CHAPTER 8

THE WORLDWIDE DEBT CAP

8.1 Introduction

The worldwide debt cap rules are an integral part of the foreign profits rules.

HMRC's aim is that the UK should not bear interest expense that, in aggregate, exceeds the amount of interest actually borne by a world-wide group.

The rules add an additional measure to restrict interest relief in the UK; the rules do not form a safe harbour for thin capitalisation purposes or replace the need for an advance thin capitalisation agreement.

The debt cap rules apply to accounting periods beginning on or after 1 January 2010. The first debt cap return will be due by 31 December 2011.

The rules only apply to large groups with at least one relevant member, but some large groups may not need to apply the rules if they pass the "Gateway test".

A group is "large" at any time if (and only if) any member of the group is not at that time within the category of micro, small and medium-sized enterprises as defined in the Annex to Commission Recommendation 2003/361/EC of 6 May 2003.

A worldwide group is any large group of entities which has at least one relevant group company. TIOPA 2010, s.337

Group is as defined in international accounting standards, which in summary is based on control of more than 50% of voting power.

A relevant group company is a company that is resident in the UK or is trading through a permanent establishment in the UK and is either the ultimate parent or a relevant subsidiary of the ultimate parent. A relevant subsidiary here is 75% subsidiary and is based on the group relief rules with regard to equity holders, now found in Ch 6 of Part 5 CTA 2010. TIOPA 2010, s.345(3)

In considering groups the rules allow for the ultimate parent company being a transparent body or a dual listed structure, collective investment schemes are excluded from the definition. TIOPA 2010, s.339-343

The rules do not apply to financial service groups. In addition certain group treasury companies can be excluded by an election which must be made within 3 years of the end of the relevant period. TIOPA 2010, s.316(3)

8.2 The Gateway Test

The debt cap rules are applied where TIOPA 2010, s.261(1)

a) the UK net debt of the group, exceeds
b) 75% of the worldwide gross debt of the group

This is called the "Gateway test".

The gateway test is applied each accounting period.

'UK net debt' is defined as the average of the opening and closing net debt of each company that was a relevant group company at any time during the period. TIOPA 2010, s.262(2)

The opening and closing dates are the beginning and end of the accounting period for the company.

Any 'net debt' amounts of less than £3 million, and the net debt amount of a dormant company, are treated as nil for this purpose respectively. TIOPA 2010, s.262(3)

The 'net debt' of a 'relevant group company' at any particular time is the company's debt liabilities less its liquid assets such as cash and loans receivables, taken from the company's balance sheet. Accounts must be drawn up under acceptable international accounting standards. TIOPA 2010, s.263

''Worldwide gross debt' is measured by looking at amounts disclosed in the balance sheet of the world wide group. It is based on the average of the amounts taken at the end of the current and preceding periods of account of the worldwide group. As this looks to the consolidated liabilities of the worldwide group, we look at external debt, in contrast to the UK net debt figure. TIOPA 2010, s.264

If an amount disclosed in a balance sheet at any given date is expressed in a currency other than sterling, then the amount must be translated into sterling by reference to the spot rate at that date. The calculation can be made by reference to the functional currency of the group where the group's and relevant group companies' balance sheets are all expressed in the same foreign currency. TIOPA 2010, s.273

Illustration 1

The Goya Group is a large worldwide group its consolidated gross debt is £40m at 31.12.2009 and 38m at 31.12.2010.

There are three UK resident companies with the following net debt amounts

	31.12.2009	31.12.2010	Average
Stubbs Ltd	10m	14m	12m
Constable Ltd	2m	1m	1.5m
Lowry Ltd	18m	18m	18m

We do not take account of the net debt of Constable Ltd as it is less than 3m.

The total of the UK net debt amounts are £30M we compare this to the gross debt figure of £39m. The UK net debt is almost 77% of the worldwide debt hence the gateway test is failed.

8.3 Calculating the disallowance

A disallowance of financing expense across the group will arise where the Tested Expense Amount (TEA) exceeds the Available Amount (AA). The difference between these amounts is the "Total disallowed amount" (TDA). TIOPA 2010, s.274

The "tested expense amount" for a period of account of the worldwide group is the sum of the net financing deductions of each relevant group company. TIOPA 2010, s.329

We look at each company separately for this test.

Where financing income exceeds the finance expense the figure is nil.

If the net amount is less than £500,000 it is excluded.

The "available amount" for a period of account of the worldwide group are to the sum of the amounts disclosed in the financial statements of the group for that period in respect of— TIOPA 2010, s.332

(a) interest payable on amounts borrowed,

(b) amortisation of discounts relating to amounts borrowed,

(c) amortisation of premiums relating to amounts borrowed,

(d) amortisation of ancillary costs relating to amounts borrowed,

(e) the financing cost implicit in payments made under finance leases,

(f) the financing cost relating to debt factoring, or

(g) amounts of such other description as may be specified in regulations made by the Commissioners.

This is an exhaustive list.

Thus in summary finance costs relate to: loan relationships but excluding amounts relating to impairments, disposal and foreign exchange gains and losses; debt factoring with third parties and finance lease arrangements with third parties.

Certain intra-group short-term financing expense can be excluded by election within 36 months of the end of the period of account for the worldwide group. TIOPA 2010, s.319-321

Short term financing arrangements are either required from the outset to last for less than twelve months, or where there is no fixed term, are considered to no longer exist within 12 months.

A loan relationship with no fixed term can only be treated as a short-term loan relationship once it has been repaid and its character as short-term determined. There is a provision for a reciprocal treatment for the creditor.

It is possible to exclude from expenses amounts relating to stranded loan relationship deficits and management expenses in non-trading loan relationships. TIOPA 2010, s.322-325

Illustration 2

Pool Ltd a UK member of a worldwide group has the following finance income and expenses:

Finance Expense		*Finance Income*	
Interest on loan from Parent company	150,000	Interest on loan to fellow subsidiary	18,000
Interest on loan from bank	50,000	Bank interest	42,000
Finance lease interest	12,000		
	212,000		60,000

Pool Ltd has a net finance expense of £152,000 for the purposes of calculating the tested expense amount.

Illustration 3

All companies are 100% subsidiaries of a common parent. The following is a table of the expenses and income with regard to UK 1 and its transactions with the rest of the group and third parties. For example, it can be seen that UK 1 has entered into a transaction with UK 2, which gives rise to finance income in UK 1 of 3m, which is a finance expense for UK 2 of the same amount.

	UK 1 Expense	UK 1 Income
UK 1	-	-
UK 2	-	3m
UK 3	4m	-
UK4	2.5m	-
O/S 1	-	5m
O/S 2	5m	-
O/S 3	-	2m
Bank	15m	-

In addition UK 4 pays interest of £1.5m to the bank

UK 1 has net finance expense of £16.5m; UK 2 has net finance expense of £3m; UK 3 has net finance income of £4m, which is not considered further for purposes of the tested amount and UK 4 has net finance expense of £1m. The total tested expense amount is £20.5m. TIOPA 2010, Part 7 Ch 4

Where there is a disallowance because the tested expense amount exceeds the available amount a return needs to be made to HMRC. TIOPA 2010, s.278 TIOPA 2010, s.284

If return of the disallowed amount is not made the allocation must be made by a formula laid down in the legislation

The formula in the legislation is

NFD/TEA x TDA

Where
NFD = the net financing deduction of the company for the AP
TEA= the tested expense amount for the AP
TDA= the total disallowed amount for the AP

Where a group needs to make returns they can appoint a member of the group to act on their behalf.

The statement of allocated disallowances must be submitted within 12 months of the end of the accounting period. a revised statement can be submitted within 36 months of the end of the period of account.

Where a company has delivered a company tax return for the relevant period, and as a result of a revised statement either the amount of profits on which corporation tax is chargeable for a relevant accounting period of a company changes, or any other information contained in the return is rendered incorrect, then the company is treated as having amended its return for the accounting period so as to reflect the change or correct the information. TIOPA 2010, s.282

8.4 Exemption of financing income

TIOPA 2010, Part 7 Ch 4

If a disallowance falls to be made then there is a mechanism to allow a compensating adjustment in UK group companies that have net finance income. The compensating adjustment means that a part or whole of the net income will not be taxable.

Note the TDA above is calculated with reference to the 75% group members whereas the exemption for finance income can be applied to 51% members of the group. TIOPA 2010, s.287

A schedule showing the allocation of the compensating adjustment must be submitted to HMRC. The statement of allocated disallowances must be submitted within 12 months of the end of the accounting period. A revised statement can be submitted within 36 months of the end of the period of account. Groups can appoint a representative person to deal with the returns. If the company does not make the allocation there is provision for a formula to be applied.

Where a company has delivered a company tax return for the relevant period, and as a result of a revised statement either the amount of profits on which corporation tax is chargeable for a relevant accounting period of a company changes, or any other information contained in the return is rendered incorrect, then the company is treated as having amended its return for the accounting period so as to reflect the change or correct the information. TIOPA 2010, s.294

TIOPA 2010 part 7 chapter 5 seeks to ensure that the rules are EU compliant by providing for intra-group financing income received from a company resident in the EEA, excluding the UK, to be exempt from corporation tax. To the extent that tax relief is not available for finance costs within the EEA excluding the UK, like consequences follow for the recipient of the income.

8.5 Anti avoidance

TIOPA 2010 part 7 chapter 6 contains anti-avoidance rules. In addition to these anti avoidance rules it is intended to introduce a statutory instrument dealing with avoidance in relation to short-term finance.

The anti-avoidance rules are split into three parts and all three have a wide scope. All three parts however contain filters to ensure that the anti-avoidance rules will only apply where they are required to.

The three parts are basically

i Schemes aimed at getting around the Gateway test;

ii Schemes aimed at manipulation of the disallowance deduction or the exemption of income;

iii Schemes aimed at manipulating the rules that give an exemption from UK tax for finance income received from a group member resident in the EEA.

The rules are quite complex and the following is an overview of the avoidance detailed in TIOPA 2010 part 7 chapter 6, drawing out some common points in its approach.

- A UK company does not have to be a party to transactions that make up the scheme for the anti-avoidance rules to apply;
- The anti-avoidance rules can apply to a scheme that is part of a larger scheme;
- The anti-avoidance rules can apply where a scheme is entered into before 1 January 2010;
- There is no formal clearance process for the debt cap anti-avoidance rules;
- "Scheme" includes any scheme, arrangements or understanding of any kind whatsoever and makes it clear that a scheme does not have to be legally enforceable; TIOPA 2010, s.312
- A scheme might involve a single transaction or it might involve any number of transactions;
- The main purpose filter is considered when a party enters into a scheme, there is a change to the structure of a scheme, or its participants are likely to mean it is a new scheme;
- There is a second filter which consists of a set of excluded schemes. HMRC state that the intention is to define particular schemes undertaken substantially for commercial purposes or which form part of a group's normal and acceptable tax planning, but also have an effect on the debt cap position. Exclusions will provide a 'safe harbour', so it will not be necessary for groups to consider in detail whether or not the 'debt cap purpose' is a main purpose. Regulations will set out the details.