Tax deductibility of corporate interest expense

Comments from ACCA to HM Government
August 2016

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SUMMARY

ACCA welcomes the opportunity to respond to the Government's consultation on the tax deductibility of corporate interest expense.

In the light of current economic uncertainty, arising both as a result of a general slow-down in the global economy and the recent referendum vote to leave the European Union, it is of paramount importance that the UK demonstrates that it remains an attractive location for businesses. We consider that the early implementation of OECD BEPS Action 4 may discourage investment at this crucial time. We would strongly urge the Government to reconsider the timing of the proposed interest restriction rules, and explore the viability of other alternatives, such as strengthened thin capitalisation and Worldwide Debt Cap rules.

Our detailed comments in respect of specific questions within the consultation are set out below.

COMMENTS

Chapter 5 - Fixed ratio rule

Question 1: 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?

ACCA supports the alignment of the definition of the group with the accounting concept of a group, as used for the purposes of preparing consolidated accounts. For consistency, we agree that the definition of the group should be based on the IFRS definition. Such definition should be set out clearly in legislation.

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?

The ability to carry forward restricted interest to set against future group-wide loan relationship non-trade credits or trading income as appropriate (subject to capacity) will give as much flexibility as can be allowed under the proposed reforms to loss carry *forward and group relief. The interactions may be complex, but the levels of 'allowance' for each regime are such that the groups subject to any restriction are likely to be sophisticated enough to arrange their affairs appropriately within the legislation.*

Question 12: 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?

Given the current state of economic uncertainty, with volatility expected both in interest rates and business profits, the 3 year limit is unlikely to provide sufficient flexibility for businesses. The interaction with the proposed changes to group relief and carry forward of losses mean that in the short-term there may be significant complexities around the availability of relief where there are changes of ownership, since it is not clear how any restriction based on the "major change in nature or conduct of trade" might apply to non-trade attributes such as spare capacity.
Paragraph 5.47 refers to spare capacity being calculated 'by subtracting the net tax-interest expense from the interest limit.' The interest limit, as defined in the Glossary in section E, includes consideration of the net adjusted-group-interest expense under the modified Debt Cap. We believe that the interest limit should be defined with reference to the Fixed Ratio or the Group Ratio only. The stated aim of OECD BEPS Action 4, was to allow a group to deduct an amount equivalent to its net third party interest expense. In considering the net adjusted-group-interest expense under the modified Debt Cap, distortions will result due to the inclusion of related party and derivative amounts.

Question 14: 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.

We note that the approach set out in paragraph 5.57 contradicts the position outlined earlier, in paragraph 3.8. We understand that the Government has now clarified that the approach set out in paragraph 5.57 reflects the intention of the new Debt Rules: namely, that related party interest (including interest on shareholder debt) are to be included within net interest.

While we agree in principle that the adjusted group-interest should include amounts due to related parties, we note that related party interest amounts are not readily available from group consolidated financial statements. Identifying the related party amounts will add a layer of complexity to the new Debt Cap rules, as the current Worldwide Debt

Cap rules are based on the amount of gross debt reported on the consolidated financial statements. Further guidance on how to identify related party amounts (for example, based on individual entity financial statements) and how to deal with mismatches arising from exchange differences and differences in accounting framework would be beneficial.

Paragraph 36 of the OECD's BEPS Action 4 Report outlines that a best practice rule to address base erosion and profit shifting using interest expense should include:
- interest on all forms of debt
- payments economically equivalent to interest, and
- expenses incurred in connection with the raising of finance.

Based on the above, dividends payable under redeemable preference shares should, in principle, be included within the amount of adjusted group-interest limit for the purposes of the new Debt Cap regime.

Chapter 6 - Group ratio rule

Question 15: 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?

We support Option 2, as this approach is more in line with the OECD's Public Discussion Draft guidance released on 11 July 2016.

However, a low interest limit percentage can cause a large amount of financing costs being restricted and carried forward during the initial (funding-intensive and low profit/loss-making) phase of projects, with a possibility that the carried forward restricted interest may not be utilised for a long time. This could have an impact on industries with long lead times, such as the pharmaceutical industry. We would urge the Government to set the interest limit percentage at 100%, or at least at the high end of the range between 30% to 100%.

Question 17: Are there any further items of profit or loss which should be included within the definition of total qualifying group-interest?

The items of profit or loss included within the definition of total qualifying group-interest are in line with OECD BEPS Action 4 recommendations.

Question 18: 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?

We request the Government to clarify whether fair value gains and losses on financial instruments and other notional interest amounts that does not represent payment of interest (for example, accrued interest on accounting provisions, the unwinding of discount on financial instruments and trade balances, and net interest on a group's defined benefit pension liability and similar post-retirement benefits) are intended to be included within the definition of adjusted group-interest. Based on the OECD Discussion Draft guidance issued on 11 July 2016, we would argue that they should be excluded, as they do not represent interest on debt, payments economically equivalent to interest, or expenses incurred in connection with the raising of finance.

Further, an issue may arise in relation to the imputation of interest on non-market rate loans, under IFRS 9 and FRS 102. Interest are required to be imputed on balances including:

- *the sale of goods or services, if payment is deferred beyond normal business terms or is financed at a rate of interest that is not a market rate (paragraph 11.13 of FRS 102);*
- *below market rate and interest-free loans between group entities; and*
- *below market rate and interest-free loans to or from directors*

As FRS 102 is in the early stages of implementation, companies are likely to be uncertain about the measurement of the amount of imputed interest. Clarification is needed as to whether such interest would be included within tax-interest. Imputed interest is arguably not relevant to base erosion, and therefore should not be included within tax-interest.

Question 19: 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?

We agree that related party interest and financing costs in respect of perpetual debt should be excluded from qualifying group-interest. However, we would strongly urge *the Government to reconsider the exclusion of financing costs in respect of compound instruments or other hybrid debt. The term 'compound instruments' is not defined in IFRS; in our response below, we assume that the term takes the meaning of 'compound financial instruments' as referred to in IAS 32. We would recommend that the Government defines compound instruments in legislation, should an exclusion apply.*

Compound instruments and hybrid debt, such as convertible bonds, are considered by businesses as forms of debt financing. Under IAS 39 and IFRS 9, such hybrid debt are split into debt and equity elements, with the related financing costs considered as interest. As convertible instruments already carry a lower level of interest, as a reflection of their equity characteristics, it would seem to be harsh, and beyond the objectives of the OECD BEPS project, to exclude such interest from qualifying group-interest.

Similar arguments may apply to certain profit participation loans, under the broad definition set out in paragraph 6.34. We would urge the Government to tighten the definition, set out an explanation of why profit participation loans should be excluded, and identify specific scenarios for exclusion.

Further, net interest on defined benefit pension liabilities and similar post-retirement benefits should be excluded from qualifying group-interest. The Public Discussion Draft of the OECD's guidance (paragraph 46) states that interest on defined benefit pension liabilities and similar post-retirement benefits should be disregarded in calculating a group's qualifying group-interest.

Question 21: 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?

In addition to the items set out in paragraphs 6.48 to 6.62, the OECD BEPS Action 4 Report also recommends that taxable branch profits and dividend income should be included, to the extent that they are shielded by foreign tax credits.

Further to our comments about net interest on defined benefit pension liabilities and similar post-retirement benefits in our response to Question 19, we would encourage the Government to clarify whether such interest should be included within the definition of group-EBITDA, in line with the OECD's guidance.

As explained in paragraphs 52 to 55 of the OECD's Public Discussion Draft guidance, non-taxable dividend income should be included in group-EBITDA. A failure to include *dividend income will lead to distortions, where a group financed with preference shares would be able obtain a greater amount of deductions than a group financed similarly with loans.*

Chapter 7 - Public benefit infrastructure

Question 24: 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.

We note the eligibility criteria for the Public Benefit Project Exclusion (PBPE), as set out in paragraph 7.7, is very narrow: in order to qualify for PBPE, a project must provide 'service which it is government policy to provide for the benefit of the public.' In addition, such projects must have a duration of at least 10 years, or a shorter rolling term which both the operator and the relevant public body have the expectation of continuing indefinitely. With the historic abolition of IBAs, the UK has already suffered as a venue for international investment into long-term infrastructure projects. The PBPE should be designed as far as possible to reverse the impact of that decision, not compound it.

Given the current uncertain economic climate and the likely reduction of government funding in the event of an economic downturn, government policy as set out in the National Infrastructure Delivery Plan may need to be revised. The possible curtailing of public infrastructure projects is likely to result in few projects qualifying for the PBPE.

As the government budget for infrastructure projects is reduced, private sector investment will be vital. We are concerned that the current narrow eligibility criteria may discourage private sector participants from undertaking or funding public benefit infrastructure projects. We would urge the Government to consider relaxing the eligibility criteria and extending grandfathering provisions for existing infrastructure projects, to mitigate the systemic adverse impact of the new rules on public infrastructure.

Chapter 11 - Commencement

Question 46: Does the phasing in of the rules as outlined above create any particular difficulties for businesses?

Paragraph 11.6 proposes that for an actual period of account which straddles 1 April 2017, the current Worldwide Debt Cap rules will apply in the normal way. The application of the current Worldwide Debt Cap (WWDC) rules in conjunction with the new Fixed Ratio and Group Ratio rules is likely to cause distortions and inconsistencies between the first period of implementation and subsequent periods. We would encourage the Government to consider replacing the current WWDC rules fully with the new Debt Cap rules in the first period of implementation, so that the new rules with regards to the deductibility of corporate interest are implemented consistently and in full from the start.

In line with the majority views from the previous consultation, ACCA believes that the introduction of the new rules from 1 April 2017 could cause significant difficulties for business. As noted in paragraph 9.24, the international accounting standards on leases, IAS 17, is to be replaced with IFRS 16 from 1 January 2019. Given that IFRS 16 will introduce fundamental changes the accounting approach for leases, the introduction of new interest deductibility rules for less than two years before the implementation of IFRS 16 will cause substantial disruption to companies in the affected sectors, including the aviation, shipping and logistics industries.

For smaller but highly-leveraged companies, the interaction between the new rules and the implementation of FRS 102 (effective for accounting periods commencing 1 January 2016) is also likely to give rise to uncertainty. The replacement of old UK GAAP or FRSSE with FRS 102 has, for many companies, a material impact on revenue recognition and the measurement and classification of financial instruments, both directly affecting the calculation of tax-EBITDA and tax-interest.

In the light of the economic uncertainty engendered by the outcome of the EU Referendum, and fully recognising the Government's desire to demonstrate the UK's leadership in implementing the G20 and OECD recommendations, we would encourage the Government to consider options which could allow the new rules to be introduced at a later date.