Gatwick Airport and Tax

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A series of research papers on a second Gatwick runway

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GATWICK AREA CONSERVATION CAMPAIGN

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With sales revenue in excess of £630 million per year, the Gatwick group generates considerable profits from the single business of operating an airport: Since Gatwick Airport Ltd (GAL) was bought out by a consortium spear-headed by funds managed by Global Infrastructure Partners (GIP), a private equity fund, in 2009, the group has reported some £738 million of cumulative operating profits. Yet during this time, the group has had no liability for, nor paid any, UK corporation tax.

The group is also considerably indebted: As at March 2015 (the last available accounts), the UK group carried over £2bn of debt on its balance sheet, including an intra-group loan from a Luxemburg-based associate company. This is common with many businesses bought out by private equity funds, and particularly so-called "infrastructure" businesses (which have relatively predictable cash flows). (Heathrow Airport, owned by Spanish infrastructure giant, Ferrovial, is also heavily indebted, unlike the days when the two airports were owned by BAA plc).

Gatwick's debt levels are undoubtedly a major part of the reason why the group pays no corporation tax in the UK, the main reasons for which would appear to be:

1. Interest on its sizeable debt pile is tax deductible – this applies to both external debt (i.e. from banks and the bond market) and the intra-group debt;
2. There are tax allowances given against the airport's substantial and ongoing capital expenditure ("capex") investment programme;
3. The group has considerable tax losses carried forward from previous years.

This paper attempts, firstly, to examine how these different factors might have contributed to its non-taxpayer status and, secondly, whether the use of offshore funding techniques available to non-UK owned companies might have been depriving the UK exchequer of corporation tax revenues.

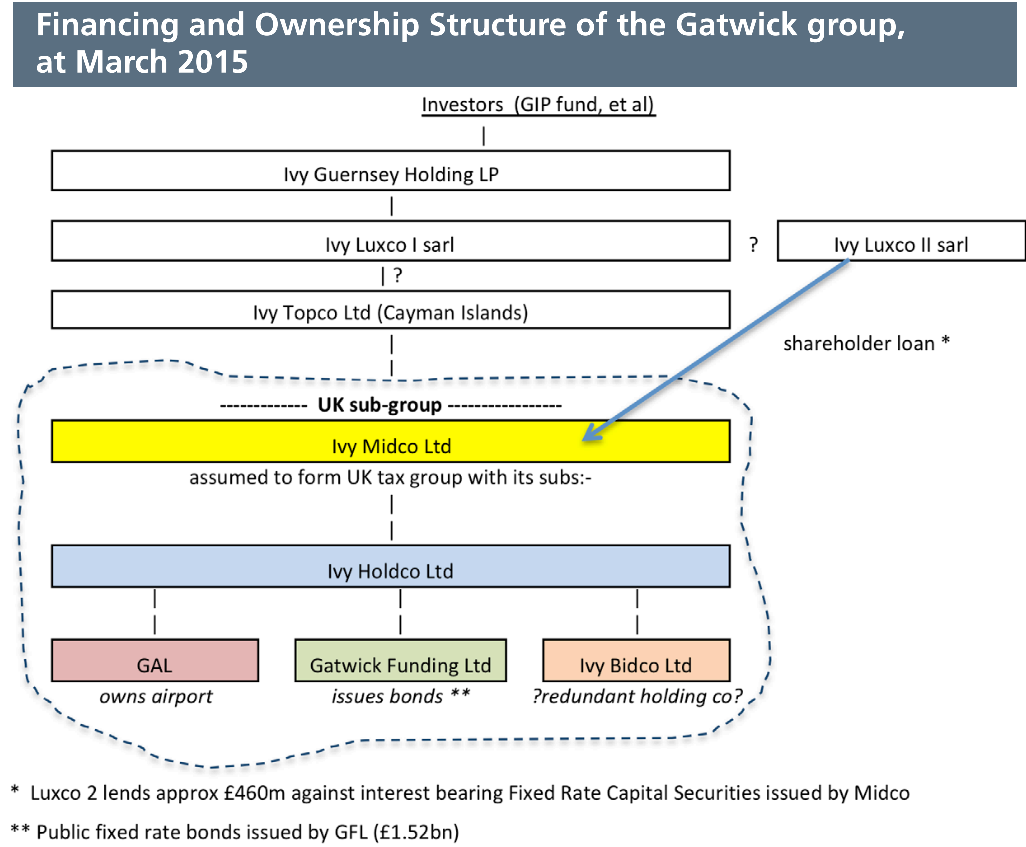
It also looks at whether this tax-free status is likely to continue for much longer.

Note of caution: It should be borne in mind that, in some areas, only rough approximations are possible given that full corporate tax computations are not publicly available. Furthermore, the intricacies of tax structuring are beyond the scope of this paper, as well as the author!

Group Structure

Whilst some of the precise inter-company relationships near the top of the group are uncertain, as figure 1, below, shows, for a relatively straightforward single-asset business, the group appears to use a fairly complex holding company structure. This structure was established following the 2009 buy-out and involves a chain of holding companies in various countries, not just the UK. Uncertain relationships are marked with a '?'.

Fig. 1. Estimated simplified structure chart



Source: Ivy Midco consolidated accounts, GACC estimates

- The bottom half of the structure is the UK group which includes GAL which operates the airport facility itself.
- Above this, and outside the UK, sit a Cayman Islands registered company, (at least) two Luxemburg holding companies and an ultimate holding company in Guernsey before we get to the individual and ultimate shareholders.
- The assumed UK tax group is shown with the dotted line around it; in other words, it is believed that all the accounts of these companies are consolidated together for tax purposes and one tax computation calculated for the whole lot. This way, costs or losses in one subsidiary can offset income or profits in another to keep the total tax liability down.

The structure chart is based on the latest information available, the March 2015 Ivy Midco group consolidated accounts. As an aside, these accounts noted that the group conducted a re-organisation as at 31st March 2015 whereby Midco acquired Holdco from Bidco who, at that time, held not just Holdco but was owned directly by Midco. Midco then sold what remained of Bidco back to Holdco. The reasons for doing this can only be guessed at, absent clarification from the company, and, in any event, are beyond the scope of this report but it would seem probable that this might well be tax driven in some way, possibly part of the preparation for disposal by GIP, whilst maintaining the ability of Midco to generate cash dividends to its offshore shareholder.

Gatwick is a very profitable business generating considerable cash for its shareholders…

In the year to March 2015, the group's consolidated revenues rose by 7.5% over the previous year to reach £638 million. Operating profit also rose: from £157 million in 2013-14 to £178 million in the most recent year. After interest costs, the group reported a pre-tax profit of £56.8 million for 2014-15, a similar level to the previous year.

In total, since the buy-out, the group has reported cumulative operating profits of £738 million.

These profits have, in part, been passed up the line, enabling Midco to declare dividends:- In 2013-14, Midco declared a dividend of £55 million to its Cayman Islands–based shareholder, Ivy Topco. In the subsequent year, however, this was increased to £69.5 million. In addition, it paid a further £63 million to a related company (in Luxemburg) in respect of an inter-company loan, following a similar payment of £50.6 million in 2013-14. Overall, just in the past two years, it has upstreamed £238 million in cash to its owners. Yet throughout this time, and despite the high and rising level of operating profits, it has not incurred any liability for corporation tax in the UK and it has even had to borrow money locally to fund this outflow to shareholders alongside an ongoing capital investment programme that has enabled GAL's management to point to the considerable improvements being made to the airport facilities as a reason for not paying tax. At the same time, however, the owners appear to have done very nicely.

… Yet it has to borrow money locally to fund dividends

In 2013-14, local borrowings rose from an already hefty £1,404 million at March 2013 to £1.52 billion at March 2014; in 2014-15 it rose even further, to £1,662 million. In 2013-14 it issued a further £350 million of bonds via Gatwick Funding Ltd; then, in 2014-15 it borrowed £138 million from its general bank facility.

In total, including money 'borrowed' from the related company in Luxemburg (see below), the business carries over £2.1 billion of debt on its balance sheet. That represents nearly twelve times its annual operating profits before interest and capex investment. Ordinarily, that would probably make the group's credit rating 'non-investment grade' (ie "junk") status with the ratings agencies; however, the nature of the business, with its virtually-guaranteed cash flow, means that the agencies can justifiably treat it differently.

Shareholder Loan: The So-Called "Quoted Eurobond" exemption

So what exactly is this loan from a related company in Luxemburg?

Since 1984, UK companies have been able to issue a certain form of theoretically tradeable debt – called "Eurobonds" – to investors based outside the UK without having to deduct any tax at source when paying interest. Given that the Gatwick group is ultimately owned by non-UK shareholders, the group has taken advantage of this facility to issue debt to a related company based in Luxemburg – a well-known low-tax jurisdiction – effectively instead of equity. It is not thought that this debt has ever been traded, as it is likely to form a generously-yielding and integral part of the ultimate shareholders' investment structure.

As table 1, below, shows, the UK Gatwick group has borrowed a sizeable sum from an associate called Ivy Luxco II sarl, ("Luxco2") (although quite exactly where Luxco2 sits in the corporate structure is, however, unclear). This debt instrument shows up clearly in the annual accounts of Ivy Midco who issued Interest-bearing (12%) Unsecured Capital Securities, to Luxco2 back in 2009-10, shortly after the buy-out. The 12% coupon would appear to have been generous, even then, compared to the returns generated on 'regular' "high yield" bonds, making the structure more akin to preference shares.

Furthermore, this inter-company debt accrues non-cash interest which means that it doesn't even need to be serviced regularly in cash but instead the interest owing gets "capitalised" i.e. added each year to the principal amount. This could potentially allow the group to time exactly when it wants to upstream cash, which it seems to do through ad hoc 'repayments' of the outstanding loan (£63m was repaid during 2014-15). The amount actually carried in the books varies from year-to-year with the accrual of interest and the ad hoc repayment of principal. As at 31 March 2015, the total amount owed to Luxco2 was £473 million, including accrued interest for the year of £18 million.

Table 1: Estimated statement of intra-group shareholder debt, 2015

Luxco2 Debt as follows (from March 2015 accounts)

	£m	
Balance as at 31/3/14	463	
plus accrued interest	18	
Total at 31/3/14	**481**	
Interest at 12% in FYE 3/15	55	
Balance as at 31/3/15	536	
Repayment of loan 2015	-63	<-- *actual cash upstreamed to Luxco2*
Actual reported balance 31/3/15	**473**	
comprising:		
Principal	455	
Accrued interest	18	

Source: Ivy Midco Ltd audited consolidated accounts

As far as the impact on UK corporation tax liability is concerned, regardless of the interest not actually being paid in cash, and the owner of the debt being an offshore sister company, the interest 'charged' each year is still allowable against tax. Meanwhile, with the recipient of the interest being based in a low-tax regime, it is to be presumed that the group avoids merely creating a significant tax liability elsewhere (indeed, it is suspected that as this cash received further up the chain is deemed a loan repayment rather than 'income', it is not taxable there at all, although this is conjecture).

Issuing this debt, therefore, instead of pure equity, has two advantages for the group:

(1) It is useful as a tax efficient means of getting cash (i.e. what would normally be called 'dividends') out to its non-UK owners.

(2) As any interest charged is deductible against UK corporation tax in just the same way as the interest on 'real' external debt , it can make it a very tax-efficient way of capitalising a UK company (whereas dividends on equity would not be tax deductible).

As a result, this type of structure has become very popular with many PE-owned businesses, especially where shareholders are non-UK based.

UK corporation tax: Why exactly is there no liability?

As we have seen, the group has paid no UK corporation tax since the buy-out, despite earning £738m in cumulative operating profits. So how exactly is this done?

In essence, the tax liability has been eliminated by the allowability of both interest costs and capital investment. None of this is either illegal or indeed 'new news': in reaction to criticism in the media that the use of the intra-group (Luxco2) loan structure discussed above was a ruse to avoid UK tax (and shift profits to a lower tax regime), GAL claimed in an article in 2013 that "the use of equity rather than shareholder debt to help fund the investment would not have moved Gatwick into a corporation tax paying position during this* time". (* presumably "this" time is the four years leading up to March 2013). In other words, they were saying that they would not have paid UK corporation tax even without the Luxco2 intra-group loan in place, owing to the local operating company debt and capital investment allowances offsetting taxable operating profits.

To test this claim, and to see whether it still applies today, it is just about possible to estimate a very simplified and approximate tax comp by sketchily reformatting the group P&L. Whilst the interest expense in each year is clear to see, the reality of working out tax allowances re capital spending is highly complex, depending on the nature of the assets invested in, and so cannot be replicated by the layman. In a note to the accounts, however, Midco does tell us the extent of allowances applied, as well as providing information on other adjustments. Table 2 (below), shows the result of this analysis.

Table 2: Estimated simplified Ivy Midco group tax comp 2010-15

Ivy Midco Ltd estimated tax comp 2010-15

all£m	2009-10	2010-11	2011-12	2012-13	2013-14	2014-15	Cumulative
Operating profit as stated	-10	119	148	145	157	178	738
add-back depreciation & amortisation	23	61	75	82	98	98	437
EBITDA	**14**	**180**	**223**	**227**	**256**	**276**	**1175**
Deduct interest payable to..							
Banks	-14	-33	-15	-4	-6	0	-74
G/Funding Ltd bondholders	0	-3	-45	-71	-71	-87	-276
other (fees, debt costs)	-7	-23	-7	-7	-11	-4	-59
Provision on fin.derivatives	-41	-104	-77	-49	39	14	-218
Total interest EXCL. Luxco2 debt charge	-62	-164	-143	-131	-49	-77	-627
Other adjustments:							
add-back disallowed expenses and other items	12	29	10	8	11	11	82
other allowances	0	-9	-9	-7	-5	0	-30
Taxable profit after normal interest etc	**-36**	**36**	**82**	**98**	**212**	**210**	**600**
Capital allowances applied	-27	-68	-85	-85	-100	-99	-465
Use of tax losses brought fwd	0	-5	-3	-2	-23	-28	-61
Taxable profit after allowances, before Luxco2 int	**-63**	**-37**	**-6**	**10**	**89**	**83**	**75**
Luxco2 debt costs (interest)	-21	-67	-55	-55	-55	-55	-308
Taxable profit for UK corporation tax before trading losses carried forward to future periods	**-84**	**-105**	**-61**	**-45**	**34**	**28**	**-233**
Memo item: Cumulative P&L Account (deficit)	-74	-98	-164	-222	-263	-285	

NOTE - 2009-10 is the year GAL was acquired, so Midco only functioned for apart of this year.

Source: Ivy Midco Ltd audited consolidated accounts

So is GAL right?..

Our figures appear to confirm that the UK Gatwick group would have had minimal (if any) corporation tax liability during the first 3-4 years post-buy-out, even without the Luxco2 debt, owing to the tax deductibility of the local interest charged on its bank facility and the locally-issued Gatwick Holding bonds, plus the impact of tax allowances from the capital investment spend. Only in the most recent three financial years might the group have had a taxable profit BEFORE the shareholder loan interest, and even then this could well have been offset by tax losses carried forward (admittedly, in part due to previous years' shareholder loan interest).

Indeed – as table 2 shows – although the Luxco2 debt has racked up some £308 million of interest over the six years since the buy-out financing , it is in fact the smallest cumulative component of the tax offset, with "true" interest, together with the cost of associated financial derivatives, totalling some £627 million over the period whilst capital investment allowances total around £465 million.

… and will this continue?

If we look at the cumulative group profit and loss account deficit as it now sits at (£285 million) (i.e. the Group has accumulated losses of this over the six years since the buy-out) and compare this to the cumulative 'interest' earned by the Luxco2 'debt' , we start to see an interesting thing: The cumulative Luxco2 interest is, as we have shown, £308 million, and in the past two years has overtaken the size of the P&L account deficit. It is not possible to state categorically that without the Luxco2 debt the group would by now be paying UK corporation tax, but this would seem to be a not unreasonable conclusion. So whilst GAL was probably right in 2013 saying that the lack of UK tax liability was not in any way due (then) the presence of the Luxco2 loan, this may not now be the case.

It could well be the case, therefore, that had the group not substituted shareholder equity with shareholder debt, then it might by now be incurring liability for UK corporation tax.

Indeed, going forward, it is entirely possible that as the capital investment programme slows, and operating profits continue to rise, the group might, either way, begin to incur liability for UK corporation tax. If this is the case, one way round that might be to incur more debt and to initiate another sizeable investment programme (such as building a second runway, perhaps).

Conclusions

It is beyond dispute that one of the UK's major airports, situated just a few miles from London, under consideration for additional government-approved runway capacity, and earning revenues in excess of £630 million each year, and growing, pays zero corporation tax despite being extremely profitable. Yet whilst the business has recycled considerable amounts of cash into upgrading and modernising airport and terminal facilities in recent years, the shareholders have still enjoyed good cash returns through both dividends and repayments of tax-efficient "debt" capital, whilst external debt investors have been called on to fund the capital investment programme.

Analysis shows that the chief reasons for the lack of any UK corporation tax liability in the six years since the buy-out, is the presence – and tax deductibility - of the large ("opco") debt at Gatwick Funding level, followed by the huge tax allowances given against the capital investment programme and not the intra-group (Luxco2) debt. Clearly, however, the extra tax shelter provided by the Luxco2 debt enabled further significant unutilised tax loss carry-forwards to be built up during the first four years which will help to shelter tax into the future as and when the capex programmes tail off.

However, without the Luxco2 structure, the group's interest bill would have been some £308 million cumulatively lower and it could well be in tax-paying mode by now.

It should be stressed that all of this has been, and is, entirely legitimate according to the UK tax laws which govern the deductibility of certain costs (i.e. interest on debt) against taxable income. It would be unfortunate, however, if this mechanism was to deprive the UK exchequer of a significant amount of tax revenue going forward, at a time when it hopes the government will grant it permission to build a second runway and whilst the shareholders have taken out cash returns. Furthermore, whether the Luxemburg structure and benefits remain feasible going forward, owing to EU pressure on so-called tax deals, remains to be seen.

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Ian Harris has a degree in Economics from the University of Bath. He spent some thirty years working in the City, initially as a corporate credit analyst within NatWest Bank, then as a corporate bond analyst with, firstly, NatWest Markets (leaving prior to the ill-fated take-over by RBS) then ING Barings (soon after the Dutch bank had bought Barings for a nominal sum).

He started covering the then-fledgling European High Yield ("junk") bond market around 1998 before joining a major US insurance company, in 2003 where he focused on the fund's European investments in both high yield and leveraged finance (mainly buy-out financing alongside Private Equity funds). He retired in 2011.

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