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Focus on Tax Strategies & Developments

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Brexit: The Consequences for International Tax Planning

By James Ross

Just over a month has now passed since the referendum in which the United Kingdom voted narrowly to leave the European Union: an event which some have characterized as the greatest potential shock to the UK economy since the Second World War. For most multinational groups considering the potential consequences of Brexit on their tax position, however, the best advice is probably the same as that provided by the famous wartime poster: "Keep Calm and Carry On."

While much remains to be resolved about the United Kingdom's exit from the European Union, what has become clear is that it will not happen quickly. The Government has stated that it will not serve formal notice of its intention to leave the European Union before the New Year, which will start a period of negotiation that, under the European Union Treaty, is anticipated to take two years. The United Kingdom is thus likely to remain an EU member state until at least 2019.

Brexit will almost certainly result in some changes to the United Kingdom's tax landscape, and these may well cause complications for some multinationals. However, the UK Government is keen to show that the United Kingdom is still "open for business" post-Brexit, and has suggested that it may cut corporation tax still further to maintain the United Kingdom's attractiveness as a destination for inward investment.

For most groups, it makes little sense to restructure until the longer-term shape of the UK's post-Brexit tax system becomes clear; for now, they should be aware of what might change as a result of Brexit, and what will probably not.

THE INTEREST AND ROYALTIES AND PARENT-SUBSIDIARY DIRECTIVES

In general, income taxes are a matter for member states rather than the European Union, which can only legislate in the field of tax with the unanimous consent of all

28 member states. In the corporate tax field, the European Union's most important interventions are the Interest and Royalties and the Parent-Subsidiary Directive, which eliminate withholding taxes between related parties that are resident in different member states.

The Interest and Royalties Directive removes withholding taxes on interest and royalties paid by a company in an EU member state to a company in another EU member state where one has a direct 25 percent shareholding in another, or a third EU company has a direct 25 percent shareholding in both. The Parent-Subsidiary Directive removes withholding taxes on dividends paid by a company in one EU member state to a company in another which has a 10 percent shareholding.

Leaving the European Union will mean that UK companies would cease to be entitled to benefit from the directives, unless the United Kingdom and the European Union agree to adhere to them as part of the terms of the United Kingdom's departure. In this regard, it is worth noting that Switzerland, which is not an EU member state, has adopted the directives in modified form in respect of payments between Swiss and EU companies.

If no such agreement is reached, however, UK companies making and receiving payments to and from related companies in other EU member states (or, indeed, Switzerland) will need to rely on tax treaties rather than the directives. While the United Kingdom has a good treaty network, a number of its treaties with other EU member states still permit some level of withholding on dividends, interest and/or royalties (in the case of the Italy treaty, it is all three). There will be no impact on dividends paid by UK companies, as the United Kingdom does not impose a dividend withholding tax, but there could be a significant impact on dividends paid to a UK holding company: in light of the fact that the United Kingdom now exempts the majority of such dividends from UK taxation, any withholding tax suffered in the country of origin would represent a real cost.

If the directives no longer apply post-Brexit, the attractiveness of the United Kingdom as a holding company jurisdiction may be impaired.

CROSS-BORDER MERGERS

The European Union has also introduced directives to enable cross-border mergers, divisions and share-for-share exchanges to take place on a tax-free basis. If these directives cease to apply in the United Kingdom as a result of Brexit, it would remove a number of restructuring options for groups with a presence in the United Kingdom. Indeed, as UK company law does not allow mergers at all, except to the extent required by EU directives, mergers involving UK companies may become impossible, meaning that groups would be forced to restructure themselves in other ways.

There are, however, relatively generous deferral and exemption reliefs in the UK tax code for intra-group transfers, reconstructions and share-for-share exchanges which do not derive from the directives; in many cases it will be possible for a group to take advantage of these. While the disapplication of the directive may make it more difficult for a group to restructure in a tax efficient manner, it should not generally render it impossible.

BASE EROSION AND PROFIT-SHIFTING (BEPS)

The United Kingdom has been an enthusiastic early adopter of BEPS-related measures proposed by the OECD, and Brexit is unlikely to change this. Shortly before the referendum, the European Union agreed on an anti-tax avoidance directive that contained a number of BEPS-related measures that member states are required to implement by January 1, 2019. While it seems likely that this directive will never come into force in the United Kingdom, all the measures within it were provisions that the United Kingdom already has in its tax code (such as controlled foreign company (CFC) rules) or has committed to introduce (such as limits on interest deductibility and anti-hybrid rules). The Finance Bill currently before Parliament implements a number of BEPS-related changes, and will not be affected by Brexit.

EUROPEAN COURT OF JUSTICE (ECJ) CORPORATE TAX PRECEDENTS

Over the last 20 years, a number of groups have succeeded in arguing that various aspects of the UK corporation tax code contravene EU law and, in particular, the right of "freedom of establishment" in different member states that is enshrined in the European Union Treaty. In particular, the ECJ has held that the United Kingdom must allow group relief for losses of EU subsidiaries against the profits of their UK parents in limited circumstances, that the application of CFC rules to the profits of EU subsidiaries contravenes EU law unless the arrangement in question is "wholly artificial" and that the United Kingdom's former credit-based system for foreign dividends was potentially discriminatory, given that domestic dividends were exempt.

Once the United Kingdom leaves the European Union, it may no longer be bound by these decisions: although this will depend on the terms of its departure. If, for example, the United Kingdom decides to remain part of the European Economic Area (EEA), freedom of establishment will still apply, and the United Kingdom will still be bound by ECJ precedents based on it.

If, however, the United Kingdom leaves the EEA (so-called "hard Brexit") these decisions will no longer be binding. Although unlikely, it is conceivable that the United Kingdom will legislate to reverse these decisions retrospectively. Companies with claims founded on these decisions therefore may wish to pursue them sooner rather than later.

A "hard Brexit" would also afford the United Kingdom greater freedom to legislate without regard to these decisions. It could, for example, strengthen its CFC rules or revert to a credit-based system for taxing foreign dividends. Given the stress that the Government has placed on remaining competitive, it seems highly unlikely that the United Kingdom would introduce measures that might reduce the attractiveness of the corporation tax regime, but it may seek to remove some of the complexities that have been introduced in order to comply with EU law. In particular, it would not be surprising if the requirement to apply transfer pricing to purely domestic transactions were abolished.

VALUE-ADDED TAXES (VAT)

EU member states are required to apply the common EU system of VAT. There is no chance of the United Kingdom abolishing VAT when it leaves the European Union (it raises too much money for that to be feasible); however, the UK system may diverge from the EU model over time.

One practical complication may arise for businesses that make supplies of internet-based services to consumers across the European Union, which are subject to VAT where the customer is located. Under the "Mini One Stop Shop" mechanism, introduced in 2015, such businesses can account for VAT on supplies to all member states to a single tax authority, which then redistributes the funds to the tax authorities of other member states as appropriate. When the United Kingdom leaves the European Union, it will probably become necessary for such businesses to be registered separately in the United Kingdom for supplies to the United Kingdom and in another member state for supplies to the remaining European Union member states.

TRANSFER TAXES

Decisions of the ECJ in recent years have effectively prevented the United Kingdom from enforcing a 1.5 percent stamp duty charge on the transfers of shares in UK companies into depositary receipts and clearance systems to enable them to be traded on foreign stock exchanges. As the United Kingdom has no way of taxing transfers within those systems, this effectively allows shares in UK companies to be traded without any transfer tax, in contrast to trades on the London exchange, where a 0.5 percent stamp duty reserve tax charge applies. This charge may be reactivated once the United Kingdom leaves the European Union.

CUSTOMS DUTIES

Perhaps the most significant change may be the reimposition of customs duties and checks on the movement of goods between the United Kingdom and the remaining members of the European Union. Again, whether this will actually happen will depend on whether the United Kingdom opts for a "hard Brexit"; if it decides to join the EEA, nothing much should change.

CONCLUSION

Following the Brexit vote, there are all manner of things which could happen to the UK tax system, but as yet nothing much has. Any adverse changes that do eventuate from the United Kingdom leaving the European Union may well be outweighed by other changes initiated by the UK Government with a view to maintaining the United Kingdom's competitiveness.

Groups with existing investment in the United Kingdom will probably be best advised to hold fire before considering any restructuring, and to wait and see what Brexit means in practice. For groups considering establishing a UK holding company or headquarters operation, the potential loss of access to the Interest and Royalties and Parent-Subsidiary directives may be a significant consideration which means that the United Kingdom is less attractive than it would have been prior to the referendum. Nonetheless, in general, the UK corporate tax code remains a competitive one, so this should not necessarily be conclusive. Groups in either situation should keep a close eye on developments over the next few months.

Discussion Draft of Modernization of Derivatives Tax Act

By William R. Pomierski

OVERVIEW

On May 18, 2016, Senate Finance Committee Ranking Member, Senator Ron Wyden, released a financial product tax reform discussion draft that, if adopted, would significantly alter the current tax rules with respect to financial products (derivatives), as well as the tax treatment of certain non-derivative positions that are offset by derivatives. The discussion draft is referred to as the Modernization of Derivatives Tax Act, or MODA.

UNIFORM TIMING, CHARACTER AND SOURCE RULES

MODA's stated goal is to provide for uniformity in the tax character, timing and source of gains and losses relating to all derivatives. If adopted, these uniform rules would apply to all taxpayers, including individuals, although businesses that enter into qualifying tax hedges would be exempt.

With respect to timing, MODA would require all non-exempt derivatives (as defined) to be taxed, regardless of the taxpayer's overall method of tax accounting, (1) upon termination or transfer and (2) if held open at the end of a tax year, on a mark to market basis. Mark to market accounting means that changes in the value of open derivatives held at year end would result in currently taxable gain or loss based on a deemed termination or transfer at the then fair market value. To the extent a derivative is marked to market, appropriate adjustments would be made in the amount of any subsequent gain or loss to reflect any gain or loss previously taken into account. (A payment with respect to a derivative that does not constitute a taxable event, as defined, would, regardless of the taxpayer's overall method of accounting, be taken into account when paid. Proper adjustments would be made for any subsequent gain or loss to reflect such payment.)

With respect to character, MODA would provide that income, deduction, gains and losses from all non-exempt derivatives would be taxed as ordinary income or loss (and losses would be attributable to a trade or business of the taxpayer for purposes of section 172(d)(4)).

Finally, MODA would impose a residency-based sourcing rule for income, deduction, gain or loss relating to non-exempt derivatives (except to the extent that section 871(m) applies to any payments with respect to the derivative).

DERIVATIVES DEFINED

MODA would apply to all *derivatives*, broadly defined as any contract (including any option, forward contract, futures contract, short position, swap or similar contract) the value of which, or any payment or other transfer with respect to which, is directly or indirectly determined by reference to: (1) any share of stock in a corporation; (2) any partnership or beneficial ownership interest in a partnership or trust; (3) any evidence of indebtedness; (4) subject to limited exceptions, any real property; (5) any commodity which is actively traded (as defined); (6) any currency; (7) any rate, price, amount, index, formula, or algorithm; or (8) any other item as the US Treasury Department (Treasury) may prescribe.

Exceptions. Limited exceptions from the definition of a derivative would be provided for the following: qualifying hedging transactions under section 1221(a)(7) and section 988(d); certain real property and related investments; employee stock options; insurance, annuity and endowment contracts issued by insurance companies; certain embedded derivatives underlying debt instruments; and American Depositary Receipts and similar instruments with respect to stock in foreign corporations.

To the extent provided by the Treasury, a derivative will not include the right to the return of the same or substantially identical securities transferred in a securities lending, repo or similar financing transaction. Exceptions also would be provided for (1) derivatives relating to stock issued by any member of the same worldwide affiliated group (as defined in section 864(f)) of which the taxpayer is a member and (2) any contract with respect to any commodity if such contract requires physical delivery (with the option of cash settlement only in unusual and exceptional circumstances), provided that such commodity is used (and is used in quantities with respect to which such derivative relates) in the normal course of the taxpayer's trade or business (or, in the case of an individual, for personal consumption).

Embedded Derivatives. Contracts with embedded derivatives would be bifurcated into their derivative and non-derivative components, with the derivative component being marked to market and generating ordinary income or loss. A limited exception would be provided for debt instruments denominated in, or determined by reference to, a nonfunctional currency. If an embedded derivative cannot be separately valued, MODA treats the entire contract as a derivative.

VALUATION PRINCIPLES

For mark to market purposes, MODA would allow taxpayers to rely on valuations provided by brokers under section 6045(b). In addition, taxpayers would be allowed to rely on certain non-tax reports and statements, subject to the following priorities: *first*, financial statements certified as being prepared in accordance with US generally accepted accounting principles (subject to sub-priority rules); *second*, financial statements prepared in accordance with international financial reporting standards (IFRS) required to be filed with agencies of a foreign government equivalent to the SEC in jurisdictions that have reporting standards at least as stringent as those in the United States; and *third*, to the extent provided by the Treasury, statements provided to other regulatory or governmental bodies.

INVESTMENT HEDGING UNITS

While MODA would not apply to stand-alone non-derivative positions (such as stock, securities or commodities), it would apply (requiring mark to market taxation and ordinary income or loss characterization) to any non-derivative that is or becomes part of an investment hedging unit (IHU).

In general, a taxpayer would be treated as having an IHU if the taxpayer holds the following offsetting positions: (1) derivatives that have the same or substantially identical underlying investment and (2) underlying investments, portions of underlying investments, or items substantially identical to those underlying investments, provided that the underlying investments or portions thereof described in (2) have the requisite "delta" with the derivatives described in (1).

For these purposes, the requisite delta between the underlying investment position and a derivative relating to the same or substantially identical underlying investment would have to be between minus 0.7 and minus 1.0. "Delta" would be defined as the ratio of the expected change in the fair market value of the derivative(s) to any change in the fair market value of the associated underlying investment(s).

Taxpayers would be required to test for delta when an IHU is first established, and any time it is subsequently modified. For purposes of a taxable event, the taxpayer will determine which portions of an underlying investment have been sold or exchanged on a first-in, first-out basis (unless the taxpayer has otherwise elected an average cost basis method).

A taxpayer would be required to identify the positions in an IHU, as well as identifying those derivatives and underlying investments which could be part of the IHU but do not meet the delta relationship. To minimize compliance burdens, a taxpayer may elect to forgo the delta test and treat all derivatives with respect to such underlying investment, and all units of such underlying investment, as part of an IHU. This election, once made, is irrevocable and will apply to all subsequently established IHUs. Additionally, the Internal Revenue Service will treat taxpayers who fail to properly identify IHUs as making this election.

Note that any built-in *gains* on non-derivative positions held prior to entering into an IHU would be recognized at the time the IHU is entered into; pre-IHU built-in losses, however, would be deferred until the non-derivative position is disposed of in an otherwise taxable transaction. When the derivative that is part of an IHU is disposed of, the underlying investment once again receives capital treatment for subsequent gains and losses, and its holding period is reset.

CONFORMING CHANGES

Several provisions of the Internal Revenue Code would be repealed by MODA, including in particular section 1256, which currently provides 60/40 tax treatment to section 1256 contracts (including domestic futures contracts and nonequity options). Other provisions that would be repealed include sections 1233, 1234, 1234A, 1234B, 1236, 1258, 1259, and 1260.

SPECIAL CHARACTER CHANGE FOR INSURANCE COMPANIES

Although not a derivative tax issue, MODA also would extend ordinary tax treatment to debt instruments held as assets by certain insurance companies.

EFFECTIVE DATE

If adopted, MODA would generally be effective for *taxable events* occurring after the 90-day period beginning with the date of enactment, in taxable years ending after the last day of such period. A transition rule applies to derivatives and underlying investments held as of the close of such 90-day period.

OBSERVATIONS

While MODA is meant to simplify the taxation of derivatives, the proposal likely raises a new round of difficult questions, including but not limited to the classification of various contracts as derivatives, mark to market valuation questions and issues relating to underlying investments subject to the IHU rules. It is obviously difficult to predict the likelihood that MODA will be adopted in its current or in a revised version. Similar proposals were first introduced by former Chairman of the Ways and Means Committee, Dave Camp, in 2013, and have also been included in the Obama Administration's Revenue Proposals for fiscal years 2014, 2015, 2016 and 2017.

Introduction to the New World of Global Tax Planning

By Cym H. Lowell

As all multinationals (MNEs) are discovering, domestic implementation of the recommendations set out in the BEPS (Base Erosion and Profit Shifting) final reports from 2015 have the potential to significantly impact effective tax rate planning. The immediate issue flows from the new country-by-country transfer pricing (TP) documentation regime (CbC). Many countries (including China, Japan, Italy, the United Kingdom and others) have implemented domestic legislation to be effective for 2016, and the United States has finalized regulations to be effective for 2017. A multilateral instrument relating to CbC, which is expected to impose the CbC requirements in all existing treaties (some 3,000), is well underway.

The critical consequence of the CbC regime, as well as many of the other BEPS initiatives, will be an inevitably heightened focus of tax authorities on testing locally reported TP results on a profit split basis. In our TP dispute resolution practice over the years (beginning long ago with the Japanese tax authority), we have found that such a focus does not, itself, provide any basis for concern. Indeed, many of our clients have developed means of testing reported TP results on such a basis (*e.g.*, as elements of APA or Competent Authority processes), though typically these are not included in local documentation.

In the case of companies that have not developed profit split models, it may be a challenge to develop pertinent TP data (due to systems limitations, accounting differences, faulty assumptions, country-specific issues and so on). Our experience is that there are inevitably surprises when a robust system profit analysis is undertaken.

In our work with clients evaluating potential CbC implications, we have developed a checklist to facilitate the process of developing profit split models, which is set forth below. It reflects our overall approach to documentation, which is to develop a customized model for the unique circumstances of each client. This approach has evolved over time. The reference in the checklist to "building blocks" has to do with the material elements of the group's global effective tax rate plan.

Our experience to date in working with clients on CbC matters underscores the importance of developing a working group composed of those internal and external colleagues who can develop an efficient and effective policy for adapting to the new requirements. Within our approach, we have resources to provide as large or small a role as needed by the working group.

A discussion of the details of the CbC regime and associated planning considerations, and standard elements of complying with CbC documentation requirements, is beyond the scope of this article and will be taken up in a subsequent edition of this newsletter.

CHECKLIST FOR FORMULATING A CBC STRATEGY

A. Formation of Working Group

- Compose the working group to address the matters noted below
- Role of attorney-client privilege in the process?

- The working group could be composed of experts from:
  - Internal departments
    - Tax (domestic and international)
    - Transfer pricing (if separate)
    - Information technology
    - CFO (financial accounting)
    - Information technology
    - Supply chain
    - Legal
  - External international tax advisor
  - External transfer pricing advisor
  - Potential use of CbC software
  - Financial auditor (as appropriate in terms of independence and related matters)

B. Current Global Effective Tax Rate Planning

- Refresh and confirm the building blocks of the existing ETR plan
- Implementation mechanics
- Structural (non- transfer pricing (TP)) aspects of the ETR plan
- TP building blocks
  - Functional analysis
  - TP performed on a one-sided basis (*e.g.*, CPM/TNMM)
  - Integration with non-TP building blocks
- Allocation of taxable income by country
- Formulation of global results on a system profit or profit split basis (a two-sided TP basis)

C. CbC Formulation for Global Documentation

[*Note*: If the group is not experienced with profit split TP methodologies, this will be an interesting experience; be patient]

- Complete a draft of the documentation (local, master and CbC)
- Evaluate local reports
  - From the standpoint of each local tax authority
  - From the standpoint of the home or other pertinent country tax authority
- Prepare a risk assessment for each building block of the global ETR strategy
- Prepare a synthesis of likely tax authority evaluations (which will be instructive in the process of re-evaluating the ETR strategy), restructure as appropriate and prepare for controversy, as noted below.

D. Re-evaluate the Global ETR Plan

- Revisit the building blocks of the ETR plan
  - Evaluate in view of the CbC analysis in B
- Consider need to change the building blocks
- Consider need to update the ETR plan
- Consider restructuring options
- Other conclusions

E. Impact of Potential Restructuring

- Income tax
- TP
- Exit or restructuring taxes
- Existing examinations or pending disputes
- Consumption taxes
- Financial accounting
- Financial reporting

F. Preparing for controversy

- Categorize building blocks of existing global ETR plan
- Model:
  - Risk of tax authority challenge (*e.g.*, in cases where some of the building blocks are specifically mentioned in the BEPS final reports)
  - Potential impact on global ETR of successful challenge
  - Likelihood of successfully defending a challenge
  - Cost-benefit analysis of defending tax authority challenges
- Decide (in conjunction with E above) which building blocks will be proactively amended
- For those building blocks that the group decides will not be amended:

  - Proactively prepare responses to possible tax authority enquiries
  - Gather and organize existing data and other materials supporting group's position
- As regards building blocks that the group will be amending, are currently under audit or are being challenged:
  - Articulate controversy positions in relation to each building block
  - Consider impact of restructuring on tax authority perception of existing building blocks

G. Agenda for Proceeding (including tax authority outreach)

- An agenda can be composed reflecting the prior elements of the Checklist and the orientation of the working group

UK Government Confirms Introduction of New Cap on Interest Deductibility

By Matthew Herrington

BACKGROUND

In October 2015, the UK government launched a consultation on the introduction of new rules to counteract BEPS (Base Erosion and Profit Shifting) arising from the use of interest payments. The outcome of the consultation was published as part of the Budget in March 2016, at which time the government confirmed that it would be proceeding with the introduction of a structural restriction on interest deductibility.

The new restriction is intended to operate alongside the various transactional-based restrictions already present in the UK tax code (such as the transfer pricing, distributions and unallowable purpose rules), and will apply with effect from April 1, 2017. The new restriction will apply both to external and intra-group debt, so it will not be precluded from applying solely by virtue of the fact that the interest in question accrues on debt advanced by a third party lender.

The UK government is currently consulting on the detailed design of the new restriction, and intends to publish legislation later this year for inclusion in Finance Bill 2017.

THE PROPOSED RESTRICTION

The proposed restriction has the following key features, and will apply on an accounting period-by-accounting period basis:

- A fixed ratio rule (the FRR), limiting UK tax deductions for net interest to a maximum of 30 percent of a group's tax-adjusted UK EBITDA;
- An optional group ratio rule (the GRR), which a group can apply in place of the FRR and which allows tax relief for interest to be calculated by reference to the group's net interest to EBITDA ratio;
- A *de minimis* rule, whereby the new restriction will not apply to groups whose net UK interest expense does not exceed £2 million in any given accounting period;
- The ability to carry forward spare borrowing capacity from one accounting period to the next (for up to 3 years), and the ability to carry forward restricted interest indefinitely;
- A modified worldwide debt cap rule, which will apply in addition to the FRR and/or GRR, and which is intended to ensure that groups with low levels of external debt cannot leverage up their UK operations to the FRR limit; and
- Targeted anti-avoidance rules aimed at preventing the circumvention of the new restriction.

For groups that are not automatically taken out of the rules by the proposed £2 million *de minimis* rule, there is likely to be a significant administrative burden involved with familiarizing themselves with the new rule and in identifying the relevant tax-adjusted amounts that have to be taken into account in applying the new rule.

Moreover, there is currently no proposal for existing debts generally to be grandfathered. While the government has indicated a willingness to grandfather some unused interest expenses carried forward from periods before the new rule comes into effect on April 1, 2017, the related principal amount outstanding on existing loans will not be grandfathered.

This means that existing financing arrangements in place as at April 1, 2017, will generally be within the scope of the new rule.

THE FRR

Group concept. The FRR will be applied on a group-wide basis (rather than on a company-by-company basis).

For the purposes of the FRR, the definition of a "group" will be based on accounting concepts: in essence, a group will comprise the "ultimate parent" (generally the top level holding company in a corporate structure), together with all companies that would be consolidated on a line-by-line basis into the consolidated accounts of the ultimate parent.

Definition of interest. The concept of 'interest' is extended by the FRR to comprise all payments that are economically equivalent to interest, as well as expenses incurred in connection with the raising of finance. This means that payments in kind (sometimes referred to as "funding bonds", or "PIK") will have to be taken into account when applying the FRR, as will related payments such as guarantee fees.

However, in applying the FRR it is only the *net* interest expense position that matters. Financing income amounts (such as interest received) are netted off against financing expense amounts in order to reach a net position: it is only the net position that is in principle subject to the FRR restriction on deductibility. This is likely to be of particular importance to multinational groups with centralized treasury functions, as an FRR that operated by reference to the gross rather than net interest position clearly would have presented serious issues for intra-group treasury activities.

Interaction with other parts of the UK tax code. The FRR is intended to apply after almost all other parts of the UK tax code have been considered. This includes the UK's transfer pricing rules, purpose rules and anti-hybrid rules in particular. This means, for example, that groups still may suffer an FRR-based restriction on interest deductibility, even though HMRC is in agreement that the interest in question has a legitimate commercial purpose, does not give rise to a hybrid mismatch outcome and (based on an Advance Thin Capitalisation Agreement) is arm's length for UK transfer pricing purposes.

In addition, although it had been hoped that the new FRR would result in the repeal of the worldwide debt cap, the UK government has indicated that a modified debt cap rule will continue to apply alongside the new FRR.

The modified debt cap rule is intended to prevent groups that would not otherwise have high levels of external debt from leveraging up their UK operations to the FRR limit. In essence, the rule will "cap" the amount of UK net interest for which a group can obtain tax relief by reference to the net external interest expense of the group.

Carry-forward rules. The government is proposing that interest restricted under the FRR should be eligible for carry-forward to future accounting periods indefinitely. This should mean that if there is sufficient capacity in those future periods, the carried-forward amount should become deductible (and should therefore be eligible for tax relief).

The government is also proposing that unused borrowing capacity (calculated by applying the borrowing limit under the FRR) from one accounting period be eligible for carry-forward for up to three future accounting periods.

These aspects of the rules will be helpful to groups, as they should go some way to mitigating the impact of the new rules on earnings volatility across multiple accounting periods.

However, disappointingly there are no proposals to allow the carry-back to previous accounting periods of interest deductions that are restricted under the new rules, or of unused borrowing capacity (calculated by applying the borrowing limit under the FRR). Moreover, the ability to carry-forward excess interest deductions may ultimately not be of any value in view of separate changes on the carrying-forward of losses (the CFL Rules), which were announced at the Budget in March 2016 and which are expected to come into force on April 1, 2017 too.

The CFL Rules will limit the amount of profit that can be sheltered using carried-forward losses, such that only 50 percent of profits in excess of £5 million can be sheltered. At present, the government intends that:

- Carried-forward losses from before April 1, 2017, will not be subject to the FRR, but will be affected by the new CFL Rules;
- Interest that arises on or after April 1, 2017, and that is affected by the FRR will not be subject to the CFL Rules; and

- Losses arising after the application of the FRR will be subject to the CFL Rules.

ILLUSTRATION OF EFFECT OF THE FRR

The following table illustrates the basic effect of the 30 percent FRR rule as proposed by the UK government

Taxable EBITDA (£m)	600
Net interest expense (£m) Table text	200
Net allowable interest (£m)	180
Interest restricted (£m)	20

THE GRR

Under the GRR, groups can elect to apply a group ratio instead of the fixed ratio that applies under the FRR. The GRR is entirely optional and is expected by the UK government to benefit only a small proportion of groups.

The GRR is aimed at groups that are highly leveraged for commercial reasons, and allows them to obtain tax relief for net interest deductions up to a limit in line with the group's overall position. The government is continuing to consult on whether the GRR should itself be subject to a percentage limitation (more than 30 percent, but less than 100 percent) in order to counter potential abuse.

Generally however, the GRR is a welcome feature of the new rules that should go some way to mitigating their impact on groups whose funding structures do not present BEPS risks.

SUMMARY AND NEXT STEPS

The FRR generally will have no grandfathering, and will apply from April 1, 2017. The rule could result in significant restrictions on interest deductibility for certain groups, such as private equity owned portfolio companies where leverage ratios typically run in the 4 to 7 times EBITDA region (and possibly even higher in the early stages of an acquisition).

All groups should therefore be considering the ramifications of these forthcoming changes and the possible need to refinance their existing funding arrangements.

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