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Seven key tax issues to consider in UK project finance transactions

An Operis white paper by Morag Loader and Daniel Adams

Overview

Ensuring financial models reflect the correct tax legislation is very important as this will help ensure post-tax returns to shareholders are accurately calculated.

Through its financial model due diligence work, Operis typically reviews around 150 financial models each year and is usually asked to give an opinion confirming that the assumptions and logic of a model are in line with applicable tax legislation. Consequently, where any tax assumption is not in line with applicable tax legislation, Operis would mention this fact in the opinion letter. Making sure that the model reflects the appropriate tax legislation therefore also ensures that Operis can issue a cleaner opinion letter with less caveats.

Operis has extensive experience of tax issues that can arise in UK project finance transactions. Previously, we discussed the key tax issues to consider in **Canadian P3 projects**.

This white paper focuses on various aspects of UK tax legislation which are often modelled incorrectly.

1. Calculation of Withholding Tax (WHT)

WHT is applicable in a number of tax jurisdictions on various sources of income resulting in the payer rather than the income recipient paying tax due to the tax authorities. The tax is thus withheld or deducted from the income due to the recipient. The most common items of income that WHT is applicable on in a financial model are dividends and interest payments.

Problem

A common error in models is to assume that any WHT payable is an additional cash outflow of the modelled entity. However, WHT is payable at the applicable rate on the gross income due to the recipient.

Solution

Dividends

Calculating WHT on dividends is usually simple as the dividends payable are calculated based on the retained earnings and available cash so WHT is calculated on the dividends payable with the net dividends then being received by shareholders.

Interest

WHT on interest is typically incorrectly calculated. Models often calculate interest payable (and fees if WHT is applicable) based on the rate quoted in loan documentation and then multiply by the applicable WHT rate with this WHT being modelled as an additional cashflow. In reality, because WHT is payable on gross interest, the interest rate payable will need to take into account any WHT due as otherwise only the net interest will be received by the lender(s). The gross interest rate should therefore equal:-

Required net interest rate x (1/[1 - WHT])

2. Introduction of the VAT Domestic Reverse Charge (DRC)

Problem

Whilst HMRC has announced that the proposed introduction of the DRC on 1 October 2020 is delayed until 1 March 2021, the DRC will impact project finance transactions particularly those that involve newly constructed assets.

Solution

In many instances, the DRC will result in no VAT cashflows being modelled on construction services and so models will need to reflect this. As a result, VAT facilities might not be used as part of the financing of projects. Whilst the DRC is likely to have a bigger impact on projects involving new construction, it will impact operational projects where the provision of some maintenance services is likely to be defined as construction services under the proposed legislation. For a more detailed discussion on the impact that the DRC might have on projects please read our blog on the matter.

3. Use of tax losses rules

Problem

Although the current use of corporate tax losses rules has applied since 1 April 2017, a number of models do not take account of the fact that losses incurred before this date need to be utilised under the 'old' loss rules. Only losses incurred after this date can be utilised under the current rules.

Solution

Models for projects that commenced before 1 April 2017 should split losses into two separate tax loss pools, one for losses incurred before this date and one for losses incurred after this date. Losses incurred before 1 April 2017 can only be offset against future income from trading activities. 'New' losses can be utilised against total income and not just income from trading activities. However, this increased flexibility is partly offset by the fact that from 1 April 2017, it has only been possible to reduce taxable income by 50% using carried forward tax losses whenever they were incurred.

4. Modelling BEPS Interest Deductibility rules

Problem

There are some aspects of the UK BEPS legislation, applicable since 1 April 2017, that are often not modelled correctly. Specifically, with respect to unused interest capacity and the exclusion of certain debt costs.

Solution

Unused interest capacity, created when the net interest incurred in a tax year is less than the allowable interest, can be carried forward for up to 5 years (some models assume interest capacity can be carried forward for 3 years but the final legislation extended this to 5 years). We would expect models to track unused capacity by showing an unused interest capacity pool with additions carried forward for 5 years from the end of the tax year in which the capacity is created.

In addition, some models exclude certain fees which should be included in the BEPS calculation. The potentially disallowable net interest expense should include all interest and fees incurred in relation to debt.

Furthermore, the calculation of allowable interest should include both senior and sub-ordinated debt unless the sub-ordinated debt qualifies for grandfathering and the terms of the loan are not substantially altered as a result of an event such as refinancing. In these circumstances the interest restriction rules do not need to be considered in relation to the grandfathered debt.

Where an election to apply the Public Infrastructure Exemption (PIE) in respect of senior debt has been made, an entity's taxable EBITDA will be zero resulting in no sub-ordinated debt interest being allowable assuming it is not part of a wider group nor grandfathered.

5. Treatment of refinancing costs

Problem

Whilst the tax treatment of refinancing costs will follow the accounting treatment, there are specific tax considerations. Firstly, the tax treatment of refinancing is dependent on the underlying purpose of the transaction. Debits under the loan relationship rules will only be allowable deductions if the refinancing is considered to be carried out for the purposes of trade. Providing the shareholders receive their share of the refinancing gain from the sale of their shares in the operating company to a new company, then the unallowable purpose legislation is not normally an issue. However, where shareholders receive a dividend distribution immediately following a refinancing, HMRC might consider the refinancing as wholly or partly in respect of an unallowable purpose.

Secondly, providing that transaction costs incurred as part of a refinancing are revenue in nature, the tax treatment will follow the accounting treatment. However, any capital element of transaction costs will not be an allowable deduction for corporation tax purposes.

Solution

Where the unallowable purpose legislation applies, models should assume that interest on the proportion of debt that is considered to be for unallowable purposes is disallowable.

If the transaction is wholly allowable for trade, no transaction costs are disallowed, though models often assume that between 5-15% of transaction costs are disallowed for tax purposes to reflect capital costs, the ultimate percentage allowable being based on the specific transaction.

6. Calculating capital allowances

Problem

A number of models calculate capital allowances on general and special rate pool tax written down balances on a period by period basis dividing the applicable annual capital allowance rate by the number of days in the period. However, if the project has been operational for more than one tax year, capital allowances are available on all qualifying additions during the year irrespective of when the expenditure is incurred.

In addition, some models still assume the applicable capital allowance rate for special rate pool additions is 8%. However, a 6% rate applies from 1 April 2019.

Solution

It is best to calculate capital allowances yearly on the start of year balance including forecast yearly additions to the pools and then split the allowance between the periods in the year based on days in each period. Pro-rating capital allowances is only necessary in the year in which operations commences if the entity has only traded for part of the tax year.

Financial models should reflect the applicable special rate pool reduction including pro-rating the applicable rate during 2019 if relevant.

7. Tax payment dates

Problem

Companies with profits of over £1.5 million in any accounting period have to pay corporation tax payments on account in quarterly instalments in the 7th and 10th months of the current year and then the 1st and 4th months of the following year. From 1 April 2019, 'very large' companies with profits over £20 million in any accounting period have had to make quarterly payments earlier in the 3rd, 6th, 9th and 12th month of the current accounting period. These profit limits need to be divided by 1 plus the number of associated companies.

The modelled entity is usually part of a larger group and will probably be a very large company for the purposes of payments on account. Many models assume that tax incurred in one period is paid in the following period to take into account the delay in paying quarterly instalments applicable to companies that are not very large.

Solution

Models should typically assume that corporation tax is paid in the same period in which it is incurred unless the entity does not have any associated companies.

Conclusion

The issues discussed above specifically relate to UK tax legislation but a number of tax jurisdictions also have similar rules. It is important to ensure that financial models reflect the applicable tax legislation. This includes ensuring that models correctly reflect the interaction of different taxes and that taxable profit is reduced by any other deductible taxes incurred. Future announced changes in tax rate(s) should be reflected in the model with taxes forecast to be paid at the appropriate point(s) during the year or after the year-end.

In addition, the calculation of taxable profit should consider any limitation in the deductibility of interest expenses and the final tax payable should take account of any restrictions in the use of tax losses. Once a project enters into the operating phase, financial models should still show VAT cashflows even if the impact may be advantageous to the project entity in the short run and the interest rate payable on loans should reflect any withholding tax payable by lenders to ensure that the lenders receive the required returns net of withholding tax.

If you have any questions regarding the above or would like to speak to the authors about potential tax issues arising in project finance transactions, please use the contact details below.

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Morag heads up Operis's Tax and Accounting team.

She began her tax career in 1992 and is a member of the Chartered Institute of Taxationís Corporate Taxes Sub-Committee.

Morag has extensive knowledge of tax and accounting issues facing project finance companies, particularly in the PPP market. She has wide sector experience in a variety of jurisdictions, which has involved working with other GAAP as well as overseas tax regimes.

Morag has lectured and provided training on a variety of subjects including tax and accounting for PPP, transfer pricing and other aspects of corporation tax.

Morag has previously worked for Lloyds TSB, Deloitte (including a secondment to BAA) and KPMG, where she specialised in corporate tax. At Deloitte she gained a wide range of corporate tax experience, working for both UK and overseas companies. She holds an MA from Cambridge University. She is a Chartered Banker, a Chartered Accountant and a Chartered Tax Adviser.

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Daniel is a senior member of the Tax & Accounting team at Operis. He is a Chartered Accountant and Chartered Tax Adviser.

He has worked on a number of infrastructure projects based overseas requiring knowledge of other GAAP and IFRS, and overseas tax regimes in addition to Oil projects based in the UK and overseas. Overseas regimes include USA, Canada, the Netherlands, Spain, Germany, Italy, Saudi Arabia, Nigeria and India. Daniel has attended training courses on US tax covering partnership and international taxation as well as state and local taxation. He has knowledge of the requirements in relation to the Foreign Account Tax Compliance Act (FACTA) 2010.

He has knowledge of Islamic finance including the different types of financing instruments used in project finance and how these are treated for tax purposes under UK tax legislation.

Prior to joining Operis, Daniel trained and practised at the UKís National Audit Office. He has provided training on a variety of tax and accounting subjects, including accounting for PFI, transfer pricing and corporation tax.

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