The Association of Corporate Treasurers

Comments in response to:

Tax Deductibility of Corporate Interest Expense: consultation on detailed policy design and implementation.

A consultation paper issued May 2016 by HM Treasury and HM Revenue & Customs for responses by 4 August 2016.

The Association of Corporate Treasurers (ACT)

The ACT is a professional body for those working in corporate treasury, risk and corporate finance. It is established by Royal Charter in the public interest. Further information is provided at the back of these comments and on our website www.treasurers.org.

Contact details and a link to our approach regarding policy submissions can also be found at the back of these comments.

We canvas the opinion of our members through our monthly e-newsletter to members and others, *The Treasurer magazine*, topic-specific working groups and our Policy and Technical Committee.

General

The ACT welcomes the opportunity to comment on this matter.

The ACT appreciates the need for government to respond to globalisation by implementing the current Base Erosion and Profit Shifting initiative of the OECD, popularly known as BEPS.

While applauding this initiative we are surprised that the UK "**government is leading the way in implementing the G20 and OECD recommendations to ensure that profits are taxed in line with activities in the UK**." (clause 1.2) at the point of time it approached the UK population to vote on Brexit and now foresees BEPS implementation as soon as August 2017.

Poorly Targeted

BEPS is a poorly targeted tool, intended to affect global multi nationals but in fact affecting purely domestic businesses which have a history of using debt capital to achieve growth and government objectives for development of UK infrastructure.

Uncertainty due to Unfinished EU Regulation and Brexit

Coming at a point of time when not only does the UK need to understand and digest the impact of leaving the European Union, but is also digesting the impact on the cost and availability of financial services on full implementation of the Basel III rules and the current EU legislation to implement finalisation of certain G20 initiatives including derivative collateralisation by non-financial businesses.

In addition, Brexit opens the exposure to businesses, whether multi-national in nature or UK based businesses with overseas operations, being discouraged from further UK investment. Changes to tax regimes will complicate decision processes. Added complexity to the process for agreeing tax computations, and uncertainty around implementation will at best make investment decisions more difficult and at worse cause businesses to consider fundamental questions of domicile.

Recognised Need for Infrastructure Investment in the UK

In particular we draw your attention to the redevelopment of infrastructure in recent decades and the substantial investment now regarded as desirable in rail, energy, and housing stocks. The former is often undertaken by government regulated utilities where regulators have pressed for increased borrowing to enable low post tax cost of capital to keep tariffs low, and in housing by UK businesses which would require substantial short to medium term financing best raised as repayable debt.

International Competitiveness Suffers

Also we do not believe there is purpose to being an "early adopter" of an OECD initiative which remains under development, and before understanding how trading partners intend to implement the initiative.

Corporate and Financial Services UK is already suffering due to the lack of the expected "level playing field" of G20. The burden of dual sided EMIR reporting against single sided in the USA as an example.

The following table sets out our answers to the specific questions set out in Annex A of the consultation paper.

We have answered on behalf of the corporate treasurer community which we represent. We have not answered questions explicitly dealing with tax and accounting unless they are on a topic with an explicit corporate finance outcome.

The responses below are based on real economy corporate treasury activities in the UK and we have included Examples and discussion based on members' responses which we cannot quote on a named basis for reasons of restrictions on public disclosure of price sensitive information. We would appreciate the opportunity to discuss these directly with HM Treasury in order to better illustrate the problems which we believe the implementation of BEPS would create if in the form of the consultation paper.

Question Number	Response
1	No response
2	The restriction to carry back capacity appears contradictory. Many industries operate in cyclical sectors such as housebuilding. The year by year approach and limited carry back could constrain new development and investment during an upturn when increased debt funding is required for mobilisation and development pending sales.
3	**Related Party Loans:** Interest should include loans from Related Parties where the total interest is within the 30% cap, as modified by Group Relief rules, or the PBP exemption applies. Related Parties loans are typically shareholder loans, subordinated to third party loans, and which can provide a valuable means of putting into effect returns on investment where cash flow is generated more quickly than accounting reserves and assist in encouraging investment in single asset projects with low residual values. Example: UK infrastructure operator with sister companies which provide corporate debt, in particular for mobilisation capital for projects which may be capable of being quickly repaid of the project is successful, or repaid more slowly if the project is less successful as planned, and offering more flexibility than a bank of bond issue but giving the debt investor the added security of a debt ranking. The effect of the disallowance of Related Party debt would be to increase the price of capital and to reduce the appetite for investment. An advantage to the debt investor in this example is that debt repaid early makes funds available for re-investment in other projects. **Financing Expense and Income Definition:** We understand the definition of financing expense and income to include movements in Mark-to-Market (MTM) value of derivatives which are not the subject of hedge accounting. This would take effect from implementation of the BEPS regulation from 1 April 2017. As drafted this would deny companies relief for amounts already accounted for pre 1 April 2017 MTM and cause volatility in the Tax-Interest/Tax-EBITDA calculation going forward where companies have fair value items in their

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	accounts. This distortion may not be resolved through the carry-forward provisions as unutilised losses will expire after only three years during which time it is entirely possible no headroom for their use will be available. Some companies will have derivatives pre dating the GFC and with many years life remaining. This distortion will create further uncertainty at a time of economic uncertainty, and during a period when companies are managing a dramatic fall in market rates, and perhaps a subsequent rise. This uncertainty will not assist companies to adopt a forward looking approach to the post Brexit economic environment. We call for this distortion to be removed in the final drafting.
4	No response
5	No response
6	No response
7	No response
8	No response
9	No response
10	No response
11	We foresee a problem in an economy which has identified the need for substantial investment in energy, housing, and transport infrastructure as well as in environmental expenditure to manage the UK's increasing population. This surge, and probably short lived increase in expenditure is best managed by repayable debt. The PBP exemption definition has changed since the first consultation but does not ensure that all these types of investment activity would benefit from the exemption. Both actual failure to achieve the exemption, and uncertainty as to whether it would be applied will affect the appetite of entrepreneurs to commit resource to these socially essential investments.
12	Clauses 5.21 and 5.22 will pick up the payments and receipts under derivatives as part of the numerator of the cap calculation. It does not differentiate between interest and forex for a basis swap. Clause 9.11 brings back Mark-To-Market movements, except for those movements arising from foreign exchange gains and losses, into the EBITDA number whether or not the accounting standard used would bring

Question Number	Response
	them into the accounting EBITDA. The risk for a corporate is that its Tax-EBITDA becomes volatile due to movements in market interest rates, while its Tax-Interest remains consistent from year to year. While this is a two way risk, the risk is that market rate increases cause Tax-EBITDA to fall while Tax-Interest remains constant, There is only recovery if rates are rising and falling in a consistent three yearly cycle. This is also a “point of time” observation. Worldwide rates are expected to rise from the current extraordinarily low point, but UK rates may become more volatile than world-wide due to the uncertainties of Brexit. UK corporates may during the next few years suffer an increased tax burden relative to their competitors while they are digesting the impact of unknown results of trade negotiations.
13	We foresee a problem in an economy which has identified the need for substantial investment in energy, housing, and transport infrastructure as well as in environmental expenditure to manage the UK’s increasing population. This surge, and probably short lived increase in expenditure is best managed by repayable debt. The PBP exemption definition has changed since the first consultation but does not ensure that all these types of investment activity would benefit from the exemption. Both actual failure to achieve the exemption, and uncertainty as to whether it would be applied will affect the appetite of entrepreneurs to commit resource to these socially essential investments.
14	No response
15	Option 2 better addresses cyclical industries and may provide some protection against volatile interest rates where a disallowance may have been made in prior periods due only to high rates. We note that the 30% limit does not recognise the historic volatility of UK interest rates, and is being imposed after the implementation of EMIR and CRD4 which make the management of interest rate risk more expensive for non-financial businesses and are likely to lead to more volatile debt rates and higher credit margins in the corporate sector.
16	No response
17	**Related Party Loans:** Interest should include loans from Related Parties where the total interest is within the 30% cap, as modified by Group Relief rules, or the PBP exemption applies. Related Parties loans are typically shareholder loans, subordinated to third party loans, and which can provide a valuable means of putting into effect returns on investment where cash flow is generated more quickly than accounting reserves and assist in encouraging investment in single asset projects with low residual values.

Question Number	Response
	Clarity is required on Related Party loans which are often used in joint venture investments in the infrastructure and property development.
18	No response
19	No response
20	We recognise circumstances where Related Parties fund with debt for sound economic reasons: typically to bring together businesses with differing skills required for one project as used in some PFI projects; or to share a substantial risk across similar businesses as used in the extractive industries. The concern for taxing authorities should be the appropriateness of the capital structure to the project, and the terms of the loan agreement relative to market terms. For example: the long term equity in a single asset project would be low to reflect the low residual asset value at the end of the asset's life.
21	No response
22	The definition of a PBP project is by reference to licence or regulation. Many forms of infrastructure investment are carried out by UK companies regulated by statute by the form of a licence issued by a regulating authority as a result of privatisations and PFI/PPP initiatives. These companies are often members of groups of companies some of which do not carry out licence and regulated activities. We are surprised that explicit reference is not made to those Acts under which infrastructure investment is regulated and licences issued thereby offering clarity as to the entity which has the PBP exclusion given that these Acts were passed explicitly to define the boundaries of the regulated infrastructure, even where it is part of accompany performing unregulated activities. Despite this, we understand that there remains some debate as to the assets which comprise the PBP infrastructure. We also believe that the PBP definition needs to enable the addition of specific projects and capital intensive industries which contribute to UK infrastructure and which have public benefit but may not be clearly defined by reference Acts of Parliament and regulations where a licence is issued. **Example**: there is political will to stimulate residential building in the UK to alleviate the shortfall of affordable housing which, if adopted by the private sector, would require substantial medium term financing. Large residential developments can easily exceed the three year cycle and anyway deferral of the interest rate deduction can reasonably be expected to either or both inflate house prices and discourage investment in large building projects due to the potential for housing sales to fall, and this latter concern exacerbated by the economic uncertainty raised by the Brexit vote. **Example**: Distribution hubs are vital to the movement of goods and materials in and out of the UK. Decision as to whether to invest in long term assets will affect long term corporation tax, income tax and VAT revenues of

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	government. The sudden shift in the UK capital model required by BEPS are likely to make long term capital investment less attractive due to its long tail returns which will become longer as the tax value of the interest deduction is diminished or deferred We believe it is essential that the BEPS UK legislation enables Budget initiatives to extend the PBP exemption to non-licenced and non-regulated activities as decided from time to time by government, and whether by single companies, group, or joint venture. The financing of the governments foreseen and material residential real estate development is an example of the type of public interest benefit project which would fall outside of the exemption of licenced and regulated activities. We are also concerned that some long term capital intensive activities
23	In answer to the bullet points in clause 7.8: • Loans from Related parties should not be treated differently to loans from other sources provided at market terms and reflecting the business plan of the investment • Agreed • The cash management exception should be by reference to cash management and not to a specific form of short term investment. We note that the combined effect of EBA guidelines and CRD4 make bank deposits a decreasingly valuable from of cash management. • Agreed • Given “project” is not a defined term, the gearing of a PBP need have no relationship to other projects of a group which may have full commercial exposure and be less able to attract debt funding available generally in the UK to projects in the nature of PBPs, and do not have the tariff control driver typically associated with public benefit investment.
24	Projects of a PBP nature are often long term, and make use of both bank and bond long term debt markets. The long tail repayment terms of these markets has proved valuable in stimulating investment in UK infrastructure both in single asset projects (hospitals, prisons, power stations) and , multi asset open ended utilities (electricity and gas networks, water networks, transport networks, and telecommunication networks). These terms also enable an orderly management of tariffs, whether payable by public or government agency. Failure to grandfather all such projects would lead to the requirement to seek emergency uplift of tariffs or would increase debt funding pending a reset of the tariff. Refinancing is not an option. Restructuring debt would require cash payment of break costs which at best reflect the net present value of future interest payments and at worse involves sunk non interest costs which must be paid

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	again on new funding, both Arranging Fees and legal and rating fees. For example, the England and Welsh water utilities would be approximately half way through its current five year tariff agreement set by Ofwat at implementation of BEPS. Their continued access to low cost debt finance could be adversely affected by the effect on their cash flows of the loss of part of their interest deduction if grandfathering does not apply. They would have no certainty that cash break costs on restructuring during one tariff period would form part of the next tariff review. Such value loss would lead to the requirement for a higher return of capital and therefore higher real tariffs.
25	No response
26	No response
27	No response
28	No response
29	No response
30	No response
31	No response
32	No response
33	No response
34	No response
35	No response
36	No response
37	No response
38	No response
39	The proposed treatment appears counter to the spirit of double taxation treaties which is to ensure the net taxable income of an entity is not taxed twice and that additional local taxation does not lead to a tax rate in excess of the local rate. The adjustment to Tax-EBITDA is an unnecessary step and yet a further discouragement for exporting businesses to domicile their trade in the UK.
40	We are surprised that the use of derivatives remains a matter of suspicion amongst regulators given the degree of transparency available throughout the EU since the implementation of EMIR. Also, businesses make material

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	disclosures of their use of derivatives in their audited accounts which are available to HMRC when assessing computations. The question for regulators is to ask if the derivative has a matching loan activity, or a commercial activity: for example; floating rate debt with a fixed rate swap; or forward foreign exchange to reflect the businesses sales and purchase from overseas. The treatment of the cash flows, interest or sale and purchase price, follows from the underlying transactions. Interest on debt is therefore the net of the interest paid on the debt and the net payments on allied derivatives which modify the interest profile of the debt, or the currency of the debt. Example 9.E only offends if there is no market exchange rate relationship between $2,000 and £100. This however would not be a hedging transaction which would be apparent from EMIR transaction reporting, and for the HMRC the audited accounts which form the basis of their computation. Example 9.G is properly disaggregated into an interest rate swap and a forward sale of a property. Pricing of the interest rate swap being capable of being priced against the market of the date of commencement of the swap.
41	Agreed: the example in 9.H is properly treated as an adjustment to the commodity price and forms part of Tax-EBITDA. We question: Clause 5.21 and 5.22 will pick up the payments and receipts under derivatives as part of the numerator of the cap calculation. It does not differentiate between interest and forex for a basis swap. Clause 9.11 brings back Mark-To-Market movements, except for those movements arising from foreign exchange gains and losses, into the EBITDA number whether or not the accounting standard used would bring them into the accounting EBITDA. The risk for a corporate is that its Tax-EBITDA becomes volatile due to movements in market interest rates, while its Tax-Interest remains consistent form year to year. While this is a two way risk, the risk is that market rate increases cause Tax-EBITDA to fall while Tax-Interest remains constant, There is only recovery if rates are rising and falling in a consistent three yearly cycle. This is also a “point of time” observation. Worldwide rates are expected to rise from the current extraordinarily low point, but UK rates may become more volatile than world-wide due to the uncertainties of Brexit. UK corporates may during the next few years suffer an increased tax burden relative to their competitors while they are digesting the impact of unknown results of trade negotiations.
42	No response

Question Number	Response
43	No response
44	No response
45	No response
46	No response

The Association of Corporate Treasurers

The Association of Corporate Treasurers (ACT) is the leading professional body for international treasury, operating in the public interest under Royal Charter. We provide the widest scope of benchmark qualifications for those working in treasury, risk and corporate finance. Membership is by examination. We define standards, promote best practice and support continuing professional development. We are the professional voice of corporate treasury, representing our members.

At June 2016 our 4,700 members work widely in companies of all sizes through industry, commerce and professional service firms, and 77% worked in the UK. We have 2,400 active students. Members and students are employed in 87% of the FTSE100 companies.

For further information visit www.treasurers.org

Guidelines about our approach to policy and technical matters are available at http://www.treasurers.org/technical/manifesto.

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