CLARITAS

The tax-deductibility Factsheet

One of the big questions when deciding how to fund an acquisition or a new business venture is the mix of equity (share capital) and debt (borrowings) to use. Debt may be advanced by external parties such as banks and/or by the shareholders.

For a UK company, debt is often seen as more flexible, as it is much easier than equity to repay once it is no longer needed in the business.

Also, interest payable on borrowings is deductible for corporation tax purposes, whereas dividends paid on shares are not tax-deductible.

Tax-deductible interest?

Although we said: "interest payable on borrowings is deductible for corporation tax purposes", while that's often the case, that isn't always true. In this note we look briefly at the different sets of rules which could apply to deny a corporation tax deduction for interest payable. Such a disallowance may be permanent or only temporary, depending on which set of rules is being applied.

Transfer pricing/Thin capitalisation

When debt has been advanced by related parties – typically shareholders – interest payable on that debt is only deductible to the extent that (a) the borrowings could have been obtained from an external lender and (b) the interest rate actually charged is no more than the hypothetical external lender would have charged.

The intention behind the rule is obvious. It stops an overseas company funding a profitable UK company with lots of expensive debt and paying little or no corporation tax because all the profits are covered by interest deductions.

The thin capitalisation rules allow HMRC to reduce the interest deductions to the amount which would have been payable if the UK company had been funded by external debt.

Obviously this rule is subjective, and disputes in this area can take a long time to resolve. Fortunately it is possible to seek HMRC's agreement pro-actively. This is still a timeconsuming process, but at least it enables companies to reach certainty sooner than if they simply waited for an HMRC challenge.

Anti-hybrids

This is a highly technical and complex area, the detail of which is out of scope for this note. Briefly, the rules target situations where there is a 'mismatch' in the tax treatment of interest paid by a UK resident company to a non-UK resident recipient, with the effect of the mismatch being that the recipient company is not subject to tax on the interest.

For example, this may be due to the recipient not being a taxable entity, or due to the income not being treated as interest under the tax rules in the recipient's territory of residence. In such situations, the anti-hybrid rules may address this 'mismatch' by denying a deduction for the interest payment in the UK.

Unallowable purposes

This is another set of complex rules. Broadly, if HMRC believe that the borrowings are part of a set of contrived arrangements designed to secure a tax deduction for interest which does not accord with a genuine commercial interest expense, then they may seek to use the unallowable purpose rules to disallow the deduction.

Late-paid interest rules

Companies are allowed to deduct interest payable as it accrues ie as it is charged to the company's income statement, whether or not it has actually been paid.

However, interest receivable by individuals is subject to tax only when it is received.

Therefore a company owner could lend money to their company and charge interest but not actually pay it for some years.

The company would have a tax deduction but the owner would not have to pay any tax until the interest is eventually paid.

Except...

the late paid interest rules are designed to catch this situation. Where a company is "close" (controlled by its directors or five or

fewer shareholders) has interest payable to a shareholder which is not paid within 12 months of the year end, then the corporation tax deduction reverts to being on a paid basis instead of the normal accruals basis.

This rule can also apply to interest payable to related companies based in tax havens, for the same reasons.

Corporate Interest Restriction (CIR)

This is the newest set of rules, and the one with which companies (and advisers!) are least familiar.

The detail of the rules is complicated, but broadly they restrict tax-deductible interest in any year to **30%** of EBITDA (as adjusted for various book/tax differences).

The calculation is on a group basis and there are two important and helpful overrides:

- Interest above **30%** of EBITDA can be deducted to the extent that the interest is not payable to related parties. So if the banks are happy to lend at this higher level then all the bank interest would normally be deductible; and
- There is a de minimis of £2 million pa per group, so that smaller companies will not normally be affected by the rules.

If any interest is disallowed under these rules, the dis-allowance is only temporary, and the excess interest can be deducted in a later period when there is more capacity for interest deductions.

Conclusion

We often say that interest is tax-deductible for companies but, as we have seen, the position is not always quite as clear-cut

As always, we hope this factsheet is helpful, but it should not be taken as constituting tax advice, and we accept no responsibility for any action taken or not taken as a result of this factsheet.

If you require advice on any of the issues raised in this note, please contact us and we will be happy to advise you.

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