this document, and where those restrictions could have wider economic consequences? If so, please provide details, including an explanation of why the consequences could not be avoided, such as by restructuring existing financing arrangements. Please suggest how the rules could be adapted to avoid those consequences while still providing an effective counteraction to BEPS involving interest.

8 Interaction with specific regimes

Oil and Gas

8.1 Profits from the exploitation of oil and gas in the UK and on the UK continental shelf are subject to a special regime known as RFCT. RFCT imposes a higher tax burden than the normal corporation tax regime. It already prevents taxable profits from oil and gas extraction being reduced by losses from other activities or by excessive interest payments.

8.2 Budget 2016 confirmed that the government will consult further on the application of the new interest restriction rules to ensure that existing commercial arrangements within the ring-fence are not adversely affected. It is inviting views on the options below which are intended to provide stability for ring-fenced trades while ensuring that the new interest restriction rules are effective outside the ring-fence. Under both options, any restriction of interest deductibility would only be applied to activities outside the ring-fence.

Option 1: Exclude ring-fence activities entirely from the interest restriction calculation.

Option 2: Perform an additional calculation to that under Option 1. Use whichever results in the lower amount of interest capacity. This additional calculation would be by reference to the whole group, including the ring-fence activities.

8.3 Option 1 risks providing an additional incentive for groups to distort how they allocate debt between activities inside and outside the ring-fence. Option 2 should remove that incentive at the cost of greater complexity. The government welcomes comments and examples to show how these options will affect companies with ring-fenced trades.

Question 25: Which of the two proposed approaches would be preferable? Please explain what you see as the advantages and disadvantages of each, and address whether the additional complexity of Option 2 is justified by the potential risks and distortions in Option 1.

Securitisation companies

8.4 Securitisation is a method of raising debt finance by the conversion of a financial asset with a predictable income stream, especially a loan, into tradable securities, typically to raise cash. It can also help manage capital requirements (for regulatory and balance sheet purposes) and risk. It is an important source of getting more credit or liquidity flowing into the economy.

8.5 Before the introduction of the securitisation tax regime, securitisation companies in the UK were largely taxed under the loan relationship rules, with income and expenditure typically recognised for tax purposes in accordance with the company's accounting treatment.

8.6 The Taxation of Securitisation Companies Regulations 2006 (the Securitisation Regulations) provide a regime with specific corporation tax rules for securitisation companies that meet the specified requirements. When all of the conditions set out in the Securitisation Regulations are met so that the regime applies, a securitisation company is taxed under regulation 14 on its "retained profit", so long as it satisfies the payments condition and it does not have an unallowable purpose. In other words, the normal tax rules apply to the computation of a company's profits, but the amount actually taxed is brought into account in accordance with

Regulation 14. If the company falls out of the regime, it will revert to the normal corporation tax rules.

8.7 “Retained profit” is not determined by reference to the normal accountancy rules for calculating profit. Broadly, “retained profit” enables the securitisation company to be liable to tax on its margin or specific amount required by the relevant capital market arrangement to be retained or designated as profit.

8.8 The purpose of the Securitisation Regulations is to provide a simplified cash-based regime. This reflects the underlying economic reality of these vehicles being conduits. If such a regime did not apply, there is a risk of unfunded tax liabilities arising in securitisation companies because of volatility in taxable profits which are determined in accordance with fair value accounting.

8.9 As the majority of UK securitisations are over interest-bearing or financial assets, and, due to the conditions for the regime to apply, it is expected that the majority of the receipts and payments of a securitisation company will constitute amounts of tax-interest. In addition, by specifying the amount of taxable profit by reference to the retained profit, the rules should invariably mean that the company will be in a net interest income position for tax purposes. As a result, it would not be expected that a securitisation company falling within the securitisation regime and taxable under Regulation 14 will be adversely affected.

8.10 Unpacking this further:

- Where a company is subject to the securitisation regime all the components of the retained profit will fall to be included within the definition of tax-interest, which determine the amounts that are potentially subject to the restriction.
- In line with the general approach of calculating tax-interest, this will not be calculated in accordance with accounting principles, but in accordance with the cash basis followed for tax, as prescribed in Regulation 10 of the Securitisation Regulations.
- A securitisation company subject to the regime will easily be able to conclude that it does not have net interest expense for the purposes of the interest restriction, because of the requirement at Regulation 10 that retained profit must always be nil or greater. This means that its tax interest income amounts will always be equal to or exceed its tax interest expense amounts.
- It would also follow that the retained profit will not form part of any tax-EBITDA for the purposes of the interest restriction calculations because it falls within the definition of tax-interest and is therefore excluded.

Question 26: As securitisation structures and transactions are often complex, there may be exceptions to the analysis set out above. Please would you set out any examples of securitisation structures or transactions within the securitisation regime where a net interest expense position might arise so that the application of the interest restriction rules could lead to an unintended restriction on the securitisation company?

Authorised Investment Funds (AIFs) including Tax Elected Funds (TEFs)

8.11 An AIF is a collective investment vehicle which is subject to corporation tax. The policy for the treatment of these vehicles is that they should place the investor in a similar position as if they held the investments directly. The regulatory rules therefore require the AIF to allocate or distribute all of the income for the period to the investors.

8.12 In certain defined circumstances, these amounts distributed to the members in the fund are deemed to be yearly interest (referred to as an ‘interest distribution’) which is deductible for corporation tax purposes. Our view is that such distributions to members of the AIF do not fall to be amounts of interest within the scope of the OECD recommendation and therefore should not be subject to the interest restriction. They do not reflect a borrowing cost of the AIF or an expense incurred with the raising of finance. They represent a mechanism for making a distribution to investors not a return on a loan.

8.13 This applies to interest distributions made by AIFs whether or not they are in the special TEF regime.

8.14 As the borrowing powers of AIFs are restricted by the Financial Conduct Authority, we would not expect AIFs (whether or not they are TEFs) to have any significant tax-interest expense beyond the interest and non-dividend distributions that they make.

Investment Trust Companies

8.15 An approved Investment Trust Company is able to designate all or part of a dividend it pays to shareholders as an interest distribution in respect of a period of account, up to the maximum amount of qualifying interest income received for the relevant accounting period. This interest distribution is treated for the corporation tax purposes of the company as interest under a debtor relationship.

8.16 We would propose making it clear that such a distribution is excluded from the tax-interest definition because it does not reflect a borrowing cost of the investment trust company.

8.17 Investment Trust Companies are able to leverage themselves and so may pay interest on loans which is not designated as an interest distribution. Our expectation is that such interest will fall within the tax-interest definition and will potentially be subject to the interest restriction.

Question 27: Are there any further issues relating to AIFS (including TEFs) or Investment Trust Companies that need to be considered for the purposes of this consultation?

Question 28: Are there any other fund structures, not considered in this consultation document, that require special consideration?

Collective investment vehicles and the definition of group

8.18 Under the current Debt Cap rules collective investment vehicles (as defined in the Financial Services and Markets Act 2000) cannot be the ultimate parent of the worldwide group. The policy aim of this provision is to ensure that where a collective investment vehicle owns two or more trading groups with no common business, each separate trading group is treated as a worldwide group in its own right for the purposes of the Debt Cap rules. We would like to continue this treatment in the interest restriction rules.

8.19 Collective investment vehicles will not typically consolidate shareholdings in subsidiary investments on a line-by-line basis, but will typically recognise the subsidiary at fair value. As such, the government’s initial view is that the investment will form its own group under the basic group definition described in paragraphs 5.6 to 5.13, without any need for a specific rule which carves out the collective investment vehicle as a parent of the group.

Question 29: As a result of the proposed exclusion from the group of subsidiaries held at fair value, views are invited as to whether a specific rule is required to prevent collective investment vehicles from being the ultimate parent company of a group.

Real Estate

Real Estate Investment Trusts (REITs)

8.20 At least 75% of a REIT's activities must constitute property rental business, with its residual activities amounting to no more than 25%. Property rental profits are exempted from taxation at the level of the REIT, as long as certain conditions are met. But distributions from those profits are instead taxable in the hands of the recipient as property income. This contrasts with the treatment of, for example, a non-REIT property investment company. Such a company would be chargeable on any profits of its property rental business, but distributions would be treated as dividends in the hands of the shareholders in the normal way.

8.21 A REIT must distribute 90% of the profits from its property rental business to its investors in order to retain its status. The calculation of this would be affected by the interest restriction rules in the absence of any special provision, because the calculation must take into account any corporation tax provisions. REITs are also already subject to a restriction on their borrowing and interest payments as they must keep to an interest cover rule.

8.22 Excessive interest deductions could be used to shelter both the property rental and the residual profits of a REIT. It is proposed to adapt the rules so that they can be applied to REITs to prevent either of these outcomes and avoid creating distortions between REITs and other property rental businesses.

Question 30: How could the rules be adapted so that they protect the property rental and residual profits of REITs from excessive interest deductions just as they do for other property rental groups?

Property Approved Investment Funds (PAIFs)

8.23 PAIFs are a form of authorised investment funds constituted as an open-ended investment company. The PAIF tax rules exempt property income and gains from corporation tax in a similar way to the rules applying to UK-REITs. Also like REITs, such profits are distributed to and taxable in the hands of investors as property income. In addition to property income distributions, PAIFs are required to distribute the balance of their income as either dividend or interest distributions depending on the source of the income. The latter amounts are deemed to be yearly interest which is deductible for corporation tax purposes. As set out in paragraphs 8.11 to 8.14, our view is that such distributions do not fall to be amounts of interest within the scope of the OECD recommendation and therefore should not be subject to the interest restriction.

8.24 PAIFs are subject to regulatory restrictions set out in the Financial Conduct Authority Handbook regarding their borrowing powers. Just as for REITs, it is possible that excessive borrowing could be used to shelter both the property rental profits and any other income of a PAIF. However, the government would like to better understand how the particular regulatory rules that limit borrowing and govern the use of inter-company debt between a PAIF and non-UK special purpose vehicles that may be used to hold non-UK property impact on this consideration.

Question 31: To what extent are PAIFs likely to be impacted by the proposals in their current form? If applicable, how could the rules be adapted so that they protect the property rental profits of PAIFs from excessive interest deductions just as they do for other property rental groups?

Corporate non-resident landlords

8.25 The government is considering whether and how the interest restriction rules should apply to companies with a liability to UK income tax. It would welcome views on this issue.

Banking and insurance activities

8.26 The core business of a bank is to make loans funded by deposits and short-term borrowing. The core business of an insurer is to be paid premiums in return for underwriting risk and to invest those premiums in order to generate a return. These are fundamentally different businesses, but both have a common characteristic in giving rise to net interest income.

8.27 This has important implications for the operation of the Fixed Ratio Rule. It means that the Fixed Ratio Rule would not be expected to impact on banking and insurance groups operating in the UK due to the significant net interest income arising from their main operating entities. It also means that the effectiveness of the Fixed Ratio Rule could be reduced for groups that have banking or insurance activities alongside their other businesses, such as a vehicle manufacturing group with a financing arm.

8.28 In response to this the UK has been engaging with businesses, regulators, the OECD and other countries participating in the BEPS project in order to understand:

- the extent to which the Fixed Ratio Rule's application to groups with banking and insurance activities could leave interest-related BEPS risks unaddressed
- whether this necessitates bespoke or modified rules for groups engaged in these types of activities

8.29 This section provides an update on this work and outlines areas on which the government would welcome additional information.

Impact of the Fixed Ratio Rule

8.30 Discussions with businesses and analysis of accounts information suggest that banking and insurance groups are generally net interest recipients. This position looks clear for insurance groups. It also looks clear for banking groups that have significant lending operations, although these groups could temporarily find themselves in a net interest expense position as a result of impairment losses or unexpected changes in the maturity curve. The position is less clear for investment banking groups which may have leveraged balance sheets but at the same time generate significant non-interest income from advisory, underwriting, and equity or commodity trading businesses.

8.31 The government will therefore be giving further consideration to the circumstances in which a banking group may be in a net interest expense position on an enduring basis, and whether and to what extent this could result in an unwarranted restriction under the Fixed Ratio Rule and Group Ratio Rule.

Assessing BEPS risks

8.32 Net interest income from banking and insurance activities means that the Fixed Ratio Rule is unlikely to act as an effective countermeasure to interest-related BEPS in groups with significant banking or insurance operations.

8.33 However, the comprehensive regulatory rules with which such groups must comply provide a number of important safeguards.

- Regulatory capital requirements limit the amount of leverage within banking companies, banking groups and banking sub-groups to levels that are considered appropriate from a financial stability perspective.
- Capital requirements also limit the ability of banking companies to borrow in the UK in order to fund significant equity investments in non-UK subsidiaries. The scope

for non-bank holding companies to borrow in the UK to fund overseas equity investments is also understood to be restricted by regulation.

- Insurers are entitled to issue subordinated debt in meeting their loss-absorbing capital requirements. However, the amount of debt that can be counted towards this requirement is capped and any debt in excess of this cap is treated as a liability, reducing an insurer's ability to write business.
- There are restrictions on where certain debt instruments can be issued within banking and insurance groups, in order to facilitate resolution in a time of crisis.
- There are limits on the extent to which both banking and insurance groups can capitalise a subsidiary before the value of this capital is deducted in calculating the group's regulatory capital resources. This reflects the fact that this capital may not be available to absorb losses in a point of stress.

8.34 The government is focused on assessing the effectiveness of these safeguards in constraining interest-related BEPS in banking and insurance groups, and identifying any residual risks.

8.35 In particular, it wants to consider the extent to which these safeguards are relevant to non-banking and insurance companies within banking and insurance groups. These are companies that are included within consolidated accounts for regulatory purposes but are not themselves subject to individual capital and funding requirements. The government would like to assess whether there is greater scope for these companies to be excessively leveraged or have UK borrowing that relates to the funding of non-UK activities.

Possible approaches

8.36 Taking into account the ongoing OECD-led work, the government will be considering the case for modified or bespoke interest restriction rules for banking and insurance activities to ensure that the new rules are effective in countering interest-related BEPS arising in connection with these activities, just as they are in non-financial businesses.

8.37 Such rules would need to be proportionate to the interest-related BEPS risks and to operate consistently with the unique safeguards provided by regulation as discussed in the previous section.

8.38 The rules would also need to recognise the integral role of interest within a banking group and the potential for a restriction on its tax deductibility to have unintended consequences or to create significant administrative burdens.

8.39 In the light of these considerations, two possible approaches are set out below.

Fixed Ratio Rule modification

8.40 One approach would be to exclude the tax-interest and tax-EBITDA of banking and insurance companies from the interest restriction calculation. This would target the Fixed Ratio Rule more effectively at non-banking and insurance companies within a group, where the regulatory constraints to interest-related BEPS may be less significant.

8.41 The government would need to consider:

- how banking and insurance companies could be defined for this purpose and the extent to which this definition could be based on solo-regulation
- what kind of companies would fall outside of this definition, such as holding companies, service companies and leasing firms, and the role of interest within these companies

- the extent to which these companies could have net interest expense as a result of funding a banking or insurance company
- whether the Group Ratio Rule could be modified correspondingly in order to prevent groups whose non-banking and insurance companies have high external leverage suffering any unwarranted restriction under the modified Fixed Ratio Rule

8.42 The government would need to consider the appropriateness and effectiveness of such an approach for groups whose earnings and balance sheet items relate almost exclusively to banking and insurance activities.

8.43 That said, this approach could still be useful in ensuring that the net interest income associated with banking and insurance activities does not undermine the Fixed Ratio Rule's effectiveness in mixed groups, such as manufacturing businesses with financing arms.

Targeted anti-abuse rule

8.44 It might be possible to augment the Fixed Ratio Rule with a targeted anti-abuse rule to restrict relief in certain situations to ensure that net financing costs deducted in the UK are commensurate with the UK business.

Question 32: Please supply any evidence that would help the government understand the full extent of interest-related BEPS risks connected with banking and insurance activities, and suggest any modifications that could be made to the Fixed Ratio Rule and the Group Ratio Rule to ensure that they operate effectively, but without giving rise to unwarranted restrictions, in respect of groups performing these activities.

Question 33: How could a targeted rule be designed to ensure that net financing costs deducted in the UK are commensurate with the UK business?

Tax incentive reliefs

Patent Box

8.45 It is proposed that the calculation of tax-EBITDA will include any deduction in respect of Patent Box profits. This ensures that the interest restriction applies correctly where a group is highly leveraged in the UK and would otherwise obtain tax relief at the full corporation tax rate for interest arising on borrowings that are used in part to generate income that is subject to reduced taxation under the Patent Box rules.

R&D Tax Relief

8.46 R&D tax relief generates an enhanced deduction linked to an amount of expenditure on R&D. Unlike the Patent Box, the enhanced relief is not linked to profits, or to interest. Therefore any interest restriction should not reduce the value of the enhanced element of the deduction. This will be achieved by adding back the enhancement in the calculation of tax-EBITDA. Conversely, where tax losses are surrendered for a payable tax credit, there should be no increase in the capacity to deduct interest, so the original amount of expenditure should still be deducted in calculating tax-EBITDA. In general, small and medium-sized companies will fall below the de minimis threshold (see paragraph 5.52) and therefore not need to perform an interest restriction calculation.

R&D Expenditure Credits

8.47 The amount of any R&D expenditure Credits (RDECs) included in profits chargeable to corporation tax will be excluded from the calculation of tax-EBITDA. This ensures that the RDECs do not have the effect of increasing the group's interest capacity.

Land remediation relief

8.48 Any land remediation relief (over and above the actual amount of expenditure incurred) will be added back in the calculation of tax-EBITDA. This ensures that the enhanced element of the deduction cannot create or increase an interest restriction.

Question 34: Do you agree with the proposed treatment of Patent Box deductions, R&D tax relief, RDEC and land remediation relief? If not, please suggest an alternative and explain why you find it preferable.

Northern Ireland rate of corporation tax

8.49 Legislation is in place to devolve power to the Northern Ireland Assembly to set a Northern Ireland rate of corporation tax. Devolution of the power is conditional upon the Northern Ireland Executive demonstrating that their finances are on a sustainable footing. The Northern Ireland rate can be different to the UK main rate of corporation tax and is expected to be set at a lower rate. The Executive have announced their intention to set a rate of 12.5%, to be introduced in 2018, subject to the power being devolved. If the legislation is commenced, the Northern Ireland rate will apply to certain trading income only. It will not apply to most financial trading activity which will remain taxed at the UK corporation tax main rate. Non-trading loan relationships also fall outside the scope of the rate. Affected groups are required to follow rules for the allocation of income and expenses between activities subject to the Northern Ireland rate and other activities. For large companies the allocation is made according to whether the income and expenses arise from a Northern Ireland presence – the Northern Ireland Regional Establishment.

8.50 A group may consist of companies which are wholly subject to the Northern Ireland rate and others wholly subject to the UK main rate. It may also be the case that a group includes companies which have both a Northern Ireland Regional Establishment as well as a presence elsewhere in the UK. In either of those cases it might not be appropriate, for example, to attribute the full amount of interest restriction to activities subject to the Northern Ireland rate. The government is considering how groups will be able to attribute any interest restriction, or spare capacity, where part of the group's activities are subject to the Northern Ireland rate and some to the UK main rate of corporation tax.

Question 35: How should amounts of interest restriction or spare capacity be allocated between activities subject to the Northern Ireland rate of corporation tax and other activities?

Charities

8.51 Companies that are established for charitable purposes only are unlikely to be directly affected by the interest restriction. Interest, or similar financial income, received by such a company will almost certainly not be charged to corporation tax, because of the exemptions granted by Part 11 of CTA 2010.

8.52 Therefore, a charitable company will not generally have tax-interest income, since the definition requires the income to be brought into account for UK corporation tax. Nor will a charitable company, in general, have any tax-interest expense. If such a company borrows money, it is likely that the debtor loan relationship will relate to activities of the company that are not within the charge to corporation tax. Debits on such loan relationships are disallowed for tax purposes.

8.53 It is not uncommon, however, for a charity - whether organised as a company, a society or a trust – to have one or more subsidiary companies that undertake trading or other 'non-charitable' activities. Such a subsidiary may be funded by interest-bearing loans from the charity.

Typically, the subsidiary will make donations over any residual profits to the charity in order to qualify for Gift Aid relief.

8.54 Without some special provision, interest on loans from the charity could give rise to an interest restriction under one or more of the Fixed Ratio Rule, the Group Ratio Rule and the modified Debt Cap Rule. The interest restriction rules are intended to address the flexibility that groups have to fund different part of the group through either debt or equity. However in this case the effect of the Gift Aid rules means that the subsidiary will be in a similar position whether it is funded through debt or equity.

8.55 The government is considering how the rules should be adapted to address this situation. One option is to exclude the payment of interest to the charity where it is a wholly owned subsidiary of the charity and where donations by the company to the charity would qualify for Gift Aid relief.

Question 36: Does this approach adequately address the situation where charities hold subsidiaries to undertake trading activities? If not, how could the rules be adapted to better address this situation?

Registered Societies

8.56 Section 499 of CTA 2009 treats dividends, bonuses and other sums payable on shareholdings in Registered Societies, held for the purposes of a trade or for other purposes, as if they were interest arising on a loan relationship.

8.57 These amounts are not interest or amounts economically equivalent to interest and so will be excluded from tax-interest. These amounts do, however, have the effect of reducing the Registered Society's liability to corporation tax on its taxable profits. It is therefore considered that the effect of this deduction should therefore be taken in account in calculating the company's tax-EBITDA.

Question 37: Does this approach adequately address the situation of interest distributions made by Registered Societies? If not, how could the rules be adapted to better address this situation?

Controlled Foreign Companies (CFCs)

8.58 The CFC charge is not a corporation tax charge. So in the absence of particular provisions, the earnings, interest receipts and expenses that give rise to a CFC charge will not be included in the aggregation calculation (although they will be included in the Group Ratio Rule in the same way as amounts in other group entities). Given that the CFC charge is primarily an anti-avoidance measure, the government does not propose to make any provision to include these amounts from CFCs.

Question 38: Do you agree with the proposed treatment of CFCs? If not, please explain the reasons and suggest an alternative approach?

9 Particular topics

Tax exempt amounts and double taxation relief

Tax-interest: tax exempt amounts

9.1 As noted in Chapter 5, tax exempt amounts would be excluded from the scope of tax-interest. In particular, any amounts which are left out of account as a result of exemption adjustments, as defined in section 18A CTA 2009, for an exempt foreign PE will also not be included in tax-interest.

Tax-EBITDA: tax exempt amounts

9.2 One of the key BEPS risks is where debt is used to fund tax exempt income. This risk is largely addressed by these proposals because the interest limit is based on tax-EBITDA, which naturally excludes tax exempt income. In particular, exempt dividends, exempt gains and income from exempt foreign PEs will not generate UK interest capacity.

Tax-EBITDA and tax-interest: Double taxation relief

9.3 Similar risks could, however, also arise if some or all of the amounts included in tax-EBITDA and tax-interest are, in effect, not or only partially subject to UK taxation as a result of double taxation relief.

9.4 To prevent this undermining the rules it is proposed that where non-interest income is brought into account for tax, and credit relief is claimed in respect of that income, the amount of income included in tax-EBITDA is reduced by an amount equal to:

$$\frac{\text{Amount of foreign tax actually credited}}{\text{Rate of corporation tax applicable to the income}}$$

9.5 This would apply, for example, in respect of non-exempt foreign PEs and dividend income that is subject to tax.

Example 9.A

A company has a PE on which it has profits of £1 million for the year to 31 March 2018 and suffers foreign tax of £100,000. The full amount of the foreign tax is deductible against corporation tax. That reduces the effective amount of UK corporation tax on the income from £190,000 to £90,000, equivalent to reducing the profits of the PE that are subject to corporation tax by £526,316 (being £100,000 ÷ 19%). For the purposes of the interest restriction, the amount of taxable profits included within tax-EBITDA is reduced by that amount.

9.6 Similarly, where credit relief is claimed in respect of interest income, some or all of that interest income is not effectively taxed in the UK and should not be reflected in tax-interest. Consequently, the amount of interest income included in tax-interest is reduced by the same fraction:

$$\frac{\text{Amount of foreign tax actually credited}}{\text{Rate of corporation tax applicable to the income}}$$

9.7 In some cases, the inclusion of financing costs in the calculation of corporation tax liabilities arising in respect of a PE may restrict the amount of double taxation relief that is available to be

credited. We propose that this calculation should be undertaken without any effect of interest restriction being taken into account. In other words, the double taxation relief calculation must be performed first in order to calculate the interest restriction, and the amount of double taxation relief is not then recalculated following the application of the interest restriction rules.

Question 39: Do you agree that the proposed treatment of income subject to double taxation relief will be fair and effective? If not, please suggest an alternative, providing an explanation of why you find it preferable.

Derivatives

Tax-interest

9.8 Groups will often take out derivative contracts in relation to interest risk. If these amounts are left out of the scope of the interest restriction rules this could lead to a distortion between economically equivalent lending arrangements.

Example 9.B

A Ltd borrows £100 million through a loan which pays floating rate interest of LIBOR plus 2% and separately enters into an interest rate swap under which it receives LIBOR and pays 3% on a notional of £100 million.

B Ltd borrows £100 million through a loan which pays fixed rate interest of 5%.

Both A Ltd and B Ltd have costs of £5 million in connection with the borrowing and it is correct that both A Ltd and B Ltd are treated as having £5 million of financing costs within the scope of the rules.

9.9 In addition, derivative contracts can be used to, in economic substance, pass financing costs from one company to another.

Example 9.C

X Ltd and Y Ltd are both UK companies in the same group.

X Ltd borrows \$2,000 million in a foreign currency (denoted as \$) through a loan which pays interest of 8%.

X Ltd and Y Ltd enter into a cross-currency swap under which X Ltd receives 8% on \$2,000 million and pays 2% on £100 million.

Assuming exchange rates stay at £1 = \$20, X Ltd will have costs of £2 million in connection with the borrowing and Y Ltd has costs of £6 million which, in economic substance, is a share of the underlying finance costs incurred by X Ltd.

9.10 It is therefore proposed that profits and losses from derivative contracts in respect of financing expense amounts and financing income amounts should be included within the scope

of the rules. In particular, this would include all derivative contracts where the underlying subject matter comprises only of:

- Interest rates (such as interest rate swaps and RPI swaps);
- Currencies (such as cross currency swaps and currency forwards); and/or
- Debt (such as credit default swaps)

9.11 All profits and losses on such instruments would be included in the scope of the rules, except for amounts of exchange gains and losses (see paragraphs 5.25 to 5.27 for treatment of exchange gains and losses). This would include fair value movements on the derivative contract (except for amounts representing exchange gains and losses) where these are brought into account for tax purposes.

9.12 Where amounts under a derivative are brought into account for tax in line with a hedged item (e.g. under the Disregard Regulations S.I. 2004 / 3256 or as a result of hedge accounting) then it will be these amounts which would be subject to the interest restriction rules.

9.13 Where a derivative contract is dependent on other types of underlying subject matters, then it would fall outside the scope of the rules. For this purpose an underlying subject matter which is minor or subordinate should be ignored.

9.14 By taking this approach, it is considered that the notional interest amounts arising under common financial instruments such as interest rate swaps and cross currency swaps would be included within the scope of the rules, as would premiums and discounts on common foreign currency forward contracts in relation to the differential in the respective interest rates.

Example 9.D

A Ltd borrows £100 million through a loan which pays floating rate interest of LIBOR plus 2% and separately enters into an interest rate swap under which it receives LIBOR and pays 3% on a notional of £100 million. The interest rate swap is hedging the company's actual borrowing costs.

In this example the derivative contract is purely a contract over interest rates, and so the profits and losses on the swap would be included within tax-interest.

Example 9.E

X Ltd borrows \$2,000 million in a foreign currency (denoted as \$) through a loan which pays interest of 8%.

X Ltd and Y Ltd enter into a cross-currency swap under which X Ltd receives 8% on \$2,000 million and pays 2% on £100 million. The cross currency swap is hedging X Ltd's actual borrowing costs

In this example the cross currency swap is a contract over interest rates and currencies. As a result, the profits and losses on the swap (excluding amounts of exchange gains and losses) would be included in X Ltd's tax-interest. In addition, Y Ltd would include its profits and losses on the swap (excluding amounts of exchange gains and losses within its tax-interest amount.

Example 9.F

X Ltd borrows \$200 million in a foreign currency (denoted as \$) through a loan which pays interest of 3%.

X Ltd and Y Ltd enter into a foreign currency forward under which X Ltd receives \$206 million and pays £101 million (this puts the company in the same position as entering into a cross currency swap under which it receives 3% on \$200 million and pays 1% on £100 million). The foreign currency forward is hedging X Ltd's actual borrowing costs.

In this example, the forward is purely over currencies. As a result, X Ltd's profits and losses on the forward (excluding amounts of exchange gains and losses) would be included in its tax-Interest amount.

In addition, Y Ltd's profits and losses on the forward (excluding amounts of exchange gains and losses) would be included within its tax-Interest amount.

Example 9.G

X Ltd holds a property which is initially worth £100 million, against which it has borrowed £100 million through a floating rate loan. X Ltd enters into a total return swap with a third party, in respect of which it pays amounts equal to the income from the property and the uplift in the value of the property over the period of the swap, and receives amounts equal to floating interest on £100 million at the end of the period of the swap. The derivative contract is not only over interest rates, as it is also over property. As a result, amounts of profit or loss from the derivative contract will fall outside of the scope of the rules.

Question 40: Do you agree with the proposed treatment of derivative contracts for calculating tax-interest? Do you foresee any unintended with this approach? If so, please explain, and suggest an alternative.

Tax-EBITDA

9.15 As noted above, only the profit and losses from certain derivative contracts are included within tax-interest. Where amounts are brought into account for tax in respect of other types of derivative contracts, these amounts would be included within tax-EBITDA.

9.16 Where amounts under a derivative are brought into account for tax in line with a hedged item (e.g. under the Disregard Regulations S.I. 2004 / 3256 or as a result of hedge accounting) then it will be these amounts which would be included in tax-EBITDA.

Example 9.H

X Ltd takes out a commodity swap to hedge its costs of purchasing fuel. All profits and losses from the commodity swap will be included in tax-EBITDA in line with the amounts brought into account for tax purposes.

Question 41: Do you agree with the proposed treatment of derivative contracts for calculating tax-EBITDA? Do you foresee any unintended consequences from this approach? If so, please explain, and suggest an alternative.

Group-interest and group-EBITDA

9.17 In line with the definition of tax-interest, profits and losses from derivative financial instruments would also be included in total group-interest where the underlying subject matter comprises only:

- interest rates (such as interest rate swaps and RPI swaps)
- currencies (such as cross currency swaps and currency forwards)
- debt (such as credit default swaps)

9.18 Where a group has a designated hedging relationship in respect of such an instrument the net amount of fair value movements included within total group-interest should only comprise any ineffectiveness of the hedge. Where, however, the group is unable to, or chooses not to, designate a hedging relationship, the full fair value movements will typically be recognised in profit or loss.

9.19 It is proposed that fair value movements recognised in profit or loss in relation to loans and relevant derivatives should be included within total group-interest. Groups will typically be able to designate hedging relationships to mitigate the volatility. Furthermore, the rules to address timing differences should address volatility in the group ratio as well as volatility in the application of the Fixed Ratio Rule.

9.20 Likewise, if the underlying subject matter contains other factors, then profits and losses from a derivative would not fall within group-interest and would instead fall to be included in group-EBITDA.

Question 42: Do you agree with the proposed treatment of fair value movements on hedging relationships? Would this cause particular difficulties for groups, that would warrant particular rules to replace the fair value movements on hedging relationships with amounts recognised on an appropriate accruals basis (for example, in line with regulations 7, 8 and 9 of the Disregard Regulations S.I. 2004 / 3256)?

Leasing

9.21 Leasing encompasses a large range of instruments. However, the essence of a lease is that it allows the user of the asset (the lessee) to pay the owner of the asset (the lessor) for use of the asset over the period of time. It therefore places the lessee in a situation which is analogous to a company which borrows to acquire an asset, and the lessor in the position of lender. This is particularly true of leases that are accounted for as 'finance leases', where the lessee will typically show the asset on its balance sheet, with a corresponding liability due to the lessor also shown.

9.22 For the purpose of the interest restriction rules it is necessary to identify which amounts under leases should be included within tax-interest and as tax-depreciation in calculating tax-EBITDA.

9.23 There are a number of different permutations in terms of the accounting and tax treatment for leases. In particular, the current tax treatment of a lease of plant or machinery depends upon whether or not the lease in question is a "long funding lease", as determined by the rules in Chapters 6 and 6A of Part 2 of the Capital Allowances Act 2001. In line with the OECD's recommendations, we propose following the determination of whether a lease is accounted for as an operating or as a finance lease – this is outlined below.

9.24 It should be noted that the accounting rules under IFRS are changing, which principally affects the accounting in the lessee, and which can mean that the accounting approach adopted by the lessor and lessee can differ significantly. The following proposals are based on

the current tax and accounting treatment of leases. The government will be engaging with interested parties to discuss a number of options on the approach that should be taken for taxing leases as a result of these accounting changes, and it may be necessary to amend the approach taken for interest restriction in relation to leases in response to any wider changes to the tax treatment of leases.

Proposed approach using accounting concepts

9.25 Under this approach both tax-interest and tax-depreciation would be based on whether a lease is accounted for as a finance lease under existing accounting standards. This would give the following treatment in relation to a finance lease:

Table 9.A: Treatment in relation to a finance lease

<p>Lessor with a long funding lease</p> <ul style="list-style-type: none"> Accounting treatment: Accounts recognise financing income on leasing receivable. Normal tax treatment: The lessor would be taxed on the amounts of financing income. Proposed treatment for interest restriction: The financing income amounts taxed by the lessor in respect of the lease will be included in tax-interest. No amounts will be included in tax-EBITDA.
<p>Lessee with a long funding lease</p> <ul style="list-style-type: none"> Accounting treatment: Accounts recognise financing expense on leasing payable. Normal tax treatment: The lessee would be able to obtain tax relief on the amounts of financing expense. The lessee would also obtain capital allowances. Proposed treatment for interest restriction: The financing expense amounts relieved by the lessee in respect of the lease will be included in tax-interest. The capital allowances will be added back to the lessee’s taxable profits in calculating tax-EBITDA.
<p>Lessor which does not have a long funding lease</p> <ul style="list-style-type: none"> Accounting treatment: Accounts recognise financing income on leasing receivable. Normal tax treatment: The lessor would be taxed on the amounts of financing income. It will also make an adjustment to its accounting profit to ensure that it is taxed on the rental receipts that are accounted for as a capital repayment of the leasing receivable. The lessor would obtain capital allowances for its cost of the leased asset. Proposed treatment for interest restriction: The financing income amounts taxed by the lessor in respect of the lease will be included in tax-interest. The capital allowances will be added back to the lessor’s taxable profits in calculating tax-EBITDA. In addition, the amount of rental receipts accounted for as a capital repayment on the leasing receivable will be deducted from the calculation of tax-EBITDA. Overall, therefore, no amounts will be included in tax-EBITDA. <p>This provides broadly equivalent treatment to where the lease is a long funding lease.</p>
<p>Lessee which does not have a long funding lease</p> <ul style="list-style-type: none"> Accounting treatment: Accounts recognise financing expense on leasing payable. Normal tax treatment: The lessee would obtain tax relief on the amounts of financing expense. The lessee would also obtain tax relief for its depreciation expense. Proposed treatment for interest restriction: The financing expense amounts relieved by the lessee in respect of the lease will be included in tax-interest. The amounts of depreciation would be added back to the lessee’s taxable profits in calculating tax-EBITDA. <p>This provides broadly equivalent treatment to where the lease is a long funding lease.</p>

9.26 A particular issue arises where the lessor or lessee has an operating lease which is a long funding lease. Under the current accounting rules, neither the lessor nor the lessee will show any amounts of financing income or financing expense in their accounts in respect of an operating lease. As a result, no amounts will be included in tax-interest in respect of the lease. The lessor will show the asset on its balance sheet, with a corresponding depreciation charge to profit or loss. However, from a tax perspective it is the lessee that is entitled to claim capital allowances for the asset as it is held under a long funding lease. To address the point that capital allowances are claimed by the lessee where the asset is treated as being held by the lessor for accounting purposes, the following adjustments would be needed. Firstly the lessor should include the full amount of rental income in calculating its tax-EBITDA (equivalent to adding back 'depreciation'). Secondly the lessee should include the full amount of rental payments in calculating its tax-EBITDA (effectively reversing the add-back for capital allowances).

9.27 This approach will require additional adjustments to be made to the tax figures in calculating tax-EBITDA. It is possible that a different accounting analysis could be adopted between the lessor and the lessee (and such differences will be more likely where the new accounting rules in IFRS 16 are followed for the lessee). However, this approach does fit closely with the current Debt Cap rules and the OECD recommendations for best practice. This approach would also align with the calculation of the group ratio, reducing the potential for tax-to-book differences giving rise to an interest restriction.

Question 43: Does this approach adequately address the position for both the lessor and lessee across the range of different leasing arrangements? If not, how could the rules be adapted to better address these situations?

Change of accounting policy

Tax-interest and tax-EBITDA

9.28 Where there is a change in accounting policy, adjustments may be required to be recognised for tax purposes, either in the year of the accounting change or spread over a period of time (e.g. under the Change of Accounting Practice Regulations S.I. 2004 / 3271). These amounts will need to be attributed to tax-interest and tax-EBITDA in line with the underlying item.

Group-interest and group-EBITDA

9.29 Likewise, where there is a change of accounting policy in the group consolidated financial statements, adjustments will be required in the calculation of adjusted group-interest and to group-EBITDA that are just and reasonable to ensure financing amounts are recognised once and only once.

Investment in non-group entities

Portfolio investments

9.30 Where a group holds a portfolio investment (i.e. any investment in an entity that is not a subsidiary, associate or joint venture), the group-interest figure will not include financing costs incurred by the investment entity. The group-EBITDA figure will, however, include any amounts of dividend income, impairment losses, and profit or loss on disposal. This should give an appropriate result given that the group debt financing will be could be, in part, funded and supported by the portfolio investment.

Associates and joint ventures

9.31 Where a group holds an investment in an associate or joint venture, the group-interest figure will not include any financing amounts incurred by the investment entity. However, the rules will include the group's share of the associate's or joint venture's income or expense for the period.

9.32 If the group holds any debt in relation to the investment this will give an appropriate result (effectively attributing some of the financing costs to the investment). However, where the investment itself holds such debt, it is considered that the group should in certain cases be able to take account of the investment's financing costs. In the case of an associate or joint venture, the group is likely to have significant influence over whether debt is issued at the investor level or by the investment entity.

9.33 It is therefore proposed that groups will have the option, if they want, of including their share of an associate's or joint venture's qualifying group-interest when calculating the group's total group-interest. Where they do so, this amount must also be added back in calculating group-EBITDA. However, the additional amounts included in total group-interest cannot be used to increase the group ratio above what it would be if that particular associate or joint venture was completely excluded.

9.34 This is illustrated in examples 2 and 3 in Annex D.

Subsidiaries measured at fair value

9.35 Where a group holds an investment in a subsidiary at fair value, the subsidiary will not be included in the group and, therefore, the group-interest figure will not include any financing amounts incurred by the subsidiary. However, the rules will mean that the amount of any movement in fair value will be included in group-EBITDA.

9.36 As with associates and joint ventures, it is proposed that a group will have the option of including its share of a subsidiary's financing costs when calculating the group's total group-interest. Where it does so, this amount would be added back to the group-EBITDA. Again, where this is done the additional amounts included in total group-interest cannot be used to increase the group ratio above what would it would be if the subsidiary was completely excluded.

Question 44: Does this approach adequately address the position for investments in non-group entities? If not, how could the rules be adapted to better address these situations?

Public bodies

9.37 A number of government, educational and other public bodies can hold subsidiaries which can undertake trading and other activities. In many cases it would be inappropriate to consider the group as comprising the government, educational or other public body and all of its subsidiaries.

9.38 The government is considering how the rules should be adapted to address this situation. One option is to ensure that a public body cannot be the ultimate parent company of a group, so that the subsidiary company would head its own group.

9.39 A public body means:

- the Crown
- a Minister of the Crown
- a government department

- a Northern Ireland department
- a foreign sovereign power
- designated educational establishments, within the meaning of section 105 of CTA 2009
- health service bodies, as defined in section of 985 CTA 2010 (this includes bodies such as Primary Care Trusts and NHS Trusts)
- local authorities
- or any other body that that acts under the remit of a statutory instrument, an Act of the Scottish Parliament, Northern Ireland legislation or a Measure or Act of the National Assembly for Wales, with a primary objective of providing goods or services for public, community or social benefit and which has been provided with capital primarily to support that objective rather than to obtain a financial return.

9.40 It would still be necessary for the subsidiary to have sufficient capacity to deduct such interest payments. However, it is noted that loans to a public body will be excluded from the definition of related party debt (see paragraph 6.46 above).

Question 45: Does this approach adequately address the situation where public bodies hold subsidiaries to undertake trading activities? If not, how could the rules be adapted to better address this situation?

Interaction with corporation tax carried forward loss reform

9.41 The government has announced that there will be a reform of carried forward losses from 1 April 2017. The impact of the interest restriction rules should be reflected in companies' taxable profits and thus taken into account in calculating the amount of carried-forward losses that can be used in a period.

9.42 Restricted interest carried forward will not be a loss carried forward, as such, and so will not be affected by the reformed loss rules. Where interest expense creates or enhances a loss (either a trade loss or a non-trading loan relationship deficit) to be carried forward, then the enhanced loss will be within the new loss rules. This will only happen where the interest expense has not been restricted under the interest restriction rules.

Example 9.1 (all years are post-2017)

Year 1:

- Company A: Trading loss 100 before interest
- Company A: Interest (trading) of 50 (fully restricted as zero capacity)
- Company A: Carry forward 100 trading loss and 50 restricted interest

Year 2:

- Company A: Trading profits of 100 before interest
- Company A: Current year interest of 50

Cumulative interest is 100 of which 30 (30% of 100) can be deducted, leaving a total of 70 to carry forward as restricted interest to year 3.

Trading profit (after interest) is 70, of which 50% (35) can be covered by losses brought forward. This leaves 35 profit in charge and 65 trading losses to carry forward.

Year 3:

- Company A: Trading profits of 200 before interest
- Company A: Current year interest of 50

Cumulative (unrelieved) interest is 120 (50 from current year plus 70 brought forward), of which 60 (30% of 200) can be deducted, leaving 60 to carry forward as restricted interest to year 4.

Trading profit (after interest) is 140. A maximum of 70 profit can be covered by losses. The brought forward trade losses of 65 can be wholly used leaving 75 of profits chargeable to tax.

10 Anti-avoidance rules

10.1 The interest restriction rules will be subject to targeted anti-avoidance rules to prevent groups entering into arrangements to undermine the effect of the rules. The government would welcome views on the design of these rules, but they will need to be effective against the following schemes or arrangements:

- schemes that are designed to circumvent or exploit the definition of group or related person
- schemes that aim to artificially structure amounts to fall inside or outside of the definition of interest (for example, to reduce the amount of net interest expense that is subject to the restriction)
- schemes that involve the acquisition of other groups' spare capacity or restricted interest amounts where that is a main purpose of the acquisition
- schemes that accelerate, or defer, income or profit as part of contrived arrangements that are designed to reduce the amount of any interest restriction.
- schemes that look to inflate the group ratio of the group for any period

10.2 As set out in paragraph 5.22, existing anti-avoidance rules relevant to the recognition of interest amounts will continue to apply.

11 Commencement

11.1 As set out in Chapter 3, the rules will apply from 1 April 2017.

Periods of account straddling 1 April 2017

11.2 Where the actual period of account for the group straddles this date, the rules will apply on the basis that the group prepares accounts for two notional periods of account, with the first one ending on 31 March 2017 and the second commencing on 1 April 2017.

11.3 Where a group has such a straddling period the following approach will apply.

Fixed Ratio Rule

11.4 For the purposes of the Fixed Ratio Rule the group will need to aggregate the amounts of tax-interest and tax-EBITDA across the group for the notional period of account commencing on 1 April 2017 under the allocation rules outlined in paragraphs 5.14 to 5.17. It is expected that in most cases time apportionment would be a suitable allocation method.

Group Ratio Rule

11.5 Where a group chooses to apply the Group Ratio Rule to increase the interest limit for the notional period of account, the group ratio would also be calculated on the assumption that amounts recognised in the group's consolidated financial statements are allocated to the notional period of account commencing on 1 April 2017 on a just and reasonable basis. In many cases, it is likely to be appropriate to allocate the same proportion of the figures for group-interest and group-EBITDA such that the group ratio for the notional period of account is the same as that for the actual period of account.

Debt Cap Rule

11.6 It is proposed that the current Debt Cap regime will apply in the normal way for an actual period of account which straddles 1 April 2017. The current Debt Cap regime would be repealed for the period of account commencing on or after 1 April 2017.

11.7 The modified Debt Cap Rule would only apply for actual periods of account for the group commencing on or after 1 April 2017. It will not apply for the actual period of account which straddles 1 April 2017.

11.8 Where a group is subject to the net restriction under the current Debt Cap regime for the actual period of account which straddles 1 April 2017, it will not be permitted to carry forward any spare capacity for the notional period of account commencing 1 April 2017.

Example 11.A

XYZ plc has a calendar year end for group reporting.

- It applies the current Debt Cap rules in the normal way for the year ended 31 December 2017.
- It applies the new interest restriction rules in respect of the 9 month period from 1 April 2017 to 31 December 2017. It does not apply the modified Debt Cap Rule for the period.
- It applies the new interest restriction rules in full (including the modified Debt Cap Rule) in the year ended 31 December 2018.

Question 46: Does the phasing in of the rules as outlined above create any particular difficulties for businesses?

Pre-2017 interest expenses

11.9 Unused interest expense from periods before the interest restriction rules come into effect will be carried forward into 2017 as either non-trading loan relationship deficits or trading losses. For a number of reasons, including the practical difficulty of identifying the interest element of the carried forward amounts, these historical interest expenses will not be subject to the interest restriction regime. Their use may, though, be limited by the proposals for reform of carried forward loss rules.

12 Tax impact assessment

Summary of impacts

Exchequer Impact	2016-17	2017-18	2018-19	2019-20	2020-21
(£ million)	0	+920	+1,165	+995	+885
	These figures are set out in Table 2.1 of Budget 2016 and have been certified by the Office for Budget Responsibility. More details can be found in the policy costings document published alongside Budget 2016.				
Economic impact	This measure may have an impact on the cost of capital for large multinational businesses that are more highly leveraged in the UK compared with the rest of the worldwide group. Groups that have engaged in aggressive tax planning using debt to reduce their tax bill may also face a higher cost of capital. This could affect their investment decisions and make some marginal investments uneconomic. The measure is not expected to have any other significant economic impacts.				
Impact on individuals, households and families	This measure applies to corporations and is not expected to directly impact on individuals, households and families. The measure is not expected to impact on family formation, stability or breakdown.				
Equalities impacts	This measure is not expected to impact on any of the groups with protected characteristics.				
Impact on business including civil society organisations	<p>No firm estimate of the impact on business is available at this time. This will depend on the final detailed policy design which will be informed by responses to this consultation.</p> <p>The measure is expected to mainly affect large multinational businesses. The £2 million de minimis threshold for net interest expense is expected to exclude 95% of groups from the rules, including the vast majority of small businesses.</p> <p>There is likely to be an initial burden in training and familiarisation with the new interest restriction rules, as well as an ongoing burden in self-assessing each group's tax liability, to ensure that they correctly reflect the new rules. We hope to gather more information on the administrative impact through the consultation process.</p>				
Operational impact (HMRC or other)	The additional costs for HMRC are expected to be negligible.				
(£ million)					
Other impacts	Other impacts have been considered and none have been identified at this stage. We would welcome views on this initial assessment of impacts.				

A Summary of questions

Question 1: Does the use of IFRS concepts cause practical difficulties for groups accounting under other accounting frameworks (e.g. UK GAAP or US GAAP)? Could the use of a range of acceptable accounting frameworks to define the group give rise to difficulties in identifying the members of the group? What would be the main consequences of relaxing the definition in this way?

Question 2: Is it reasonable to take the proposed approach to the periods for making interest restriction calculations? What changes or alternatives to that approach, if any, should be adopted?

Question 3: Do you agree that these are the right amounts to be included with the scope of tax-interest? Are there any other amounts that should be included within the scope of tax-interest, or any amounts which should be excluded? If so, please explain the reasons why?

Question 4: Do you agree with the proposed treatment of exchange gains and losses? Do you foresee any unintended consequences from this approach? If so, please explain, and suggest an alternative.

Question 5: Do you agree with the proposed treatment of impairment losses? Do you foresee any unintended consequences from this approach? If so, please explain, and suggest an alternative.

Question 6: Do you agree with the proposed treatment of related transactions? Do you foresee any unintended consequences from this approach? If so, please explain, and suggest an alternative.

Question 7: Are there any other amounts that should be included with the definition of tax-EBITDA, or any more items which should be excluded? If so, please explain the reasons why?

Question 8: Do you agree with the proposed treatment for tax-depreciation and tax-amortisation?

Question 9: Do you agree that the proposed treatment of different types of loss relief will be fair and effective while minimising the need to analyse and trace loss amounts? If not, please suggest an alternative, providing an explanation of why you find it preferable.

Question 10: Do you agree with the proposed treatment of chargeable gains and allowable capital losses? If not, please suggest an alternative, providing an explanation of why you find it preferable.

Question 11: Given the proposed reform of losses, does carrying forward restricted interest to be treated as an interest expense of a later period give companies sufficient flexibility?

Question 12: Does the 3 year limit on the carry forward of spare capacity provide sufficient flexibility for addressing short term fluctuations in levels of tax-interest and tax-EBITDA?

Question 13: Are there common circumstances where the proposals will substantially fail to deal with problems around timing differences?

Question 14: Does the proposed modification of the Debt Cap rule balance the objectives of maintaining effective Exchequer protection in this area, aligning the mechanics with the interest restriction rules and ensuring that the relevant figures are readily available from the group's consolidated financial statements.

Question 15: Which of these two approaches do you consider to be the most appropriate way to address the risks arising from very high group ratios or negative group-EBITDA, and why? How should the percentage cap be set under the second approach? Are there other approaches which would better address this situation?

Question 16: Are there specific cases where the removal of the 'broadly comparable' limb contained in the current Debt Cap regime would give rise to particularly difficult outcomes? If so, please suggest how this extension should be modified to allow the calculation of the group ratio.

Question 17: Are there any further items of profit or loss which should be included within the definition of total qualifying group-interest?

Question 18: Are there any other amounts that should be included with the definition of adjusted group-interest, or any more items which should be excluded? If so, please explain the reasons why?

Question 19: Are there any other amounts that should be included with the definition of qualifying group-interest, or any more items which should be excluded? If so, please explain the reasons why?

Question 20: Do you agree that the proposed definition of related party will be effective in preventing equity investors inflating the group ratio by investing using debt instruments? Please identify situations where this definition would prevent the Group Ratio Rule from taking into account interest payable to lenders that invest for a fixed return and without seeking influence over the borrower?

Question 21: Are there any other amounts that should be included with the definition of group-EBITDA, or any more items which should be excluded? If so, please explain the reasons why?

Question 22: Bearing in mind the Fixed Ratio Rule permitting net interest deductions of up to 30% of tax-EBITDA, the Group Ratio Rule, the £2 million de minimis amount, rules permitting the carry forward of restricted interest and excess capacity, and the inclusion in tax-interest of income accounted for as finance income, please describe the key features of situations involving the financing of public benefit infrastructure where a specific exclusion will be necessary to prevent interest restrictions arising in cases where there is no BEPS.

Question 23: Are there any situations involving the financing of public benefit infrastructure where interest restrictions could arise in the absence of BEPS despite a PBPE with the above conditions? If so, please provide details and suggest how the proposals could be changed to prevent undue restrictions occurring.

Question 24: Are there any situations where interest restrictions would arise connected with public benefit infrastructure despite the provisions outlined in this document, and where those restrictions could have wider economic consequences? If so, please provide details, including an explanation of why the consequences could not be avoided, such as by restructuring existing financing arrangements. Please suggest how the rules could be adapted to avoid those consequences while still providing an effective counteraction to BEPS involving interest.

Question 25: Which of the two proposed approaches would be preferable? Please explain what you see as the advantages and disadvantages of each, and address whether the additional complexity of Option 2 is justified by the potential risks and distortions in Option 1.

Question 26: As securitisation structures and transactions are often complex, there may be exceptions to the analysis set out above. Please would you set out any examples of securitisation structures or transactions within the securitisation regime where a net interest expense position

might arise so that the application of the interest restriction rules could lead to an unintended restriction on the securitisation company?

Question 27: Are there any further issues relating to AIFS (including TEFs) or Investment Trust Companies that need to be considered for the purposes of this consultation?

Question 28: Are there any other fund structures, not considered in this consultation document, that require special consideration?

Question 29: As a result of the proposed exclusion from the group of subsidiaries held at fair value, views are invited as to whether a specific rule is required to prevent collective investment vehicles from being the ultimate parent company of a group.

Question 30: How could the rules be adapted so that they protect the property rental and residual profits of REITs from excessive interest deductions just as they do for other property rental groups?

Question 31: To what extent are PAIFs likely to be impacted by the proposals in their current form? If applicable, how could the rules be adapted so that they protect the property rental profits of PAIFs from excessive interest deductions just as they do for other property rental groups?

Question 32: Please supply any evidence that would help the government understand the full extent of interest-related BEPS risks connected with banking and insurances activities, and suggest any modifications that could be made to the Fixed Ratio Rule and the Group Ratio Rule to ensure that they operate effectively, but without giving rise to unwarranted restrictions, in respect of groups performing these activities.

Question 33: How could a targeted rule be designed to ensure that net financing costs deducted in the UK are commensurate with the UK business?

Question 34: Do you agree with the proposed treatment of Patent Box deductions, R&D tax relief, RDEC and land remediation relief? If not, please suggest an alternative and explain why you find it preferable.

Question 35: How should amounts of interest restriction or spare capacity be allocated between activities subject to the Northern Ireland rate of corporation tax and other activities?

Question 36: Does this approach adequately address the situation where charities hold subsidiaries to undertake trading activities? If not, how could the rules be adapted to better address this situation?

Question 37: Does this approach adequately address the situation of interest distributions made by Registered Societies? If not, how could the rules be adapted to better address this situation?

Question 38: Do you agree with the proposed treatment of CFCs? If not, please explain the reasons and suggest an alternative approach?

Question 39: Do you agree that the proposed treatment of income subject to double taxation relief will be fair and effective? If not, please suggest an alternative, providing an explanation of why you find it preferable.

Question 40: Do you agree with the proposed treatment of derivative contracts for calculating tax-interest? Do you foresee any unintended with this approach? If so, please explain, and suggest an alternative.

Question 41: Do you agree with the proposed treatment of derivative contracts for calculating tax-EBITDA? Do you foresee any unintended consequences from this approach? If so, please explain, and suggest an alternative.

Question 42: Do you agree with the proposed treatment of fair value movements on hedging relationships? Would this cause particular difficulties for groups, that would warrant particular rules to replace the fair value movements on hedging relationships with amounts recognised on an appropriate accruals basis (for example, in line with regulations 7, 8 and 9 of the Disregard Regulations S.I. 2004 / 3256)?

Question 43: Does this approach adequately address the position for both the lessor and lessee across the range of different leasing arrangements? If not, how could the rules be adapted to better address these situations?

Question 44: Does this approach adequately address the position for investments in non-group entities? If not, how could the rules be adapted to better address these situations?

Question 45: Does this approach adequately address the situation where public bodies hold subsidiaries to undertake trading activities? If not, how could the rules be adapted to better address this situation?

Question 46: Does the phasing in of the rules as outlined above create any particular difficulties for businesses?

Summary of responses to the previous consultation

B

B.1 Shortly after the OECD published its report on Action 4 of the BEPS project, the UK government launched a consultation on 22 October 2015 seeking views on the OECD proposals in a UK context. That consultation closed on 14 January 2016 and the responses were used to inform the government's decisions announced at Budget 2016 and the proposals contained in this document. The government received 163 formal responses to the consultation, from 5 individuals and 158 organisations. A list of those who responded is provided in Annex C. This section summarises the responses received and the government's decisions in respect of the previous consultation. The government is grateful to all those who contributed their views during the consultation process.

Summary of responses

B.2 In general, respondents were not in favour of the UK introducing an interest restriction in line with the OECD proposals. The majority of respondents argued that the UK's existing rules already provide sufficient protection from BEPS. Many respondents were of the view that the OECD recommendations represented a blunt approach that was disproportionate to the BEPS risk present.

B.3 The government has decided to introduce rules necessary to tackle BEPS involving interest in line with the OECD recommendations, which were endorsed by G20 finance ministers. Similar rules already exist in a number of G7 countries.

Timing

Question 1: What are your views on when a general interest restriction should be introduced in the UK?

B.4 Around two thirds of responses addressed this question. In general, respondents who answered this question either said the rules should not be introduced earlier than 2018, or that the UK should not implement ahead of its international partners. Some respondents said that the government should wait for the conclusion of further work at the OECD. A later start date was suggested by respondents to limit the potential impact of the rules on the UK's competitiveness, and to give businesses adequate time to restructure and reorganise before the rules took effect. However, most respondents did want the government's decision on the proposals to be published as soon as possible to ensure certainty for businesses.

B.5 The point was also made by many respondents that a longer discussion period before implementation would allow a lot of the issues to be ironed out before implementation. There were respondents who warned that a new interest restriction could result in double taxation, whereby interest is non-deductible and interest receipt is taxed, especially if countries introduce the rules at different times or with different features.

B.6 The government has decided to introduce new rules for addressing base erosion and profit shifting through interest expenses from 1 April 2017. This decision is in line with the OECD recommendations, and demonstrates the UK's leadership in implementing the G20 and OECD recommendations to ensure that profits are taxed in line with activities in the UK.

Scope of an interest restriction

Question 2: Should an interest restriction only apply to multinational groups or should it also be applied to domestic groups and stand-alone companies?

B.7 Around half of the respondents answered this question. Of those that expressed a view, around half said that an interest restriction should only apply to multinational groups. Most of these respondents were UK domestic groups. Their argument for limiting the scope of the rules to multinational groups was that multinational groups pose the greatest BEPS risk.

B.8 Around a third of the respondents that answered this question said an interest restriction should apply to all entities. This view was held by most multinational groups. They argued that only applying the restriction to certain entities would have a distortive effect, and that in any case, an appropriate de minimis would eliminate the compliance burden for smaller businesses.

B.9 Only a few respondents said that the rules should apply only to groups and not stand-alone companies.

B.10 One respondent instead made the case for introducing the group allocation model (apportioning net interest expense according to EBITDA) which was previously considered by the OECD.

B.11 The interest restriction rules will apply on a group-by-group, rather than entity-by-entity, basis and apply to all companies within the charge to corporation tax, including UK PEs. There will be an annual £2 million de minimis allowance per group, which will exclude 95% of groups from the scope of the rules. There will also be a Group Ratio Rule, in line with the optional OECD recommendation, but not a group allocation model (which was not taken forward by the OECD).

Definition of interest

Question 3: Are there any other amounts which should be included or excluded in the definition of interest?

B.12 There were a variety of responses to this question. Some respondents expressed a desire for a narrow definition that was easy to administer and understand. Other respondents expressed a preference for a wider definition to prevent get-outs and distortions. A number of respondents suggested that the definition of interest should link through to existing tax definitions, such as loan relationships, in line with the approach currently taken in the Debt Cap rules. A smaller number of respondents preferred an accounting based test. Several respondents made the point that the rules should apply after other rules, and that a number of the categories suggested by the OECD would not be typically deductible in the UK. There were also a few general comments about how the rules should only restrict intra-group interest. A few specifically advocated excluding all amounts relating to derivatives, as it can be difficult in practice to separate out the amounts equivalent to interest.

B.13 With regards to specific items, the most common suggestion made by respondents was that fair value movements on derivatives should be excluded from the definition, although some also noted that existing tax rules could be used to achieve a similar effect. A number of respondents considered that one-off costs, such as arrangement fees, break costs, swap termination payments should be excluded. Some also noted that they thought that interest income taxed under the CFC rules should also be included. Specific points were also raised in connection with the treatment of finance debtors (e.g. under IFRIC 12), capitalised interest, late interest, interest on tax debts and changes in the accounting standard for leasing. Sector specific

comments were also made in respect of tonnage tax regime, insurance companies and collective investment schemes.

B.14 In line with the recommendations of the OECD report, it is proposed that the interest restriction rule should apply to interest on all forms of debt; payments economically equivalent to interest; and expenses incurred in connection with the raising of finance. More details on the amounts to be included can be found in this document.

Question 4: How could the rules identify the foreign exchange gains and losses to be included?

B.15 Just under half of the respondents answered this question. Most of those who commented considered that in general, foreign exchange gains and losses should be excluded, with exceptions noted to address cases where amounts that are economically equivalent to interest are taken into account in calculating interest or where the exclusion is being abused. Some supported a broader definition of interest, which generally included foreign exchange gains and losses, but then with exceptions noted to address cases where there are instruments that directly hedge non-financial risks of the business (e.g. construction costs).

B.16 The government will exclude exchange gains and losses (as defined in the loan relationship rules) from tax-interest, in line with the majority view of respondents.

Fixed Ratio Rule

Question 5: If the rules operate at the UK sub-group level, how should any restriction be allocated to individual companies?

B.17 This question was answered by around half of the respondents, of which almost all wanted freedom of choice for a business to allocate the restriction as it sees fit across the UK group/sub-group. Some suggested having similar rules to the current Debt Cap regime.

B.18 A few respondents mentioned a variety of other points, such as the freedom to allocate the restriction could be subject to anti-avoidance rules; a consolidated approach should be taken for the sub-group rather than allocating the restriction between entities; an approach similar to group relief should be used; and the restriction should be applied to subordinated debt before senior debt.

B.19 The government view is that tax-interest and tax-EBITDA will be aggregated across all entities in the group that are within the UK corporation tax charge. The rules will result in a group-wide amount of restricted interest or spare capacity that will have to be allocated to individual group entities. Groups will be able to choose how to allocate the interest restriction between the entities of that group, subject to certain limitations. The amount of restriction allocated to an entity will be limited to its net interest expense or spare capacity calculated as a stand-alone entity. More details about the proposed rules can be found in this document.

Question 6: Are there items which should be excluded from both the definition of interest and from tax-EBITDA, as referred to in the section on a Fixed Ratio Rule?

B.20 There were very wide range of responses to this question. Some respondents preferred the use of accounting EBITDA than tax-EBITDA, as it is more familiar and more easily available. Pension obligations were frequently mentioned as being problematic and thus should be excluded.

B.21 Respondents suggested items which should be excluded from the rules, including foreign exchange gains and losses; share based payments (e.g. exercise of share options); exceptional items; unrealised gains and losses; fair value movements; enhanced tax reliefs (e.g. for research and development); intangible fixed assets; and deferred revenue expenditure.

B.22 Respondents also suggested items which should be included in tax-EBITDA, such as dividends; gains (even if tax exempt); gains/surplus on real property and fixed asset sales; and tax exempt income including exceptional items.

B.23 It was pointed out that tax-EBITDA is not appropriate for charities.

B.24 The adjustment for interest in calculating tax-EBITDA will equal the amount of tax-interest that is tested under the rule. Further details about the proposed definition of tax-EBITDA can be found in this document.

Setting a fixed ratio

Question 7: What do you consider would be an appropriate percentage for a Fixed Ratio Rule within the proposed corridor of 10% to 30% bearing in mind the recommended linkages to some of the optional rules described below?

B.25 There was almost unanimity in the responses that 30%, or the upper level for the fixed ratio recommended by the OECD would be preferred. Some respondents thought that 30% was too low, particularly for sectors such as infrastructure and property. Other respondents argued that a lower level than 30% would be uncompetitive, as other countries with an existing, similar Fixed Ratio Rule (e.g. Germany) generally had restrictions at 30%. Several respondents noted that even with a Fixed Ratio Rule at 30%, there still needs to be a Group Ratio Rule. A few responses suggested retaining some flexibility in the level of the fixed ratio, to cater for changing interest rates and economic circumstances.

B.26 The UK will be introducing a Fixed Ratio Rule limiting a group's UK tax deductions for net interest expense to 30% of its UK tax-EBITDA, in addition to a Group Ratio Rule and a number of other rules as set out in this document.

Question 8: What are your views on including in any new rules an option for businesses to use a Group Ratio Rule in addition to a Fixed Ratio Rule?

B.27 Almost all of the respondents who answered this question advocated the inclusion of a Group Ratio Rule if the UK introduced the rules. Some respondents stressed that even if the UK introduced a Group Ratio Rule, the Fixed Ratio Rule should be set at a high percentage. Respondents also warned against making the Group Ratio Rule too complex.

B.28 Respondents frequently made the point that all third-party interest should be deductible, and many argued the Group Ratio Rule should be designed to achieve this. Some respondents asked for existing third party debt to be grandfathered, and a few suggested amendments to the proposals which would guarantee full relief for third-party debt. Several respondents made the case for shareholder debt to be deductible as well, either by allowing it under the Group Ratio Rule or expanding the PBPE.

B.29 It was noted by some respondents that the definition of a 'group' was important. The point was made that the definition of a 'group' should include the investing holding company, but extend no further, and that joint ventures need to be considered separately.

B.30 Some respondents wanted the rules to give the option looking at the assets of the group rather than the earnings. A few respondents preferred accounting EBITDA to be used over tax-EBITDA.

B.31 A few respondents raised concerns that the Group Ratio Rule did not take into account the circumstances of mixed-business groups, especially if a heavily geared project is consolidated under a multinational enterprise with relatively 'normal' gearing across the rest of the group.

B.32 Recognising that some groups may have high external gearing for genuine commercial purposes, the UK will also be implementing a Group Ratio Rule based on the net interest to EBITDA ratio for the worldwide group as recommended in the OECD report. This should enable businesses operating in the UK to continue to obtain deductions for interest expenses commensurate with their activities.

De minimis threshold

Question 9: What form of de minimis threshold would be most effective at minimising the compliance burden without introducing discrimination or undermining the effectiveness of any rules?

B.33 Around half of the respondents favoured a fixed de minimis threshold, with scope for it to change if interest rates increase. There were calls to make the rules as simple as possible to apply. There were also calls to make the rules similar to the Debt Cap rules which business is familiar with.

B.34 A few respondents raised the issue of how the de minimis should be calculated, with some respondents suggesting it should be set by reference to the principal of the loan; and others suggesting the de minimis should be set by reference to the net-debt position of the group.

Question 10: What level should the de minimis threshold be set at, balancing fairness, BEPS risks and compliance burdens?

B.35 Just over half of respondents thought that the de minimis should be set at above £1 million but not higher than £2 million. A number of respondents said this would be similar to the amount set by other European states. One respondent felt a de minimis set at a monetary level would not be appropriate for high value, capital intensive industries as they would be highly unlikely to benefit from a de minimis. This was echoed by another company in the same sector who felt a high de minimis threshold would be necessary.

B.36 Around a fifth of the respondents thought the level should be set above £2 million but not higher than £5 million. Another fifth felt it should be set at £1 million.

B.37 Other respondents felt that if 90% of companies are exempted by the £1 million level then this would seem acceptable.

Question 11: Should SMEs as defined by the EU criteria be exempted from the rules, in addition or as an alternative to a de minimis threshold?

B.38 The majority of respondents said that there should be a de minimis threshold and an exemption for SMEs along the lines of transfer pricing rules and with a modified definition of a SME. One respondent said that even with these exemptions, the de minimis would be unlikely to help real estate groups, or other capital intensive industries. Another respondent suggested there should be a 'grace period' when a group exceeds SME limits. One of the respondents said that small companies should be exempted but not medium companies.

B.39 Some respondents said there should be no SME exemption. One of these respondents said this was because an internet based worldwide company could have few balance sheet assets or employees and still be classed as a SME. One respondent chose this as property companies are often not classed as small due to their large assets and they would find a single criteria preferable. Another respondent selected this to stop groups setting up as SMEs to fit the exemption.

B.40 A few respondents selected SMEs being exempted as alternative to the de minimis threshold. Only one respondent commented that SMEs whose role may be deemed eligible for public benefit projects should be exempted.

B.41 Consistent with the view of most respondents, the government will allow all groups to deduct their net interest expense up to a fixed amount of £2 million per annum. This will target the rules at large businesses where the greatest BEPS risks lie, and minimise the compliance burden for smaller groups. The threshold is estimated to exclude 95% of groups from the rules. To avoid unnecessary complexity, the government will not be introducing an SME exemption in addition to the de minimis threshold.

Addressing volatility

Question 12: What is the best way of ensuring that the rules remain effective and proportionate even when earnings are volatile?

B.42 The general consensus was that business should have the ability to carry forward unused capacity as well as disallowed interest, to help ease the burden of compliance. A number of respondents said that the carry forward should be indefinite, particularly in capital intensive industries which may not be able to use the interest for a long time.

B.43 A limited carry back facility with a cut off was suggested by a number of respondents, suggesting a time period ranging from 1-10 years.

B.44 One respondent pointed out that charities would not benefit from a carry forward due to the way trading entities interact with the parent. It was also noted that without unlimited carry forward, there is a risk of groups engaging in tax-driven transactions in response to pending expirations of carried forward interest.

B.45 Several respondents flagged that the ability to share restricted deductions around group companies within jurisdictions would help to reduce the impact where another company has excess capacity. It was also suggested by some respondents that capacity could be carried forward and survive a change of ownership as losses do.

B.46 However most respondents believe there should be appropriate provisions, in line with existing ruled on business combinations, to limit this capacity carry forward in a change of ownership.

B.47 One respondent suggested there should be a balancing allowance in the final year of a loan where interest was previously restricted.

B.48 Many respondents made the suggestion that there should be a mechanism to protect businesses with low or negative profits for a number of years to help deal with volatility, such as suspending the restriction after a number of years of declining profits, or using an average EBITDA over preceding years when calculating the restriction, to provide greater consistency for business.

B.49 One respondent suggested that grandfathering could be applied to all internal and external debt if linked to a portfolio of assets.

B.50 A few respondents raised concerns about the interaction of the rules with the business cycle. In particular, they note it is likely that groups will have a greater restriction in an economic downturn (due to lower tax-EBITDA), reducing their cash flow when it is most needed.

B.51 The government is proposing to allow the carry forward of restricted interest indefinitely and spare capacity for up to 3 years, to prevent unwarranted restrictions arising from volatility in earnings and interest.

Public Benefit Project Exclusion

Question 13: In what situations would businesses choose to use the PBPE? How would this differ if no Group Ratio Rule was implemented?

B.52 Where both a Group Ratio Rule and PBPE are available, the majority of respondents would opt to use the PBPE, citing factors such as it being simpler to understand; the removal of the necessity for potentially complex interest deductibility calculations; and it not being subject to changes (period on period) of a group's financing arrangements.

B.53 It was noted by some respondents that the further into an infrastructure project, as the debt principal outstanding and associated finance costs reduce, a Group Ratio Rule could be more beneficial than a PBPE. It was also noted by some respondents that where the group net interest expense / EBITDA ratio was higher than that of a group company which could benefit from the PBPE, the PBPE would be used to avoid depressing the Group Ratio Rule.

B.54 As a result of concerns as to the scope of the PBPE, respondents were broadly in agreement that a Group Ratio Rule should be introduced in concert with the PBPE.

B.55 A number of respondents noted that further clarity would be needed over the meaning of 'group' for the Group Ratio Rule and the conditions for the PBPE before they could comment with confidence.

B.56 The government recognises that many businesses would prefer to use a PBPE, and has suggested an approach for such an exclusion in this consultation, to ensure that the rules do not impede the provision of private finance for public infrastructure in the UK where there are no material risks of BEPS.

Question 14: Do you have any suggestions regarding the design of a PBPE, taking account of the OECD recommendations?

B.57 Many respondents stated that the PBPE, as drafted in the OECD Report, had too narrow a scope, although this was for a range of reasons. Around a quarter of respondents requested the PBPE be expanded to include related party interest.

B.58 There was also a common consensus that the type of projects included in the OECD PBPE was too narrowly defined along the lines of PFI / PPP model and it excluded many capital intensive; regulated, public sector; charity; utility; oil; gas; renewables; and other power companies.

B.59 Definitions used for scoping IFRIC 12 and by the European Insurance and Occupational Pensions Authority ('EIOPA') were put forward as being a basis for a broader application for the PBPE. A small proportion of respondents desired the PBPE be scoped widely enough to include all capital intensive real estate projects.

B.60 The difficulty in a definition which would include all intended beneficiaries was acknowledged and guidance, including an approved list of project types and / or a system for advanced clearance, was suggested.

B.61 Another theme from respondents was a desire to include debt raised for a project outside of an immediate project company e.g. through a finance company. Some respondents requested acquisition debt at the investor level be included within the scope of the PBPE.

B.62 A significant proportion of respondents raised state aid concerns in respect of the PBPE.

B.63 Several respondents argued that an interest restriction would reduce the attractiveness of areas that the government was encouraging investment in, such as property development, infrastructure, renewable energy and the UK continental shelf.

B.64 Many respondents from the oil and gas sector were concerned that an interest restriction would reduce investment and new entrants in the mature UK continental shelf. They argue the existing rules, in addition to the RFCT, Supplementary Charge and the Petroleum Revenue Tax which apply to ring fence trades, are already sufficient to prevent BEPS. They point to the fact that ring fence trades are already exempt from the Debt Cap. There are groups that say the whole sector should be exempt from any new interest restriction, while others say that only the ring fence trades should be exempt.

B.65 Many respondents from the property sector point out that if an interest restriction is applied to REITs, the required Property Income Distribution (PID) will increase. Their view was that REITs should be exempted from any new rules to ensure they remain attractive to investors. Respondents referred to the fact that REITs are excluded from the Debt Cap, and that other countries with structural interest restrictions exempt REITs from their regimes.

B.66 Respondents from charities have said they should be exempt from the rules, and point to the fact that they are exempt from the Debt Cap.

B.67 The government has set out a design for the PBPE intended to ensure that the provision of private finance for public infrastructure in the UK is not impeded where there are no material risks of BEPS. We invite views on this design in this consultation. Profits within the oil and gas ring fence, that are subject to a higher tax burden and are already protected by rules limiting interest deductions, will not be subject to these rules.

Question 15: Do you have any views on the specific risks that might sensibly be dealt with through targeted rules?

B.68 Most respondents to this question took it as an opportunity to argue against targeted rules. Just over half of the responses were against additional targeted rules, many citing other existing rules as providing sufficient protection. A small proportion of respondents expressed views in support of additional targeted rules, though there was no recurring theme in the type of rule favoured.

B.69 There are no targeted rules proposed in this document other than the anti-avoidance rules intended to prevent avoidance of the proposed structural rules. The government will keep the need for targeted rules under review.

Banking and insurance groups

Question 16: Do you have any suggestions as to how to address BEPS issues involving interest raised by the banking and insurance sectors?

B.70 Most of the respondents that answered this question suggested that regulated groups, or at least regulated entities, should be excluded from the rules. The effect of regulatory requirements on such groups and the effectiveness of existing tax rules were the reasons most commonly cited for such an approach. It was argued that the UK should wait for the outcome of the OECD's ongoing work, on the interest deductibility in banking and insurance groups, before considering any rules. Some respondents suggested that rules should only be applicable to non-regulated entities within a group or to interest that was not related to regulated activity. It was also suggested that targeted rules represented the best approach.

B.71 As banks and insurers are generally net interest recipients, the government will be looking at alternative ways to deal with BEPS in the financial sector. The UK will continue to participate in the work the OECD is undertaking in this area.

Transitional rules

Question 17: What are the types of arrangement for which transitional rules would be particularly necessary to prevent any rules having unfair or unintended consequences, and what scope would these rules need to be effective?

B.72 Many respondents said there was a need for grandfathering either all existing debt or all third party debt, although there was no clear consensus on whether this should be as at the date of announcement or implementation. In particular, respondents emphasised the importance of a grandfathering rule for long term debt, and for specific industries involving long term projects, such as infrastructure and utilities. Where a time limit was suggested, responses ranged from 2 to 5 years. Some respondents suggested that a period of transition between announcing the legislation and its effective date would be more appropriate. Respondents also suggested using the carry-forward rules to achieve the desired outcome. Only a very few argued for having no form of transitional rule.

B.73 As grandfathering would introduce distortions between market participants and reduce the effectiveness of the new rules, the government will only consider grandfathering in exceptional circumstances. This consultation invites interested parties' views on circumstances in which grandfathering would be necessary, taking into account the other reliefs proposed in this document.

Interaction with other restrictions on tax relief for interest

Question 18: To what extent do you believe that the new general interest restriction rule should replace existing rules?

B.74 The majority of respondents were in favour of any new general interest restriction rule replacing the current Debt Cap rules, with a majority in favour of abolishing any kind of cap on interest deductibility. Around a third of respondents were in favour of building on the existing Debt Cap concepts and definitions, with several citing these as well understood and bedded in, therefore giving a good basis for any new rule. A few respondents wanted a general simplification of interest rules without specifying what should be replaced. A few also identified the interaction with existing thin cap rules as an area of concern.

B.75 The point was also made that existing interest restrictions should be amended to resolve the issue of interest costs trapped in entities that cannot benefit from them.

B.76 Recognising the desire for a simpler set of rules, the existing legislation for the Debt Cap will be repealed. Rules with similar effect will be integrated into the new interest restriction rules, such that group's net UK interest deductions cannot exceed the global net third party expense of the group, unless they fall below the de minimis threshold.

List of respondents to C previous consultation

100 Group	Brackenridge Hanson Tate	CMS Cameron McKenna
A & J Mucklow Group	Bristol Water	Commercial Real Estate Finance Council (CREFC) Europe
Aberdeen Asset Management	British American Tobacco (BAT)	Confederation of British Industry (CBI)
Association for Financial Markets in Europe (AFME)	British Bankers' Association (BBA)	Crowe Clarke Whitehill
Alternative Investment Management Association (AIMA)	British Council	Cubico Sustainable Investments Limited
Amberside Capital	British Land	Dalore Capital
Anglian Water	British Private Equity & Venture Capital Association (BVCA)	Deloitte
Argent (Property Development) Services	British Property Federation (BPF)	Derwent
Ashurst	British Telecommunications (BT)	Diageo
Association of British Insurers (ABI)	Bruntwood Group Limited	DWF
Association of Corporate Treasurers	C W Harwood & Co. Solicitors	EDF Energy
Association of Foreign Banks (AFB)	Caledonia Investments	Edgewest Group
Association of Investment Companies (AIC)	Canada Pension Plan Investment Board (CPPIB)	Enterprise Inns
Association of Real Estate Funds (AREF)	Capital & Counties Properties	Evans Property Group
AstraZeneca	Carter Jonas	ExxonMobil
Atkins Properties	Charity Law Association	EY (Anonymous Client)
Aviva	Chartered Accountants Ireland	EY (PPP/PFI Consortium)
AWS	Chartered Institute of Taxation (CIOT)	EY (REITs)
Balfour Beatty	Chryasor	EY
BDO	City of London Law Society Revenue Law Committee	Faroe Petroleum
Benson Elliot Capital Management	CLS Holdings	Fieldfisher
BEPS Monitoring Group		Freshfields
BlackRock		FTI Consulting
		G4S
		Gary Richards
		Gazprom Marketing and Trading
		Good Energy
		Goodman
		Grainger

Grant Thornton	Liberty Global	Scottish Water
Great Portland Estates	Loans Market Association	SEGRO
Grosvenor Group	M&G Investments	Severn Trent
GSK	Mathew Halliwell	Sky
Hammerson	Mazars	Smith & Nephew
Harcourt Capital	Ministry of Defence	Smith & Williamson
Heathrow	Moorfield	Social Stock Exchange
Mark James Holland (HKO Mercury)	National Grid	Solar Trade Associations
Hogg Robinson	National Housing Federation	South Gloucestershire Council
Home Builders Federation	Northern Ireland Water	South Staffordshire PLC
Home from Home Care	Northern Ireland Electricity Networks	SSE
Horizon Nuclear Power	Octopus Investments	Suncor
Ian Roxan	Open University (OU)	Target Healthcare REIT Ltd
IFM Investors	Osborne Clarke	Thames Water
Intercontinental Hotels Group (IHG)	Oxfam	The Infrastructure Forum (TIF)
Institute of Chartered Accountants in England and Wales (ICAEW)	Oxford Properties Group	Tideway
Institute of Chartered Accountants of Scotland (ICAS)	Petrofac	TUI
International Hotel Investment Council (IHIC)	Pickard Properties	UK energy sector
International Underwriting Association of London	Pinsent Masons	UK Oil Industry Taxation Committee (UKOITC)
Intu Properties	PPP Forum	Unite Students
Investment Association	Professor Michael P. Devereux	United Utilities
Joel Weis	Progress Housing Group	University of Leicester
John Webster	Prudential	University Partnership Programme (UPP)
KPMG	Punch Taverns	Viridian
Land Securities	PwC	Vodafone
Law Society of England and Wales	Rolls Royce	Water UK
Legal & General	RSA Insurance Group	Wellcome Trust
	RSM	Western Power Distribution
	RWE	White & Case
	SABMiller	Woodhead Investments & Development Services
	Schroders	Zurich
	Scottish Power	
	Scottish Renewables	

Group Ratio Rule:

D Examples

Figures are rounded to whole numbers and percentages.

Example 1: Simple UK Group

X Ltd and its smaller subsidiary Y Ltd, which it acquired a number of years ago, constitute a group. To purchase Y Ltd, X Ltd raised funds through bank loans and these sit alongside other 3rd party debt on its balance sheet. Y Ltd has no external debt on its balance sheet.

Accounts	X Ltd	Y Ltd	Group
Operating Profit	100	20	120
3 rd party interest expense	(70)	-	(70)
Profit before tax ("PBT")	30	20	50

Calculation of Group Ratio

Qualifying group-interest expense	70	(A)
Group PBT	50	
Add back total group-interest expense	70	
Group-EBITDA	120	(B)
Group Ratio	58%	(A/B)

Example 2: Investing in a joint venture (JV) – including share of JV interest

X plc with ongoing operations decides to enter into a 50:50 JV with Y plc to expand their operations into a new territory. The JV raises its funds using a public bond issue. In addition, the groups themselves raise further funds as debt.

Accounts	X plc	JV	Group
Operating Profit	100	150	100
3 rd party interest expense	(50)	(60)	(50)
Share of Profits of JV			45 (50% of JV PBT)
PBT	50	90	95

X plc has the choice of whether or not to include a share of the JV's interest expense within total group-interest expense.

A. Calculation of Group Ratio - no inclusion of the JV's interest

Qualifying group-interest expense	50	(A)
Group PBT	95	
Add back total group-interest expense	50	
Group-EBITDA	145	(B)
Group Ratio	34%	(A/B)

B. Calculation of Group Ratio with its share of the JV's interest included

If X plc chooses to include its share of the JV's interest then it must also calculate the group ratio on the basis that the joint venture is completely excluded as this acts as a cap on the group ratio calculated including the JV's interest.

	JV interest included		JV completely excluded	
Group-interest expense	50		50	
Share of JV net interest expense	30	(50% of 60)	-	
Group-interest expense for group ratio	80	(A)	50	(A)
Group PBT	95		95	
Deduct share of JV's profits			(45)	
Add back total group-interest expense	80	(A)	50	(A)
Group-EBITDA	175	(B)	100	(B)
Group Ratio	46%	(A/B)	50%	(A/B)

As the group ratio with the JV interest included is lower than with the JV completely excluded from X plc it can use this result. It can therefore apply a 46% group ratio.

In this example it is advantageous for X plc to include the share of the JV's interest in total group-interest expense.

Example 3: Investing in a joint venture (JV) – group ratio capped

C plc with ongoing operations decides to enter into a 50:50 JV with D plc to win a tender for a new research project. The JV raises its funds using a public bond issue and through the groups themselves issuing further debt.

Like example 2 above, C plc has the choice of whether to calculate its group ratio with or without the JV's interest being included.

Accounts	C plc	JV	Group
Operating Profit	200	200	200
3 rd party interest expense	(70)	(150)	(70)
Share of Profits of JV			25 <i>50% of the JV's PBT</i>
PBT	130	50	155

A. Calculation of Group Ratio - no inclusion of the JV's interest

Qualifying group-interest expense	70	(A)
Group PBT	155	
Add back total group-interest expense	70	
Group EBITDA	225	(B)
Group Ratio	31%	(A/B)

B. Calculation of Group Ratio with the JV's interest included

C plc looks to calculate its group ratio to include its share of the JV's interest expense. C plc must compare this result against the group ratio if the JV was completely excluded from the calculation.

	JV interest included		JV completely excluded	
Group-interest expense	70		70	
Share of JV net interest expense	75	(50% of 150)	-	
Group-interest expense for group ratio	145	(A)	70	(A)
Group PBT	155		155	
Deduct share of JV's profits			(25)	
Add back total group-interest expense	145	(A)	70	(A)
Group-EBITDA	300	(B)	200	(B)
Group Ratio	48%	(A/B)	35%	(A/B)

As the group ratio with the JV completely excluded gives a lower amount, the allowed group ratio is capped at this amount. C plc can therefore apply a 35% group ratio against its interest expense.

In this example it is still advantageous for C plc to use the calculation based on including the share of the JV's interest in total group-interest expense, even though it is capped at the value calculated with the JV completely excluded.

Example 4: UK group with Deferred Revenue Expenditure

C plc is a domestic group which owns a power station in the UK. C plc undertakes a 4 yearly statutory overhaul of the station. Included in this expenditure is £100 million that under accounting standards is capitalised in the group accounts, but is considered to be revenue for tax purposes - Deferred Revenue Expenditure. This is to be released to profit or loss over 4 years on a straight line basis (£25 million per annum). This amount is included in the group's depreciation figure for the period of £90 million. C plc claims capital allowances of £120 million in the period.

Accounts	Group
Operating Profit	250
3 rd party interest expense	(100)
PBT	150

Calculation of Group Ratio

Qualifying group-interest expense	100	(A)
Group PBT	150	
Add back total group-interest expense	100	
Add back depreciation (excluding DRE)	65	(90-25)
Group-EBITDA	315	(B)
Group Ratio	32%	(A/B)

Apply Group Ratio to calculate interest limit for C plc

PBT	150
Add back depreciation	90
Deduct capital allowances	(120)
Deduct deferred revenue expenditure	(25)
Profits chargeable to corporation tax	95
Profits chargeable to corporation tax	95
Add back interest	100
Add back capital allowances	120
Tax-EBITDA	315
Multiplied by group ratio	32%
Interest limit	100

The deferred revenue expenditure is treated in the same way for both the calculation of tax-EBITDA and group-EBITDA. As a result, the group gets full relief for its interest costs.

Example 5: Qualifying group-interest – redeemable preference shares

X plc is the parent company of a highly leveraged group. The group's operating profits are earned in the UK market through X plc and its wholly owned subsidiary Y Ltd.

X plc issues redeemable preference shares to replace its issued equity. The preference shares meet the conditions to be treated as debt and the accounts include accruals for the payment of dividends as an interest expense in the income statement.

Accounts	X plc	Y Ltd	Group
Operating profit	100	150	250
Preference dividends	(100)		(100)
3 rd party interest expense	(50)	(30)	(80)
Intra-group dividends receivable	100		-
PBT	50	120	70
Intra-group dividends payable		(100)	

Calculation of Group Ratio

Total group-interest expense	180	(A1)
Exclude preference dividends	(100)	
Adjusted group-interest expense	80	
<i>No further amounts excluded from qualifying group-interest</i>	-	
Qualifying group-interest expense	80	(A2)
Group PBT	70	
Add back total group-interest expense	180	(A1)
Group EBITDA	250	(B)
Group Ratio	32%	(A2/B)

In this example, the accrual for the payment of dividends on the preference shares is not included in adjusted group-interest expense and so is also excluded from qualifying group-interest, which is the numerator in the calculation of the group ratio. It is, however, included in total group-interest expense and so is added back in calculating group-EBITDA. As a result, the group ratio is calculated in the same way as if the group had issued ordinary equity shares instead of the redeemable preference shares.

E Glossary of defined terms

The terms tax-interest, tax-EBITDA and group are defined and discussed extensively above. Below are brief definitions for a selection of other defined terms used in this document, arranged alphabetically, together with cross-references to the parts of this document where they are explored in further detail.

Adjusted group-interest

Adjusted group-interest is an accounting measure of interest (expense or income) based on the consolidated accounts of the parent company. It is defined in paragraphs 6.22 to 6.27 and used for the new Debt Cap. A similar but narrower measure of **qualifying group-interest** is used for the Group Ratio Rule.

Fixed Ratio Rule

The **Fixed Ratio Rule** is one way of calculating the **interest limit** equal to 30% of **tax-EBITDA**.

Group-EBITDA

The **group-EBITDA** is an accounting measure of earnings before interest tax depreciation and amortisation based on the consolidated accounts of the parent company. It is defined in paragraphs 6.48 to 6.62.

Group ratio

The **group ratio** is the net **qualifying group-interest** expense divided by **group-EBITDA**. It is only defined when both these amounts are positive. The use of the group ratio in the Group Ratio Rule is explained in Chapter 6.

Group Ratio Rule

The **Group Ratio Rule** is an optional way of calculating the **interest limit**, based around multiplying the **tax-EBITDA** by the **group ratio**. It is described in Chapter 6.

Interest capacity

The **interest capacity** is the maximum amount of net tax-interest expense that the group can deduct for a given period of account. It is the higher of:

- £2 million per annum, or
- the group's **interest limit** plus any **spare capacity** carried forward from earlier periods

Interest limit

The **interest limit** is the lower of:

- the result of the Fixed Ratio Rule or the Group Ratio Rule, or
- the net adjusted-group-interest expense (this is the modified Debt Cap)

Interest restriction

The **interest restriction** equals the amount (if any) by which a group's net **tax-interest** expense exceeds its **interest capacity**. The consequences of an interest restriction are set out in Chapter 5.

Period of account

The **period of account** used for the interest restriction rules is generally the period of account used by the ultimate parent company for its consolidated accounts. More comprehensive rules are set out in paragraphs 5.14 to 5.17.

Qualifying group-interest

Qualifying group-interest is an accounting measure of interest (expense or income) based on the consolidated accounts of the parent company. It is defined in paragraphs 6.29 to 6.39 and used for the Group Ratio Rule. A similar but more inclusive measure of **adjusted group-interest** is used for the new Debt Cap rule.

Restricted interest

Restricted interest refers to expenses falling within tax-interest for which the tax deduction is initially denied as a result of an **interest restriction**. It is carried forward and may, subject to conditions, be treated as a tax-interest expense in a subsequent period.

Spare capacity

If the interest limit exceeds the net tax-interest expense, there may be an amount of **spare capacity** to carry forward and use as additional interest capacity in subsequent periods until it expires after 3 years. Further details are in paragraphs 5.46 to 5.51.

Total group-interest

Total group-interest is an accounting measure of interest (expense or income) based on the consolidated accounts of the parent company. It is defined in paragraphs 6.14 to 6.21 and used to adjust the group's profit to calculate group-EBITDA.

HM Treasury contacts

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If you require this information in an alternative
format or have general enquiries about
HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 5000

Email: public.enquiries@hmtreasury.gsi.gov.uk