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INVESTMENT MATTERS

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Dear Sir/ Madam

HM Treasury consultation: tax deductibility of corporate interest expense

The Investment Association[1] welcomes the opportunity to respond to HM Treasury's consultation on the tax deductibility of corporate interest expense.

We fully endorse the analysis and comments put forward by the Association of Real Estate Funds (AREF) in its response to this consultation paper. The response highlights the role of debt finance in property fund structures. The same is true of funds investing in other capital intensive asset classes, such as infrastructure and securitisation, and other forms of investment providing vital capital into the economy.

Investment funds serve an important social purpose in the pooling of capital from a number of sources to finance economic activity. Capital may be pooled from pensions and other forms of savings vehicle used by citizens, as well as from life assurance companies, endowments and charities. The capital raised is used to finance small and medium-sized enterprises (SMEs) through private equity investment, infrastructure projects, and commercial and residential property. As the volume of traditional lending to SMEs and infrastructure projects has been in decline, the need for alternative sources of financing has never been greater.

We would like to emphasise that debt plays a significant role in structuring many forms of investment fund. As explained in AREF's letter, debt is vitally important in ensuring that investments through funds achieve the same outcome for tax purposes as direct investment. This tax neutrality is critical to the viability of funds. Funds often comprise various legal entities, and interest deductions in fund structures ensure that tax is not levied more than once.

[1] The Investment Association is the trade body that represents UK investment managers, whose members collectively manage over £5.5 trillion on behalf of clients. The money is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks & shares ISAs.

More generally debt finance is vital for investment in business, whether or not through collectivised funds. There are many commercial reasons why equity finance is not a viable alternative to debt – cost of raising finance, access to market, ownership, flexibility for issuers, simpler exit routes for investors.

In recent years, and particularly since the onset of the financial crisis, there has been a range of initiatives to improve access to finance for SMEs that have been by withheld from traditional forms of bank lending. Most recently, the EU's Capital Markets Union Action Plan aims to promote access to capital markets for SMEs that might otherwise struggle to raise equity finance. Such companies might rely on the ease of access to debt markets for funding, particularly businesses that require significant up front capital investment, or have limited credit history. We believe that the protection of access to funding is vitally important to UK businesses and the economy.

The proposals would result in the cost of debt becoming significantly higher for issuers seeking to access debt capital markets. This is because issuers would need to pay a higher coupon to incentivise investors coupled with an increased tax burden. A restriction on the deductibility of interest would increase the cost of debt and would be a threat to debt financing for many business, particularly small and medium businesses that have limited access to equity markets.

The current tax system for equity and debt achieves symmetry because interest income is taxed at a higher rate that dividends (which, for example, are exempt for corporate holders). BEPS occurs only when profits are shifted to low tax jurisdictions. In our view a fixed ratio rule is not an effective measure to counter BEPS because it will have wide-ranging ramifications for all investors in businesses, property and infrastructure, irrespective of whether BEPS occurs or not. Where BEPS does not feature, the outcome will be double taxation for investors.

BEPS vs debt bias

We note the comments in section 6.6 of the consultation paper about incentives to use debt over equity. We believe that this so-called 'debt bias' has many causes not related to tax (such as market access, current interest rate environment and commercial factors) and that the tax drivers of debt bias are as much related to the tax treatment of institutional investors (such as pension funds) as they are to the deductibility of debt in issuers. A policy response to debt bias and its impact on cyclical and financial stability might be very different to one that focuses on BEPS and we believe the two issues should not be conflated.

Impact on specific forms of investment

Below we have outlined specific areas of concern for investors where we believe more work is needed in order to determine the impact of any interest deduction limitation rule.

Infrastructure

The importance of private investment into infrastructure is recognised in the OECD's report by the inclusion of a rule to protect public benefit project investment from the scope of the rules. For the reasons we describe in the appendix, we believe that the scope of the exclusion is drawn too narrowly, and will not provide effective protection for existing and future private investment in infrastructure projects.

Private placement

Private placements are a form of long-term, non-bank debt financing, which are particularly relevant to mid-sized businesses and infrastructure projects. In Autumn Statement 2014, the government signalled its support for promoting private placement as a form of finance to the economy by announcing an exemption from withholding tax on interest payment. The announcement, implemented in Finance Act 2015, was intended to attract investment to the UK, support alternative forms of getting credit to businesses and support growth in business through non-bank forms of financing.

We believe that the proposals to restrict tax deductions for interest work against government policy to attract investment to alternative forms finance for businesses and reduce reliance on bank financing.

Securitisation

Securitisation is a means of changing illiquid balance sheet assets (receivables such as mortgages, leases, etc), which generate a regular payment flow, into liquidity. The receivables are sold to a securitisation special purpose vehicle, which issues tradable asset backed securities in the market for the purpose of raising the necessary funds. The servicing of those securities (payments of interest and principal amount borrowed) is ensured from the cash flow of the underlying assets including the collateral that backs the assets. All future payments arising from the receivables, which continue to be paid to the originator, are channeled to the SPV. There are typically no equity holders in a securitisation SPV. As a result, any additional cash needed to pay tax would directly impact the amount of cash available for returns to investors in the SPV.

Any reduction from coupon or interest payments could lead to events of default and would be at the cost of the investor.

High yield investment

High yield bond issuers are typically highly leveraged for various economic reasons, particularly in asset intensive industries such as telecoms and cable. Restrictions on interest deductibility would push many high yield issuers into liquidity stress due to the increased tax burden. In turn this would increase the likelihood of default for many high yield bonds with a resultant loss to investors. This situation would be difficult to resolve as investors would pull away from funding distressed high yield issuers limiting those issuers' ability to refinance existing debt.

Property investment

The impact on property investment is detailed in the response from AREF, which we fully support. Property funds are highly dependent on debt funding (as is property ownership in households and the wider economy). Any adverse tax treatment of property investment could have a significant adverse impact on long-term financing of UK housing development with wider socio-economic impact to the UK.

Group ratio rule

We believe that it is vital to investment to have the group ratio rule, and that such a rule would be treated as the default rule for many capital intensive forms of financing. Work on the design of such a rule, to be carried out during 2016 by the OECD will be of critical importance to the investment industry, and we urge the government to defer the implementation of any fixed ratio rule in the UK until there is international consensus on a group ratio rule that would protect the interests of investors.

Grandfathering

A lack of appropriate grandfathering would create significant problems across capital markets for two reasons. First, there would be a real prospect of existing investments becoming unviable, insolvent or at risk of default. Covenants on high yield bonds and securitisation could result in default and investors would bear the cost of this. Investors in existing infrastructure projects often have the expectation of long-term investment and certainty of returns, which could be compromised by a change in tax treatment. Second, wide-scale refinancing of businesses and projects will take significant amounts of time.

We urge that any recommendations in relation to limiting interest deductions should take into account the specific nature of investment into a range of asset classes and forms of investment, types of fund structures, the purpose of funds, and the role of investors in providing a vital source of capital to the economy.

Thank you again for the opportunity to respond to the consultation and we hope to continue to be able to contribute. If you would like to discuss anything in this letter, I am available at jms@theinvestmentassociation.org or on +44 (0)20 7831 0898.

Yours faithfully

Jorge Morley-Smith
Director, Business Support & Promotion

APPENDIX

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

For the reasons highlighted in our letter, we do not believe that a general interest restriction is an effective measure for countering BEPS. An interest restriction would have far reaching ramification across capital markets in a way that would not target BEPS specifically, and could damage investment activity.

We believe that because of the potentially significant impact on capital markets, international coordination of implementation is very important in order to protect UK competitiveness and cross border investment.

It is extremely difficult to quantify the impact on capital markets of a restriction, and we urge the government to allow additional time to consider the impact on financing of a range of asset classes, including the impact on housing and infrastructure.

Finally, we believe that the group ratio rule could be critically important to international investment, and we urge the government to defer implementation of any restriction rule. Until the OECD has completed work on this in 2016.

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

We believe that efforts to banish tax avoidance by curbing BEPS should impact only situations where a risk of tax avoidance exists. For reasons we highlight in the body of our response letter, we do not think more general economic concerns around debt bias should play a role in determining the most appropriate response to BEPS.

In order to protect access to capital markets of SMEs that rely on debt funding, we believe that interest restriction should apply as narrowly as possible, and applying the rule only to multinational groups may be one option of limiting its impact.

However such a limitation in scope itself raises significant issues. First, we question whether it would be compatible with EU non-discrimination principles. Second, it establishes a precedent for discouraging international ownership, raising barriers to cross border investment.

We believe a better approach would be to introduce measures, where necessary, that more specifically target BEPS, and to provide a broad exemption for SMEs that have limited access to equities markets and that would otherwise struggle to obtain funding.

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

Distributions of authorised investment funds that meet the qualifying investments test in the AIF (Tax) Regulations (SI 964/2006) are treated as interest expense of the fund. The rules are specifically designed to ensure that investors are not disadvantaged by investing in authorised funds, and such distributions are taxed as interest in the hands of investors. We do not believe that these rules give rise to any opportunity for tax avoidance through BEPS.

We urge the government to ensure that any interest restriction rules should not apply to authorised funds paying interest distributions and that the rules in the AIF (Tax) Regulations are not affected.

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

We believe that groups should be afforded the flexibility to allocate capacity between group members. This would allow groups to maintain the most commercially efficient structures and in some cases will prevent the need for widescale group restructuring in UK businesses.

Question 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?

For the reasons highlighted in our letter, we do not believe that a general interest restriction is an effective measure for countering BEPS.

However, we concur with the views expressed by the CBI and others that, in order to preserve international competitiveness and to minimise business disruption, a ratio should be set no lower than 30%.

Question 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 believe that a group ratio rule is vital to preserving the interests of investors, particularly in capital intensive industries, infrastructure and property.

The design of a group ratio rule should carefully consider the types of fund structures that exist to provide capital to businesses. In particular, funds source equity and debt finance from a range of investors. Investors are typically unconnected, but funds often need to be 'seeded' by a person connected to the fund promoter (typically a life company connected to the fund manager). Investment structures also often afford fund promoters an opportunity for co-investment into equity and debt of the fund, which is particularly important in the early funding stages.

The design of any group ratio rule should have regard to the equal and fair treatment of internal and external funding sources in early stage investment. We urge the government to have regard to existing UK tax rules that are particular to alternative fund structures - particularly the Investment Manager Exemption - that deal with these issues.

Particular issues for life companies

Life assurance companies often invest in collective investment schemes open to a wide range of investors. They do this to support their liabilities to policyholders. Given the quantum of assets invested by life assurance companies, it is relatively common for a life assurance company to hold a majority interest in a collective investment scheme such that the scheme is included on the consolidated balance sheet of the relevant life group.

The effect of this would be that a group ratio rule applicable to the life group would also be applied to the collective investment scheme. The funding requirements of collective investment schemes are often very different to those of the rest of a life group, so applying one rule to both would almost inevitably lead to interest deductions being partially denied.

Question 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?

For the reasons outlined above, specifically:

- disproportionate impact on companies that typically struggle to obtain funding
- competitiveness of the UK
- targeting the rules at areas most at risk of tax avoidance through BEPS,

we agree that an exemption should apply to SMEs as defined by the EU criteria.

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

We welcome the inclusion of a PBP exclusion in the OECD's approach. However, we are concerned that, as drafted, the conditions mean that the exclusion is drawn too narrowly to be of practical benefit for infrastructure investment (see response to question 14 below).

A PBP would have a significant benefit over a group ratio rule in that the issuer would not have to compute a group ratio and that the conditions would apply simply to prevent the rules applying.

However, investors are likely to be cautious about the application of rules that are politically subjective. In particular, the requirements that the investment has a general public interest, or that the investment is subject to a "regulatory framework" could have a very wide interpretation, which could fluctuate with political cycles. Such rules do not lend themselves to the type of long-term financial commitment that is usually required of infrastructure investment.

So while the inclusion of a PBP exclusion is, subject to drafting, welcome, it does not remove the need to have a group ratio rule that applies broadly to infrastructure investment also.

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

We are still consulting members about improvements to the PBP exclusion and we will follow up with specific recommendation in due course.

Question 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?

Interest restriction rules are likely to have a wide impact across a range of capital markets activities. Widescale refinancing of investment would take a long time - we expect years, not months. Therefore effective and broad grandfathering is essential to prevent failures in the functioning of capital markets.

While the above applies broadly, it is especially true of infrastructure and property investment, which is normally made with commitments and covenants that apply over many years. Changes in the tax treatment of such investments could cause them to become unviable and prone to failure. This would come at a cost to investors - mostly pension funds and other institutional investors - and to the economy that would be deprived of the long-term benefits of infrastructure project finance.

We urge the government to consider broad and lengthy transitional provision for existing debt finance in order to prevent the abandonment of projects and company failures, and to allow a stable transition to alternative forms of finance.