ICAS response to the HM Treasury consultation

‘Tax deductibility of corporate interest expense’

14 January 2016

About ICAS

The following submission has been prepared by the ICAS Tax Committee. This Committee, with its five technical sub-Committees, is responsible for putting forward the views of the ICAS tax community, which consists of Chartered Accountants and ICAS Tax Professionals working across the UK and beyond, and it does this with the active input and support of over 60 committee members. The Institute of Chartered Accountants of Scotland ('ICAS') is the world's oldest professional body of accountants and we represent over 20,000 members working across the UK and internationally. Our members work in all fields – predominantly across the private and not for profit sectors.

General Comments

ICAS welcomes the opportunity to comment on the HM Treasury consultation 'Tax deductibility of corporate interest expense'.

We believe that the proposals in the consultation are a good starting point. However we are concerned that the proposed implementation date of 1 April 2017 is too soon to allow for appropriate consultation and to give companies the chance to review and adjust existing long term arrangements.

The government states in the foreword to the consultation that the government has continued with its strategy to deliver the most competitive corporate tax system in the G20 with the aim of encouraging greater investment and to enable UK based companies to compete successfully in global markets. A longer pre-implementation consultation period will ensure that appropriate consideration can be given to ensuring that UK companies are not left at a competitive disadvantage. It would allow for account to be taken of the approach in other jurisdictions.

It might also be helpful to consider whether there could be some flexibility on interest deductions for acquisitions overseas, to assist UK companies expanding in the global market. In such acquisitions it may be difficult or impossible to push debt down, for example on acquisitions in China or Brazil. Flexibility in the UK rules would therefore be useful.

Specific questions

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

As noted in our general comments we believe that the proposed implementation date of 1 April 2017 is too ambitious given that the process is only at the consultation stage and that the OECD continues to work on several aspects of Action 4, for example the group ratio rule, the application to banks and insurance companies and the transfer pricing of debt. This work will continue during 2016 and we assume that HMRC will wish to take it into account when formulating the UK rules. 1 April 2017 would be a challenging deadline because it would require the legislation to be included in Finance Bill 2016.

The introduction of a general interest restriction represents a major change to the taxation of corporate debt in the UK. It is important that such a major change for the UK should not be rushed and that time should be taken to assess the approach of other jurisdictions to ensure that UK companies are not left at a competitive disadvantage.

We consider that 1 April 2018 is the earliest possible date by which it would be feasible for the new rules to be introduced, with the inclusion of the legislation in Finance Bill 2017. It would however also be helpful if companies did not have to deal with split years so implementation should be for accounting periods beginning on or after a given date. As December is the most common year end a start date of 1 January would be a better option than 1 April. The earliest commencement date would therefore be accounting periods beginning on or after 1 January 2019.

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

If there is a suitable de minimis threshold, which will remove most domestic groups, we believe that the simplest approach would be to apply the restriction to all companies. This will avoid the necessity for complex definitions.

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

The proposed definition looks sensible. We agree that capitalised interest should be included in the definition as suggested. Adjustments relevant to specific sectors will need to be discussed with those sectors, for example, the treatment of embedded interest in reinsurance.

The definition of finance costs should explicitly be based on tax deductible finance costs less taxable finance income, so that the existence of non-deductible funding costs does not reduce capacity. This would mean that amounts disallowed under thin capitalisation rules would be excluded, as would amounts disallowed as a result of other anti-avoidance provisions (eg unallowable purpose, arbitrage / hybrid mismatches, loan relationships/derivative contracts regime TAAR etc). Amounts treated as non-deductible for any other reason should also be excluded. Examples include amounts treated as distributions (e.g. returns on profit participating loans, preference dividends and similar, and non-commercial interest. Also the rules should apply only to finance costs accrued in the current period; amounts accrued in prior periods but deductible in the current period (eg due to the late paid interest or discounted bonds rules) should be excluded.

The consultation document does not mention the position where a company lends via a CFC. If the company had lent from the UK, rather than the CFC, and received interest, the interest would form part of the net interest calculation. We therefore suggest that where a company lends via a CFC and suffers an apportionment, the interest should also be included to the extent that it is taxed in the UK.

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

We suggest that the treatment of foreign exchange gains and losses should depend on how they arise. Where they arise on interest and other financing costs they should be included. However foreign exchange gains and losses on principal amounts should not be viewed as contributing towards a group's finance costs and should be excluded together with exchange gains and losses on working capital.

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

We believe that the rules should operate at the UK sub-group level. The allocation of any restriction should then be a choice for the group to make – as is the case with the worldwide debt cap regime. Groups should be allowed as much flexibility as possible in making their allocation.

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?

As noted in our response to question 4 we suggest that the treatment of foreign exchange gains and losses should depend on how they arise.

We do not think that tax exempt income (eg dividends) should necessarily be excluded from the definition of Tax EBITDA. A third party lender would take account of all cash flows when determining the borrowing capacity of a borrower as any cash income can be used to service interest payments. The tax treatment of specific categories of income is a policy matter for the UK government.

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?

We consider that the percentage should be set at 30%. It is important that the rate is sustainable in the medium term because stability and certainty are essential for companies. As noted in our general comments we believe that time needs to be taken to get the legislation right. This would include striking the correct balance between the rate and the optional rules below to ensure that the UK remains a competitive jurisdiction for all companies.

We believe there are a number of factors which support a 30% ratio for the UK:

- The UK has a range of strong targeted anti-avoidance rules around interest deductibility which reduce the possibility of base erosion strategies succeeding under UK tax rules.
- It is important to minimise any disallowance of third party debt costs, which would have economic consequences going beyond the BEPS project and could distort capital markets.
- Ratios can be affected by regulatory restrictions, currency of the debt, the stage in a borrower's lifecycle and a variety of other factors.
- The UK is currently in a period of unprecedentedly low interest rates and levels of borrowing. Any fixed ratio set now should also be appropriate in an economic environment with higher interest rates and/or higher levels of borrowing.
- A 30% ratio would be consistent with limits set by other competitor jurisdictions such as Germany, Italy, Spain and Portugal. France has a ratio of 25% but this only applies to related party lending. It would be inappropriate for the UK to set its ratio at a level which puts it at a competitive disadvantage.

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?

The group ratio rule is likely to be complex and difficult for many groups to apply – the OECD is still working on areas of difficulty. For some companies it may therefore be of less importance than a 30% rate and the carry-back/carry-forward options.

However whilst we accept that a group ratio rule will add complexity we believe that it should be included to reduce the risk that groups will suffer a disallowance of third party finance costs, which could distort commercial behaviour. We believe that the complexity will be manageable because the group ratio rule would be optional so companies could choose whether to use it. If the complexity of the calculations is not justified by the additional deductions which could be claimed a group would not choose to use the rule. Many companies would also be used to complexity as a result of dealing with the worldwide debt cap regime – the operation is different but many of the issues are the same.

The importance of the group ratio option might be reduced for some companies if the proposed public benefit project exclusion was made less restrictive than is currently proposed.

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?

As noted in our response to Question 2 the de minimis threshold should be set at a level which will remove most domestic groups from the scope of the new rules and should be as simple as possible. The consultation document suggests that both these objectives could be achieved by setting the threshold at £1 million of net interest expense. We suggest that consideration should be given to allowing periodic reviews of the threshold or some form of indexed increase to take account of changes in interest rates and erosion of the threshold over time.

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

See our response to question 9 above.

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?

This should only be considered as an addition to a de minimis threshold not as an alternative. As discussed in our response to question 9, if the de minimis is set at an appropriate level, a further exemption for SMEs should not be necessary.

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

Carry back and carry forward of disallowed interest expense and carry forward of unused capacity will be essential for dealing with volatility. We suggest that any rules introduced should be in line with existing rules in the UK for the carry forward of losses and as such there should be no time limit to restrict carry forward. Any carried forward interest expense should be treated as a new deduction in each year and added to the finance costs of the next succeeding year. A restriction would be disadvantageous to large capital projects. Time limits would also lead to complexity in tracking tax capacity and complications in deferred tax accounting.

We are also concerned that the introduction of time limits for carry forward of unused capacity could cause problems for certain sectors. For example the life insurance industry operates on long term timescales (the profits on a pension policy written today are projected for up to 40 years) so the introduction of an arbitrary time limit on using interest deduction capacity would cause distortion. A TAAR would be a preferable mechanism for dealing with tax driven business combinations intended to utilise unused capacity; it would be helpful to model this, as far as possible, on the conditions used for other carried forward reliefs.

We suggest allowing corresponding interest income related to disallowed interest expense to be exempted from tax to address the issue of mismatches. Without such a provision a risk of double taxation arises.

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

The PBPE as currently proposed is very narrow. It would largely be restricted to PFI and PPP arrangements. However current UK policy on infrastructure does not envisage that the delivery model for most major projects will be PFI/PPP. We suggest that HMRC should consider whether the exclusion could be extended so that more public interest projects located entirely within the UK would be able to use it. As noted in our response to Question 8 above a less restrictive PBPE could reduce the importance of the Group Ratio because more companies could use the PBPE. We also suggest that any PBPE should include a clearance mechanism to provide certainty for companies investing in public benefit projects.

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

See our response to Question 13 above.

As currently proposed the exclusion would only apply to third party debt. Many large infrastructure projects are carried out by joint ventures with foreign investors. In many cases borrowing would be carried out by the parent and lent into the UK group. Unless the proposals are amended this will make the exclusion unworkable for many groups.

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

The UK already has extensive rules targeting risks in this area. We do not see the necessity for any additional targeted rules which would add further layers of complexity. As noted in our response to Question 18 we would like to see all the existing rules reviewed with a view to removing any which would no longer be necessary once the new regime is introduced.

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

We understand that HMRC are having discussions with these sectors. In addition, we understand that further work is to be conducted by the OECD on the banking and insurance sectors, to identify best practice rules to deal with potential base erosion and profit shifting risks which take into account the particular features of these sectors. This work is due to be completed in 2016. We therefore do not consider it appropriate to comment at this stage but would be happy to do so when proposals are put forward. In terms of the general approach we consider that any proposals need to take account of the approach adopted by other major financial centres, such as the US and Germany, to avoid damaging the UK's position.

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?

Many companies will have raised long term third party debt. Ideally indefinite grandfathering should apply to such debt because refinancing is not simple. Companies will have to look closely at their arrangements and this could lead, in some cases, to a reconsideration of their presence in the UK.

If grandfathering is only likely to be available in exceptional circumstances, one possibility would be to allow indefinite grandfathering for certain (limited) types of debt. For all other existing debt there would be a transitional period of between three and five years to allow companies to carry out re-financing and to amend forecasts. The precise length of the transitional period required would depend on the time between announcement of the details of the new regime and the implementation date.

The break costs of any refinancing driven by the tax changes should be deductible in full.

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

It would be helpful to review all the existing restrictions and targeted rules covering interest and to remove as many of the existing rules as possible to reduce complexity rather than solely adding another layer. In particular we believe that it should be possible to remove the worldwide debt cap WWDC) regime once the new rules are in place.

Alternatively rather than repealing the WWDC rules it might be possible to use them as the basis for the group ratio rule. Many of the complexities associated with such a rule have already been considered in applying the WWDC. The operative provisions of the WWDC rules (disallowances and exemptions) could be repealed as the fixed ratio and group ratio would apply an alternative restriction on deductible finance costs.