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If, as Benjamin Franklin believed, nothing is certain but death and taxes, then in the 21st century it is perhaps almost as certain that something advertised as a tax simplification measure will, despite the best of intentions, add complexity to the tax system.

This is exemplified by the current proposals to reform the U.K.'s international tax system, and in particular by the proposed rules for restricting interest deductions by reference to the group's external borrowing costs: the "worldwide debt cap." This reform will have a direct impact on inbound investors in the U.K., which may have thought that reform of the U.K. system of foreign profits would affect only U.K.-based corporations and was therefore of no concern to them at all.

I should first highlight the positive aspects of the reforms. The centerpiece — the exemption from U.K. tax for most foreign dividends — is a welcome simplification as far as U.K.-based multinationals are concerned and brings the U.K.'s system into line with that of most other major EU economies, although it does somewhat complicate the treatment of U.K.-to-U.K. dividends. The government has also listened during consultation over the past year and retreated from its earlier, more aggressive proposals to extend the controlled foreign company rules and purpose-based anti-avoidance rules, which will now be strengthened in a more modest and considered fashion.

Practitioners' concern is therefore now mainly focused on the worldwide debt cap, which is an attempt by the government to prevent erosion of the corporate tax base in the U.K. From the government's perspective, the risk is obvious: Absent any other measures, a dividend exemption regime would potentially enable U.K.-parented groups to gain substantial tax advantages by having their subsidiaries repatriate funds by making upstream loans to the U.K. parent rather than by declaring dividends. The interest on those loans would be deductible in the U.K., and once paid to the subsidiary, could then be paid back to the U.K. parent tax free as a dividend.

The principle behind the debt cap is simple — the interest deductions of U.K. group companies should not exceed the external finance costs of the group as a whole. Unlike much recent antiavoidance legislation, it is an objective mathematical test that does not look to the purpose behind the relevant structure or transaction — so ought to be certain in its operation. It is therefore regrettable that the draft legislation takes 57 clauses to express this supposedly simple and certain test and is still not yet complete.

Some of the complexity is probably unavoidable: In particular, the need to cater specifically to financial institutions that use debt as an integral part of their trade. However, additional complexities have been created by the need to ensure that the legislation complies with EU law nondiscrimination principles. One important consequence of this is that while the main intended target of the cap is U.K.-parented groups, the rules will also apply to U.K. inbound investors, which are less likely to benefit from the dividend exemption.

### Summary of the Rules

The rules, which apply only to "large" groups as defined under EU law, require the taxpayer to calculate two amounts: the tested amount and the available amount. The tested amount is, broadly, the gross intra-group finance expense of U.K. group companies, calculated in accordance with standard U.K. tax principles. The available amount is the net external finance expense of the worldwide group, calculated in accordance with international financial reporting standards.

In calculating both the tested amount and the available amount, it is necessary to take into account all manner of finance costs, including interest, discounts, hedging and factoring costs, and the finance element of finance leases. For simplicity, in the remainder of this article, I refer only to interest.

If the tested amount exceeds the available amount, the difference will be disallowed, with the relevant group companies allowed to allocate the disallowance

among themselves as they see fit. U.K. group companies with intragroup interest income can then potentially claim a corresponding reduction of their taxable income up to the amount of the disallowance.

U.K. external interest expense (such as interest on an overdraft or credit facility) is disregarded in calculating the tested amount, as the legislation is not intended to change the treatment of borrowings from third parties. However, it will also not count toward the available amount. This is understandable: If U.K. interest counted toward the available amount, it could effectively “frank” an equivalent amount of intragroup interest, thus (in the government’s view) providing a double deduction for the same expense.

One might have thought, therefore, that the same logic would require the external interest income of U.K. group companies to be excluded from calculating the available amount, because to include it would effectively result in double taxation. That income does, however, count toward (and effectively reduce) the available amount. This is almost certainly because excluding this income would be open to challenge on the basis that it gave U.K. bank deposits more favorable treatment than foreign deposits, thus infringing on the right to freedom of establishment under European law. Perversely, this is instead likely to offer an incentive to U.K. companies to hold surplus cash outside the U.K. tax net.

As a result, the test is fundamentally an unbalanced one: A gross figure (the tested amount) is being compared to a net figure (the available amount). Moreover, the available amount is calculated according to accounting principles (specifically, IFRS, although other methods may also be permitted), while the tested amount is calculated under U.K. tax law principles. The intention is that the available amount can be easily determined from the relevant group’s published accounts, but this means that the test is not comparing like with like.

Comparing figures compiled on two different bases may be expected to produce surprising results from time to time, although how this might happen may take time to become clear. Other unforeseen consequences are more readily apparent, and this article focuses on two specific situations — cash pooling and debt restructurings — which appear likely to be caught in the crossfire of the new rules.

### Impact of Cash-Pooling Arrangements

As already indicated, EU law looms large over this proposal. This becomes clear when the treatment of financial transactions between U.K. group companies is considered. As they do not increase the leverage of the U.K. group as a whole, they are clearly not the target of the legislation and could be safely excluded from its scope, which would reduce compliance costs.

However, the government has been down that path before. By the same logic, there is no need for transfer pricing rules to govern purely domestic transactions, but this logic did not impress the European Court of Justice in *Lankhorst-Hohorst*, which held that exempting domestic transactions from transfer pricing rules was discriminatory.

As a result, the government has adopted the same solution as it did then, by bringing purely domestic transactions within the rules but providing a corresponding adjustment mechanism. The effect is that when a U.K. resident company suffers a disallowance regarding domestic intragroup interest, the U.K. resident counterparty can claim a reduction of its income by a corresponding amount. The group as a whole ought to be in the same position as if the rules had not applied to the loan, but getting there involves an extensive compliance exercise.

This added compliance work might be manageable for groups with relatively few intragroup loans through the U.K. It would become considerably more of a burden for groups with more complex arrangements, and particularly so for groups that have established cash-pooling companies in the U.K. Most affected of all will be actual cash-pooling arrangements, in which all external borrowing and lending is routed through a single U.K. company, which then has intercompany balances with other group entities. Because the tested amount is a gross rather than a net amount, it is possible that the company may be caught by the rules even if it is a net lender of money overall.

Although in those circumstances corresponding adjustments may mean that the company is not liable to pay any additional tax, the greater compliance burden may well dissuade multinationals from establishing cash-pooling arrangements in the U.K. The government has recognized that the compliance burden of this legislation remains a concern. It is hoped that this issue is addressed in the final legislation.

### Effect on Refinancing Transactions

The impact on cash-pooling transactions is one of several technical issues with the rules that should be ironed out before they come into force. However, the debt cap could have an impact in more subtle and unexpected ways. This is because for the first time (that I am aware) it makes the tax treatment of a U.K. company dependent in part on transactions to which that company is not party, and over which it may have no control.

Consider the example of a heavily indebted non-U.K. parent company with U.K. subsidiaries that are partly funded by intragroup debt. If the parent renegotiates its credit facilities to cut interest costs (perhaps by converting some of it to equity), this will probably reduce the available amount, which in turn might lead

to a disallowance at the level of the U.K. subsidiary if it reduces the available amount to below the tested amount.

It is not hard to imagine this point being missed by financial officers at a group level who will probably reasonably assume that there is no need to consider the U.K. tax effect of a transaction to which no U.K. companies are party. Also, an additional disallowance that may result in these circumstances could fundamentally alter the economics of the overall transaction and further add to the difficulties of groups already struggling in a difficult economic climate.

### Conclusion

The government has recognized that the test may be something of a blunt instrument and has promised measures to mitigate its effect when the tested amount exceeds the available amount temporarily for purely commercial reasons. While welcome, this will inevitably complicate what is supposed to be part of a tax simplification package and may introduce a degree of value judgment into what was supposed to be an objective test.

The government has also promised to consider introducing some “gateway tests,” to enable groups to quickly assess that they are not caught by the regime without needing to perform a full calculation of the relevant amounts. For inbound investors, this is likely to involve a comparison of U.K. and worldwide balance sheet indebtedness, and it is welcome, provided it is a genuinely straightforward test. The antiavoidance measures that are likely to accompany the test may well mean that it is anything but.

Thus, a simplification exercise introduces new complexity into the tax system. It is hoped that the government can strike a balance — if one exists — between simplicity and certainty on the one hand and fairness on the other. But however it does so, linking the tax profile of a U.K. group to the fortunes of the worldwide group introduces an entirely new compliance exercise. This poses a challenge not only to U.K. tax managers, but also to group-level officers of U.K. inbound investors — a challenge that they may not be expecting. ◆