The Association of Corporate Treasurers

Comments in response to

Tax deductibility of corporate interest expense: consultation Published by Her Majesty's Treasury,
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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 expert forums, seminars and conferences, 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.

Preamble

Debt leverage is an integral part of the capitalisation of UK businesses and has enabled the development of the UK economy. In particular, it is important for asset intensive businesses. It has, for example enabled infrastructure funding through Public Finance Initiative/Public Private Partnership (PFI/PPP) projects sponsored by government, and other infrastructure investment made by regulated utilities.

Debt funding in the UK is a flexible means of capitalisation which enables entrepreneurs to choose between short and long term repayable finance, and between private and bank borrowing, and publicly traded debt issues. At times of high interest rates or high tax rates or both, it is important for very many firms. This flexibility also benefits institutional lenders and self-invested pensions for individuals, who are able to use debt to match the cash flows arising from insurance and pension obligations/ expectations more efficiently than is possible with equity investments with their relative cash flow uncertainty.

The OECD BEPS initiative is welcomed both in its intent and its broad international acceptance as a move towards limiting tax treaty arbitrage and the creation of a commercial international "level playing field". However, such initiatives should not be allowed to damage genuine commercial activity.

The proposal in the consultation paper of 22 October 2015 is made against the background of reducing the UK corporate tax rate to 20% and with the intent to further reduce it 18% in 2020 and favours the implementation of a cap on the deductibility of interest against profits

We appreciate that such a deductibility cap may be the simplest means of discouraging excessive borrowing within the UK by multinational businesses. Furthermore, the introduction of such a cap would be consistent with a number of OECD member state tax regimes already in existence and thereby may reduce legal objection to its imposition.

It may however be very damaging to the UK economy and the ACT caution against over-reliance on profit based measures such as the interest cap.

For the reasons set out below, such profit based measures are exposed to unintended consequences particularly:

- in growing companies or companies with long investment cycles or
- as a result of movements in either benchmark interest rates and/or credit margins.

Focus on gearing may reduce exposure to such consequences (and capture alternate funding structures such as those achieved under Islamic financing). However, the risk of an adverse cash flow effect of, for example, a gearing cap, remains where investment cycles require temporary periods of raised debt funding.

The UK introduction of measures to support the OECD's BEPS initiative, should be undertaken in a manner that supports business as much as possible and should include all the ancillary measures proposed by the OECD to remove unfairness and limit unintended consequences.

The eighteen questions set out in the consultation paper are answered in Section G. below.

Concerns over the Imposition of a Cap on Interest Deductibility

In summary, we believe the introduction of the proposed cap on interest deductibility from UK profits could work against UK investment in asset intensive and long-cycle projects in the UK.

A. Economic Cyclicality

An interest deductibility cap would expose businesses to reduced cash flows at times of macroeconomic volatility.

Notwithstanding that individual businesses may be able to comply with the proposed cap at inception, the UK economy is in a period of growth but remains extremely fragile and interest rates are at historically low levels but rises are increasingly anticipated.

An interest deductibility cap exposes businesses to the loss of the cash flow benefit of an interest deduction in the event that:

- interest rates rise materially and this rise is reflected in costs of refinancing although trading profits remain constant; and/or
- one-off events lead to a dip in profits in a single year;
- the UK's cyclical economy suffers a downturn and profits are reduced (in which case the cash flow effect of reduced deductibility of interest would be suffered at the worst point of time in the economic cycle).

At any point in the business cycle the profits of any individual business will be volatile due to individual circumstances, accounting policies and other factors, so it is important to include the OECD's measures to protect businesses against profit volatility by allowing carry back and carry forward of disallowed interest for use in past or future periods when profits are higher.

B. Debt Reduction Through Effect on Loan Agreement Covenants

A deductibility cap would require greater headroom in debt cash flow covenants to manage fluctuations in profits and interest rates. This may result in lower borrowing levels with an adverse impact on growth.

Loan agreements contain a range of terms and conditions which include financial covenants.

A commonly used covenant calculates interest cover as the ratio of accounting EBITDA to Net Finance Charges. The interest cover ratio will have been set on the understanding and expectation that the tax treatment of the trading and financing cash flows is symmetrical and therefore should not be impacted by a deductibility cap.

However, a cash flow cover covenant ratio is usually defined as EBITDA adjusted for non-cash items, compared to debt service obligations. The application of the deductibility cap would affect a cash flow cover covenant as any additional tax payable would operate to reduce the "cash flow" side of the ratio, but the debt service side of the ratio (comprising principal and interest payments during the period) would remain unchanged.

Implementation of the proposed cap during the life of existing loans may lead to loss of part of the cash flow benefit of the interest tax deduction and may increase risk of default by borrowers

unless re-negotiated; although as a real cash flow impact there is no rationale for lenders agreeing to any change.

Similarly such loss of cash flow may impact on the credit ratings issued by the credit rating agencies and hence restrict access to markets for borrowers.

Businesses can only react to more restrictive covenants by reducing investment or restricting dividends to shareholders, themselves reliant on dividends for private shareholder income.

C. Groups of Companies and the Worldwide Debt Cap

Large businesses with overseas investments already carry the compliance cost and potential limit on interest deductibility of the Worldwide Debt Cap.

The UK implemented a form of debt cap in 2009 under which UK companies which are part of international groups must ensure that debt is not excessively borrowed within the UK. In essence the interest deduction from taxable profits is limited to the interest cost of the worldwide group of which the UK companies are members.

It is unclear from the 22 October consultation whether the proposed cap on interest deduction is complementary to or is intended to replace the Worldwide Debt Cap.

Corporate treasuries work with their tax colleagues to monitor and prepare data for the Worldwide Debt Cap. This can be onerous and risks that decisions about borrowing be "wagged by the tax tail". This resource intensive workload would be exacerbated by the two forms of debt cap inter-relating.

We recommend the two regimes be considered mutually exclusive and that the Worldwide Debt Cap regime be removed if the interest cap is to be implemented.

D. UK Businesses

The consultation discusses a general cap on interest deductibility. Many UK businesses operate as single companies or in groups of companies solely within the UK and are not involved in cross border tax arbitrage which initiatives under the aegis of BEPS seek to stop.

As a topical example, most UK house builders/developers are UK domiciled with no overseas operations. Therefore the issue that the proposal seeks to address is not relevant for most of the house builders/developers as they do not tend to 'arbitrage' interest deductibility through different tax regimes/jurisdictions. Typically the tax returns for UK house builders/developers reflect, after UK group reliefs, a tax deduction from third party financing costs and they tend to be in the 'low risk' category with HMRC.

We are concerned that in a climate where the Government wants to encourage and increase housing output, the proposed measure could have the opposite effect as house builders/developers may decide to borrow less and try to raise more equity to finance development. In addition the industry is cyclical and profit margins can be eroded creating issues on interest deductibility for tax purposes should the proposal of an EBITDA multiple be introduced.

This concern extends to UK businesses more generally. The governmental drive for growth and jobs, consistent with that of the broader EU, will require mobilisation of significant capital with debt a convenient means of funding within established markets.

Theoretically of course all listed companies can reduce their debt levels by raising equity from shareholders but in reality this is difficult and costly.

We would therefore recommend that UK domiciled businesses with no material overseas group members are excluded from the proposed cap on interest deductibility.

However, we do support the inclusion of the "group ratio rule" so that the rules operate fairly on taking the total funding of a business into account, and focus - as intended - on profit shifting, not on arbitrary discrimination against interest expense in relation to other costs of running a business.

E. Public-Benefit Project (PBP) Exclusion

UK public service and infrastructure investment that requires substantial funding will be adversely affected by any deferral of interest deductibility unless the PBP Exclusion is broad based.

The UK has been near unique within the EU in promoting asset intensive infrastructure investment through privatised utilities, and through PFI and PPP projects. This has allowed the modernisation of much of the UK's utility infrastructure and the provision and maintenance of new public service assets.

Alongside the public asset initiatives has been the redevelopment of commercial property such as the Canary Wharf site, and construction of domestic housing assets to alleviate the country's chronic shortage of affordable housing.

It is a factor of these infrastructure investments whether single asset or made within open ended corporate entities, that significant long term debt funding is required to reduce sponsor capital, reduce cost of capital, enable the rapid build-up and refurbishment of assets and reduce the impact on end user tariffs.

Repayment of debt is typically spread over up to 30 years and is often back-ended to allow for periods of asset development. The structure of loans, and the assumption of prompt availability of tax deductions for interest when the firm is profitable has contributed to enabling affordable service charges and rents.

All these funding structures rely on continued use of interest to reduce tax on a year by year basis, and often in legal arrangements which fix the tariff and service charge into the future. For example, utility network tariffs have been fixed as far ahead as 2020.

Renegotiation of tariffs and government paid service charges may be feasible as a trade-off for lower tax deductions for interest but this will not be of assistance to infrastructure spend where third parties rely on the provision of affordable rents, such as social housing and essential utility services, and may have no offsetting cash flows.

The scope of the PBP exclusion should be clarified and be sufficiently broad so as to cover the full range of asset intensive projects as discussed above.

F. Other long-term or asset intensive projects

Projects or long-term investments that require or are likely to require substantial funding will be adversely affected by any deferral of interest deductibility unless they benefit from an exclusion.

A specialised factory or a mining development with a long construction period or a firm undertaking tech based development with a long period to profitability (that may not be achieved until it grows to very large scale) is what we have in mind here.

The availability of carried forward finance expenses is important in considering the project at the outset. The long period before positive cash flows arise and the higher discount rates as a result of the underlying project itself being risky, makes earliest possible use of potential tax deductions very important. Deferral or loss arising from a deductibility cap will reduce the project's attractiveness. Especial provision should be made to avoid such an effect for potentially affected firms.

G. Answers To Questions Set Out in the Consultation Paper

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

   The restriction's introduction needs to take account of the ongoing nature of debt finance. Existing finance arrangements may have lives of 30+ years and have been based on an expectation of continued symmetrical tax treatment of revenue and costs, including interest. In some cases outlined above, businesses may be locked into revenue agreements with retail customers and government agencies which may not be capable of amendment for contractual and economic reasons. This requires addressing through transitional rules.

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

   The OECD launched the BEPS project to drive out aggressive tax planning by multinational enterprises. The interest restriction is proposed as part of the BEPS Action Plan implementation and therefore should be restricted to multinational groups with a materiality test to avoid applying the cap to businesses where the main business activity is within the UK.

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

   We recommend the interest definition remains consistent with that used in current UK tax arrangements; for example the "finance expenses" used in the Worldwide Debt Cap rules.

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

   We recommend consistency with current UK tax arrangements.

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

   We recommend that rules do not operate at UK sub-group level. Businesses may need to structure the balance sheet of subsidiaries to facilitate their independent commercial operation, and borrowers will structure their borrowings either at Holdco level or trading entity level to better manage lender concerns over structural subordination.

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?

   We recommend consistency with current UK tax arrangements.

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?

   As discussed in our Concerns above, we recommend HMT considers economic cyclicality, optional gearing based restrictions, and exceptions required by capital intensive businesses before setting a cap percentage. Otherwise we recommend a high percentage.

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?

   We do not believe the inclusion of a group ratio would encourage groups to borrow more than they would have done in the absence of BEPS, as such decisions will be determined by many economic factors that drive a businesses' choice of capital, not just tax.

   We support the inclusion of the "group ratio rule" so that the rules operate fairly on taking the total funding of a business into account, and focus - as intended - on profit shifting.

   We recommend the form of implementation that optimises the objectives of the BEPS Action Plan.

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?

   We recommend that Small and Medium Undertakings as defined in Article 3 of EU DIRECTIVE 2013/34/EU be exempted from the interest restriction.

   Thereafter a de minimis threshold similar to that used in the Worldwide Debt Cap rules be used to ensure consistency in transition: i.e. based on financing costs.

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

    A de minimis threshold similar to that used in the Worldwide Debt Cap rules be used to ensure consistency in transition: i.e. based on financing costs.

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?

    We recommend that Small and Medium Undertakings as defined in Article 3 of EU DIRECTIVE 2013/34/EU be exempted from the interest restriction.

    Thereafter a de minimis threshold similar to that used in the Worldwide Debt Cap rules be used to ensure consistency in transition: i.e. based on financing costs.

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

    We are concerned that this is one of the two substantive weakness of the Interest Cap proposal: the other being the impact on businesses which require short or prolonged periods of high gearing to stimulate growth.

    We have seen during the 2007/08 crisis and subsequent years that many businesses have been affected by what was essentially a financial services crisis. We would expect debt service costs of non-financial businesses to remain constant in an economic downturn while revenues are quickly affected. (This is despite any central bank action to lower rates which will tend to feed through to businesses only as finance renews.) The effect of the downturn would be markedly lower EBITDA while interest costs remain constant. Business earnings would be reduced further by any restriction on interest deductibility and therefore the business is most affected by the cap at the worst time for this to occur.

    We reiterate that it is important to include the OECD's measures to protect businesses against profit volatility including permitting carry back and carry forward of disallowed interest for use in past or future periods when profits are higher. We suggest that the carry back should be five years and carry forward unlimited.

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

    We believe the PBP exemption needs to take regard of the nature of each business and then consider the implementation methodology. The PBP exclusion needs to include business activities which require significant investment in assets, both those used long term in infrastructure businesses, and to meet short term initiatives to create asset stock such as the current initiative to increase house building.

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

    The OECD recommendations:

    - do not allow for UK utility network regulation which does not enable lenders to take control of assets and revenue streams;
    - would not include short term capital intensive asset programmes such as that required for the current house development initiative where assets would be re-sold.

    We recommend the PBP exclusion takes into account all asset intensive industries to enable the current cash flow advantage of prompt use against profits and Group Relief to be maintained.

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

    Many of the exemptions in the Worldwide Debt Cap rules may be usefully included with appropriate amendment.

    See also comment in F (Other long-term or asset intensive projects), above.

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

    No response

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?

    We agree that transitional rules should apply to existing debt but recommend transitional rules should be extended to debt required to be refinanced as a result of the introduction of the interest cap and which is used in legal structures where the ability to pass on the loss of cash flow is restricted by regulatory process (for example: utility network businesses; and PPP/PFI projects), or by social ability to pay (for example: social housing initiatives) where these businesses would not receive the PBP exclusion.

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

    Our members have raised the considerable incremental cost of complying with increasing levels of tax regulation as a growing concern.

    We recommend that any interest restriction rules to replace the Worldwide Debt Cap rules.

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 October 2015 our 4,700 members work in companies of all sizes through industry, commerce and professional service firms. We have 2,450 active students. Members and students work in 95 countries and are employed in 88% 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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