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COMPLEXITY, UNCERTAINTY AND COST

THE IMPACT OF NEW RULES TO RESTRICT TAX RELIEF ON INTEREST COSTS ON REAL ESTATE INVESTMENT

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SUMMARY

- The Government's recent pledge to introduce new rules that will restrict the ability of companies to reduce their tax bills through interest deductions, risks jeopardising UK competiveness and investment.
- The Government's initiative is understandable in its intention: to crack down on corporate tax avoidance. However the new rules will also unintentionally damage the real estate and infrastructure investment sectors – estimates suggest by as much as £700 million per year.
- The new rules, to be introduced from April 2017, are intended to target conventional multinational enterprises, such as certain tech giants and coffee brands. However they do not work as well – or deliver a fair tax outcome – for businesses that rely heavily on debt for genuinely commercial reasons: namely the real estate and infrastructure investment sectors.
- The principal rule is for the tax relief on interest costs to be restricted to 30% of a company's earnings; with a secondary "group ratio" rule for more capital intensive groups with commercially higher interest costs.
- Real estate and infrastructure projects rely on debt finance far more than most other industries. It is not unusual for real estate investors to incur interest costs of as much as 60% of earnings. The 30% restriction would mean that real estate and infrastructure investors will be subject to a far higher tax liability than under the current rules.
- While the "group ratio" will offer some businesses a more appropriate tax deduction, it still won't guarantee a full deduction for third party interest. The new rules will also add uncertainty for businesses. A number of factors will affect the group ratio calculation: loss of earnings; a change in interest costs; a change in the value of the assets (even if they're not being sold and so don't result in realised earnings). These factors are outside a company's control and should not impact the tax relief available on their interest costs.
- Riskier developments typically have higher interest costs and thus are likely to be the worst affected. This would be particularly bad news for the regeneration of brown field sites and other more challenging infrastructure projects.
- The Government should therefore not introduce new rules until it is clear that they will not harm investment into capital intensive industries such as real estate and infrastructure development.

1. INTRODUCTION

In a post-Brexit era; it has never been more important to maintain UK competitiveness. However, at a time when investment into British property and infrastructure development should be encouraged, new proposals to address tax avoidance by multinational corporations may, unintentionally, have exactly the opposite effect. Any reduction in investment would not only mean less housing and less infrastructure; it will also lead to a reduction in jobs and growth that the investment would have stimulated.

This paper outlines what the proposals are; why the real estate industry is particularly concerned; and what the impact could be on investment in the UK's towns and cities.

2. BACKGROUND

The OECD was asked by the G20 to address the issue of tax avoidance by multinational enterprises (MNEs), through an initiative known as "BEPS" (Base Erosion and Profit Shifting). As a result, the OECD has recommended changes to the international tax system, as it was perceived to facilitate tax avoidance. One such recommendation referred to the use of interest deductions.

2.1 What mischief are they trying to address?

An MNE is able to use intra-group debt to generate taxable income in low tax countries, and decrease taxable profits in high tax countries, as illustrated in Appendix 1. This kind of arrangement is by no means illegal. Indeed, there are a number of commercial benefits from lending money intra-group – not least because it often allows a single entity in the group to negotiate the whole group's borrowing at better rates. However, it also provides an opportunity to 'shift' taxable profits to those companies in the group taxed at the lowest rate. The OECD considers that current rules allow MNEs to 'shift' profits far too easily, which creates mismatches between where profits are created and where they are taxed.

2.2 What are the proposals?

Further to the OECD's recommendations, the UK Government has confirmed that it will introduce new rules from April 2017 which will restrict the ability of companies to reduce their tax bill through interest deductions.

The principal rule is for the tax relief on interest costs to be restricted to 30% of a company's earnings; with a secondary "group ratio" rule for more capital intensive groups with commercially higher interest costs. There will be a *de minimis* threshold so the new rules will not apply to companies with interest costs below £2 million. Furthermore, the Government is considering a Public Benefit Project (PBP) exemption, to protect tax relief on interest for 'public benefit' infrastructure. Further details of the proposals are set out in Appendix 2.

These proposals are at least in part inspired by the public outcry over the way in which some MNEs (particularly certain tech giants and global coffee brands) have used the current system to reduce their tax bills (albeit perfectly legally). So it is understandable that countries are coming together, through the OECD, to tackle international tax avoidance – this is something that cannot be addressed by individual countries acting in isolation. However, the rules have been designed to address the tax behaviour of 'conventional' MNEs. They do not work as well – or deliver a fair tax outcome – for businesses that rely heavily on debt for genuinely commercial reasons, even where they are wholly UK-based and there is by definition no risk of profit shifting. If these rules are introduced as proposed, there will be adverse consequences for the real estate and infrastructure sectors in the UK.

3. HOW DO REAL ESTATE AND INFRASTRUCTURE INVESTORS USE DEBT?

Real estate and infrastructure projects rely far more heavily on debt finance than do most other industries. This is unsurprising, as investment in large physical assets such as roads, airports and logistics centres generally requires commensurately large sums of money. It is generally too expensive to fund such investment purely through equity capital and as a result investors use debt – often cheaper than equity – to make projects viable.

Lenders are typically willing to lend higher amounts against real estate assets than against other businesses because of the secure and long-term nature of rental income derived from the asset. Lenders will often seek security over the asset itself which reduces their risk further. Using the asset as security also reduces the risk of the kind of profit-shifting that the OECD is trying to target with these measures – because the debt is secured against an asset that is impossible to move to a low tax jurisdiction.

Real estate investments are typically appraised on a stand-alone basis – per asset or per portfolio of assets. The amount of debt that an asset can support is typically a function of three things; how much a third party lender is willing to lend, how much risk the investor wants to take on and most importantly for an investment asset, whether the rental income can cover the interest cost.

Some real estate businesses borrow on an unsecured basis and in such instances lenders rely on the overall financial strength of the business rather than on taking security over individual assets. However, ultimately that strength derives from the properties owned by the business.

4. WHY DO THE PROPOSALS MATTER?

These changes represent a huge shift in traditional tax principles in the UK. Until now, it was widely accepted that the genuine expenses of a business should be deductible for tax purposes. This allows a business to forecast approximately how much tax it will pay on its activities.

Historically, all interest paid to an independent third party (such as a bank) would be tax deductible. In addition to this, interest paid to a related party would also be deductible, providing it meets certain criteria, such as being on arm's length terms. Under these new proposals, this long-standing principle will no longer apply to

Table 1: Comparison of tax return under existing rules and new rules:

Tax computation	Current Rules	New 30% Fixed Ratio Rule
Rental income	100	100
Expenses		
Management fees	-10	-10
Allowable interest costs *(assume actual interest costs are 60 – either all paid to a third party lender or on equivalent terms).*	-60	-30
Taxable profit *(commercial profit is 30)*	30	60
Tax @ 20%	**6**	**12**

interest costs, and the restrictions will apply to related party and third party interest alike.

As already stated, investment in physical assets relies heavily on debt; it is not unusual for real estate investors to incur interest costs of as much as 60% of earnings. The figure is typically even higher for infrastructure investments. Compare those numbers to the 30% limit that the new rules would impose and it becomes clear that real estate and infrastructure investors will be liable to considerably more tax than under the current rules.

Table 1 shows how the tax computation of a typical real estate investor would change under the new proposals, compared to the existing rules. In this example, the company's tax bill increases by 100%.

These numbers represent a 'worst-case' scenario, as investors may be able to avail themselves of the potentially more generous "group ratio" rule. However, there are a number of flaws in the group ratio rule (more on this below) which means that investing in real estate and infrastructure is likely to become more expensive and less viable than it is at the moment. If this worst-case scenario is extrapolated across the whole sector, the costs to real estate industry are estimated to be over £700 million per year (see Appendix 4).

5. THE GROUP RATIO CALCULATION

A business's Group Ratio is calculated by dividing its worldwide interest cost by its worldwide earnings. As a mathematical formula:

Group Ratio (GR) =
Worldwide Interest / Worldwide Earnings

These numbers are taken from the business's consolidated financial statements. The ratio is then applied to the taxable earnings of the business's UK group to give the total amount of tax relief on interest costs available to the UK group.

The group ratio is a factor of anything that impacts on the total earnings and interest expense of the worldwide group, most of which are outside of the control of the group; including:

1. A recession, and resulting void periods in properties.
2. Development activity with limited earnings for a period.
3. Different debt markets and interest rates around the world.

Appendix 3 is a case study of a UK property company with investments overseas, which shows the application of a group ratio over an eight year period. The graphs illustrate how volatile the group ratio can be, even when the business has relatively stable earnings (from rental income) and interest costs. This volatility ultimately results in cashflow uncertainty for businesses, which makes further investment riskier and less likely. Other concerns with the group ratio include:

Tax-to-book differences

Differences in the way that tax and accounting figures are calculated under the new rules can give rise to group ratios that bear little relation to commercial reality. For instance, when an investor's property assets go up in value, this is reflected in the earnings figure for accounts purposes. Unless those assets were sold in the period, the increase in their value is purely hypothetical – an unrealised gain. Yet these unrealised gains and losses will directly influence a business's group ratio, which makes little sense because they do not really represent 'earnings' or 'profit'. Movements in property values are often completely outside of the control of investors and are generally very unpredictable; they should therefore have no bearing on the tax relief obtainable on interest costs.

Overseas groups with diverse debt profiles
The group ratio rule works well for groups that have similar debt profiles (or interest/earnings ratios) across their worldwide group. But where a group carries out different activities in different countries which naturally require different levels of leverage (e.g. development projects in the UK and a service sector business in France), this will result in the more highly leveraged activity suffering a restriction in their interest deductions.

This could lead to some unwelcome distortions in the market where overseas investors competing for the same real estate or infrastructure asset are able to pay different amounts for the same asset, because their groups have different levels of gearing. For example; a cash-rich purchaser (such as a sovereign wealth fund) will have a lower group ratio than a highly leveraged investor. The highly leveraged investor will be more likely to obtain a full deduction for their third party interest costs, and may therefore be able to bid more for the given asset (because their tax costs in respect of the same investment will be lower).

Development activity
These rules are concerning for development activity for two reasons. Firstly, the fixed and group ratio rules are earnings-based measures. Businesses carrying out development activity will not have earnings, often for several years, which illustrates how inappropriate these measures are for businesses undertaking development activity. Secondly, the cost of debt secured against development assets is typically much higher, given the riskier nature of the asset. These rules will disproportionately impact development activity, because interest costs will naturally be higher. The riskier the development, the worse the impact of these new rules – which is particularly bad news for the regeneration of brown field sites and riskier infrastructure development projects.

6. THE CONCERNS OF INVESTORS

Cost
Interest costs will often be the largest single expense for real estate and infrastructure investors. Therefore, any restriction in the tax deductibility of interest will disproportionately impact on these investors. In the illustration above, the real estate investor's tax bill would be increased by 100% because debt is such a material expense of the business. Debt is nowhere nearly as widely used in other industries so real estate and infrastructure are likely to be disproportionately affected by these rules.

Complexity
According to the government's consultation; the group ratio should afford capital intensive businesses a deduction for interest costs commensurate with their activities, in line with the worldwide group's financial position.

The group ratio calculation is complex enough from an administrative perspective. However, as the allowable interest deduction will be a function of the performance and debt profile of a worldwide group, it will be virtually impossible to model and forecast the tax cost of an investment in year one, let alone over the life of the investment.

Uncertainty
Historically, whether the rental income from a particular investment would cover the costs of financing that investment was a simple mathematical equation. However, the new rules will make it difficult to calculate the post-tax income from an investment. It will therefore become harder to determine whether that income will cover the financing costs (particularly at high levels of gearing). This in turn will make it difficult to ascertain exactly how much risk is being taken on and will make it increasingly difficult for third

party lenders to know how much they can lend against an investment.

7. THE IMPACT ON UK COMPETITIVENESS

In a post-Brexit era, the need to remain competitive has never been more important. To some extent this will mean keeping taxes low – but even more important is the need for certainty.

Certainty that the tax rules in place today will still be in place in the years to come.

Certainty around tax cash flows at the point an investment decision is made.

Certainty that the tax outcome of an investment does not depend on the tax attributes of a co-investment partner (or the debt profile of the wider group).

The UK is also the first country to propose restrictions on tax relief for interest as a result of the OECD's recommendations, well ahead of its peers. While some countries, like France and Germany, already have rules which are more similar to the OECD's recommendations; there are some key aspects of their rules which divert from the OECD's recommendations. These allow a more appropriate outcome for real estate investors. In order to ensure that the UK stays competitive and attractive to real estate and infrastructure investors, the UK should not go beyond its peers.

8. POLICY RECOMMENDATIONS

1. Rules should work for capital intensive industries.

The Government should not introduce the new rules unless it is clear that they will not harm investment into capital intensive industries. As a matter of principle, all genuine third party debt relating to such investment should be tax deductible as it poses a low risk of tax avoidance. Removing tax relief for the cost of servicing such debt would mean that many real estate businesses' mere running costs would become subject to tax.

As a minimum, there should be safeguards for debt which represents very low BEPS risk – such as third party debt secured against real estate or infrastructure in the UK or third party debt provided to a wholly UK group. Such a safeguard would help provide certainty for many investors; as well as ensure an appropriate tax outcome, as interest expense will be matched against the rental income which is taxable in the UK.

2. Existing debt arrangements should not be affected.

These changes represent one of most significant tax changes in recent years; a shift from long-established tax principles that generally allow for a full tax deduction for genuine business costs. Applying these new rules to existing debt arrangements will fundamentally undermine the basis on which businesses have made investment decisions. It would be extremely costly to restructure existing finance arrangements and these changes could put borrowers at risk of breaching their banking covenants or defaulting on loans. It would put exceptional and unprecedented pressure on businesses if the tax treatment of existing financing arrangements was not excluded from the new rules. As such, existing third party debt should be grandfathered indefinitely, as envisaged by the OECD and the EU's Anti-Tax Avoidance Directive (ATAD).

3. The UK should not act in haste.

Implementation from April 2017, as currently proposed, is too ambitious given the complexity of the new rules. It will not allow sufficient time to consider the impact of these new measures; nor will it allow sufficient time for business to adapt. In addition, these changes risk damaging the UK's relative competitiveness. The Government should therefore not introduce any changes until it is clear how other countries will respond to the OECD's recommendations.

There are other reasons to take a measured approach to implementing the new rules; the EU's ATAD allows for countries to adopt these measures by December 2018, and the shape of the OECD's final recommendations in respect of the group ratio rule (expected towards the end of 2016) are not yet known. The group ratio rule is a fundamental part of these new measures, and one which investors in real estate and infrastructure will rely on to function appropriately. The UK should therefore delay implementation until at least April 2018, to allow time to take on board the OECD's final recommendations, and to see how other countries respond to these recommendations.

APPENDIX 1: ILLUSTRATION OF ‘PROFIT SHIFTING’

The following tables illustrate the kind of ‘profit shifting’ activity that the OECD are trying to target. Scenario 1 shows two companies in a group – Company A sells coffee and Company B grows coffee. In Scenario 2, the profit has been 'shifted' to new Company C; reducing the group's total tax cost from 4 to 3 (or by 25%).

Scenario 1: ***No group treasury function - interest is paid directly to a third party lender***

	Company A	**Company B**	
	Sells coffee in Country A (20% tax rate)	*Grows coffee beans in Country B (20% tax rate).*	
Tax calculation:			
Revenue:	100	50	
Less:			
Interest costs	-15	-15	→ *Interest paid to third party lender.*
Other costs of business	-75	-25	
Profit after tax	***10***	***10***	
Tax payable	***2***	***2***	

Total tax paid by the group: 4

Scenario 2: ***A group treasury function is added – Company C***

	Company A	***Company B***	***Company C***
	Sells coffee in Country A (20% tax rate)	*Grows coffee beans in Country B (20% tax rate).*	*Performs group admin. and treasury function in Country C (10% tax rate)*
Tax calculation:			
Revenue	100	50	40
Less:			*(20+20 from Co. A. and Co. B)*
Interest costs	-20	-20	-30
	Intra-group payment to Co. C	Intra-group payment to Co. C	Payment to third party lender.
Other costs of business	-75	-25	
Profit after tax	***5***	***5***	***10***
Tax payable	***1***	***1***	***1***

Total tax paid by the group: 3

APPENDIX 2: WHAT ARE THE GOVERNMENT'S PROPOSALS?

Primary rule - fixed ratio of 30%: this will restrict the tax deductibility of interest to 30% of a company's earnings, more specifically EBITDA.

Secondary rule - Group Ratio Rule: where groups have high external gearing for genuine commercial reasons, this ratio is intended to give a tax deduction for interest which is commensurate with their activities, in line with the worldwide group's financial position.

A Public Benefit Project (PBP) exemption: to protect tax relief on interest for 'public benefit' infrastructure (This is yet to be clearly defined but it is likely to be fairly narrow in scope).

A £2m de minimis threshold: this de minimis, which will be applied on a UK group basis, should exclude the vast majority of smaller businesses.

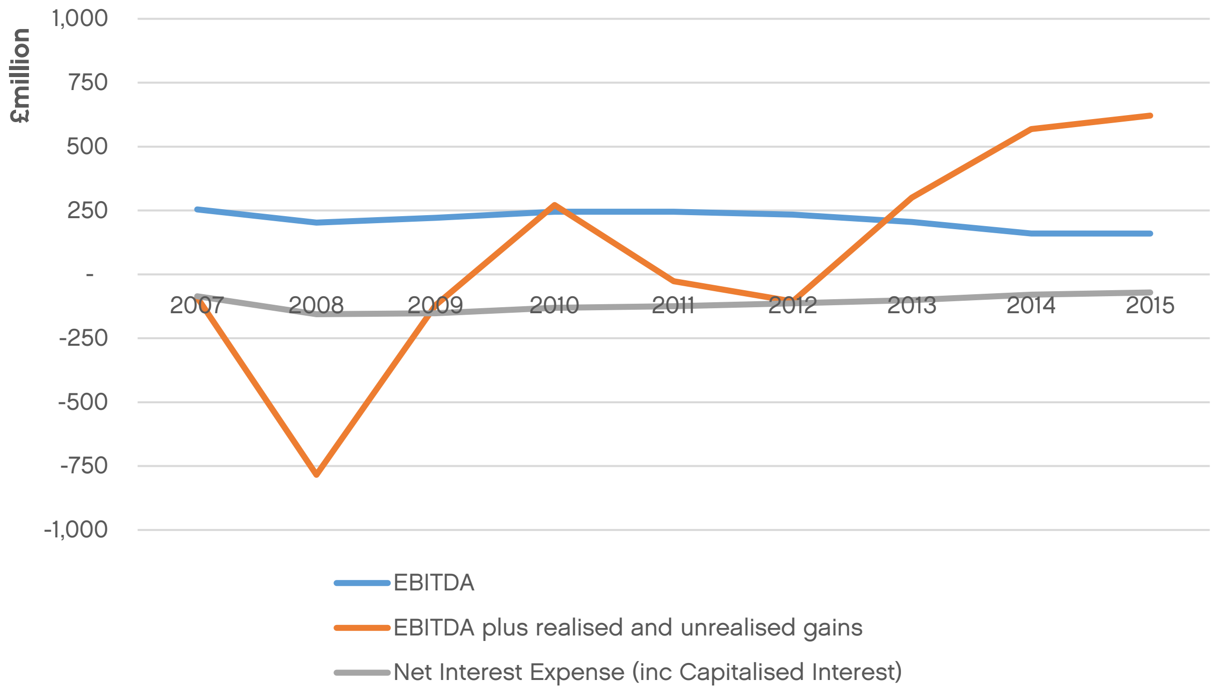
APPENDIX 3: CASE STUDY OF UK REAL ESTATE BUSINESS WITH OVERSEAS INVESTMENTS – APPLICATION OF THE GROUP RATIO RULE

The graphs below illustrate how the group ratio rule will often result in tax outcomes that are different from commercial reality. They are based on an actual UK real estate business with overseas operations.

GRAPH A

The following graph illustrates the earnings and interest expense of a real estate business over an 8 year period. The orange line illustrates the earnings of the group, including realised and unrealised gains and losses. The blue line strips out the realised and unrealised gains and losses, which shows that the underlying rental income arising in the business is relatively stable over time. The interest expense (the grey line) is also relatively stable over time.

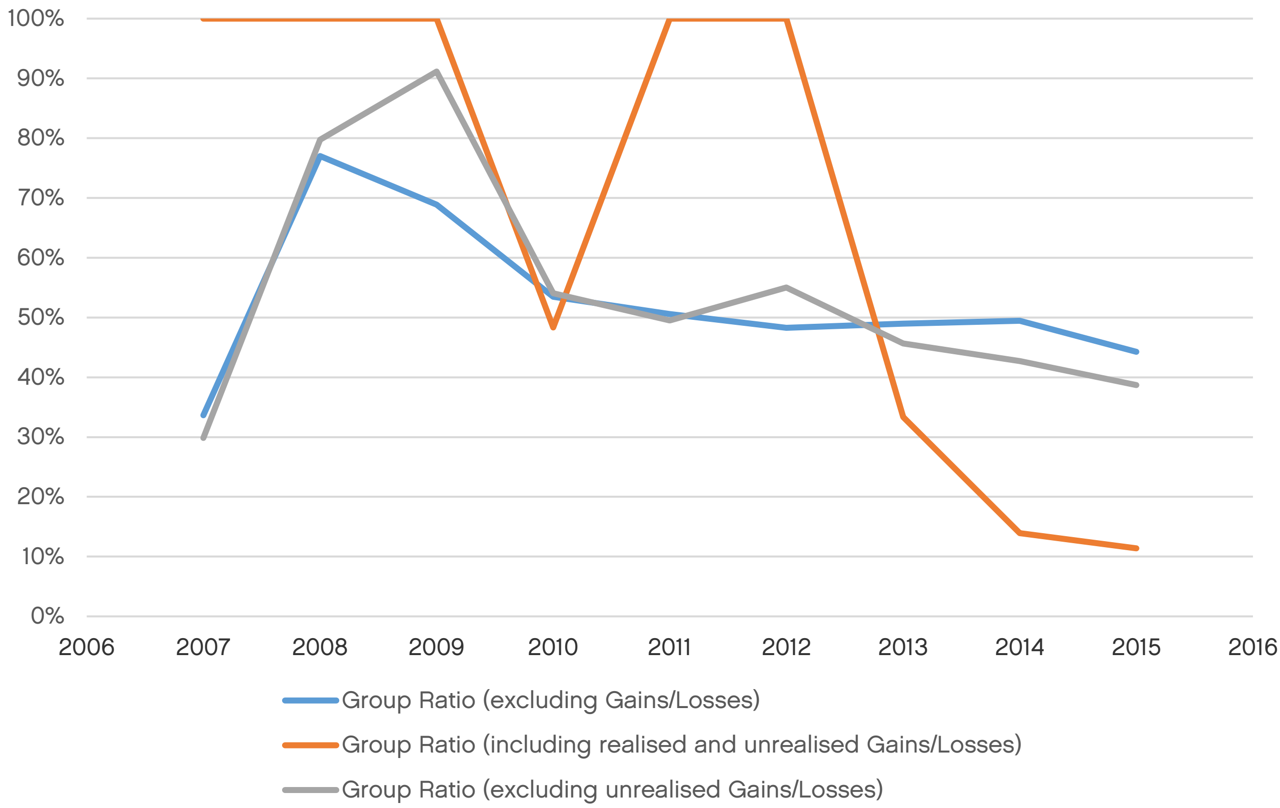
Graph A: EBITDA Considerations – Cyclical nature of Real Estate, UK REIT with Overseas Business



GRAPH B

Graph B shows what the group ratio for this business would be over the same 8 year period; the different lines represent different amounts being included within the group earnings figure in calculating the ratio. The orange line, which includes realised and unrealised gains and losses, creates the most volatile group ratio. The volatility is reduced when unrealised gains and losses are excluded (represented by the grey line); and the volatility is further reduced when all gains and losses are excluded (the blue line).

Graph B: Group Ratio – Impact of Valuation and Gain/Loss Movements, UK REIT with Overseas Business



Graph B shows that where realised and unrealised gains are included within the group ratio calculation it becomes significantly more volatile; ranging from 10% to 100% (orange line).

The volatility decreases when realised and unrealised gains and losses are removed from EBITDA; decreasing the Group Ratio range from 45% to 75% (blue line).

If the stability of the underlying businesses (represented by the blue line in graph A) is considered, it seems inappropriate for the group ratio to impose such volatility on the amount of interest that can be deducted by the UK business.

Why is there still volatility in the group ratio after realised and unrealised gains are removed?
The group ratio is a factor of anything that impacts on the total earnings and interest expense of the worldwide group, including:

1. A recession, and resulting void periods in properties.
2. Development activity with limited earnings for a period.
3. Different debt markets and interest rates around the world.

The larger the group, the more countries in which it operates, and the more diverse its activities and the debt profile, the harder it will be to predict what tax relief will be due on their interest costs. This would be an extraordinary amount of uncertainty to impose on businesses and more importantly, it does not result in a fair or appropriate outcome.

Debt secured against real assets in the UK that derive rental income in the UK is appropriately based in the UK. If the group ratio rule cannot achieve a deduction for this interest in all cases; a safeguard must be introduced as part of these new measures.

APPENDIX 4: ESTIMATED COST TO THE REAL ESTATE INDUSTRY IF THE GROUP RATIO RULE DOES NOT PROVIDE A FULL DEDUCTION FOR THIRD PARTY INTEREST

It is clear that the group ratio rule will not provide the right result in all cases. In a worst case scenario, businesses will be forced to limit their restrictions to 30% of earnings. The following calculation estimates this worst case scenario for the real estate sector.

2015 estimated tax impact of interest restrictions on the real estate industry	(£m)
Outstanding loan amount (per De Montfort)	183,300
Annual interest expense (ass. 5%)	9,165
Annual implied EBITDA (based on aver rage interest cover ratio of 2 times income)	18,330
Tax deductible interest @30%	5,499
Difference between annual interest and deductible interest	3,666
Tax thereon @20%	***733***

The data is predominantly taken from the 2015 De Montfort University Commercial Property Lending Market Report ("the Report"), which is the most comprehensive report on real estate lending in the market.

The Report shows loans outstanding in the industry of £183 billion as of 31 December 2015. An average interest cost of 5% on these loans is estimated; which while slightly above the current low interest rates available, reflects the fact that many businesses still have legacy debt at higher rates.

Finally, the Report provided data on typical interest cover ratios in the industry, showing that roughly half of loans have interest cover above two, and half have interest cover below two. Therefore, it was reasonable to assume a typical interest/earnings ratio for the industry of 50%.

THE AUTHOR

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