Further written evidence submitted by the Chartered Institute of Taxation (FB08)

Corporate interest restriction
(clause 20 and schedule 5)

Summary

Notwithstanding that the delay as a result of the general election enabled stakeholders to point out further problems with the draft legislation so that it could be corrected before enactment, these provisions have been rushed. A more usual and reasonable timetable for the introduction of such a structural change to the tax system would have been sensible, to allow businesses time to understand and plan for the impact of the new regime. In addition it is unsatisfactory that businesses have been put in a position of having to plan for these proposals before they are enacted due to their significantly retrospective effect (we are now more than half way through the tax year!)

The proposal

This clause and Schedule 5 introduce new rules, effective from 1 April 2017, which restrict the amount of interest and other financing amounts that a company may deduct in computing its profits for the purposes of corporation tax. All groups will be able to deduct up to a £2m de minimis amount. After this amount, net interest expense is restricted to 30% of taxable profits before interest, tax, depreciation and amortisation (tax-EBITDA), or the group ratio percentage (based on the ratio of accounting net interest expense to accounting EBITDA) of tax-EBITDA if that is higher and a group elects to use it. Both ratios are limited by a modified debt cap to the group's aggregate net interest expense of the period.

This measure is significantly revenue-raising. The Government expect to raise just under £4 billion from it over its first four years.

Timetable

This legislation implements one of the recommendations made by the G20/OECD project to tackle Base Erosion and Profit Shifting (BEPS). We recognise that the government's intention has been to be leading the way in implementing the BEPS recommendations and the CIOT has consistently been supportive of this approach in principle. However, a longer timetable to implementation for these rules would not have been be detrimental to the Government's overall support of the BEPS project, as the UK would still be in the first wave of 'early adopters'. This would also have been more in line with the timetable other OECD member countries are working to.

The new rules are extremely complex and the late publication of what was intended to be the final legislation in Finance (No2) Bill 2017 in March (as a result of the short timetable) meant there was a tremendous amount for taxpayers and advisers to digest before the commencement of the rules in April 2017, and to take into account in administering the rules on an ongoing basis.

This was then followed by the removal of these provisions from the pre-election Finance Bill, which caused more uncertainty for taxpayers. Although the delay in enacting the legislation has allowed a period of further informal consultation which has improved the legislation, it inevitably led to a degree of uncertainty among those affected.

In our view, there was no need to rush in changes in this area because there were already a variety of rules which limit the tax deductibility of corporate interest expense, such as the Worldwide Debt Cap (WWDC) restrictions and the General Anti-Abuse Rule (GAAR). The CIOT suggested in August 2016[1] that a delay of two years would give the Government time to properly review the impact of this new regime on the UK's competitiveness, and enable further and ongoing consultation on the detail of the legislation, allowing the policy to be translated into law accurately and effectively. The CIOT still believes that a more usual and reasonable timetable for the introduction of such a structural change to the tax system would have been sensible, to allow businesses time to understand and plan for the impact of the new regime on their business.

Background

The Corporate Interest Restriction legislation has been designed to combat attempts by multinational enterprises (MNEs) and other companies to obtain excessive tax relief for net interest and similar financing costs and the aim of these new rules is to ensure relief on financing costs is commensurate with the extent to which a business's activities are subject to UK corporation tax. As noted above, these aims arose from recommendations of the BEPS project. The CIOT has consistently been supportive of the BEPS process and of the UK Government's full participation. However, as we pointed out, a longer timetable to implementation would not have been detrimental to the Government's overall support of the BEPS project. The UK would still have been in the first wave of 'early adopters' and would have been in line with the timetable that other OECD member countries are working to. We suggested that legislation should be included in a Finance Bill in 2018 with a start date of 1 January 2019.

From the time it became clear that the Government was going to act on interest deductibility (Budget 2016, following an earlier consultation in 2015/16) it was clear that the legislation was likely to be voluminous and highly complex. This was highlighted at the time[2]; and it is worth noting that the new rules are not anti-avoidance provisions, but are a structural change to the way interest expense is treated in the corporate tax code. The complexity of applying a formulaic rule to a wide range of industries and different group structures should have made it imperative that the change from one set of rules to another was better thought through over a longer time period to ensure that the legislation when it is implemented is correct and the transition can occur smoothly for businesses who are affected by the rules.

Criticism of the process

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[1] https://www.tax.org.uk/media-centre/press-releases/press-release-tax-experts-fear-rush-greater-restrictions-corporate

[2] In our response to the second consultation on these rules, which ran between May and August 2016 we said at paragraph 2.4: "*In our submission of 14 January 2016 on the October consultation we expressed the view that implementation of any measures to restrict interest deductibility should be deferred to a date somewhat later than 1 April 2017. Even before the EU referendum result, we considered that the timeframe for a 1 April 2017 start date was too ambitious given the scale and complexity of the new regime. Now, given the uncertainty caused by the referendum decision to leave the EU, and the potential negative short-term impact it might have on the UK's economic growth, the requirement for the UK to maintain a highly competitive tax regime which does not impose undue administrative burdens and the limited impact this measure will have on the core BEPS issue of double non-taxation, we are even more strongly of the view that deferral of these measures would be the right course of action (even if they are still considered desirable in the longer-term).*" See further at: https://www.tax.org.uk/policy-technical/submissions/tax-deductibility-corporate-interest-expense-ciot-comments-0

In our view, the legislation for these new rules has been rushed (notwithstanding the consultations and the additional time which became available as a result of the general election) which we would suggest has a negative effect on our international competitiveness at a sensitive time which is disproportionate to the amount of revenue likely to be at stake.

Draft legislation was initially published on 5 December 2016. However this was incomplete and the parts that were published were substantially rewritten and re-published alongside other aspects of the new rules on 26 January 2017. Whilst consultation on draft legislation is welcome, it would appear that the draft legislation for these new rules was initially published prematurely, before it adequately implemented the policy intent.

These clauses have remained a work in progress, with those published as part the Finance (No 2) Bill 2017 on 20 March 2017, on 13 July 2017 and finally as part of this Finance Bill on 8 September 2017 each containing substantial changes from the earlier draft legislation. These changes reflect the ongoing work by HMRC and the continuing discussions that HMRC was having with stakeholders up to this late date, which is welcomed. However, the late finalisation of the legislation was entirely predictable given the timetable required.

Retrospection

Following the decision to remove these provisions from the Finance (No 2) Bill 2017 before the general election, taxpayers were left in the difficult position of having to take account of potential new tax rules which could apply from 1 April 2017, without knowing exactly what those rules would look like. It was not confirmed until the Government’s announcement on 13 July 2017 that the start date for the new rules would remain 1 April 2017. Introducing legislation retrospectively like this is clearly not ideal, but we recognised that the timing of the Finance Bill and the election left the Government in a quandary with no perfect options. Looking forward, the move to an autumn Budget and winter Finance Bill, with a promise it will be passed before measures take effect the following April, should mean that this will be the last time we have this problem.

Remaining points within the legislation

The additional time afforded by the dropping of these provisions from the pre-election Finance Bill has meant that many of the issues known to remain within the draft legislation in the Spring Finance Bill were able to be resolved. However, some issues do still remain; for example, around pre-trading restrictions to the modified debt cap and the just and reasonable test.

Pre-trading restrictions to the modified debt cap

Where interest is incurred prior to a company making profits, interest expense (in excess of the de minimis) would be carried forward to future years and may be deductible then. To the extent that the debt cap would restrict the amount deductible in future years, companies are now able to carry forward excess, unused debt cap under sub-clause 400(2) which is in the new Part 10 of Taxation (International and Other Provisions) Act 2010 (TIOPA 2010) to be introduced by Schedule 5 of the Finance Bill.

Where interest expense is generated in a period prior to the company coming within the charge to corporation tax, however, the rules still do not operate as intended. The corporate interest restriction rules do not apply unless a company is within the charge to corporation tax. Accordingly, any such interest expense generated in the pre-trading period, may be brought into account for tax purposes in the first trading period. However, interest will be recognised in the financial statements of the company in the period in which it accrues. Sub-clause 400(2) does not operate to allow this pre-trading expenditure to be included in the unused debt cap calculation and, therefore, some or all of this amount is likely to be permanently restricted.

If the company is part of a group with other UK companies which are subject to the Corporate Interest Restriction rules, then the interest expense of the pre-trading company which is recognised in the group's financial statements will form part of the modified debt cap for the group. However, where there are no other UK companies within the CIR rules, then the expense will never be included within the modified debt cap.

This is particularly in point, for example, in infrastructure or PFI companies, which generally start to incur interest expense prior to trading and whose interest expense remains stable throughout their lifecycle.

We understand that it is not a policy intention that start-ups should be penalised by the operation of these rules and, therefore assume that this is an unintended consequence of the operation of these rules. We think that a specific solution would be needed, to include within section 411 amounts, which would otherwise be relevant expense amounts, which are deductible in line with the pre-trading expense rules in a period of account different to when they were recognised in the worldwide group's financial statements (and which have not previously been included as relevant expense amounts).

Just and reasonable

We also consider that the new rule, which was first included in Finance (No 2) Bill 2017, but was not in previously published draft legislation, is detrimental and unfair to taxpayers. Paragraph 54 of the new Schedule 7A which is introduced into TIOPA 2010 by Schedule 5 of the Finance Bill permits HMRC to change the basis on which a taxpayer has prepared their returns where anything is required to be done on a "just and reasonable" basis for the purposes of the rules. Our objection to this provision is that there is no requirement for HMRC to determine that the basis that the taxpayer has used is not just and reasonable before HMRC go ahead and apply what they think is just and reasonable. The only requirement is for HMRC to give a notice of enquiry; following this they are able to determine that a different 'just and reasonable' basis should be used. Any imposition of a revised just and reasonable amount can only be challenged by the taxpayer on the grounds that HMRC's assessment is not just and reasonable.

We suggest that this provision is unfair to the taxpayer and should be limited so that HMRC can only apply their view of what is a just and reasonable basis if they can demonstrate that the taxpayer's view is not just and reasonable. It should not be possible in our view to replace one just and reasonable amount with another which is adverse to the taxpayer if the original amount was within the range of what is considered a just and reasonable amount.

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