ROPES & GRAY

ALERT

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BEPS – are you affected?

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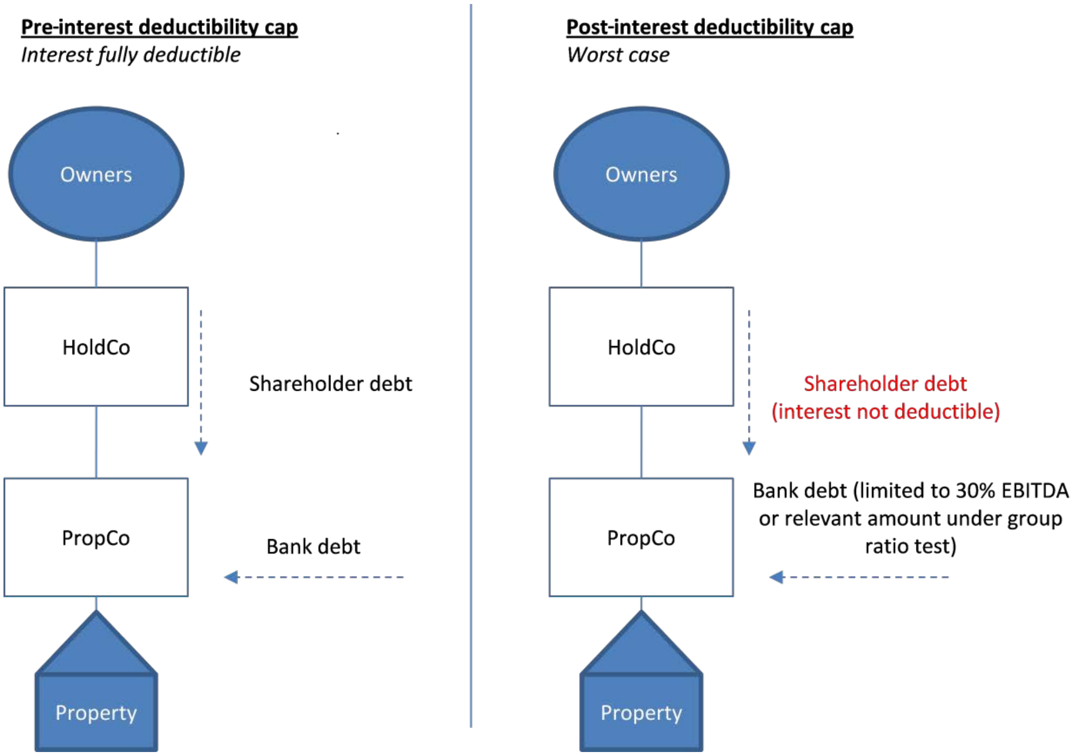
Over 100 countries and jurisdictions are collaborating through the OECD to implement measures to tackle base erosion and profit shifting (BEPS). The OECD have set out 15 actions points that aim to equip governments with the domestic and international instruments needed to tackle BEPS (i.e., to ensure that profits are taxed where economic activities generating the profits are performed and where value is created).

Draft legislation has been published for inclusion in Finance Bill 2017 imposing a restriction on interest deductibility for UK corporation tax payers from 1 April 2017. Supplementary legislation was published on 26 January 2017 clarifying certain aspects of the new regime including the public infrastructure exemption described below. Existing loans are not grandfathered. The proposal has caused significant concern amongst taxpayers in certain sectors, including the real estate sector where historically significant leverage has been deployed.

In brief, under the new restriction, above a *de minimis* threshold of GBP2m of net interest expense, a group's net annual interest deductions will be capped at the higher of (i) 30% of UK EBITDA; and (ii) the group's overall net interest-to-EBITDA ratio for external debt. In addition special rules apply which are aimed at preventing groups using shareholder debt to use any excess capacity under these rules.

How will the cap affect real estate transactions?

A typical transaction structure is set out in the diagram below:



In the worst case scenario, no deduction will be available for shareholder debt and the deductibility of interest on third-party debt will be restricted. However, there are three factors which may prevent this worst case scenario coming to pass: (i) the application of the rules to corporation taxpayers only; (ii) the group ratio test; and (iii) the public infrastructure exception.

(i) Rules apply to corporation tax only

When the legislation is introduced, it will not immediately have any effect for non-UK propcos because deductions will only be limited for the purposes of corporation tax and not income tax. The initial impact on the real estate holding sector is therefore cushioned somewhat as the majority of UK real estate assets have historically been held in offshore structures in order to ensure that any gains are outside the UK tax net. However, in the Autumn Statement 2016 the Government signalled its intention to consult later this year on bringing non-resident companies into the corporation tax regime rather than the income tax regime, presumably to ensure that measures such as the restriction on tax deductibility of interest applies to such entities.

(ii) The group ratio test

The basic rule proposed in the legislation is that interest deductibility will be capped at 30% of EBITDA for the period (the fixed ratio). However, subject to making an election to opt in to the alternative calculation method, if higher, a group-ratio rule will allow a greater amount of interest to be deducted by reference to the consolidated group's interest:EBITDA ratio.

Taking the example in the diagram, if a group comprising a holding company and a property company has third-party interest expense of £50m for a relevant period (all of which is attributable to third-party financing for the property company) and the EBITDA of the group is £100m, the group ratio percentage is likely to be 50% such that all of the £50m third-party interest expense will be deductible for the property company. Differences can arise due to the group ratio being calculated based on the accounts, but some adjustments are allowed under the rules to reduce the scope for mismatches. The group ratio test will not protect the deductibility of the shareholder debt in this example. The group ratio test will also not protect deductibility in the case of a group with both UK and non-UK assets where all the debt is in the UK.

(iii) Public infrastructure exception

As part of its recommendation under BEPS, the OECD proposed an exception for public infrastructure projects. This exception is included in the draft legislation and, although the rationale behind the move is unclear, the Government has chosen to include some UK property rental businesses within this exception.

The conditions for the exception, as they apply to a UK property rental company or group with only a single asset (the conditions are even more complicated if a property company is part of a wider corporate group and we do not consider this further here), are in summary:

1. the company carries on a UK property business including a building or part of a building;
2. the building is let to unrelated parties on a lease of 50 years or less;
3. the building has an expected economic life of at least 10 years;
4. the building is on balance sheet (and the company does not have any significant unrelated assets);
5. all but an insignificant portion of the company's income derives from the building;
6. the company is fully taxed in the UK; and
7. it has made an election for the exception to apply.

To give rise to exempt interest a loan has to be:

1. owed to an unrelated party creditor; and
2. limited recourse to the income, assets or shares of the company.

If interest is exempt, it is disregarded for the purposes of calculating restrictions on interest deductibility. On that basis, if a loan is fully exempt there may be scope for deductions on shareholder debt to count towards the GBP2m de minimis. In many cases this may be the main benefit of falling into the exemption, as, broadly speaking in the context of a single property asset group, you would expect the group ratio test described above to protect deductibility for third-party debt.

While care will need to be taken with some of these conditions to ensure compliance with all of the requirements, a typical onshore real estate holding entity should meet the conditions and so should be able to elect into the regime.

Where is this likely to end up and what action should be taken now?

For now, potentially affected parties should continue to monitor the situation both as regards the interest deductibility cap and the proposal to bring non-resident entities within the charge to UK corporation tax. At this time, it would be prudent to assume for modelling purposes that interest on shareholder debt will no longer be tax-deductible after 2017. For new transactions, it should also be considered whether any debt can be structured as far as possible to meet the requirements of the public infrastructure exemption to provide an element of future proofing.

Even if non-resident entities are brought within the charge to UK corporation tax, both the group ratio test and public infrastructure exemption provide a reasonable expectation that full tax deductions for third-party interest expense will continue to be available for single asset UK real estate holding structures. One issue for the latter is whether the non-resident will be able to meet the requirement of being fully taxed in the UK—there has so far not been any suggestion that the change to bring non-resident entities within the charge to UK corporation tax would involve increasing the scope of UK tax on such companies (for example, bringing them into the capital gains tax net).

Even absent these two protections, however, it is possible to envisage a structure where real estate is held by a UK company (which would be subject to capital gains if it ever sold the property, but can benefit from the public infrastructure exemption), which itself is held by a non-UK company, with the preferred exit route being a sale of the shares in the asset holding company (any gain on such disposal not generally being subject to UK capital gains tax absent further changes).