HM Treasury

HM Revenue & Customs

Tax deductibility of corporate interest expense: Consultation event

14 December 2015

Objectives of Today's Event

- Provide opportunities for all interested parties to
  - ask questions
  - seek clarity and
  - suggest aspects needing particular consideration

- Highlight the key trade-offs where the government will need to find the right balance

- To encourage and facilitate constructive written responses to the public consultation

Format of Today's Event

9:30	Introduction
9:45	Format & objectives of day Policy objectives Scope of consultation
9:55	OECD Recommendations
10:05	Q&A
10:15	Group Ratio Rule Public Benefit Project Exclusion
10:20	Q&A
10:30	Table discussions – First set of questions
10:50	Feedback from tables
11:05	Tea/Coffee Break
11:20	Administrative issues: Jurisdiction basis, Volatility, Grandfathering
11:30	Q&A
11:35	Table discussions – Second set of questions
11:55	Feedback from tables
12:10	Final Q&A
12:20	Closing Comments
12:30	Ends

Policy objectives

- Policy objectives
  - tackle BEPS involving interest expense in order to reduce unfair outcomes and imbalances
  - maintain the competitiveness of the UK tax system and ensure that there is certainty for businesses operating in the UK
  - efficiency in terms of business compliance and government administration
- The UK was a key participant in the OECD's work leading up to the Action 4 Report, which has been endorsed by G20 Ministers.
- Through the development of the Report, countries have agreed a general tax policy direction and it is expected that there will be convergence over time through the implementation of agreed common approaches.

This consultation

- The government recognises that introducing a structural interest restriction will be a major change to the UK corporate tax regime.
- Careful consideration is required to ensure any new rules work appropriately, including taking into account the beneficial impact of an 18% CT rate.
- The government is seeking views from all stakeholders on the proposals in the OECD report.
- All responses will be considered for the business tax roadmap to be published by April.
- Please send responses by 14 January 2016 to BEPSinterestconsultation@hmtreasury.gsi.gov.uk

OECD BEPS Project Action 4: What's it about?

From *Action Plan*, July2013

- BEPS […] also relates to arrangements that achieve no or low taxation by shifting profits away from the jurisdictions where the activities creating those profits take place.

Action 4 (extract):

- Develop recommendations regarding best practices in the design of rules to prevent base erosion through the use of interest expense, for example through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income, and other financial payments that are economically equivalent to interest payments.

OECD Report: Sets out the issue

From *Action 4: Final Report*, October 2015

- The use of third party and related party interest is perhaps one of the most simple of the profit-shifting techniques available in international tax planning.
- Parent companies are typically able to claim relief for their interest expense while the return on equity holdings is taxed on a preferential basis, benefiting from a participation exemption, preferential tax rate or taxation only on distribution. On the other hand, subsidiary entities may be heavily debt financed, using excessive deductions on intragroup loans to shelter local profits from tax. Taken together, these opportunities surrounding inbound and outbound investment potentially create competitive distortions between groups operating internationally and those operating in the domestic market.

OECD Report: Common scenarios

From *Action 4: Final Report*, October 2015

- Groups placing higher levels of third party debt in high tax countries.
- Groups using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense.
- Groups using third party or intragroup financing to fund the generation of tax exempt income.

OECD Report: Rationale

- The OECD Report recognises that BEPS can arise as a result of the structure of countries' tax rules. It therefore recommends a structural solution.

From *Action 4: Final Report*, October 2015

Base erosion and profit shifting can arise from arrangements using **third party debt** (e.g. where one entity or country bears an excessive proportion of the group's total net third party interest expense) and **intragroup debt** (e.g. where a group uses intragroup interest expense to shift taxable income from high tax to low tax countries). It can also occur where payments are made to a **lender outside a country or within the same country**. […] In order to be effective in tackling base erosion and profit shifting, a best practice approach should therefore apply to all of these situations.

OECD Report: Objectives

From *Action 4: Final Report*, October 2015

- It has therefore become increasingly apparent that a consistent approach utilising international best practices would be a more effective and efficient way of addressing concerns surrounding the use of interest in base erosion and profit shifting.
- This approach should encourage groups to adopt funding structures whereby: (i) the net interest expense of an entity is linked to the overall net interest expense of the group; and (ii) the distribution of a group's net interest expense should be linked to income-producing activities.
- Groups should also benefit from a consistent approach between countries. Similar rules based on the same principles should make the operation of rules more predictable, enabling groups to plan their capital structures with greater confidence.

Summary of the OECD best practice recommendations

De minimis **monetary threshold to remove low risk entities**
Optional

+

Fixed ratio rule
Allows an entity to deduct net interest expense up to a net interest/EBITDA ratio within a corridor of 10%-30%

+

Group ratio rule
Allows an entity to deduct net interest expense up to its group's net interest/EBITDA ratio, where this is higher than the fixed ratio
Option for a country to apply a different group ratio rule or no group ratio rule

+

Rules to address volatility
Including carry forward of disallowed interest / unused interest capacity and/or carry back of disallowed interest
Optional

+

Public-benefit project exclusion
Optional

+

Targeted rules to support general interest limitation rules and address specific risks

+

Specific rules to address issues raised by the banking and insurance sectors

Group Ratio Rule (GRR)

Group ratio rule is an optional component of the OECD proposals for best practice:

Allows interest relief where net debt / interest expense for an entity / jurisdiction is in line with the group's overall position.

- Group ratio to be calculated by reference to group accounts:

$$Group\ ratio = \frac{Group\ interest}{Group\ EBITDA}$$

- Group interest is total net third party interest for the group.
- 'Group' defined in line with accounting standards, and would exclude portfolio holdings, associates / JVs and subsidiaries recognised at fair value.
- Alternative option for a carve out based on equity / net assets.
- Potentially subject to an overall cap of 100% and total group interest.

Public Benefit Project (PBP) exemption

Public Benefit Project exemption is an optional component of the OECD’s proposals for best practice:

Excludes both interest and earnings from restriction in respect of highly geared projects where conditions are satisfied:

- Project under which the *operator* provides, operates and/or maintains assets on a long term basis.
- Obligation to public sector body or public benefit entity (the *grantor*) to provide goods or services in which there is a general public interest, and which is subject to regulatory framework.
- Interest is on third party debt on non-recourse terms / supported by the project’s assets.
- Operator, interest, assets and income from the project are all in the same country, and income taxed at ordinary rates.

Possible approach to apply on a jurisdiction-basis

OECD proposals permit approach to be applied at an entity or jurisdiction level.

One possible approach:

- Step 1: Calculate *Net interest* and *Tax EBITDA* on an entity by entity basis.
- Step 2: Aggregate amounts across *group*
- Step 3: Calculate restricted interest in the UK for the group:

  Interest cap = *Ratio* x aggregate *Tax EBITDA*

- Step 4: *Interest restriction* = aggregate *net interest* – *interest cap*
- Step 5: Allocate restriction across entities within the group.

Addressing volatility

OECD proposals include options to address volatility:

- Carry forward of restricted interest
- Carry back of restricted interest
- Carry forward of excess tax-EBITDA
- Use of averaging

Grandfathering

OECD proposals include options on grandfathering of third party debt and related party debt

- A country may also apply transitional rules which exclude interest on certain existing loans from the scope of the rules, either for a fixed period or indefinitely. In this case it is recommended that these transitional rules are primarily restricted to interest on third party loans entered into before the rules were announced.

Expectation is for grandfathering only in exceptional circumstances

- address concerns around impact on specific debt instruments / projects
- level playing field

We are keen to understand the impact on existing instruments / projects.

Tax Deductibility of Corporate Interest Expense

HMT/HMRC Consultation Event, 14 December 2015

HM Treasury and HM Revenue and Customs jointly held a stakeholder event on the open consultation on *tax deductibility of corporate interest expense*, which was published on 22 October 2015 seeking views on the proposals in the OECD report on *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*. There were 73 representatives from a wide range of business sectors including manufacturing, retail, services, oil and gas, utilities, telecoms, publishing, infrastructure, real estate, banking, insurance, and fund management, as well as from accountancy and legal firms, regulators, trade associations, civil society organisations and academia.

The event provided an opportunity for stakeholders to share their views on the consultation with HMT and HMRC officials, as well as allowing for more detailed discussion of selected aspects of the consultation. Delegates were given opportunity to present outcomes of table discussions to the room, comment on other aspects of the consultation and ask questions.

A summary of comments made is set out below.

Fixed Ratio Rule (FRR)

The objective of the proposal for a FRR as set out in the OECD report to address BEPS risks by aligning interest deductions with funding of UK taxable assets and activities was explained. Several delegates expressed a preference for an arm's length test based on UK assets, but acknowledged an FRR at upper end of 10-30% would perform a similar role.

Other points made by delegates included:

- a FRR at the higher end of 10-30% would be appropriate as this would be in line with other countries that already restrict interest deductions (e.g. Germany) and would mitigate impacts on the UK's relative competiveness;
- a higher FRR would not be as effective at addressing BEPS risks as a lower FRR combined with a Group Ratio Rule (GRR); although a lower FRR would result in greater reliance on GRR, it would be manageable for those affected;
- even a FRR as high as 30% would have an impact on most infrastructure, real estate and utilities companies.

Group Ratio Rule (GRR)

Most delegates who commented on the GRR expressed support for it – some saw it as a useful fall back while others saw it as essential for heavily geared and capital intensive sectors (e.g. infrastructure, real estate and utilities). It was also suggested that the GRR would be an important safety net if interest rates rose.

The view was expressed that the GRR is not an alternative to the FRR, as most companies would prefer to use the FRR for simplicity, while only those wishing to use the GRR would have the burden of extra compliance.

It was noted that, even in cases where debt financing does not give rise to BEPS, the GRR would not necessarily allow a deduction for all interest expense, as the debt is not spread around the group in exact proportion to earnings (which vary from year to year).

There was discussion around whether the GRR should be based on EBITDA or assets, and the view was expressed that companies should have the option of using whichever was more suitable.

Some delegates suggested that the GRR should be applied to an accounting rather than a tax measure of EBITDA.

Some delegates suggested that the surrender of capacity between group companies in the UK should be allowed, though nobody expressed a preference for such an approach over a system for allocating any restriction, such as that used by the existing Worldwide Debt Cap.

Definition of Interest

Delegates expressed support for the use of tax principles to define interest, as this would be logical, but there was the question of how this would work in practice.

Definition of 'Group'

Most delegates supported basing the definition of a 'group' on the accounting definition. However, it was pointed out that most private equity investments would count as separate groups under this definition, and the concern was raised that this could limit the effectiveness of the restriction in these cases.

Public Benefit Project (PBP) Exclusion

Several delegates sought more clarity around the definition of 'public benefit'. Many considered the PBP exclusion to be targeted at infrastructure investment. The type of projects that would come under the exclusion was discussed, in particular whether a government counterparty would be required and whether the definition could be expanded to include regulated entities. Several delegates noted that the proposed public benefit definition in the OECD report is tightly drawn.

It was pointed out that for highly geared infrastructure projects, a PBP exclusion would give more certainty than the GRR. This is because investors in a project change over its lifecycle, so that the project is, at different times, a separate group or part of other groups, with the applicable group ratio changing as a result.

Grandfathering

There were mixed views on grandfathering. Some delegates saw grandfathering as essential for certain long-term projects, while others observed that if the rules were designed carefully to restrict only BEPS then grandfathering should not be necessary. Several delegates supported a long period of notice before the rules take effect to allow business time to adapt to the new regime.

Volatility

Several delegates expressed the importance of some form of carry forward/carry back rules to deal with volatility in earnings, but it was acknowledged that these could be complex. There was support for flexibility, with ability to both carry forward and carry back. It was pointed out that the time limit for carry forward/carry back rules needs to be appropriate, since some industries have very long development cycles.

Some delegates noted that indefinite carry forward would be consistent with UK rules for loss relief, but others questioned the usefulness of this, as the carried forward interest would be added to year on year with no real likelihood of relief.

De Minimis

The importance of de minimis rules was acknowledged to appropriately target the rules. Support was expressed for a fixed allowance, and there were suggestions that this be set at a comparable level to Germany's 3 million euros.

Several delegates questioned what would happen to the de minimis if interest rates rise, with some suggesting an uprating of the de minimis when this happens.

There was discussion around the possibility under EU law of an exemption for wholly domestic groups as they pose limited BEPS risk.

Banks and Insurers

It was questioned how any rules should apply to banks and insurers, since their capital structure is subject to existing financial regulation, which removes much BEPS risk involving interest expense.

If rules do apply, it was noted that carry forward and carry back rules would be appropriate to accommodate groups that are in a net interest negative position for cyclical reasons.

Other Comments

Several delegates suggested that the UK should not seek to be a first mover, and time should be taken over implementing the OECD recommendations in order to weigh up issues concerning competitiveness.

Some participants raised concerns about the economic impact of the interest restriction when interest rates rise again.

Delegates pointed out the difficulty of applying the rules to mixed business groups and mixed financial/non-financial groups, which may present unique issues.

There were mixed views on how any new rules would interact with the existing Worldwide Debt Cap (WWDC). Some called for any new rules to replace the WWDC, while others favoured building on the existing WWDC legislation. The observation was made that the WWDC performed a different function from the FRR and GRR, and could therefore be retained alongside them.

It was suggested that any new rules use the definitions which are already in the WWDC wherever possible. It was also suggested that the operation of any interest restriction should be based on information already available in the business to minimise compliance burden, as is the case with WWDC.

Attendees

Association of British Insurers (ABI)
Action Aid
Association for Financial Markets in Europe (AFME)
American International Group (AIG)
Alternative Investment Management Association (AIMA)
Allen & Overy
Alvarez & Marsal
Amazon
Anglican Water Group
Anglo American
Asos
Association of Investment Companies (AIC)
Association of Real Estate Funds (AREF)
BAE Systems
Baker & Mckenzie
Balfour Beatty
Barclays
British Bankers' Association (BBA)
BDO
Base Erosion and Profit Shifting (BEPS) Monitoring Group
BG Group
BHP Biliton
BP
British Property Federation (BPF)
British Land Corporation
BT
Confederation of British Industry (CBI)
Chartered Institute of Taxation (CIOT)
Deloitte
Diageo
Disney
Duff and Phelps
Evans Property Group
EY
Ford
Freshfields Bruckhaus Deringer
G4S
General Electric (GE)
Grant Thornton
GlaxoSmithKline (GSK)
Heathrow
HSBC
Institute of Chartered Accountants of Scotland (ICAS)
Informa
InterContinental Hotels Group (IHG)
Investment Association
Investment Property Forum
Johnson Matthey
KPMG
Liberty Global
London School of Economics and Political Science (LSE)
Microsoft
National Grid
Nomura
Norton Rose Fulbright
Ofwat
Oxfam
Pearson
Pinsent Masons
Prudential
PwC
Rolls Royce
RSM
Santander
Severn Trent
Shell
Slaughter & May
Tesco
Unilever
United Utilities
Vodafone
XL