Taxing times

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Robert Walker considers the potential implications for real-estate structures of restrictions on interest deductibility

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As a part of its Base Erosion and Profits Shifting (BEPS) project , the OECD has, through action 4, recommended rules that limit the deductibility of interest expenses and economically equivalent payments.

In the context of the property sector, where debt is commonly secured on assets, the BEPS risk should be low because interest deductions in respect of third-party debt are typically claimed in the territory where the property is located and the income is taxed.

However, while there have been a number of representations on behalf of the sector claiming that the deductibility of interest on third-party debt is sacrosanct, this is not the OECD?s stated intention; it is concerned that third-party debt may intentionally be taken out in the most highly taxed jurisdictions in order to reduce a group?s overall liability for tax.

As interest will commonly be a ? if not the ? significant expense for real-estate investors, the financial impact of restrictions in the availability of relief will need to be carefully considered. The UK has already confirmed that it intends to implement the OECD?s interest-relief proposals. Following an earlier consultation and the publication of the Business Tax Road Map in March, the Treasury issued a further consultation document on 12 May, in respect of its intention to introduce interest restriction rules from 1 April 2017.

Outline of proposals

The starting point of the proposed regime is to restrict the deduction for interest to 30% of the ?UK group? taxable earnings before income tax, depreciation and amortisation (EBITDA) for corporation taxpayers.

Taxpayers will then have the option of increasing this to the level of the ratio between the worldwide group?s actual net external interest and EBITDA, if that is higher than 30%.

There will also be a ?2m de minimis amount. This means that the first ?2m of interest will always be deductible regardless of the rate of deduction set under the ratio tests.

An infrastructure exclusion is also mooted for certain long-term public benefit projects. The key criteria proposed for these are that the project benefits from private finance, a public body obliges the operator to provide public benefit services, it is financed by third parties, and revenues are subject to UK tax.

Real-estate implications

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For groups that operate in different territories, issues are likely to arise where the level of gearing and interest charges naturally vary from one territory to another. So if the UK-interest-to-EBITDA ratio is higher than that of the worldwide group ? and more than 30% ? there will be restrictions on deductibility.

Other complications may arise where, for example, interest is capitalised or profitability patterns naturally vary, such as in the early stages of property development when interest costs may be high and income low.

Restrictions on interest deductibility could result in a breach of the loan covenants that relate to cash flows.

Non-resident landlords

Offshore investors in UK property will usually be subject to UK income tax on rents received rather than corporation tax. The initial proposals apply to corporation taxpayers only, which would, therefore, exclude most non-resident landlords. However, the consultation paper asks whether and how the regime should be applied to companies that are subject to income tax rules under the non-resident landlord regime.

Property investment funds

One issue affecting funds is that some structures will be established as corporate groups preparing full consolidated accounts. In these situations, it is likely that the debt of all the group companies will be counted in determining the ratio of group interest to EBITDA, which may therefore increase the capacity for deductions.

However, the holding entity of a fund may equally be a partnership or a trust that holds its assets through separate subsidiaries. In this case, each subsidiary will be subject to the single-company fixed rate of 30% for its interest-to-EBITDA ratio.

The government has recognised that there are potential issues with regards to real estate investment trusts and property authorised investment funds ? for instance, the rules may mean an increase in the amount required to be distributed ? but have not indicated that they would provide for an outright exemption.

Next steps

Although the Treasury has invited comments on the proposals, it is not anticipated that substantial changes will be made before the introduction of the rules in April 2017. Hence, investors in real estate should be starting to consider the potential impact of the rules on their financial models.

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Further information

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