Baker McKenzie.

Whose tax is it anyway?

Finance: **where's my relief?**

Historically, the basic principle of capital structure theory was that debt is cheaper than equity, in part because interest expense was deductible for tax purposes whilst dividends are not. Recent developments around BEPS Action 4 will challenge the historical principles. Here, we look at its UK implementation.

Issues to consider...

- Tax deduction on the cost of external borrowings cannot be taken for granted; even one times global interest shield could be challenging.
- Geographically diverse groups are more likely to be affected by the new limitations, especially groups with operations in developing countries.
- General uncertainty on tax relief available for interest expense especially during periods of volatile EBITDA.
- Potential risk of double taxation (e.g. denial of interest deduction, foreign tax, UK CFC charges and withholding tax).
- Significant impact for highly leveraged investments (e.g. real estate investment and development projects) with impact on company valuations and cost of capital.
- Potentially less flexibility in managing the group's effective tax rate. If debt financing does not deliver a tax shield, other techniques will need to be considered.

Actions for UK business...

Review existing financing arrangements...

- Analyse historical data to consider potential impacts (internal and external) of the proposed rules. Model scenarios to identify structural inefficiencies and reduce volatility.

Reduce structural inefficiencies...

- Push down debt to local territories such that EBITDA and global interest shield is matched.
- Move profitable activities to the debt issuer countries to align the location of taxable profits with the location of economic activity.
- Change the debt issuer: issue new debt from territories where there are profitable activities.
- Re-size or re-price the existing debt.

Allign EBITDA volatility with interest capacity...

- Discuss with auditors the possibility of recognising deferred tax assets in relation to disallowed interest, thereby ensuring any denial is only a cash and not a book tax issue.

Educate board members and finance team on proposed tax law changes...

- Tax changes should be factored into investment decisions and in establishing systems and processes to give early warning of any EBITDA volatility.
- Days of double dip structures are gone. Focus on achieving one times global interest shield on external debt.