

Corporate interest restriction – Part 3 (Lecture B1242 – 25.32 minutes)

Group ratio calculation – blended rate

The group ratio ($\text{QNGIE} \div \text{Worldwide Group EBITDA}$) can potentially be enhanced if there are related party investors with a higher group ratio.

Related parties were defined in an earlier Part of this topic review, but are broadly defined as

1. a party which would be required to be included in a consolidation of the group, or
2. there is common participation in the management, control or capital (based on definitions in transfer pricing rules), or
3. There is common 25% participation between or by a third party in the parties (votes, disposal proceeds, assets, or income)

For each investor, take the highest of

1. 30%;
2. The actual GRR for this group; and
3. The investor's own GRR.

Multiply that by the investor's share in the group and add the results together.

Example

Z Ltd heads a worldwide group of ten companies with a group ratio rate of 35%.

Its shareholders are:

	Shareholding	Investor's Group Ratio
A Ltd	25%	28%
B Inc	40%	55%
C Ltd	30%	40%
D Ltd	5%	45%

Assume that none of the investors satisfies the participation condition, nor the consolidation condition so we only consider if their investment is at least 25%.

D Ltd is not a related party and is ignored. For A, B and C we take their percentage of the highest of 30%, their own group ratio, or Z's group ratio.

The blended rate is therefore:

A Ltd: 25% x 35% (Z's ratio being the highest)	8.75%
B Ltd: 40% x 55% (B's ratio being the highest)	22.00%
C Ltd: 30% x 40% (C's ratio being the highest)	<u>12.00%</u>
	<u>42.75%</u>

Z Ltd is therefore able to use a group ratio of 42.75% instead of its own ratio of 35% in calculating the interest allowance under the group ratio method.

Public infrastructure exemption (PIE)

Where the PIE applies to a qualifying infrastructure company (QIC), tax-interest expenses on non-related party borrowing are excluded from the CIR regime, subject to a requirement that the recourse of the creditor is limited to income, assets or shares in or loans issued by the QIC.

Any tax-interest income of the QIC is also excluded from the CIR regime.

Tax-interest expenses on related party borrowings are not generally exempted under the PIE (although some debt may be grandfathered), unless the lender is also a QIC. Where the PIE applies, the QIC's tax-EBITDA is also reduced to zero.

As a result, where the QIC forms a single company CIR group, it is unlikely to be worthwhile electing into the PIE regime where the QIC is wholly or substantially funded by (non-grandfathered) related party debt.

Where the QIC forms part of a wider CIR group and elects into the PIE regime, it may be possible to access some relief for its interest costs on (non-grandfathered) related party debt but this will depend upon the group's wider CIR position.

A joint infrastructure election can be made to include one or more group companies such that the rules apply to them collectively.

Conditions for the exemption to apply

The company must elect for the exemption to apply - such an election must be made before the end of the accounting period to which it is to have effect.

The election can be revoked before the start of the accounting period for which revocation cannot have effect in relation to any accounting period which begins less than five years after the first day of the first accounting period in which the election to be a QIC had effect.

Once revoked, no new election can be made for a further 5 years.

Example

A company makes an election on 31 December 2018 to be a QIC. It meets the other conditions necessary, so the election has effect for the 12 month accounting period ended 31 December 2019. It subsequently brings forward its balance sheet date to 30 June 2020.

On 1 January 2023 the company revokes its election. This cannot have effect for the 12 month accounting period ended 30 June 2024, as this began (on 1 July 2023) less than five years after the existing election had begun to have effect (1 January 2019).

The revocation must be prospective; as such the earliest it can have effect is the 12 month accounting period ended 30 June 2025.

The earliest another election to be a QIC could have effect would be for the 12 month accounting period ended 31 June 2030, if the election was made prior to 1 July 2029.

Qualifying infrastructure activities

To qualify, the QIC should derive its income/value of its assets from qualifying infrastructure activities (QIA).

A company carries on a QIA if it provides a public infrastructure asset or carries on any other activity that is ancillary to, or facilitates the provision of, a public infrastructure asset.

A building or part of a building, is a public infrastructure asset if the company or another member of the worldwide group carries on a UK property rental business; and

- The building, or part, is or is to be let (or sub-let) on a short-term basis (a lease term of 50 years or less) to parties unrelated to the company or group member;
- The expected economic life of the building is at least 10 years; and
- The building or part is recognised on the balance sheet of the PIE company or an associated company, which itself must be subject to UK corporation tax on all sources of income.

Key points to note and practical implications

A PIE election may be beneficial in some circumstances, such as for groups with significant third-party debt and low tax-EBITDA at UK group level, and a low group ratio at group level.

For many groups with significant related party lending, the fixed ratio method or the group ratio method (where the wider group has a high gearing ratio) may provide better relief than the PIE treatment.

Even where there is significant third-party debt, the group ratio method could provide similar deductions to PIE treatment and should be modelled to compare the benefit.

Grandfathering of related party debt is unlikely to apply to the majority of real estate type structures but there can be arguments to support grandfathering for some type of property businesses such as student accommodation, hospitals, health, etc., and so each case should be considered separately.

The PIE election is irrevocable for at least five years so the impact of future plans should be considered before making the election.

Where only some group companies make the election, any cross guarantees or financial assistance provided by non-QICs within the worldwide group to the lenders of the QIC can taint the third party debt as related party debt (reducing Qualifying net-group interest expense “QNGIE”— see later)

A PIE election can simplify the compliance burden significantly.

Income generated from activities that are ancillary to or facilitate the provision of qualifying infrastructure activities (required for the exemption to apply) also qualify but what constitutes 'ancillary' or 'facilitates the provision' is not clearly defined and is subject to interpretation.

Excess debt cap brought forward

This can arise where there is an interest disallowance in a period and the debt cap (i.e. ANGIE or QNGIE depending on which method is used) is not the limiting factor in computing a group's basic interest allowance for a period.

Excess debt cap can arise if either the fixed ratio method or the group ratio method is applied.

Where the fixed ratio method applies, excess debt cap for a period of account is the fixed ratio debt cap as calculated by reference to the group's adjusted net group-interest expense - (ANGIE) less the fixed ratio, 30%, of aggregate tax-EBITDA.

Where the group ratio method applies, excess debt cap for a period of account is the group ratio debt cap as calculated by reference to the group's qualifying net group-interest expense (QNGIE), less the group ratio percentage of aggregate net tax-interest expense.

Unlike interest allowance, which can be carried forward up to five years, excess debt cap can only carry forward from one period to the next period. However, the debt cap brought forward from the immediately preceding period may have the effect of increasing the amount that can be carried forward to the following period. As such, an amount of excess debt cap can, in effect, be carried forward indefinitely.

There is a limit on the amount of excess debt cap that can be carried forward "the carried forward limit".

This is the sum of the total disallowed amount for that period, plus excess debt cap, if any, from the period immediately before the period of account. This therefore limits the increase in the excess debt cap that arises in a period to the amount of the disallowance that has arisen in the period.

The excess debt cap carry-forward is of practical significance for a group where the factor limiting interest allowance sometimes the fixed ratio or group ratio percentage of aggregate tax-EBITDA, and sometimes the debt cap.

The excess debt cap is available in the next period even if the group switches from applying the fixed ratio method to the group ratio method, or vice versa; there is no need to recalculate the figure on a different basis when this happens.

Example 1

Year end 31 March 2020

Aggregate UK tax-EBITDA = £10 million

Aggregate UK net tax-interest expense = £3.15 million

ANGIE = £3.2 million

QNGIE = £2.85 million (due to £350,000 interest payable to related parties)

Group ratio = 33%

Interest allowance based on either

1. Fixed ratio = smaller of 30% x aggregate UK tax-EBITDA = £3.0m, or ANGIE £3.2m (i.e. £3.0m)
2. Group ratio = smaller of 33% x UK tax-EBITDA = £3.3m or QNGIE £2.85m (i.e. £2.85m)

No election is made for group ratio and the interest allowance is £3.0m. £150,000 of net UK tax-interest expense is disallowed and is carried forward indefinitely for deduction in future periods.

As the fixed ratio was used, the excess debt cap is:

1. ANGIE £3.2 million, minus
2. 30% x UK tax-EBIDA £3.0 million
i.e. £0.2 million, or £200,000

There is a cap on the amount carried forward, being:

1. The interest disallowed for the period £150,000, plus
2. Debt cap b/fwd from the prior period Nil
i.e. £150,000

This is carried forward and can increase interest allowance in the year ended 31 March 2019.

So there are now two amounts carried forward:

1. Interest disallowed £150,000
2. Excess debt cap £150,000

Year ended 31 March 2021

Aggregate UK tax-EBITDA = £9 million

Aggregate UK net tax-interest expense = £2.73 million

ANGIE = £2.65 million

QNGIE = £2.41 million (due to £240,000 interest payable to related parties)

Group ratio = 25%

Interest allowance based on either:

1. Fixed ratio = smaller of 30% x aggregate UK tax-EBITDA = £2.7m, or ANGIE £2.65m (i.e. £2.65m)
2. Group ratio = smaller of 25% x UK tax-EBITDA = £2.25m or QNGIE £2.41m (i.e. £2.41m)

No election is made for group ratio.

Without any excess debt cap brought forward, the interest allowance would be £2.65m and £80,000 of net UK tax-interest expense would potentially be disallowed.

As the fixed ratio was used, the debt cap is:

1. ANGIE £2.65 million, plus
2. Excess debt cap b/fwd £0.15 million
i.e. £2.80 million

The actual interest allowance is the smaller of the debt cap (£2.80 million) and the 30% of the aggregate UK tax-EBITDA (£2.70m), i.e. £2.70 million, so the actual interest disallowed is £2.73m minus £2.70 million, i.e. £30,000.

The excess debt cap brought forward has allowed a further (80,000 – 30,000) £50,000 interest to be deducted in the year ended 31 March 2019.

The excess debt cap (before considering any carry forward limit) is:

- | | |
|--------------------|---|
| Debt cap | £2.80 million, minus |
| Interest allowance | <u>£2.70 million</u> |
| | i.e. <u>£0.10 million</u> , or £100,000 |

Debt cap carry forward limit

- | | |
|---------------------------------|-----------------|
| Excess debt cap b/fwd | £150,000 |
| Disallowed interest this period | <u>£30,000</u> |
| | <u>£180,000</u> |

Excess debt cap c/fwd is the smaller of:

1. Carry forward limit £180,000 or
 2. Excess debt cap £100,000
- i.e. £100,000

This looks complicated, but in reality, all that has happened is that £50,000 of debt cap brought forward has been used up in the period to 31 March 2019. As £150,000 was brought forward from the previous year, there is a balance of £100,000 to carry forward.

Corporate interest restriction and lease accounting under FRS 101/IFRS 16

The CIR rules operate to limit interest and other financing costs that are deductible for corporation tax purposes. Under IAS 17 (and FRS 102), for leases classified as finance leases for tax purposes, any finance charges in the accounts are tax-interest amounts for CIR. For leases classified as operating leases for tax purposes, any finance charges in the accounts are not tax-interest amounts for CIR.

Where a lessee has a right-of-use asset under IFRS 16, the legislation requires the company to determine whether they would have accounted for the lease as a finance lease if they were required to determine whether the lease was a finance lease or not for accounting purposes.

Therefore, lessees will not suffer any interest restriction on amounts paid in respect of operating leases. This means effectively that this change in the legislation will not have any impact for the purposes of CIR, but it will mean an adjustment to the accounting figures for CIR purposes, disallowing any depreciation and interest on IFRS 16 leases that would have been operating leases under IAS 17 and instead deducting a rental expense figure (therefore reducing EBITDA).

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