HM Treasury

By email: BEPSinterestconsultation@hmtreasury.gsi.gov.uk

4 August 2016

Dear Sirs,

Re: Tax Deductibility of Corporate Interest Expense: Consultation on Detailed Policy Design and Implementation

We are writing on behalf of the British Private Equity and Venture Capital Association (the "BVCA"), which is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of almost 600 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers. While our membership is predominantly focussed on private equity and venture capital, a significant number of our members are active in infrastructure, debt and real estate. These types of alternative funds are a growing source of finance for investment by business.

Our members have invested over £30 billion in nearly 3,900 UK-based companies over the last five years. Companies backed by private equity and venture capital in the UK employ around 490,000 people and almost 90% of UK investments in 2014 were directed at small and medium-sized businesses. The availability of debt finance facilitates this investment in business and jobs growth and the benefits of debt finance in the broader economy should not be underestimated.

We set out in our written response to the initial consultation paper in January the reasons why we did not agree with the proposal to introduce a new general rule for restricting the deductibility of interest for UK corporation tax purposes, primarily because it could deter investment in UK businesses at a time when it is very much needed.

It is clear from the latest consultation paper that new rules will, in all likelihood, be introduced with effect from 1 April 2017. The submissions in this response are therefore made with the primary aim of ensuring that, so far as possible, the new rules:

- provide businesses, particularly those which may be significantly affected by the changes, with sufficient time to adapt to the new environment;
- continue to allow businesses to deduct external financing costs in line with the OECD recommendations in respect of AP4 and the principles behind the group ratio rule, without unintended distortions and anomalies.

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Summary of key points

A summary of our key points is set out below. Responses to the specific questions raised in the consultation paper, insofar as they are of particular relevance to the private equity and venture capital industry, follow on from that.

A. Transitional Provisions

Any changes which affect the deductibility of interest costs could have a significant effect on business cash flows and forecasts. The position may be particularly acute where those interest costs have, quite reasonably, been assumed to be deductible because they relate to external third party debt or have been the subject of an Advance Thin Capitalisation Agreement with HM Revenue and Customs.

This, in turn, could put businesses at risk of breaching the financial covenants in their financing documents, triggering events of default and / or increases in the interest rates payable under those documents. In these circumstances, businesses will typically look to reduce costs (e.g., jobs) and capital investment to protect themselves from the effects of this. For some businesses, this may not be feasible and the ability to refinance their existing arrangements may be limited. At a time when the global economy is emerging from a very significant downturn and remains fragile, particularly in light of Brexit, this seems counterproductive and potentially damaging to the UK economy.

The issue of timing and grandfathering is extremely important to our industry, where term financing of 5 to 7 years and detailed financial covenants are common and term financing in some sectors (e.g., utilities, infrastructure and property) can be even longer.

We understand that the government is reluctant to introduce any grandfathering provisions, save in exceptional circumstances, but we strongly believe that this position should be reconsidered. We include in Appendix 1 an illustrative example of how financial covenants could be breached if the new rules were introduced and it seems to us that a two year transitional period from 1 April 2017 would provide businesses with an appropriate period to adjust to any changes. There is also precedent for this in the changes to the transfer pricing rules applicable to financing arrangements in F(No.2)A 2005 and the implications of those changes were arguably far less significant than the potential consequences of the current proposals.

We are also unclear as to why a transitional period of, say, two years would introduce significant distortions between market participants and reduce the effectiveness of the new rules. Someone coming into the market or refinancing now will always be in a different position to someone who is already established or has long term financing arrangements in place, simply by virtue of changing market conditions. The effects of this were clear in 2008. We can understand the desire to try and create a level playing field but that must most sensibly be done over a transitional period to avoid equally (and

potentially even more) distortive disruption for existing businesses. At least, if implementing new financing arrangements now, businesses can model the effects of the changes and agree the financing terms accordingly. Businesses which have existing financing arrangements in place are unlikely to enjoy that flexibility.

B. Group Ratio Rule

We believe that this is critical to ensuring that, so far as possible, genuine third party financing costs generally remain deductible in keeping with the OECD recommendations in respect of AP4.

There are, in our view, three important aspects to this which must be addressed for the group ratio rule to work properly and to achieve what appears to be the underlying policy objective. It is also worth noting that if genuine third party interest costs are restricted and the relevant lenders are in the UK, the question of what compensating adjustments should be made in these circumstances arises. There is clearly no base erosion or profit shifting, as all amounts remain within the UK tax net, but the overall UK tax position has been distorted.

- **Tax EBITDA and Group EBITDA**

  EBITDA for the purposes of the fixed ratio rule and EBITDA for the purposes of the group ratio rule should be determined on the same basis otherwise there is not a like for like comparison and a significant risk that, in circumstances where EBITDA from an accounting perspective is greater than tax EBITDA for the purposes of the fixed ratio rule, financing costs on genuine third party debt could be subject to restriction, even in the context of a solely UK group.

- **Effect of Non-UK Operations**

  The group ratio rule, as currently proposed, produces some particularly anomalous results where there are non-UK operations in the group. We include in Appendix 2 an illustrative example of this. The consultation paper identifies potential anomalies where group EBITDA is low in comparison to group interest costs but does not address specifically the effects of increases and decreases in non-UK operations on group EBITDA. As is evident from the example, it cannot be right that the deductibility of external financing costs is potentially restricted if, by virtue of the performance of non-UK operations, group EBITDA improves but increases if, on the same basis, group EBITDA falls.

  One potential solution to this would be to allow businesses to elect to peg interest deductions by reference to the group interest to EBITDA ratio day 1, which should in practice reflect the worldwide borrowing capacity of the group at that time. That election would apply for so long as there were no material changes to the financing arrangements of the group and, while in these circumstances the relevant business

would be protected from future restrictions, similarly it would not benefit from any increased interest capacity over that period.

- **Qualifying Interest and Related Party Debt**

  We have previously expressed our concerns over the introduction of any related party restrictions. We acknowledge that, under the proposals put forward in the consultation paper, these will apply only for the purposes of the group ratio rule. We remain concerned, however, that, in the context of the private equity and venture capital industry in particular, this could lead to double taxation where there is a restriction at the level of the investee company but tax in the hands of any UK taxpaying investors in the fund. There is, at the very least, a case for some sort of compensating adjustment in these circumstances.

  More importantly, we believe that in the application of any related party test, including where parties are acting together, the legislation or, more likely, accompanying guidance needs to be clear that in circumstances where:

  - an institutional investor in a fund which controls a portfolio company and a related party within that institution lends to that portfolio company on genuine arm's length terms or even participates in or acquires a tranche of an external loan to that portfolio company;
  - an asset manager, which manages both private equity and credit funds, brings both funds into a portfolio company but clearly on independent terms; or
  - a venture capital / minority fund invests in a family / owner-manager business, primarily by way of loan and with less than a 25% interest in the company,

  the institutional lender, credit fund or venture capital fund respectively are not to be treated as related parties for these purposes.

C. Interaction with Loss Reform

We generally support the proposal that any interest restricted under the new rules should be carried forward and, subject to available capacity in subsequent periods, be treated as if it had accrued in those subsequent periods so that it is not subject to both the interest restriction and the proposed 50% restriction on carry forward losses.

We would, however, suggest that businesses should also be able to carry forward any interest costs which would have been restricted under the fixed ratio rule but for the £2m de minimis otherwise the de minimis inadvertently imposes a second restriction on interest expenses. This is particularly relevant for businesses which are in development phase for the first few years of operation but then generate significant earnings.

BICA

Detailed response to questions of particular relevance to industry

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 flexibilty?

We believe that this is helpful but, as set out above, suggest that businesses are also entitled to carry forward interest which would have been restricted but for the £2m de minimis.

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 would obviously welcome the removal of the Debt Cap altogether from a compliance perspective but can understand why the modified debt cap has been proposed and, if the test is to be applied on broadly the same terms as before, including very limited restrictions on amounts to be included within total group-interest, we do not have any material objections to the proposal and believe that it should operate effectively.

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 believe that option 2 would be preferable in these circumstances. Applying the group ratio rule on a current year basis would be unnecessarily restrictive and distortive. We would also suggest that transfer pricing and a 'just and reasonable' apportionment by reference to UK activities would provide a much more sensible basis of assessment than some arbitrary fixed percentage of tax-EBITDA, higher than 30% but less than 100%. The test then becomes completely detached from the mischief it is intended to address.

Question 20: Do you agree that the proposed definition of related party will be effective in preventing equity investors inflating the group ratio by investing using debt instruments? Please identify situations where this definition would prevent the Group Ratio Rule from taking into account interest payable to lenders that invest for a fixed return and without seeking influence over the borrower.

We do. Please see comments in Section B above for situations in which it needs to be clear that the holder of a debt investment in a portfolio company would not be regarded as a related party for these purposes.

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?

Please see comments in Section B above and, in particular, the concern that if EBITDA for the purposes of the fixed ratio rule and EBITDA for the purposes of the group ratio rule are not determined on a comparable basis, there is a significant risk that the group ratio rule will not

achieve what appears to be the policy objective of ensuring that external financing costs generally remain deductible.

Question 29: As a result of the proposed exclusion from the group of subsidiaries held at fair value, views are invited as to whether a specific rule is required to prevent collective investment vehicles from being the ultimate parent company of the group.

If the proposed exclusion is included and for so long as it remains possible to fair value investments in portfolio companies, we do not believe that a specific rule should be required for such vehicles or, indeed, master holding company structures, where completely separate portfolio investments may be held by a fund through a single holding company.

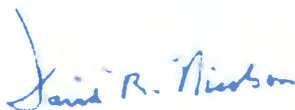
Question 46: Does the phasing in of the rules as outlined above create any particular difficulties for businesses?

The amount of change which UK businesses are having to cope with in this area is significant. The introduction of the hybrid rules from yet another date (1 January 2017) only complicates things further. The government should be sympathetic to that and give businesses time to adapt. Ideally, all of this would be deferred until 2018 and then brought in as one complete package.

We recognise that this is unlikely but would like to reiterate at the close our request that a transitional period of two years from 1 April 2017 be considered in respect of any new interest restriction rules for the reasons set out at the beginning of this letter.

We hope that the comments and responses above are helpful. We would, of course, be very happy to discuss any of them with you further.

Yours faithfully,



David Nicolson
Chairman of the BVCA Taxation Committee

APPENDIX 1

POTENTIAL BREACH OF FINANCIAL COVENANTS

Commentary

The example overleaf illustrates the potential impact of the new rules on external financing arrangements put in place to acquire a UK headed business.

It assumes that:

- the business is acquired by way of an acquisition of the shares in UK Holdco;
- initially 25% of the group's business (by EBITDA) is based in the UK and the remaining 75% in non-UK territories;
- the acquisition is funded by way of bank debt and equity through a UK Bidco;
- the group starts to forecast a dip in non-UK earnings in FY17 and to a lesser extent in FY18.

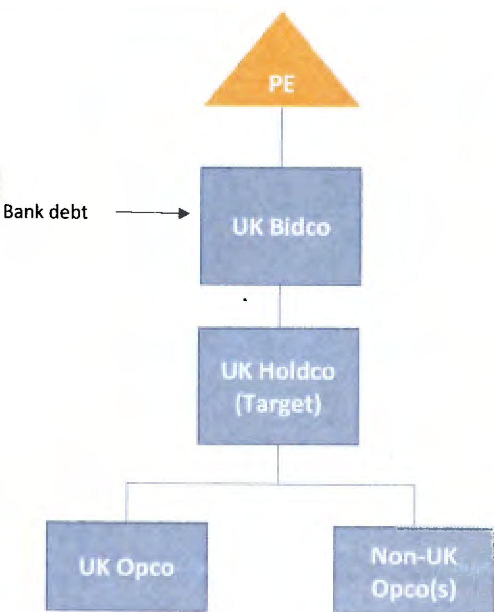
The level of bank debt and the cash flow covenants are based on real deal metrics seen last year before the new rules were proposed.

The base case (the box in the top right hand corner) reflects the position under the current rules. The alternative (the box in the bottom left hand corner) reflects the position under the new rules and clearly shows how in FY17 and FY18, even applying the group ratio rule, the financial covenants under the financing arrangements may be breached, when under the existing rules they would not have been. As set out in the main body of our letter, this may cause the group to consider reducing spending in other areas, e.g., jobs and capex, in order to try and avoid triggering that breach, which is clearly detrimental to the business and the wider economy.

Assumptions

FY16	
Group EBITDA	50
Enterprise Value (10 x EBITDA)	500
UK EBITDA (% of group)	25%
Non-UK EBITDA (% of group)	75%
Annual Capex (all UK)	5
EBITDA growth rate	12%
DEBT	
Bank debt (all UK)	250
Interest rate (paid)	*5%*
Covenants	
Cash flow cover	01:01

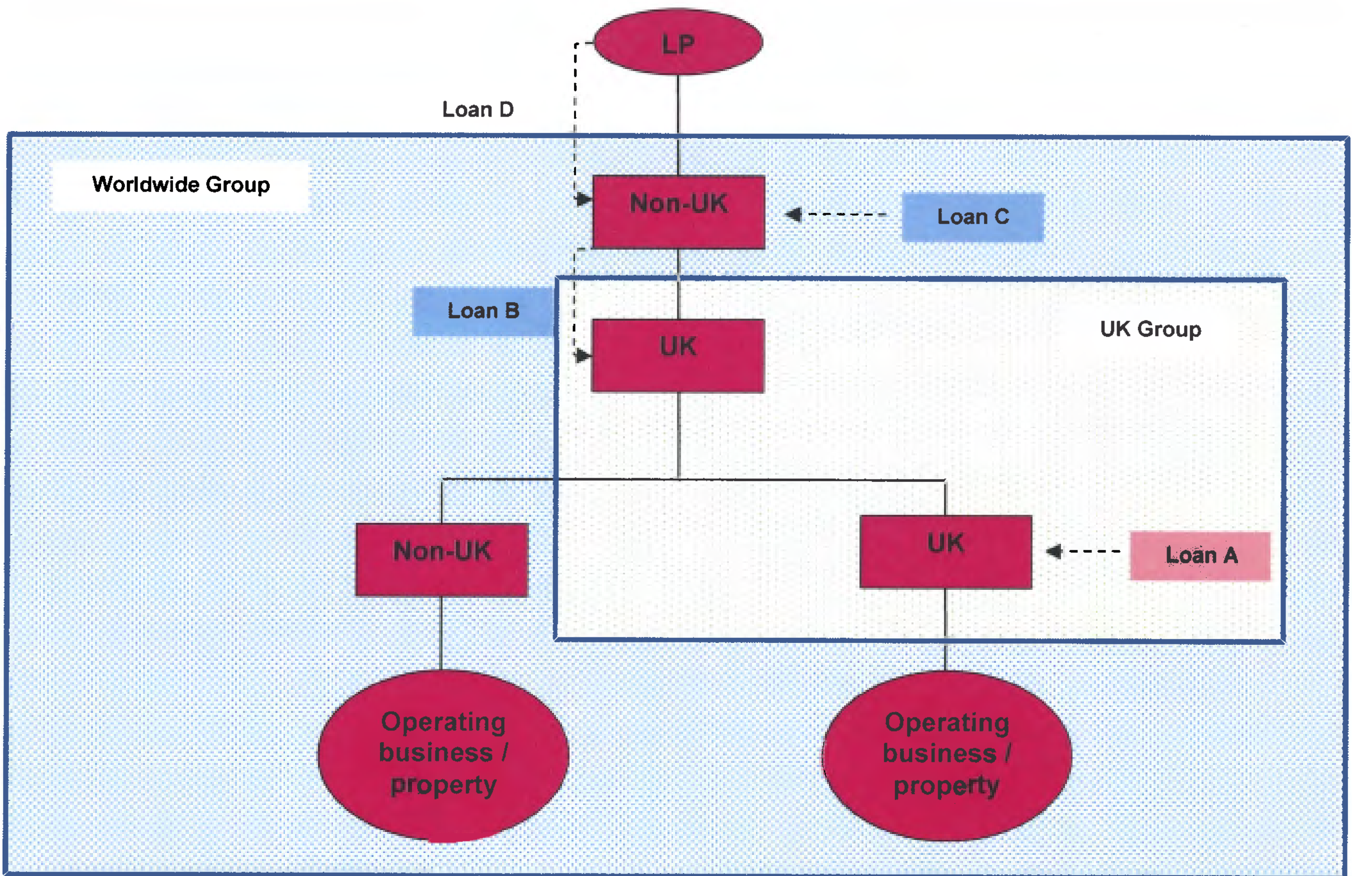
*** Non-UK EBITDA falls by 35% in FY17 and a further 10% in FY18, before returning to its previous growth rate.**



Base Case: All bank debt allowed	FY16	FY17*	FY18	FY19	FY20	FY21
UK						
EBITDA	12.50	14.00	15.68	17.56	19.67	22.03
Capex	(5.00)	(5.00)	(5.00)	(5.00)	(5.00)	(5.00)
Interest deduction	(12.50)	(12.50)	(12.50)	(12.50)	(12.50)	(12.50)
Taxable income	0.00	1.50	3.18	5.06	7.17	9.53
Tax rate	20%	19%	19%	19%	17%	17%
Tax	0.00	0.29	0.60	0.96	1.22	1.62
Interest paid	12.50	12.50	12.50	12.50	12.50	12.50
Free cash flow	(5.00)	(3.79)	(2.42)	(0.90)	0.95	2.91
Non-UK						
EBITDA	37.50	24.38	21.94	24.57	27.52	30.82
Tax rate	28%	28%	28%	28%	28%	28%
Tax	10.50	6.83	6.14	6.88	7.71	8.63
Free cash flow	27.00	17.55	15.80	17.69	19.81	22.19
Group						
Total cash	22.00	13.77	13.37	16.79	20.76	25.10
Cash flow cover	176%	110%	107%	134%	166%	201%

Alternative: New rules	FY16	FY17*	FY18	FY19	FY20	FY21
Group Ratio	25%	33%	33%	30%	26%	24%
Applicable rule	Fixed ratio	Group ratio	Group ratio	Fixed ratio	Fixed ratio	Fixed ratio
UK						
EBITDA	12.50	14.00	15.68	17.56	19.67	22.03
Capex	(5.00)	(5.00)	(5.00)	(5.00)	(5.00)	(5.00)
Interest deduction	(3.75)	(4.56)	(5.21)	(5.27)	(5.90)	(6.61)
Taxable income	8.75	9.44	10.47	12.29	13.77	15.42
Tax rate	19%	19%	19%	19%	17%	17%
Tax	1.66	1.79	1.99	2.34	2.34	2.62
Interest paid	12.50	12.50	12.50	12.50	12.50	12.50
Free cash flow	(6.66)	(5.29)	(3.81)	(2.27)	(0.17)	1.91
Non-UK						
EBITDA	37.50	24.38	21.94	24.57	27.52	30.82
Tax rate	28%	28%	28%	28%	28%	28%
Tax	10.50	6.83	6.14	6.88	7.71	8.63
Free cash flow	27.00	17.55	15.80	17.69	19.81	22.19
Group						
Total cash	20.34	12.26	11.99	15.42	19.64	24.10
Cash flow cover	163%	98%	96%	123%	157%	193%
Interest disallowance	*8.75*	*7.94*	*7.29*	*7.23*	*6.60*	*5.89*

APPENDIX 2



	Year 1	Year 2
UK EBITDA	1000	1000
Group EBITDA	1600	2400
Interest Cost		
- Loan A	250	250
- Loan B	150	150
- Loan C	350	350
- Loan D	200	200
Net UK Interest Expense	400	400
Net Worldwide Interest (Unadjusted)	800	800
Net Worldwide Interest (Adjusted)	600	600

Commentary

The net interest expense of the UK Group is the interest on Loans A and B: 400.

The net interest expense of the Worldwide Group is the interest on Loans A, C and D: 800.

In Year 1, the UK net interest:EBITDA ratio is 40 per cent. Ostensibly, therefore, 100 of interest expense will be denied under the fixed ratio rule on the basis that 30 per cent of UK EBITDA is 300.

Applying the group ratio rule:

- the unadjusted worldwide net interest:EBITDA ratio would be 50 per cent and so UK net interest expenses could be claimed, under the group ratio rule, at up to 50 per cent of 1000 and there would be no restriction on the 400 of actual UK interest expense;

- the adjusted worldwide net interest:EBITDA ratio would be 37.5 per cent and so UK net interest expenses could be claimed, under the group ratio rule, at up to 37.5 per cent of 1000 and there would be a small restriction (i.e. 25) on the 400 of actual UK interest expense.

The unadjusted interest expense figure reflects the qualifying worldwide interest expense if the interest on Loan D is not excluded under the related party proposals. The adjusted interest expense figure reflects the position if it is.

In Year 2, the worldwide net interest:EBITDA ratio is 30 per cent (and 25 per cent on an adjusted basis) because the non-UK EBITDA is more significant. In this instance, the group ratio rule would provide no relief from the fixed ratio rule.