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# Response to the consultation on the tax deductibility of corporate interest expense

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This note is a response to the consultation on the corporate interest expense, published by HM Treasury on October 22, 2015. It reflects the views of the named authors, rather than the Oxford University Centre for Business Taxation, which has no corporate views.

Our aim is to address the big picture regarding the nature of relief for the cost of finance. We do not offer answers to most of the questions raised in the consultation document, other than perhaps the first, on whether a general interest restriction should be introduced in the UK.

**Background**

The views set out here reflect two broad starting points.

First, it is clear that introducing a general restriction on interest would represent a change of direction for the UK. In 2010, the government stated:

> *"The UK's current interest rules, which do not significantly restrict relief for interest, are considered by businesses as a competitive advantage; other comparable countries tend to have more severe restrictions on such relief."*
> Corporate Tax Roadmap, 2010

The approach of using relatively more generous treatment of interest deductions has clearly been used to try to attract business to the UK. For example, one publication encouraging businesses to locate in the UK stated:

> *"In the UK, interest expense for share acquisitions is available, which also helps promote the UK as a holding company location"*
> Why invest in the UK, UK Trade and Investment, 2013

The OECD BEPS reports identified two reasons why generous treatment of interest may be problematic for base erosion and profit shifting. For outbound investment, it identified the case where a parent company can borrow and receive an interest deduction, even if funds are used to equity finance outbound investment, the return on which is not taxed in the parent's country. This is broadly true for the UK. However, to the extent to which this is regarded as problematic, the solution is surely to restrict the deduction in such cases, rather than to introduce a general restriction.[1]

For inbound investment, the OECD identified the case where a subsidiary entity may be heavily debt financed, using "excessive" deductions on intragroup loans. The term "excessive" is not defined by the OECD. However, it appears to be this issue which prompts the UK to state, in its consultation document:

> *"The government believes that the new rules on interest deductibility as set out in the OECD report are an appropriate response to the BEPS issues identified therein"*
> Consultation document, 2015

and

> *"Consistent adoption and application of rules across all countries would have the benefit of certainty for business as well as ensuring a more level playing field"*
> Consultation document, 2015

It is not clear whether the "level playing field" is intended to refer to competition between companies operating in the UK, or between countries competing for inward investment. In either case, this seems to be an abrupt departure from the government's previous stance.

The second starting point for the views expressed here is that economists have long held the view that there is no good reason to discriminate between debt and equity finance. In their pure forms, these financial instruments clearly have different characteristics, but these differences do not create a convincing case for different tax treatment. It might be argued that the return to debt finance is generally taxed at the level of the recipient, whereas the return to equity finance is generally taxed at the level of the company. But this is not generally true. Even if it were, treating the two sources of finance differently offers opportunities for the development of hybrid instruments in which the return may avoid tax entirely. In our view, it would be better to address the underlying discrimination between debt and equity finance, rather than to create ever more complex rules by introducing an arbitrary restriction on interest deductions (which would be still more complex if they did not apply to the financial sector, since that distinction would also need to be defined) or by changing the treatment of hybrid instruments.

In the academic and policy literature, there have been two broad directions of debate for the reform of the treatment of debt and equity.[2] The first is to eliminate any deduction for interest payments, turning the corporation tax into a tax on the full return earned by the

[1] Consideration would have to be given to making this consistent with EU law.

[2] For more discussion, see Devereux, M.P. and Birch Sorensen, P. "The Corporate Income Tax: international trends and options for fundamental reform", *European Commission Economic Paper 253,* December 2006. Available at http://ec.europa.eu/economy_finance/publications/publication530_en.pdf.

corporation. Such a reform was analysed in detail by the US Treasury in 1992, and was referred to as the Comprehensive Business Income Tax (CBIT).[3]

The second is to give relief for the opportunity cost of equity finance, to match the deductibility of interest payments. This "Allowance for Corporate Equity (ACE)" was first proposed by the IFS Capital Taxes Committee in 1991,[4] and was recently advocated by the IFS Mirrlees Committee.[5] A form of ACE has been introduced in other countries, for example, Belgium and Italy. A full ACE in combination with full interest deductibility has the effect of turning the corporation tax into a tax on economic rent – that is on profit over and above the minimum required rate of return. In many settings, such a tax is non-distortionary, and has therefore long been advocated as a reform to corporation tax.[6]

A problem with introducing an ACE is that the tax base is clearly reduced by the extent of the allowance. Raising the tax rate to compensate for the loss of revenue would have other harmful effects, not least in increasing the incentive to shift profits to other jurisdictions. For this reason, the Mirrlees review advocated introducing an ACE while permitting the overall revenue from corporation tax to decline.

**Partial relief for the costs of finance**

These two points of background lead us to propose that the UK should adopt a partial ACE at the same time as restricting the deductibility of interest.[7] A partial ACE would give relief along the lines of an ACE, but without giving full relief. Matched with a reduction in the relief for interest payments, the idea of such partial relief is to reduce the deduction for debt finance, but to maintain the size of the tax base by giving relief for equity finance. The extent of relief under both forms of finance would in principle be determined by the need to maintain revenue at the existing corporate tax rate. Ideally, relief should be given for the same proportion of both sources of finance.

The key advantages of such an approach are:

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[3] "Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once", US Treasury, 1992.

[4] "Equity for companies: a Corporation Tax for the 1990s", IFS Capital; Taxes Committee, chaired by Malcolm Gammie, 1991, available at http://www.ifs.org.uk/comms/comm26.pdf.

[5] "Tax by Design", IFS Mirrlees Review, 2011, available at http://www.ifs.org.uk/publications/5353.

[6] In present values terms, it is equivalent to the flow of funds tax advocated by the Meade Committee in 1978: "The Structure and Reform of Direct Taxation", Meade Committee, 1978. Theoretical analysis of the ACE is provided in Devereux, M.P. and S.R. Bond "On the design of a neutral business tax under uncertainty", *Journal of Public Economics,* 1995, 58, 57-71 and Devereux, M.P. and S.R. Bond "Generalised R-based and S-based taxes under uncertainty", *Journal of Public Economics,* 2003, 87, 1291-1311.

[7] A more detailed discussion of the UK position after BEPS, and of the possible introduction of an ACE, is in Collier, R. and G. Maffini (2015) "The UK international tax agenda for business and the impact of the OECD BEPS project", Oxford University Centre for Business Taxation Working Paper 15/13.

- The UK can maintain a competitive advantage in the provision of relief for the cost of finance, while complying with the proposals of the BEPS project to introduce a restriction on interest deducibility.

- The UK can take the opportunity to introduce a more principled approach by eliminating (or at least significantly reducing) the incentive for British business to use debt, rather than equity, finance.

- Depending on how the partial ACE is combined with relief for interest payments, there could be a significant reduction in complexity (compared to an increase in complexity if new restrictions are introduced). Even if there remained a difference in the method by which relief was given for the two forms of finance, more equivalent treatment would make the distinction between them a less important dividing line. A more far-reaching reform would be to abolish the deduction for interest payments altogether, and replace it with a (partial) ACE-type relief for the opportunity cost of all capital (ie. debt plus equity). Then there would be no need to discriminate between the two sources of finance.

Partial relief for both debt and equity finance has been studied in detail by Devereux and De Mooij (where more details are available).[8] This reform was modelled for all EU member states. In each case, the model assumed that only one EU member state introduced such a reform at a time. The impact on that economy was then modelled. And then the average effect of introducing the reform, one-by-one in all member states, was calculated. The results were as follows:

**Predicted Effects of combined partial ACE and interest deductibility**[9]

| | |
|---|---|
| Debt share (%Δ) | – 6.1 |
| Cost of capital (%Δ) | – 0.1 |
| Wage (%) | 0.3 |
| Investment (%) | 0.7 |
| Employment (%) | 0.1 |
| GDP (%) | 0.3 |

[8] Devereux, M.P. and R. de Mooij, "An applied analysis of ACE and CBIT reforms in the EU?" *International Tax and Public Finance,* 2011, 18, 93-120.

[9] Source: Devereux, M.P. and R. de Mooij, "An applied analysis of ACE and CBIT reforms in the EU?" *International Tax and Public Finance,* 2011, 18, 93-120, and "Alternative Systems of Business Tax in Europe An applied analysis of ACE and CBIT Reforms", 2011, available at http://ec.europa.eu/taxation_customs/resources/documents/common/publications/studies/acecbit_study.pdf

The results for the UK introducing this system on its own were very similar.

The prediction is that there would be a significant reduction in the use of debt finance, as would be expected. There would be a small impact on the overall cost of capital. But overall, the reform would stimulate investment, raising the demand for labour and hence raising wages and employment, and increasing GDP – all with no impact on corporate tax revenues.

The OECD proposal to limit the interest deduction to a fixed ratio of EBITDA is not wholly consistent with the approach described, which would instead limit the allowance for the cost of finance to a proportion of the total cost. However, the OECD Fixed Ratio Rule could form an element of a new system in the UK which was designed to harmonise the treatment of debt and equity finance.

There would of course need to be considerable work undertaken to determine the way in which a partial ACE relief could be introduced, although there is a detailed discussion of this in the original report of the IFS Capital Taxes Committee. This discussion also addresses the issue of restricting relief to capital used in the UK.

Work would also need to be undertaken to estimate the impact on the aggregate tax base and tax revenue of any restriction to interest deductibility, and hence the consequent opportunity for introducing a relief for the opportunity cost of equity finance. The revenue cost of a partial ACE would depend in part on how it was introduced. If the base for the ACE relief included only new equity and retained earnings from the point of its introduction, then the initial costs would be small, although they would increase over time. This was the approach taken by Italy in 2011. The Italian Ministry of Finance estimated the revenue cost of introducing a full ACE in 2011, to be 1.2% of corporation tax revenue in 2012, rising to 2.7% of corporation tax revenue in 2013. Data from the Italian Ministry of Finance show that the take up of the Italian ACE was good, implying that it was not too complex for firms to understand. The take up was substantially higher for larger firms with between 59% and 65% of medium to large firms claiming the ACE allowance.

**Conclusion**

Given that the UK is considering a fundamental change to the treatment of interest, we believe that it would be a missed opportunity not to take a broader and more principled view of the costs of equity and debt finance together. We propose a revenue-neutral reform which uses the revenue benefit from limiting the deductibility of interest to introduce partial relief for the cost of equity finance. This is a principled approach designed to equalise the treatment of the two forms of finance, maintaining the competitive position of the UK, and reducing complexity.