Refinancing and the taxation of interest explained

Simon Crookston outlines some of the consequences of injecting more debt financing into a business in the current economic climate

There is no doubt that in 2024 we are living in interesting times and that world events are impacting many businesses; for some it has been positive, for others less so. We are also now seeing increased costs and higher interest rates, albeit from historical lows.

Understanding what the consequences may be of injecting more debt financing into a business or the consequences of changing borrowing arrangements is important for advisers and their clients.

Below are some common themes worth bearing in mind when advising clients in this area.

Corporate interest restriction

For corporate businesses, the Corporate Interest Restriction (CIR) limits the amount of interest expense the business can deduct when computing its taxable profits to 30% of UK tax-EBITDA. This restriction applies if the company or group's total UK net tax interest expense is greater than the £2 million de minimis amount.

The actual rules surrounding the calculation of the interest restriction are detailed and complex, although some of the key points to consider are:

- The term 'interest expense' includes a wide range of items including loan interest expenses, some derivative contract expenses, and the finance cost element of arranging some loans, finance leasing, or debt factoring transactions.
- The rules work on a group basis rather than a company by company basis and therefore most calculations are carried out looking at the overall group position, with restrictions then being pushed down to individual companies as appropriate.
- The group referred to in the rules is the 'worldwide group' and broadly covers the ultimate parent entity and each of its consolidated subsidiaries.
- The CIR rules apply after other potential restrictions on interest deductibility are applied, such as transfer pricing adjustments, late payment rules, the anti-hybrid rules, and the unallowable purpose rules.
- For a net interest expense in excess of £2 million the basic tax deductible interest amount is based on 30% of UK taxable profits (tax-EBITDA). Although there are other calculations and adjustments that need to be considered before being able to conclude on the final interest allowable amount.
- Where an interest restriction occurs, or if interest is over £2 million, a separate interest restriction return needs to be filed with HMRC.
- Disallowed interest amounts can be carried forward to be used in future periods where there is sufficient interest capacity.

With many companies seeing their interest costs increasing, owing to increased debt and higher interest rates, it will be important for advisors to understand whether all of the associated interest

will be tax deductible for corporation tax. To the extent that the total UK net tax interest expense is greater than £2 million, then full relief may not be given.

Late paid and rolled up interest

Interest paid between one company and another is generally treated as 'paid' for corporate tax purposes at the time it is accrued in the accounts.

However, in some circumstances for example, where the interest is paid to a non-corporate, like an individual or partnership, or the debtor is a close company and the creditor is a participator in a close company, then the late payment interest rules need to be taken into account.

Under these rules, if the interest is rolled up and accrued, but not paid within 12 months of the accounting period end, then a corporate tax deduction can only be taken in the year in which the interest is paid. This can lead to an unexpected tax charge for those who are not familiar with this rule.

A further issue can arise if the late paid interest is paid all in one go at some point in the future. As tax relief may not be available in full, if the interest expense paid at that time exceeds the £2 million de minimis and 30% of UK tax-EBITDA under the CIR rules noted above.

For groups that are sold, further advice may be required as to when any rolled-up interest is paid, as the sale of a whole group can cause the group's original CIR group to end at that time. If the rolled-up interest is then paid post-sale, any brought forward interest allowance under the CIR rules may not be able to be used. Instead, the interest expense will form part of the new group's CIR calculation, which can lead to unintended interest restrictions for the purchaser.

As an alternative to paying interest, in order to obtain a tax deduction under the late payment rules, the borrower can issue Payment in Kind notes (PIK notes) to the lender. The PIK notes are treated for tax purposes as representing interest paid, although they are in fact further loans which themselves bear interest.

This can lead to the lender having a tax cost but with no cash to settle the liability, so care needs to be taken to understand the tax position on both sides of the transaction.

Thin capitalisation and transfer pricing

The UK has a transfer pricing regime under which it is a group/company's responsibility to ensure that transactions between connected parties are undertaken on an arm's length basis. To the extent that transactions between associated persons have not taken place on an arm's length basis, then the UK transfer pricing rules require an appropriate profit adjustment to be made.

As readers will be aware, in the UK there are exemptions from the UK transfer pricing rules for small and medium sized groups and enterprises (SMEs).

The UK's transfer pricing rules apply to all types of transactions including financing transactions. In addition, for financing transactions, it is important that companies are not thinly capitalised when considering their level of debt versus equity. Broadly, this is to ensure that the quantum of the loan amount and the interest rate charged are equivalent to those that would apply on an arm's length transaction.

When considering whether the interest rate charged is similar to a third-party arm's length rate, all aspects of the funding cost should be considered, including any commitment fees, arrangement

fees, guarantee, or other costs. To the extent that the interest charged is higher than that which would be charged by a third party on a commercially acceptable sized loan, the borrower must make a tax adjustment to disallow the excess interest amount. Where an adjustment is required, the lender may, depending on the facts, be able to claim a compensating adjustment.

With higher interest rates and increased debt financing in the market, along with new transfer pricing legislation for large multinational groups (those that meet the Country by Country reporting threshold) for periods beginning on or after 1 April 2023, transfer pricing will continue to become more topical for UK businesses.

Withholding tax

If a UK company pays interest to another UK company, then withholding tax is not required to be withheld. However, in other instances, where yearly interest is paid, broadly interest paid on loans capable of lasting more than 12 months, withholding tax may need to be applied at the rate of 20%.

Examples would include interest paid to individuals, partnerships, overseas companies, or other hybrid entities. Where withholding tax is required to be applied then this should be withheld and paid over to HMRC quarterly using form CT61. These forms are not available online and need to be requested directly from HMRC.

The recipient of the interest can then usually claim relief from the withholding tax suffered against their UK or overseas tax liability. Many Double Tax Treaties include the ability to claim reduced levels of withholding tax which helps to reduce the ongoing compliance burden.

Withholding tax should be borne in mind, particularly when advising clients in relation to shareholder loans from individuals, as the deduction of 20% tax on interest paid can be an unwelcome surprise and create a cashflow issue for some investors.

Debt releases

Debt restructuring and debt releases are becoming more common as businesses look at ways to restructure their existing financing arrangements to change the level of debt or manage their future interest obligations.

Where a company releases a debt and for the borrower there is a corresponding credit to profit and loss account, this credit can often be taxable. However, in some situations a tax-free debt release is possible. The main situations where a tax-free debt release can arise are:

- Release of a connected company loan relationship.
- The release is part of a statutory insolvency arrangement.
- Where a loan is released and falls within the parameters of the UK's corporate rescue exemption. In particular, it is reasonable to assume that, absent the release, there would be a material risk that the company would be unable to pay its debts within 12 months.
- There is a qualifying debt for equity swap which falls within the debt for equity swap exemption.

The tax rules in this area are not straight forward and whether a tax-free debt release arises will turn on the individual facts in each case and whether the debt is a loan relationship for tax purposes. Advisers should therefore encourage their clients to seek advice in advance of any debt restructuring or debt being released.

Preference shares
As part of an overall funding solution, preference shares are sometimes used instead of loans. The accounting for the two can often be similar, as the preference shares and the dividends on them are frequently shown as creditors and interest respectively. This can create some confusion for clients, as whilst this treatment is an accounting requirement, the tax rules continue to treat them as equity and dividends and not interest.

Conclusion
In the current environment, many advisers and their clients are finding themselves needing to consider the implications of refinancing options as part of the wider package of measures clients are considering to be able to meet inflationary cost pressures, innovate, and adapt to the interesting times in which we find ourselves.

As noted above, various considerations need to be borne in mind. In many cases, with appropriate upfront planning, a number of the above areas can be mitigated, or at worst they can be highlighted and planned for, enabling informed business decisions to be made. However, without a broad view of the potential tax implications of refinancing options, unwelcome surprises can arise.

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