TAX DEDUCTIBILITY OF CORPORATE INTEREST RESPONSE: CONSULTATION ON DETAILED POLICY DESIGN AND IMPLEMENTATION

ICAEW welcomes the opportunity to comment on the consultation paper/ *Tax deductibility of corporate interest response: consultation on detailed policy design and implementation* published by HM Treasury and HM Revenue & Customs on 19 May 2016.

This response of 4 August 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 should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

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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

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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

OVERARCHING COMMENTS

1. On 14 January 2016 we submitted our response to the earlier consultation Tax deductibility of corporate interest expense which had been published on 22 October 2015.

2. We have repeated our comments in that earlier response to the extent our comments remain of relevance.

3. That earlier consultation was seeking views as to how the government could honour its commitment to introduce the policy measures set out in the conclusions of the OECD BEPS (Base Erosion Profit Shifting) Action Plan, in this case in relation to the appropriate level of deductible interest expense, while at the same time ensuring that "the UK tax system remains competitive so that it continues to play a part in attracting and retaining business investment in the UK".

4. The earlier consultation went on to state:

   "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."

5. Our major concern remains as stated in our earlier response:

   "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."

6. Our concerns about the impact of the changes on the UK positive environment for business have been exacerbated by the vote in the 23 June 2016 Referendum to leave the European Union. The current interest deductibility proposals are anticipated to cost business as much as £1bn per annum which is likely to have a significant impact on business sentiment and intentions. Given the uncertainties now facing business due to our departure from the EU and the real risk of a slow down in the economy, we believe that the introduction of the new rules ought to be delayed for a further 2 years. This should be possible without the UK being viewed as non compliant with its BEPs commitment.

7. In our previous response we recommended that the new provisions should not apply when there was no intent on the part of the business concerned to erode its UK tax base or shift profit outside the UK. We repeat our earlier recommendation:

   "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."

General comments

8. The existing world wide debt cap is to be integrated into the new interest deductibility regime. We do not believe that in the light of the restrictions set out in the present consultation document there remains a case for the continuation of a debt cap rule and we recommend that it should not be introduced. The debt cap has served its purpose of ensuring that excess debt is not deductible in the UK. This is no longer necessary with the introduction of a 30% EBITDA restriction and existing 'unallowable purpose' anti avoidance. Including the debt cap makes the UK look uncompetitive compare to other European countries such as Germany.

9. In relation to the group relief rule we also believe that groups should have the option of a German style escape claim test to help ensure that groups should be able to claim a deduction for all their external debt costs.

10. We believe that it should be possible to allocate interest between group companies without restriction and be allocated to individual companies even if the particular company does not have an interest expense. This would significantly simplify the compliance and is in keeping with the recent simplification of the loss rules to remove the need to trace losses within individual companies.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Does the use of IFRS concepts cause practical difficulties for groups accounting under other accounting frameworks (e.g. UK GAAP or US GAAP)? Could the use of a range of acceptable accounting frameworks to define the group give rise to difficulties in identifying the members of the group? What would be the main consequences of relaxing the definition in this way?

11. We believe that the most practical solution is to permit the group, which should be the same for the Fixed and Group Ratio Rules, to be defined by IFRS or a comparable GAAP used by the group to prepare its accounts

Q2: Is it reasonable to take the proposed approach to the periods for making interest restriction calculations? What changes or alternatives to that approach, if any, should be adopted?

12. We think the suggested approach is a reasonable one.

Q3: Do you agree that these are the right amounts to be included with the scope of taxinterest? Are there any other amounts that should be included within the scope of tax-interest, or any amounts which should be excluded? If so, please explain the reasons why?

13. We agree that it is right to base the definition of tax interest on loan relationship debits and credits.

14. To the extent that amounts payable / receivable under some derivative contracts will affect a company's funding costs and should, therefore, be include in the definition of tax interest. We accept that this is going to add to the complexity of the eventual provisions.

Q4: Do you agree with the proposed treatment of exchange gains and losses? Do you foresee any unintended consequences from this approach? If so, please explain, and suggest an alternative.

15. The right approach is being taken in relation to exchange gains and losses.

Q5: Do you agree with the proposed treatment of impairment losses? Do you foresee any unintended consequences from this approach? If so, please explain, and suggest an alternative.

16. Impairment costs relate to the credit risk of the borrower and are not amounts equivalent to interest so should not be included in tax-interest.

Q6: Do you agree with the proposed treatment of related transactions? Do you foresee any unintended consequences from this approach? If so, please explain, and suggest an alternative.

17. Debits and credits arising from related transactions which are commercially equivalent to interest should be included which will cover premiums on early redemption of loans and break costs which represent "lost" interest and do represent a financé cost or return.

Q7: Are there any other amounts that should be included with the definition of tax EBITDA, or any more items which should be excluded? If so, please explain the reasons why?

18. No other amounts to be included.

Q8: Do you agree with the proposed treatment for tax-depreciation and tax-amortisation?

19. We agree the proposed treatment.

Q9: Do you agree that the proposed treatment of different types of loss relief will be fair and effective while minimising the need to analyse and trace loss amounts? If not, please suggest an alternative, providing an explanation of why you find it preferable.

20. We support the proposal not to add rules requiring negative tax-EBITDA to be carried forward to minimise potential complexity.

Q10: Do you agree with the proposed treatment of chargeable gains and allowable capital losses? If not, please suggest an alternative, providing an explanation of why you find it preferable.

21. We agree.

Question 11: Given the proposed reform of losses, does carrying forward restricted interest to be treated as an interest expense of a later period give companies sufficient flexibility?

22. We agree with the indefinite carry forward of restricted interest.

Q12: Does the 3 year limit on the carry forward of spare capacity provide sufficient flexibility for addressing short term fluctuations in levels of tax-interest and tax-EBITDA?

23. We do not understand the rationale to limit the carry forward of spare capacity to a 3 year period. Further, having to track the age of a credit adds to complexity and, indeed, with the current proposals for calculating credits each year, it is not obvious how this would be done.

Q13: Are there common circumstances where the proposals will substantially fail to deal with problems around timing differences?

24. The timing differences will arise when there is a timing difference between the accounting and tax treatment of certain items and we have concerns that this could cause difficulties particularly if there is a time limit on the carry forward of spare capacity.

Q14: Does the proposed modification of the Debt Cap rule balance the objectives of maintaining effective Exchequer protection in this area, aligning the mechanics with the interest restriction rules and ensuring that the relevant figures are readily available from the group's consolidated financial statements.

25. We are not convinced of the necessity of a "replacement" of the debt cap rule within the context of the new corporate interest expense rule where the basic rules are much more restrictive on the deductibility of interest and there is an anti avoidance provision which should act to prevent abuse of the new rules. No other country has such additional restrictions but rather uses group wide rules purely to expand the level of interest reduction. Therefore, to include this additional restriction would make the UK uncompetitive as well as significantly adding to the complexity of the rules.

Q15: Which of these two approaches do you consider to be the most appropriate way to address the risks arising from very high group ratios or negative group-EBITDA, and why? How should the percentage cap be set under the second approach? Are there other approaches which would better address this situation?

26. We are not convinced that a revised debt cap rule is necessary

Q16: Are there specific cases where the removal of the 'broadly comparable' limb contained in the current Debt Cap regime would give rise to particularly difficult outcomes? If so, please suggest how this extension should be modified to allow the calculation of the group ratio.

27. Again as we are not convinced that a revised debt cap rule is necessary we are not commenting on this question.

Q17: Are there any further items of profit or loss which should be included within the definition of total qualifying group-interest?

28. There could be major items which are not included in total qualifying group interest, for instance some fair value adjustments or mark-to-market of financial assets. If groups were permitted to elect to calculate EBITDA and interest of the group ratio calculation based on UK tax principles that might solve the problem.

Q18: Are there any other amounts that should be included with the definition of adjusted group-interest, or any more items which should be excluded? If so, please explain the reasons why?

29. No.

Q19: Are there any other amounts that should be included with the definition of qualifying group-interest, or any more items which should be excluded? If so, please explain the reasons why?

30. The proposal to disallow interest deductions on related party debt is likely to cause practical difficulties for instance in joint venture arrangements where what is de facto third party debt will be treated as related party debt on which the interest does not count as qualifying.

Q20: Do you agree that the proposed definition of related party will be effective in preventing equity investors inflating the group ratio by investing using debt instruments? Please identify situations where this definition would prevent the Group Ratio Rule from taking into account interest payable to lenders that invest for a fixed return and without seeking influence over the borrower?

31. We believe that the potential definition of acting together needs to be carefully calibrated and the current proposal that it should include “entities …that collaborate in a more general sense” almost certainly goes too far.

Q21: Are there any other amounts that should be included with the definition of group EBITDA, or any more items which should be excluded? If so, please explain the reasons why?

32. We have set out some concerns in our response to question 29 above.

Q22: Bearing in mind the Fixed Ratio Rule permitting net interest deductions of up to 30% of tax-EBITDA, the Group Ratio Rule, the £2 million de minimis amount, rules permitting the carry forward of restricted interest and excess capacity, and the inclusion in tax-interest of income accounted for as finance income, please describe the key features of situations involving the financing of public benefit infrastructure where a specific exclusion will be necessary to prevent interest restrictions arising in cases where there is no BEPS.

33. We think there could be problems for companies operating in the public benefit which are part of multinational groups which are not involved in public benefit operations outside the UK and where as a result the UK leverage is relatively high.

Q23: Are there any situations involving the financing of public benefit infrastructure where interest restrictions could arise in the absence of BEPS despite a PBPE with the above conditions? If so, please provide details and suggest how the proposals could be changed to prevent undue restrictions occurring.

34. See answer to question 24 below.

Q24: Are there any situations where interest restrictions would arise connected with public benefit infrastructure despite the provisions outlined in this document, and where those restrictions could have wider economic consequences? If so, please provide details, including an explanation of why the consequences could not be avoided, such as by restructuring existing financing arrangements. Please suggest how the rules could be adapted to avoid those consequences while still providing an effective counteraction to BEPS involving interest.

35. We believe there is a genuine concern that many public benefit activities will not qualify under the current definition and it would be appropriate to use a more broadly drawn definition with an advance approval arrangement with HMRC.

Qs25 to 33
These questions relate to specific industries and we have not submitted a response

> **Q25: Which of the two proposed approaches would be preferable? Please explain what you see as the advantages and disadvantages of each, and address whether the additional complexity of Option 2 is justified by the potential risks and distortions in Option 1.**
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> **Q: As securitisation structures and transactions are often complex, there may be exceptions to the analysis set out above. Please would you set out any examples of securitisation structures or transactions within the securitisation regime where a net**

interest expense position 65 might arise so that the application of the interest restriction rules could lead to an unintended restriction on the securitisation company?

Q27: Are there any further issues relating to AIFS (including TEFs) or Investment Trust Companies that need to be considered for the purposes of this consultation?

Q28: Are there any other fund structures, not considered in this consultation document, that require special consideration?

Q29: As a result of the proposed exclusion from the group of subsidiaries held at fair value, views are invited as to whether a specific rule is required to prevent collective investment vehicles from being the ultimate parent company of a group.

Q30: How could the rules be adapted so that they protect the property rental and residual profits of REITs from excessive interest deductions just as they do for other property rental groups?

Q31: To what extent are PAIFs likely to be impacted by the proposals in their current form? If applicable, how could the rules be adapted so that they protect the property rental profits of PAIFs from excessive interest deductions just as they do for other property rental groups?

Q32: Please supply any evidence that would help the government understand the full extent of interest-related BEPS risks connected with banking and insurances activities, and suggest any modifications that could be made to the Fixed Ratio Rule and the Group Ratio Rule to ensure that they operate effectively, but without giving rise to unwarranted restrictions, in respect of groups performing these activities.

Q33: How could a targeted rule be designed to ensure that net financing costs deducted in the UK are commensurate with the UK business?

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Q34: Do you agree with the proposed treatment of Patent Box deductions, R&D tax relief, RDEC and land remediation relief? If not, please suggest an alternative and explain why you find it preferable

36. We do not believe it is appropriate to completely exclude patent box income from tax-EBITDA but just a proportion to reflect its rate of tax compared with the full rate so at current rates of 10 and 20% half the income allocated to the patent box would be included in tax-EDITDA.

Q35: How should amounts of interest restriction or spare capacity be allocated between activities subject to the Northern Ireland rate of corporation tax and other activities?

37. There needs to be a simple mechanism to achieve this, perhaps by reference to tax-EBITDA in Northern Ireland and in other jurisdictions.

Q36: Does this approach adequately address the situation where charities hold subsidiaries to undertake trading activities? If not, how could the rules be adapted to better address this situation?

38. No comment.

Q37: Does this approach adequately address the situation of interest distributions made by Registered Societies? If not, how could the rules be adapted to better address this situation?

39. No comment.

Q38: Do you agree with the proposed treatment of CFCs? If not, please explain the reasons and suggest an alternative approach?

40. The CFC regime was reformed in 2013 following extensive consultation and was designed to make the UK CFC regime more competitive for multinational companies. We believe that CFC apportionments ought to be included in the new definitions. It would be penal to tax foreign profits as if they arise in the UK but not to allow those profits to then be included within the fixed ratio. We do not believe the intention of the 2013 reform was to introduce a penal regime to tax companies in a more detrimental way than if they held the income onshore. Indeed, this seems contrary to the CFC finance company regime introduced at that time.

Q39: Do you agree that the proposed treatment of income subject to double taxation relief will be fair and effective? If not, please suggest an alternative, providing an explanation of why you find it preferable.

41. We do not believe that any adjustment should be made for double taxation relief in the calculation of a disallowance under the new rules.

Q40: Do you agree with the proposed treatment of derivative contracts for calculating tax-interest? Do you foresee any unintended with this approach? If so, please explain, and suggest an alternative.

42. We can see the merit of including derivatives in the new regime to the extent they hedge underlying items which are part of the financing costs of the business. We are concerned about the level of complexity that this will introduce and also because fair value accounting for derivatives could lead to substantial mismatches which could result in a disallowance of significant amounts of interest.

Q41: Do you agree with the proposed treatment of derivative contracts for calculating tax-EBITDA? Do you foresee any unintended consequences from this approach? If so, please explain, and suggest an alternative.

43. See our response to questions 40 and 42.

Q42: Do you agree with the proposed treatment of fair value movements on hedging relationships? Would this cause particular difficulties for groups, that would warrant particular rules to replace the fair value movements on hedging relationships with amounts recognised on an appropriate accruals basis (for example, in line with regulations 7, 8 and 9 of the Disregard Regulations S.I. 2004 / 3256)?

44. There could be problems at the time of introduction of the new regime for “losses” which have been recognised for accounting purposes under fair value accounting and which would subsequently have been recognised for tax purposes under the Disregard Regulations. This will not now happen under the new regime. A second problem could result from the volatility of on-going fair value movements on derivatives which could result in “losses” being permanently disallowed as a result of the 3 year cap.

Q43: Does this approach adequately address the position for both the lessor and lessee across the range of different leasing arrangements? If not, how could the rules be adapted to better address these situations?

45. The treatment of leases needs further consideration and consultation to ensure that it reflects the amended accounting treatment that will apply from 2019 when IFRS 16 comes into effect. IN the meantime lessors of operating leases are likely to be adversely impacted compared with finance leases lessors.

Q44: Does this approach adequately address the position for investments in non-group entities? If not, how could the rules be adapted to better address these situations?

46. The approach appears to be reasonable.

Q45: Does this approach adequately address the situation where public bodies hold subsidiaries to undertake trading activities? If not, how could the rules be adapted to better address this situation?

47. No comment.

Q46: Does the phasing in of the rules as outlined above create any particular difficulties for businesses?

48. Companies face increasing uncertainty to which the result of the June 2016 Referendum result has contributed. We think that, at the very least, these new interest deductibility rules should not apply earlier than for accounting periods beginning on or after 31 March 2018 to simplify the transition and tie in to the timing for us exiting the Europe Union when more will be known about the impact on the UK economy.

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).