ICAEW REPRESENTATION 07/16
TAX REPRESENTATION

TAX DEDUCTIBILITY OF CORPORATE INTEREST EXPENSE: CONSULTATION

ICAEW welcomes the opportunity to comment on the consultation *Tax deductibility of corporate interest expense* published by HM Treasury on 22 October 2015.

This response of 14 January 2016 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

We would be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

On 8 January 2016 we attended a meeting with HM Treasury at which we were able to put forward some key comments and concerns and discuss aspects of the consultation.

Contents

The Institute of Chartered Accountants in England and Wales
Chartered Accountants' Hall
Moorgate Place London EC2R 6EA UK
icaew.com/taxfac

T +44 (0)20 7920 8646
F +44 (0)20 7920 0547
E taxfac@icaew.com

ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 146,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

For more information, please contact ICAEW Tax Faculty: taxfac@icaew.com

icaew.com

OVERALL COMMENTS

The scope of the Consultation

1. This is set out in the consultation document itself as follows:

2. “The government wishes to look at ways to tackle [Base Erosion Profit Shifting] BEPS involving interest expense in order to reduce unfair outcomes and imbalances in the tax system. However, the government wants to ensure the UK tax system remains competitive so that it continues to play a part in attracting and retaining business investment in the UK.

3. The government wants to ensure that there is certainty for businesses operating in the UK, and that they can continue to obtain deductions for interest expenses commensurate with their activities, while limiting risk to the exchequer. Any changes to tackling BEPS involving interest expense would also need to be operationally efficient and take account of the compliance and administration burden for the government and business.

4. This [consultation] document summarises the key aspects of the OECD report on Action 4 and sets out some specific questions to frame a discussion for a UK domestic policy context. At this stage, the government is seeking views from all stakeholders on the proposals in the OECD report. The responses to this document will be considered in the development of a future business tax roadmap.”

Major concerns

5. We have set out in paragraphs six to eight below some overarching considerations in relation to the proposals which could involve a major recalibration of the UK domestic tax environment. The current, relative benign, regime for Interest deductibility has been a key positive feature of the UK domestic tax environment and the UK government needs to consider very carefully any changes which would impact negatively on business and on the UK as a desirable business location. There are major concerns amongst UK business as to how potential changes could adversely affect them. The UK government needs to understand these concerns while at the same time it must honour the commitments it has made to its fellow OECD and G20 countries when it endorsed the OECD BEPS Action Plan last November.

Overarching comments

6. The UK’s response to Action 4 will, by the nature of the Final Report recommendations, need to be long and complex. In such situations, there will always be scenarios that weren't envisaged at the time of drafting and so end up getting caught when they should not be. No matter how well the rules are drafted, their prescriptive nature means that we will still have companies who end up with a restriction even though there is no BEPS.

7. Since it is not, we believe, the Government’s intention to apply restrictions where there is no BEPS, we would recommend that the rules have a backstop provision which provides a general exclusion from the rules where there is no BEPS. This could then be coupled with a clearance process for areas of uncertainty. The clearance process would need to be narrowly drafted, of course, to avoid HMRC being inundated and to ensure that it was only used for genuine commercial structures without a BEPS intent. However, we believe both of these issues could be addressed by: a) putting the clearance process within the COP 10 process such that companies had to show uncertainty for their cases to be considered and; b) using a main purpose/no tax avoidance provision as the “no BEPS” test as this is well established in UK law both as a tax concept and as an area for clearance.

8. Recognising that this law change will be a significant policy change with negative consequences for some key industries, we believe consideration should be given to negating some of the impact by considering the introduction of additional balancing reliefs. The introduction of enhanced capital allowances for example, might go some way to addressing the impact for some UK groups.

RESPONSES TO SPECIFIC QUESTION

Q1: What are your views on when a general interest restriction should be introduced in the UK?

9. The UK should not be a first mover. We have led the way in many of the discussions which is right but the end proposals have been prepared on the basis that the recommendations would be followed by all. However, initial responses suggest that this will not be the case with several of our key competitors implying that they will stay with their existing rules on the basis that they are within the spirit of the recommendations while others, most notably the US, are not in the position to be able to pass a law change in this area. This is particularly key when we consider certain aspects of the rules (such as the group ratio) which assume consistent application across all relevant countries in order to achieve the intended result.

10. Further, the OECD will continue to work on several aspects of Action 4 throughout 2016 and we assume that the UK will wish to take account of this ongoing work before finalizing our new law. In addition, it needs to be recognised that debt is key to the funding of capital intensive industries such as infrastructure, utilities and property, all of which are key to our economy. The long term nature of their debt needs to be taken into account when considering our entry date.

11. Therefore, while it is right for the UK to start discussions and elicit views from interested parties, we should not rush to introduce any new changes. We recommend that the UK continues to consult while also monitoring what is happening in other countries and participating in the ongoing OECD discussions. We would therefore recommend that changes are not therefore introduced for 2-5 years depending on what is introduced in respect of grandfathering (see below).

Q 2: Should an interest restriction only apply to multinational groups or should it also be applied to domestic groups and stand-alone companies?

12. It is hard to see how domestic groups could be using interest relief to achieve BEPS and, on this basis, it seems appropriate to exclude them. However, it is hard to see how this would be compliant with EU law. Therefore, we would propose that the SME exemption and a de minimis level be introduced to go some way to helping UK businesses.

Q 3: Are there any other amounts which should be included or excluded in the definition of interest?

13. As the rule is focused on achieving a disallowance for tax purposes, we recommend that it should be applied by reference to what is a tax deductible finance cost under normal rules (ie the loan relationships and derivative contract rules).

14. The following should not be within the definition:

1) Any disallowance costs associated raising or exiting funding.
2) Financing costs that are recharacterised as distributions and so non-deductible such as profit participation loan interest.
3) Items which are accounted for as interest (such as certain preference dividends) but which would not be viewed as interest for tax purposes.
4) Amounts disallowed under any of the UK's existing- and retained- legislation such as the transfer pricing rules.
5) Non-loan relationship money debts should not be included as these are rarely financing related.
6) Short term debts could be excluded to allow for cash pooling etc and to remove the complexity of dealing with short term intra group cash transfers.

Q 4: How could the rules identify the foreign exchange gains and losses to be included?

15. Forex movements, other than those forming part of the interest payment, should be ignored as these are not funding costs and outside the control of the borrower.

Q 5: If the rules operate at the UK sub group level, how should any restriction be allocated to individual companies?

16. We agree that the rule should operate at the subgroup level for simplicity. Groups should then be given the flexibility to choose where the deductions are taken. This would be the simplest solution and would be in line with the approach taken with the World Wide Debt Cap (WWDC). Being able to choose the allocation of the deduction (rather than the restriction) would have the benefit of simplifying compliance for many groups and removing the difficulties arising from non trading deficits (a common issue for groups in start up or turnaround mode or with significant initial capex spend requirements). Since the fixed ratio proposal is likely to have a negative impact on many groups, it would be a positive sign if the Government could use this opportunity to remove the issue groups can have with trapped interest costs.

Q 6: Are there items which should be excluded from both the definition of interest and from "tax EBITDA", as referred to in the section on a fixed ratio rule?

17. The definition of interest is covered above.

18. However, we do not think that all tax exempt income should be excluded from the definition of Tax EBITDA. It needs to be recognized that the two definitions are focused on different aspects. As the definition of interest drives the disallowance, this must be based on a pure tax definition to ensure that these new rules applies on top of the existing rules and we do not, for example, end up with effectively double disallowances.

19. However, the Tax EBITDA definition is focused on what is a reasonable deduction and this ought to, therefore, be defined with some reference to how third party debt is lent commercially. A third party lender would take account of all cash flows when determining the borrowing capacity of a borrower, because any cash income can be used to service interest payments, and the tax treatment of specific categories of income is not relevant in this respect. A tax based EBIDTA is required (rather than the accounting figures) since, for example, unrealised gains and losses should not impact the calculation. However, the Tax EBITDA figure should include certain non-taxable items such as dividends and share gains since these would factor into a bank lending case.

20. Further, the reason for not taxing, for example, dividends is to prevent multiple levels of taxation. The idea is not to tax income that has already been taxed in the company which has made the profits, and so excluding this income doesn't not seem appropriate. Taking a consolidated approach within the UK group would remove some of this issue but distributions into the UK group from foreign subsidiaries should be included within Tax EBITDA.

Q 7: What do you consider would be an appropriate percentage for a fixed ratio rule within the proposed corridor of 10% to 30% bearing in mind the recommended linkages to some of the optional rules described below?

21. We strongly recommend that a 30% ratio be introduced to ensure that we are consistent with ratio limits set by our European competitions such as Germany. It would not be appropriate for the UK to sets its ratio at a level which put it at a competitive disadvantage. It is noted that, even at this level, we are likely to be at a competitive disadvantage to the US since its ratio is 50% and although the US has, we understand, been a strong proponent of a lower ratio, the political landscape does not allow for a tax law change there. Indeed, there have been no significant corporate income tax law change in the US in many years.

Q 8: What are your views on including in any new rules an option for businesses to use a group ratio rule in addition to a fixed ratio rule?

22. It is imperative that some form of group ratio rule should be introduced alongside the fixed ratio rule to negate the impact of the proposals on sectors such as property and capital intensive industries such as infrastructure and utilities which are key to our economy. This will also be fundamental to ensuring that companies aren't additionally hampered in a downturn when profits drop and there would, otherwise, also be the additional hit of a further tax disallowance.

23. However, to ensure that the rules are BEPS focused, it is key that the aim of any such provision be to allow a deduction for all third party debt. The issue with a group ratio test applied along the "net interest to EBITDA" basis outlined in the report is that it could result in a significant third party interest disallowance for groups with overseas EBITDA. In theory, this issue would be resolved if the overseas territories had a reciprocal group ratio provision but the comments made so far on the Final Report suggest that many countries (including mainland European countries such as Germany and France) will not go down this route. There are also many countries that do not allow an interest deduction anyway under their domestic law (such as countries following Sharia law). Even if a country does allow interest relief and introduces a group ratio, it seems likely that the rules would only give relief if debt was actually pushed down overseas. However, it is often not possible to move external debt under the financing terms and, even if approval is granted, this would definitely be an example of the "tax tail wagging the commercial dog".

24. The BEPS proposal assumes that an overall fair result is achieved because the ratio is intended to spread the external interest relief evenly around the worldwide group. However, with an earnings based test alone, there is a significant risk that this will not be achieved.

25. This is particularly important for UK headed multinationals since most external debt will be located at the UK holding level since this is required commercially by the banks to ensure that they have maximum security. The problem with a group ratio focused solely on earnings is that it only recognises half the picture and a much more material commercial factor in obtaining external funding is asset profile. The Final Report recognises a concern with external debt where groups choose to place high levels of debt in high tax countries but, in practice, the location of external debt is often driven by the banks security requirements and not the choice of the borrower. In any case, the UK's low corporate tax rates ensure that this is not a concern with UK located debt.

26. Therefore, we would recommend that, if a group ratio test is introduced, it should be focused not just on EBIDTA but also on asset values (including subsidiary investments). This ought to help address the concerns above and would, we believe, be within the spirit of the Final Report which allows for the possibility of different group ratios. Alternatively, the UK deduction could be calculated taking into account EBITDA arising outside the UK in countries where either there is no possibility for interest relief. However, this seems complex to identify and police.

27. We would also recommend that the UK consider introducing an equity escape clause similar to that used in Germany alongside a group ratio test. This would provide a simple solution to help many UK multinational groups. However, an escape clause alone might not help UK inbound groups especially where the UK group carries on different activities to the worldwide group which justify higher gearing (such as where the UK external debt is non-recourse debt secured solely on the UK assets). Therefore, we believe a combination of the two approaches is needed to address concerns across the range of UK corporates. The Final Report notes that both options, or a variation, are acceptable and while a combined approach may lead to more complex legislation it seems that this is necessary to ensure that the maximum number of scenarios are covered so as to reduce the risk of groups being left with disallowable third party interest.

28. The definition of external debt will also be key as it needs to extend beyond traditional bank debt to public placements, mezzanine debt, funding from private debt funds etc. The UK should not introduce rules which effectively limit the funding routes available to companies.

Q 9: What form of de minimis threshold would be most effective at minimising the compliance burden without introducing discrimination or undermining the effectiveness of any rules?

Q 10: What level should the de minimis threshold be set at balancing fairness, BEPS risks and compliance burdens?

29. It is key that the de minimis be set at a suitable level to exclude the vast majority of UK only groups and to ensure that the UK looks competitive compared to other European members. Given that Germany has a Eur3m de minimis, we would propose that the UK set its limit at £3m.

30. However, we recommend that thought should be given to setting a de minimis by reference to net debt (i.e. a balance sheet measure) as well as net interest expense. Our reasoning is that the level of interest expense is often variable and fluctuations in interest rates might push a company above the de minimis threshold. By comparison, the level of indebtedness should be within an entity's control to a far greater extent. It would seem easy enough to bring in a de minimis under which the rules would not apply if the company was below either figure.

Q 11: Should SMEs as defined by the EU criteria be exempted from the rules, in addition or as an alternative to a de minimis threshold?

31. We agree SMEs should be exempted from the rules. The SME approach is a tried and tested one in the UK and so would be a well understood approach to assist smaller businesses.

32. However, the level of debt in a UK company will not necessarily correlate to the size of its overall group and large groups may have UK companies with little debt in them. The de minimis threshold is therefore also required as it would not be reasonable to expect such companies to go through the detailed calculations to show that they had no material disallowance. This would also keep the UK consistent with the other key European countries already operating an earning stripping approach.

Q 12: What is the best way of ensuring that the rules remain effective and proportionate even when earnings are volatile?

33. We agree that volatility in earnings needs to be taken into account. Carry forward and back of both excess interest and excess capacity would be our preferred option. While this leads to more complexity in calculations we believe corporates would prefer this flexibility to enable them to better manage the negative impact of the proposals and where trading/non-trading income is volatile it will enable the excess income in good years not to be wasted. . Further, this would allow us to be consistent with other countries already operating a fixed ratio such as the US.

34. We would suggest that any such rules could be based around the rules for carry forward of trading losses. In line with trading losses, we do not believe there should be a restriction on the period of carry forward. This is important to address long lead time projects and we believe that excess interest should not be viewed any differently from other trading expenses. Indeed, the change of control rules for losses could equally be applied to excess interest carried forward.

Q 13: In what situations would businesses choose to use the PBP exclusion? How would this differ if no group ratio rule was implemented?

Q 14: Do you have any suggestions regarding the design of a PBP exclusion, taking account of the OECD recommendations?

35. The PBP is welcome and an imperative for many infrastructure businesses. However, to be effective in practice, it is important that it is drafted widely and clearly. It is, for example, not easy to see how certain terms such as the need for the "public benefit entity... [to] contractually or otherwise obliges the operator to provide goods or services in which there is a general public interest" would apply to some infrastructure deals. Many infrastructure companies are concerned that this exception is too narrow because of the uncertainty around the detailed conditions in the Final Report. We would recommend that this be addressed by making it clear that the key test is that there be a public benefit and that the other conditions in the Final Report should only be viewed as indicators of this (ie a company doesn't need to pass them all).

36. This will go some way to allay concerns. However, infrastructure is a developing area and there will always be fact patterns that might not have been contemplated initially but are still clearly within for the Public Benefit (such as new developments in alternative energy). We believe that there should also, therefore, be an overriding provision to confirm that the PBP exclusion will apply in situations cleared with HMRC as being for the public benefit.

37. To reduce down the number of clearance then required, we would also recommend that the legislation or guidance lists what is the current view of Public Benefit assets (ie it clearly cover hospitals etc but does it extend to eg retirement homes, broadband infrastructure, military housing, car parks, ports?). The guidance should also expand on some of the other uncertainties in the Final Report conditions such as the quote above. This would help reduce some uncertainty and the number of clearances needed.

38. It is also important that, as mentioned above, the definition of external debt is drafted widely to go beyond traditional bank debt to allow corporates continued access to alternative sources of funding such as mezzanine debt and debt from debt, private equity or other alternative investment funds. This funding forms a key part of our economy and is not, we believe, a key risk to BEPS. External debt needs to be defined to exclude traditional intra group debt where there are BEPS concerns. However, debt provided by the various investment funds is usually motivated purely by commercial factors such as ease of cash extraction, improved returns to investors, to reduce the risks on investment into more volatile or newer businesses, and to allow for quicker funding were needed. Such funding provides a key source of additional funds for many industries and should, we believe, be included within the definition of third party debt.

Q 15: Do you have any views on the specific risks that might be sensibly dealt with through targeted rules?

39. The UK already has an extensive anti-avoidance regime, including transfer pricing, the WWDC, anti-arbitrage rules, the unallowable purpose rule and a GAAR. Therefore, we do not think that it is necessary for any more targeted rules to be introduced. Indeed, we would propose that the WWDC rules be repealed once these new proposals are enacted.

Q 16: Do you have any suggestions as to how to address BEPS issues involving interest raised by the banking and insurance sectors?

40. Any decision on this issue obviously depends on how the ongoing OECD/G20 discussions in this area progress. However, it is not clear to us that this sector needs to be brought within this complex regime given that the capital structures in this sector are already closely regulated.

Q 17: What are the types of arrangement for which transitional rules would be particularly necessary to prevent any rules having unfair or unintended consequences, and what scope would these rules need to be effective?

41. Grandfathering is essential especially for businesses of a long term nature such as infrastructure and real estate where decisions were historically made on the basis of full interest deductions and so any change now (once funding and pricing etc are locked in) would be tantamount to retrospective taxation.

42. The grandfathering needs to extend indefinitely for existing debt and should allow for an element of refinancing to avoid companies being further hampered in the event of, for example, a downturn.

Q 18: To what extent do you believe that the new general interest restriction rule should replace existing rules?

43. The new general interest restriction rules should supersede the WWDC rules in the UK. There should not be two concurrent group regimes as this would increase compliance for groups with little need for the Exchequer.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see via http://www.icaew.com/en/about-icaew/what-we-do/technical-releases/tax).