

WORLDWIDE DEBT CAP CURRENT THINKING: UPDATE NOTE ON DESIGN CHANGES - 7 APRIL 2009

INTRODUCTION

1. In the 2008 Pre-Budget Report, the Government announced a package of reforms to the taxation of foreign profits to be introduced in Finance Bill 2009. Draft clauses were released for consultation on 9 December 2008, together with explanatory notes. In order to allow adequate time for consultation, the draft clauses for the worldwide debt cap portion were released at an earlier stage of development than is usual, with the expectation that further changes would be needed. Updated draft clauses and additional guidance notes were published to deal with particular exclusions from the worldwide debt cap measure on 26 January 2009.
2. Since December, there has been ongoing and constructive consultation about the design of the debt-cap. The Government held three 'open day' events on 12 January 2009, 27 January 2009, and 3 February 2009. The Government also received approximately 200 representations from businesses, accountants, lawyers and representative bodies on the draft clauses. This consultation, along with further consideration of various issues, has facilitated the development of numerous changes to the legislation.
3. **This note summarises the current thinking on the design and function of the worldwide debt cap.**

DESIGN OF DEBT CAP AS ORIGINALLY PROPOSED

4. As originally proposed, the debt cap measure broadly requires any large group of entities ("the worldwide group"), when at least one of the relevant group companies is tax resident in the UK, to compare the total intra-group finance expenses in the UK from the CT computations (the "tested amount") with the net external finance expense of the worldwide group from consolidated accounts (the "available amount"). Any excess of the tested amount over the available amount is disallowed, but the worldwide group may reduce the amount of UK taxable receipts to match the disallowance that arises.
5. Specifically, each UK relevant group company computes its intra-group finance expense (taking no account of any intra-group interest received). The total for each UK company is added together to form one tested amount for all the UK members of the worldwide group.
6. The worldwide group then calculates the available amount by reference to the consolidated net finance expense of the group as a whole. This amount consists of the worldwide external finance expense of the

group (excluding amounts paid by the UK members of the group), less the UK and non-UK external finance income of the group.

7. To the extent that the tested amount exceeds the available amount, the UK members of the group are denied a deduction for the intra-group financing costs of the UK members of the group. In this situation, the group must make a return that allocates the difference (“the disallowance”) among the UK members of the group that pay intra-group finance expense.
8. The group has autonomy in allocating the disallowance as it chooses. If no return is made, there is a default rule to allocate the disallowance.
9. Each UK group company must also make a corresponding adjustment in line with the return.
10. If a disallowance is made, then the worldwide group can make a compensating adjustment in relation to the intra-group finance income received by UK members of the group. The worldwide group may reduce its taxable intra-group finance income of the UK members of the group (“the disregard”), up to the total disallowance, again allocating as it chooses.
11. The disregard comprises two classes and an overall limitation. Class 1 is the situation when the intra-group finance income is paid between two UK group companies; to the extent the payer has to make a disallowance, the recipient can reduce its taxable intra-group finance income by a like amount. Class 2 is the situation when a UK group company receives intra-group finance income from a non-UK group company; that taxable income is reduced to nil. The overall limitation prohibits the total amount of these reductions from exceeding the total amount disallowed.
12. Both the reduction in taxable intra-group finance income and the effect of the limitation are dealt with in a return that must be made by the group. The group has autonomy in deciding the amounts that are reduced. Each UK company can only reduce its intra-group finance income in line with the return. If no return is made, there is a default rule to allocate the reduction in taxable intra-group finance income.
13. For purposes of these calculations, intra-group finance expenses fall within four broad categories: (a) interest costs; (b) derivative contract adjustments to the costs of borrowing; (c) finance element of finance leases and (d) debt factoring costs. Intra-group finance income broadly mirrors this composition.
14. Particular activities of financial services companies (including lending, insurance, and dealings in securities and debt forming part of the regulatory capital) are excluded from both the tested amount and available amount on a transactional basis.

SUMMARY OF PROPOSED MAJOR CHANGES TO DRAFT CLAUSES

Part 1 (Paragraphs 1-11) Introduction

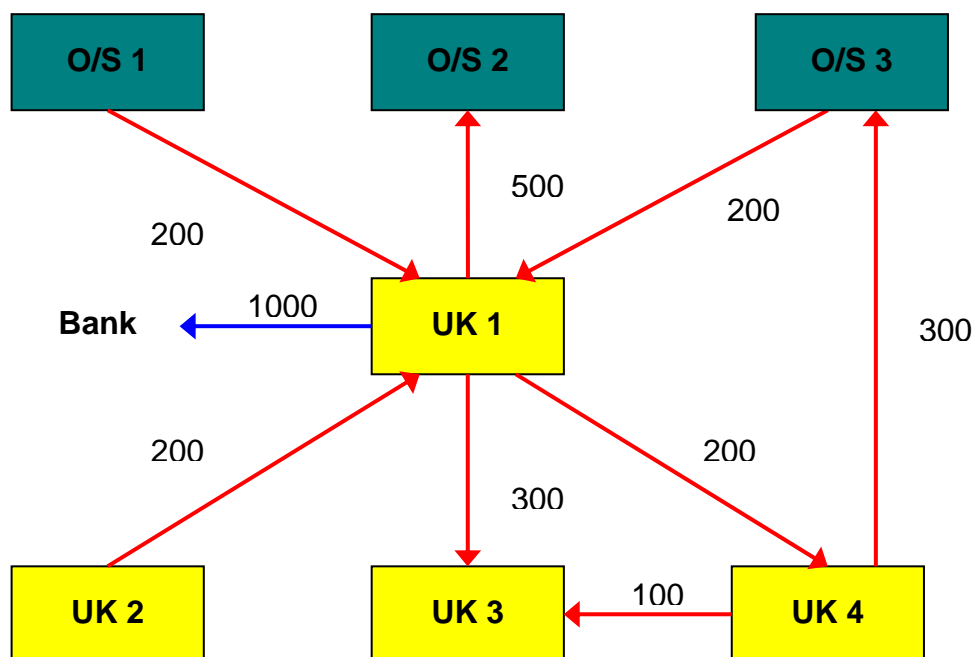
15. The structure of Part 1 generally remains the same, except for consequential changes to reflect the revisions made in the other Parts. Changes are proposed to ensure that a 'relevant group company' can be a member of only one worldwide group at a time, and to allow for circumstances where the 'ultimate corporate parent' is not in fact a body corporate, being for example a tax transparent body traded on a recognised stock exchange, or is not a single body corporate, being for example a dual listed structure. It is also proposed to ensure that in appropriate circumstances, collective investment schemes are excluded from the definition of ultimate corporate parent so that in such circumstances, the debt cap applies at the level of the portfolio investment.
16. Changes have been identified that would allow incorporated charities and other exempt bodies corporate to remain within the debt cap rules while not being subject to an asymmetric disallowance simply as a consequence of their tax exemption.
17. It is proposed that in addition to IAS, the GAAPs applicable in the UK, US, Canada, Japan, India, China, and Korea will also be acceptable for the purposes of the debt cap. If a group prepares accounts in accordance with any other local accounting standards, such standards will be accepted as not materially different to IAS if only the types of finance expense that would be included under IAS are included under the local GAAP, and the interest and interest-like expense is calculated using the effective interest rate method. Under the debt cap, there is no requirement for a group to produce full consolidated accounts conforming with IAS.
18. More generally, the updated debt cap design still relies on the controlling investor providing sufficient information to the UK group companies to enable them to calculate the available amount. Where this information is not forthcoming, the UK companies must calculate the available amount to the best of their ability, based on the information they have at their disposal.

Part 2 (Paragraphs 12-13) Calculation of the tested amount

19. We suggest revising former paragraphs 12 and 13 to reflect a move from a group transaction based approach to an entity based one.
20. The tested amount is now the total of each relevant group company's net financing expense. To obtain this figure, the first step is to identify each relevant UK group company with a net finance expense, by taking account of all intra-group and external finance expense and finance income of the company in question. The second step is to aggregate the net finance expense for each of these companies to produce a total for the UK group. This is the tested amount.
21. Under this approach, relevant group companies that do not have net finance expense will have either net finance income or no finance income or expense. These companies are not considered further for the purposes of the tested amount, but where there is a disallowance under these rules, any consequent reduction of finance income applies to the relevant group companies that have net finance income.
22. Where there is at least one relevant UK group company with net finance expense, the calculation of the tested amount will be positive; if there are no relevant UK group companies with net finance expense, then the tested amount is nil. The calculation cannot produce a negative figure.
23. Example A: Consider a relevant group company A with the following transactions:

<u>Finance expense on borrowings</u>		<u>Finance income on deposits</u>	
Loan from group co. B	3000		
Loan from group co. C	2000	Deposit with bank	500
Finance lease payments	<u>1000</u>	Deposit with group co. D	<u>1500</u>
	6000		2000

24. Company A has net finance expense of 4000 for purposes of calculating the tested amount.
25. Example B: Consider a worldwide group with the following relevant group companies:



26. UK 1 has net finance expense of 1400; UK 2 has net finance expense of 200; and UK 4 has net finance expense of 200. UK 3 has net finance income of 400, which is not considered further for purposes of the tested amount. The total tested amount under Example B is 1800.

27. We suggest amending the definitions of finance expense and finance income for the purposes of the tested amount as follows.

Loan relationships

28. This category of finance costs and finance expense is broadly to be restricted to interest and interest-like amounts. The following finance expense categories are to be excluded from the tested amount:

- impairment losses (and loss reversals)
- profits or losses on acquisition or disposal of rights under a loan relationship, for example 'capital' losses arising on transfer of a loan relationship to another party or when its terms are varied
- foreign exchange gains and losses.

Hedging adjustments

29. It is proposed to limit the inclusion of hedging adjustments to those intra-group hedging adjustments that only impact one group company and only affect the amount of interest that would be payable/receivable.

Finance leases

30. It is proposed to include the finance cost of any finance lease, not just finance leases for plant and machinery.

Debt Factoring

31. It is proposed to exclude debt factoring charges when the factoring arrangements are with a third party.

Other Changes

32. In circumstances where one or more companies become, or cease to be, relevant group companies of a worldwide group during the accounting period of the ultimate parent company, it will be necessary to apportion finance income and finance expense in computing the tested amount. Where for example companies A and B are relevant group companies of group C for four months of their accounting periods, and are relevant group companies of group D for the remaining eight months of their accounting periods, both A and B will perform separate calculations of their net finance expense (or as the case may be net finance income) for each discrete period. The finance expense and income to be apportioned will be calculated on an accruals basis.

Part 3 (Paragraphs 14-23) Amounts to be disregarded from tested amount

Financial Services

33. Discussions with representative bodies for financial services groups have led to the conclusion that the current draft clauses would not work effectively.

34. It is now proposed to exclude financial services on a group-wide basis, rather than particular activities of financial services companies being excluded from both the tested amount and available amount on a transactional basis. As such, former paragraphs 14-20 and former paragraphs 34 to 39 are now unnecessary.

35. The new financial services exclusion is intended to exclude business where debt forms an intrinsic part of the way in which that business is conducted. Provided that the income generated from these qualifying activities represents substantially all of the group's consolidated income for an accounting period, none of the relevant group companies in that group will be subject to the debt cap for an equivalent accounting period.

36. The qualifying activities consist broadly of lending business, insurance business and dealing in financial instruments on own account. The income from a lending business will broadly consist of gross interest income and fees/commission that are ancillary to a lending business. The income from an insurance business will broadly consist of net earned insurance premiums, net trading income and net investment income. The income from a dealing business will broadly consist of net trading income and potentially net investment income.
37. Income from both qualifying activities and the group as a whole will likely consist of gross interest income, gross fees/commission, net earned insurance premiums, net trading income, net investment income and other income as generally presented by financial services groups; and gross income from the sale of goods, the rendering of services and revenue in the form of interest, royalties and dividends as generally presented by non-financial services groups.
38. The aim will be to introduce a degree of flexibility into the assessment of whether a group's consolidated income is substantially represented by income from the qualifying activities. This will allow, for example, consideration of the impact of unrealised losses at fair value though profit or loss on the income figures, and on the 'substantially represented' test.
39. We are considering whether it is appropriate to provide for an alternative test where substantially all the income from a group's UK members would substantially derive from qualifying activities.
40. We will continue to consult with financial services groups to ensure that the proposals meet the Government's policy in this area, but are also workable in practice.

Short-Term Debt and De Minimis Exclusions

41. Finance expense and finance income in respect of short-term debt can be excluded in calculating the tested amount. Short-term will mean debt with a fixed repayment date of less than 12 months and repayable on demand facilities where an average of opening, closing and highest balances during the accounting period will be compared with the opening balance of the accounting period to establish whether borrowings have been repaid in any accounting period. The exclusion is not provided if the short-term debt is repaid and effectively borrowed again within 6 months.
42. A de minimis limit is introduced for purposes of excluding amounts that the government does not consider material for purposes of the debt cap. This exception ensures that only groups with significantly large amounts of interest costs are affected by the measure.
43. Where the total finance expense or total finance income arising from the borrowing arrangements between a relevant group company and

any other person does not exceed a set amount, that amount is excluded from the calculation of that relevant group company's figure of net finance expense (or as the case may be net finance income). Where the relevant group company has borrowing arrangements with more than one person, then the exclusion will apply separately to each set of arrangements.

Treasury Companies

44. The proposed change from a group-wide transaction basis to an entity basis will reduce the impact of the debt cap rules on a relevant group company which has a treasury function. Other changes to further reduce the impact of the debt cap on treasury functions of non-financial service companies are being considered, including rules to cover arrangements where the treasury operations are spread over a number of group companies, or are contained within a division of a company.

Stranded Loan Relationship deficits

45. If it is found that the operation of the disallowance and disregard rules gives rise to stranded standard non-trading loan relationship deficits, the group may elect for any specific loan relationship to be disregarded completely from the debt cap measure, provided that the person accounting for the loan relationship credits is the UK group company with the non-trading loan relationship deficits. In addition, a similar elective disregard will be available where the reduction in finance income would mean that management expenses could not be set against that finance income, and those management expenses could not be otherwise relieved in that accounting period.

Part 4 (Paragraphs 24-26) Tested Amount: External finance treated as intra-group finance

46. Part 4 currently provides that external finance expense will be treated as intra-group finance expense for the purposes of calculating the tested amount in certain circumstances. The circumstances are those where there is a scheme for external borrowings backed by an arrangement with another group member to replace intra-group borrowings by a relevant group company (often described as back to back arrangements).

47. As a consequence of the substantial design changes, particularly with regard to the available amount (see paragraphs 50-56 below), the intention is now to produce a targeted anti-avoidance rule ("TAAR") that will cover all aspects of the debt cap measure. The situations currently targeted by Part 4 will be incorporated into the TAAR.

48. The TAAR will counter a tax advantage where there are avoidance arrangements. Arrangements (which will be defined in a similar way to

existing anti-avoidance rules concerned with arrangements) will be avoidance arrangements where the main purpose or one of the main purposes of any person concerned with the creation or implementation of the arrangements is to enable a tax advantage. In considering what is a main purpose, account will be taken of the structure that the arrangements take.

49. A tax advantage will include a decrease in the tested amount, an increase in the available amount and increases or decreases of debt that are taken into account in the gateway test. The test of whether there is a tax advantage will apply at a group rather than a company level.

Part 5 (Paragraphs 27-32) Calculation of the available amount

50. We propose significantly revising paragraphs 27-32 of the original draft to reflect a new basis for computation of the available amount. Rather than the available amount being the net consolidated finance expense of the group (excluding the finance expense payable by the UK members of the group), the available amount is now proposed to be the worldwide group's gross consolidated finance expense (both UK and non-UK). The new test, therefore, ignores any interest receivable and considers only the gross amounts payable. These amounts are intended to be derived from consolidated accounts created in accordance with IAS or other acceptable standards.
51. The worldwide group's consolidated external finance expense is either a positive amount or nil. The draft can therefore be simplified as the available amount can no longer be negative and there is no need for the default position of the available amount being deemed to be nil. The need to consider worldwide external finance income or separately consider UK external finance expense is also eliminated.
52. Example C: Under the same facts as Example B, the worldwide group has gross consolidated finance expense of 1000 due to the payment from UK 1 to Bank. This is the available amount.
53. To maintain broad parity with the expenses comprised in the tested amount, it is proposed that the available amount excludes foreign exchange gains and losses, impairment and capital losses, and external hedging arrangements. It is also proposed to extend the reference to the finance costs of finance leasing to all finance leases.
54. In circumstances where the UK group companies
- operate and prepare accounts in a currency other than sterling, and that currency is the company's functional currency (so within s.92B FA1993), or

- operates in one currency other than sterling, and prepare accounts in another (so within s.92C FA1993),

so that the tested amount is calculated in the group's functional currency, it is proposed that the available amount will be calculated by reference to the functional currency.

55. Where finance expenses are, in accordance with IAS or other specified GAAP, capitalised in the consolidated financial statements, those costs may be included in the available amount.
56. Provision will be made to ensure that all alternative finance arrangements giving rise to external finance expense are included in the available amount irrespective of their treatment under IAS or other specified GAAP.

Part 6 (Paragraphs 33-43) Amounts to be disregarded from the available amount

57. As a consequence of the proposed changes to the treatment of financial services groups, much of the material in Part 6 which relates to financial services is no longer needed. No changes of substance are proposed to the paragraphs dealing with the specific tax regimes dealing with oil extraction, income from shipping, or income from property rental.

Part 7 (Paragraphs 44-47) Disallowance of deductions

58. There are no major changes proposed to the core rules in former paragraphs 44-47 regarding the calculation of the disallowance for the group. The tested amount is still compared with the available amount and the excess amount remains the figure of disallowance. If the available amount is greater than, or the same as, the tested amount, no disallowance of finance expense arises and the group does not need to take any further action in respect of the debt cap rules for the relevant accounting period. When the available amount is less than the tested amount, a disallowance of finance expense in one or more relevant group company will arise.
59. The requirement to return the tested amount, available amount, the total disallowed amount and the allocation of the disallowance remains. The group, however, will have the option to make a statement that it is satisfied that the tested amount does not exceed the available amount for the accounting period, although it would be expected to be able to demonstrate on enquiry that it has systems in place to be able to support this statement.

60. Provided the group makes a return, it will have autonomy in allocating the total disallowed amount between the relevant group companies which have net finance expense. If no return is made, there will still be a default rule to allocate the disallowance between the relevant group companies with net finance expense.
61. We suggest including two additional rules on the allocation of disallowances follow from the change to an entity based approach to calculating the tested amount. First, a disallowance can only be allocated to a relevant group company that has net finance expense. Second, the disallowance allocated to any one company cannot exceed that company's figure of net finance expense. Thus, in Example A above, only 4000 of the total disallowance can be allocated against that company, even though it has total finance expense of 6000. These restrictions prevent a group from allocating all of the disallowance against a company that has significant gross finance expense, but much smaller net finance expense.
62. The original draft clauses provided for a return to be signed by the proper officer for each relevant group company that was allocated a disallowance. HMRC is considering the scope for additionally providing for an authorised person to act on behalf of all relevant group companies in the worldwide group in discharging this obligation (together with the obligation to return information showing the corresponding disregards of net finance income).

Part 8 (Paragraphs 48-55): Treatment of intra-group financing income

63. The basic approach taken by the measure of disregarding finance income received by relevant group companies up to the amount of the total disallowance is retained, but with some modifications. The modifications are a consequence of the changes to the computation of the tested amount. The disregard of finance income is to be given by reference to relevant group companies that have net finance income. This means that:
- the reduction is calculated by reference to the net finance income by entity, rather than by transaction,
 - the reduction is no longer limited to intra-group finance income (external finance income can now be disregarded), and
 - the calculation of net finance income is made in the same way that a relevant group company calculates its net finance expense.
64. It is also necessary to provide that a reduction in finance income can only be allocated to a relevant group company that has net finance income. The reduction in finance income allocated to any one relevant

group company cannot exceed that company's figure of net finance income.

65. A return showing how the reductions in finance income have been allocated among relevant group companies is required, but now the group will have autonomy in deciding which companies should be able to reduce their finance income, and which amounts of finance income should be reduced. If no return is made, there are default rules to allocate the disregard of income between relevant group companies with net finance income.
66. It is possible that a disallowance will arise on a relevant group company, but a UK group company which is not a relevant group company (because it is not a 75% subsidiary) receives the finance income in question. On this situation, Part 8 will also encompass such a company, allowing its finance income to be reduced.
67. As indicated above, if a UK resident relevant group company has net finance income, the figure of net finance income can generally be reduced up to the amount of the total disallowance (the "limitation"). In addition, rules are proposed to ensure parity of treatment between a UK company being able to reduce finance income as a result of the debt cap measure, and a UK company being able to reduce finance income where the payer is a group company within the EEA that does not receive a general deduction for that payment.

Part 9 (Paragraphs 56-57): Commencement, etc.

68. A commencement date for the debt cap legislation of 1 April 2009 has been ruled out, but no announcement has yet been made about a commencement date.

Gateway Tests

69. During consultation the possibility of including gateway tests as part of the debt cap measure was discussed. The aim was to set conditions that, if satisfied by a group, would simplify the operation of the debt cap for the group.
70. It is proposed to introduce a single gateway test based upon comparison of debt. The conditions set by the gateway aim to identify those groups whose available amount will be at least equal to the tested amount, so that no disallowance would arise if the full debt cap rules were applied. The test would work as follows:
- Add together the net debt figures of all the relevant group companies that have net debt (U);

- Take the gross debt from the group's worldwide consolidated accounts (W);
- If $U < [75\%]$ of W, the gateway is passed.

71. When the above gateway is passed, the group does not need to take any further action in respect of the debt cap measure. While this gateway test is available to all groups, it is likely that the gateway is more likely to apply to inbound groups.

72. It is intended that the figures of debt should be taken from the group's consolidated accounts and the relevant group company accounts.

Self-Certification

73. As discussed in paragraph 59 above, it is proposed that a group that does not pass the above gateway test may obtain the same result if, on behalf of the relevant group companies, a certifying statement is provided confirming that for the relevant accounting period, the available amount exceeds the tested amount.

Interaction with other legislation

74. There will be rules to explain the interaction of the debt cap measure with various other legislation, including rules that deal with transfer pricing, controlled foreign companies and Chapter 8 Part 5 CTB 2009 (rules dealing with late paid interest).