Association of Business Recovery Professionals

120 Aldersgate Street
London EC1A 4JQ

Telephone: 020 7566 4200
Facsimile: 020 7566 4224

email: association@r3.org.uk
Internet:r3.org.uk

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Comments by the Association of Business Recovery Professionals (R3) in response to the Consultation paper issued by HM Treasury.

Tax Deductibility of Corporate Interest Expense: consultation on detailed policy design and implementation.

R3 is the leading professional association for insolvency practitioners (IPs) in the UK, promoting best practice for professionals working with financially troubled individuals and businesses, promoting the work to Government and key policy makers, producing guides for insolvency professionals and members of the public, running courses and conferences to promote learning and best practice within the insolvency profession. Our members (approximately 3,000) work in firms of all sizes, from the global legal and accountancy firms through to smaller local firms and sole practices, and include insolvency lawyers and other professionals working in the insolvency and restructuring professions. Our members cover the whole spectrum of work with financially distressed businesses and individuals including advice, rescue and turnaround, and formal Insolvency Act 1986 appointments.

R3 believes that it is imperative that the tax deductibility of corporate interest expense proposals be specifically considered in relation to distressed companies or groups requiring special financial restructuring as well as for formal insolvency scenarios.

R3 stresses both the accepted principle that UK insolvency legislation should support struggling businesses and that HMRC has also, historically, indicated keenness to aid struggling businesses that can be made viable. Furthermore HMRC's principle purpose for the proposals, to stop aggressive tax planning, should not be a concern for a distressed or insolvent business.

It is important to note that common features of distressed companies are volatile trading results, normally within a relatively short concentrated period, poor quality of information, a changing management team and a generally unstable business environment.

R3's principle concerns

1. In a rescue scenario interest restrictions of the type envisaged may have the adverse impact of creating a tax liability for a loss making business, creating an additional cash drain when company survival is the desired outcome. The result of this is likely to be increased business failures as existing creditors are unlikely to be willing to support a rescue plan which would result in significant financial losses to them at the same time as tax being payable to HMRC.

2. In a formal insolvency process it seems inequitable that HMRC should be an additional or even greater tax creditor to the prejudice of existing creditors.

3. A regime of group based calculations requiring access to group information does not sit naturally with companies that are in an insolvency process. Both in relation to the periods of the insolvency

process itself, and also in respect of the liquidator or administrator sharing information that relates to the pre-administration period with solvent companies in the group who are mutually dependent upon it for their own tax calculations.

4. Allowing group allocations of restrictions could unfairly prejudice creditors of an insolvent group company.

5. Companies in insolvency will rarely prepare statutory accounts and therefore no information will be available to calculate the company's EBITDA in the manor envisaged by the proposals.

6. On the basis that the proposals do proceed we believe that an implementation timetable of 1 April 2017 is insufficient time for UK businesses to react. The proposals are complicated, and groups and companies need much more time to fully understand the implications of the new rules, model various structures, and generally restructure finances if necessary. We are therefore of the view that once the form of interest relief is agreed, there is a sensible period for draft legislation to be consulted on, and there should be at least be a 2- 3 year period before it becomes effective. In addition it is important that further clarification be given as to how these proposals will interact with the concurrent consultation on loss relief restriction.

7. The stated objective of the proposals is to leave 95% of existing companies unaffected which by corollary means the target is the larger companies, which it is reasonable to assume will be international and leveraged. We accept that the £2million interest allowance equates to say £20-£40 million debt leverage and therefore the new rules are focussed on larger companies. We would not wish to see scope creep as interest rates rise so a mechanism for increasing the £2million allowance would be welcome.

R3's principle recommendations

Consideration should be given to ensuring an equitable result for all creditors of an ailing or failed business. This might include;

- **a.** an automatic group pro rata mechanism for the interest restriction which can only be amended by a joint election
- **b.** a form of corporate rescue exemption to be applied for formal rescue procedures
- **c.** exempting companies in a formal insolvency process from the restrictions altogether
- **d.** in insolvent situations restricted interest or spare capacity could be carried back in a similar fashion to terminal loss relief.

Further background

The distressed corporate sector can, for the purposes of this paper, be segregated into two categories as follows;

- Distressed companies contemplating administration or other insolvency process;
- Distressed companies actually in administration or other insolvency process. This may include distressed companies in an administration that may survive (pre- packs).

<u>Distressed companies contemplating administration or other insolvency process; The period before a process.</u>

<u>Interest restriction</u>

An interest restriction can have the effect of creating a tax liability for a company which is making losses, at the very time it needs to preserve cash.

The concept of interest restriction allocation amongst groups presumably creates the initial starting point that any group company is entitled to a full tax deduction for the interest cost it has incurred. The UK parent company can, as proposed, however radically change that position unilaterally by allocating the interest restriction. This puts the parent company in a powerful position of control over a subsidiary, and minority interests.

The concept of interest allocation amongst groups also challenges the question of who within a group owns the interest restriction. In a distressed group situation, one company could be unfairly prejudiced, (as could that company's creditors) through injudicious allocation.

Our suggestion therefore is a default basis of pro rata allocation which could be overridden by a joint consenting election similar to group relief.

Interest capacity

The proposals are for spare capacity within a group to be allocated at the group's discretion to other group companies to be carried forward for 3 years, but such allocation to be constrained by capacity calculated as a stand-alone company. Distressed companies, for obvious reasons (poor trading results), may not have capacity on a standalone basis, and under the proposals could not benefit from the capacity allocation rules. On the other hand allowing interest capacity to be allocated to such companies would, consistent with government policy, enhance their chances of survival by making them potentially more attractive to a wider population of prospective purchasers. Our suggestion is therefore that interest capacity should be a) capable of allocation to any group company without restriction or b) the general rule should be relaxed for distressed companies meeting specific conditions, for example, the corporate rescue definition now incorporated into the Loan Relationship legislation.

Internal Reorganisations reliefs

Rescuing businesses and company restructuring often requires hive downs and resurrecting businesses in new companies often packaged up for sale to 3rd parties. We would recommend that interest capacity and excess interest (restricted interest carry-forward) be allowed to follow the business, similar to tax losses on business transfers between commonly owned companies. Whilst aiding business rescue, to prevent abuse the government could have similar change of trade and ownership constraints as used in S 674 CTA 2010.

One off Exceptional restructuring costs

One-off tax deductible restructuring costs or other exceptional costs have a distorting impact on the tax-EBITDA calculation, by depressing it for the purposes of the fixed ratio. This has the effect of restricting interest tax deductibility and possibly converting interest to restricted expense carry forward, at the expense of current tax payable. This is at the very time when stakeholders (members, creditors, banks etc) will be required to accept financial loss to rescue a business. Whilst it is recognised that in some circumstances, certain costs may themselves fall within the interest line, and the group ratio rule may alleviate the problem, it is suggested that there is a case for certain types of restructuring costs undertaken for rescue purposes be excluded from the tax-EBITDA calculation probably on the basis of a form of corporate rescue exemption.

Acting together

In rescue scenarios lenders and new investors become heavily involved, often unwillingly, in the refinancing process. It is recommended that specific consideration to this is given by HMRC as R3 do not believe that such matters should be classified as "acting together". It is probable that rescues may fail if interest arising from a restructuring were to be disregarded for the purposes of the group ratio rule.

Distressed companies actually in administration or other insolvency process
Excluding companies in Insolvency process from the definition of a group

The grouping definition is to be based on the accountancy concepts of a group used for the purposes of preparing consolidated accounts and IFRS concepts (5.8 & 5.11). There are a whole host of technical issues that arise for companies in administration or other insolvency processes. There are practical issues concerning the sharing of group information by and to companies in administration that potentially affect the tax liabilities of all group members whether in a process or not. A company in insolvency will not prepare statutory accounts during the process and it is highly unlikely that it will have done so for the period leading to the appointment.

A UK parent company that goes into administration does not produce consolidated accounts which begs the following questions in the period of administration;

- whether the parent is to be grouped with its subsidiaries for interest purposes,
- how are the fixed and group ratios are to be calculated, and
- whether the allocations of capacity and restricted interest expense can be made to subsidiaries, or
- should there be separate subgroups and stand-alone calculations.

Companies in administration or other insolvency process are often excluded from consolidation accounts on the basis of the control tests anyway. This means that that those companies in such a process, whilst retaining any tax attributes allocated to it in a pre-process period will, going forward, be treated as a stand-alone company for interest purposes. Is this the intention? If not, would it not anyway be sensible to exclude companies subject to an insolvency procedure from the definition of a group?

As noted above, there is a concern that insolvent group members (and therefore the creditors of such companies) could be unfairly prejudiced by the ability of a parent company to allocate restrictions. It is recommended that the restriction is allocated on a pro rata basis unless a specific election has been made to the contrary.

Information sharing obligations in relation to pre-administrations periods;

Furthermore where a UK parent company is in administration or other process, it will often be the case that it has to deal with matters arising for pre-administration periods. Calculating fixed or group ratios for the purposes of determining capacity / interest restrictions for the other group companies will be one such matter. In distressed situations these are onerous obligations and given the circumstances difficult to discharge.

There could also be a subsidiary in administration within an otherwise trading group. Information will be needed from the administrator relating to the pre administration period. This will be needed for the purposes of computing the interest restriction/ capacity. Again this could prove difficult.

It is suggested that groups could elect to calculate the relevant ratios without reference to companies that are in administration, for periods in, and perhaps 2 years prior to, administration. This allows solvent companies within groups more flexibility and avoids difficulties with the administrators. It is accepted that intercompany interest between the company in administration and the group will become related party for the purposes of the group ratio, and that this will require a separate carve out perhaps on similar lines to the above.