International Co-operation and Tax Administration Division, OECD/CTPA

Elements of the design and operation of the group ratio rule

Introduction

Real estate plays a critical role in all aspects of our everyday lives. Property companies serve businesses and the society by actively developing, managing, maintaining and improving the built environment; where we all live, work, shop and relax. They also play a crucial part in providing retirement security to millions of people, by offering pension funds stable and highly competitive assets to invest in.

EPRA, the European Public Real Estate Association, is the voice of the publicly traded European real estate sector. With more than 220 members, covering the whole spectrum of the listed real estate industry (companies, investors and their suppliers), EPRA represents over EUR 365 billion of real estate assets and 90% of the market capitalisation of the FTSE EPRA/NAREIT Europe Index.

EPRA's mission is to promote, develop and represent the European public real estate sector. We achieve this through the provision of better information to investors and stakeholders, active involvement in the public and political debate, improvement of the general operating environment, promotion of best practices and the cohesion and strengthening of the industry.

Key points

We understand the aim of the group ratio rule (GRR) to be to provide tax relief for interest costs in excess of that afforded by the fixed ratio rule (FRR) in the context of groups that for commercial reasons may be more highly leveraged. In other words, it is recognition that on its own, an FRR will not deliver a fair outcome for more highly leveraged or capital intensive industries like real estate and infrastructure.

If investment in those industries is not to be undermined by an increase in the post-tax cost of debt capital, the design of the GRR is of critical importance. The aim should be to not restrict the tax deductibility of interest costs beyond that needed to counter BEPS risks. Sadly, the OECD's proposed approach to the GRR will not achieve that outcome, but may instead punish low-BEPS risk groups for using debt capital and will lead to significant complexity for both businesses and tax authorities.

Our key points are as follows:

1 The OECD's GRR framework should explicitly provide significant flexibility to individual countries in implementing its recommendations. Countries will have widely differing tax systems and while we appreciate the OECD's desire for consistency in the application of its recommendations, the reality is that their practical implementation will differ widely. As long as individual countries are satisfied that BEPS risks are adequately mitigated, we do not see these differences as bad things.

2 The GRR as proposed will disproportionately affect groups with diverse businesses. Where a group carries on activities with very different debt profiles, the more highly leveraged activities will always suffer a restriction on their third party interest costs, even where a group is based wholly in one country and therefore poses absolutely no BEPS risk. This is a clearly unfair outcome and the GRR framework should allow countries the scope to rectify this result.

3 A group ratio based on earnings and income does not provide fair outcomes for taxpayers where their costs and income arise in different periods, such as in the case of real estate development projects. We therefore welcome the proposals to allow a GRR based on balance sheet measures such as a debt:equity ratio, as this could go some way to mitigating that unfairness.

4 We agree that fair value movements on derivative contracts should be excluded from the definition of 'group net third party interest'. We would also propose that amounts representing rental payments under the new IFRS16 accounting standard (lease accounting) be excluded from that definition. Failure to do so will lead to a business's rent payments potentially becoming restricted for tax purposes.

5 The definition of 'group EBITDA' should exclude fair value movements arising from the revaluation of investment property assets. These amounts represent unrealised gains, can be highly volatile and unpredictable and are often entirely outside the control of a business. This can lead to massive fluctuations in group ratios that introduce considerable uncertainty into tax liability forecasting. Ultimately this makes real estate investment and development a more uncertain proposition, with harmful implications for the real economy if the supply of business space is affected.

Appendix – detailed responses to selected consultation questions

Q1: Are there any particular practical issues that could arise from any of approaches 1 to 3 to determining net third party interest expense which are not identified in the discussion draft? If so, what are these issues and how could they be addressed by a country?

IFRS 16, a new accounting standard due to take effect in 2019, will require all businesses that lease properties to recognise the value of that lease on their balance sheets. In addition, payments in respect of property leases, which are currently recognised as rental expense in a company's income statement, will be split into two components: amortisation of the lease asset and the financing cost of entering into that lease.

The commercial nature of property rental agreements will not change, but the way they are recognised in business's financial statements will be very different – income statements will effectively no longer show rental expenses as a separate line item. The accounting treatment of all leases will move to that which currently applies to finance leases.

Unless the GRR makes special provision for it, businesses may under the new rules face a restriction on the amount of rental expenses on which they are able to obtain tax relief. The financing cost component of a property lease will – unless specifically excluded – be included in the definition of 'net third party interest' as a result of its accounting treatment.

We cannot see a justification for restricting the tax deductibility of property rental expenses. Indeed doing so could lead to double taxation where lease rentals are not wholly deductible in the hands of the lessee but are taxed in full in the hands of the landlord. Rents on property assets are almost invariably subject to tax in the jurisdiction in which the property is located. As a result, no BEPS risk exists and we see no reason to restrict a tax deduction for the lessee.

It should therefore be clear that the financing cost component of a property rental lease does not form part of a group's net third party interest expense for the purposes of the GRR. We note this issue will arise in the context of all leases currently treated as 'operating' leases for accounting purposes – not just real estate.

Q10: Are there any practical issues raised by the approach contained in the discussion draft to dealing with non-recurring items in calculating group EBITDA? If so, what are these issues and how could they be addressed by a country?

IFRS requires groups owning investment property to report the fair value of that property in the group's balance sheet and to recognise any movement in that fair value from the preceding period in the group's income statement. The fair value of an investment property at any one time will depend on a number of factors including its condition, the extent to which it is let and the general state of the real estate market, reflecting strength of investor confidence.

Some of these factors (e.g. market sentiment, the construction of a competing building nearby) are often unpredictable, are totally outside of the control of a particular investor and can lead to significant fluctuations in a group's EBITDA. Movements in the fair value of investment property represent unrealised gains and losses and can reverse within a short space of time.

Such movements are therefore akin to the type of non-recurring item identified in the discussion draft. Although they happen every year, their size and direction is unknowable and can have a material impact on a group's income statement. If they were to be included within 'group EBITDA' for the purposes of the GRR the result would be highly volatile group ratio figures and therefore highly volatile and uncertain tax relief on interest costs.

Not only would this be difficult from an administrative perspective for those groups affected, it would also make budgeting for the tax cost of a given investment almost impossible. This raises the level of uncertainty associated with a particular project, which ultimately makes that project less likely to go ahead. Were this to happen at sufficient scale, we are concerned that the supply of new business space could be negatively affected with a deleterious (for occupiers – and the economy more generally) impact on the rental cost of that space.

While the application of carry forward or carry back of unused interest capacity may mitigate some of the ill effects described above, it does not eliminate them. This is particularly the case when countries choose not to permit carrying-back unused interest capacity.

We therefore strongly recommend that movements in the fair value of investment property are not included within group EBITDA for the purposes of the GRR. Alternatively, groups could be given the ability to elect to calculate their group ratio by reference to some form of 'tax EBITDA'. While this may be complicated for multinational groups, it would reduce the potential volatility of the group ratios of businesses based wholly in one country.

Q11: Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with positive group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and, if so what are they?

Where a group has a very high group ratio, providing tax relief for this level of interest would appear to be in line with the policy objective, even where this creates an overall taxable loss. If a group has (at a global level) suffered an overall economic loss because external interest expense exceeds its profits, we do not see why it would be appropriate to penalise it. If countries are minded to introduce a cap, this should be at the level of the gross third party interest expense of the group, to ensure that loss making enteritis are not further penalised by these restrictions.

Q12: If a country does introduce a cap on a group's net third party interest expense/EBITDA ratio, what considerations might it take into account in setting this cap and how could the relevant information be obtainted?

Whether an expense is tax deductible or not should not be subject to an arbitrary cap. If the OECD were to recommend such a cap, it would need to be reflective of the industry that each entity operates in. In a real estate context, it is not uncommon to see interest at 60%-80% of earnings, particularly in a higher interest rate environment. For infrastructure projects, it is typically even higher.

A cap based on third party interest expense would be more appropriate. However, the OECD should allow countries to permit a deduction for *gross* third party interest expense where appropriate. In a real estate context, it is typical for interest expense to be matched against rental income in the same country, it will not necessarily be matched against interest income in the same country. If the same group earned interest income in another country, the net interest expense of the group would reduce, which would inappropriately restrict the interest deduction available against the rental income.

Q13: Are there any practical issues raised by the approaches set out in the discussion draft to dealing with the impact on the group ratio rule of an entity with negative EBITDA in a group with zero or negative group-EBITDA? If so, what are these issues and how could they be addressed by a country? Are there any other approaches that should be considered and if so what are they?

The GRR is not designed for businesses with life cycles which span more than one accounting period, and as such, the rules will be particularly inappropriate for real estate developers.

In order to ensure that loss making entities are not penalised, we would agree that safeguards should be introduced. As noted in response to question 12, where the GRR has not resulted in an appropriate outcome, entities should be allowed to deduct up to the gross third party interest expense of their group (and it would be fair to cap the deduction to this amount).

Q14: Do you have any other comments on any of the issues covered by this discussion draft?

While the GRR is designed to provide more highly capital intensive businesses with a higher (and more appropriate) level of tax relief on their interest costs than the FRR, there are still instances in which the GRR will deny such groups a deduction for *bona fide* third party interest – even where there is no BEPS risk involved. This is particularly the case where a group carries on activities with different financing needs and therefore different debt profiles.

For instance, where a business carries on a lowly leveraged property management business alongside a more highly leveraged property investment business, the group's ratio would reflect an average of those two very different activities. Applying the GRR on an entity by entity basis in such situations would always result in a restriction of interest in the more highly leveraged entities. Where a group is based wholly in one country this feels like entirely the wrong outcome, as the group is being penalised and yet poses no BEPS risk whatsoever.

The OECD's final recommendations on the GRR should allow countries to counteract this sort of unfair outcome in whatever way best suits their particular tax system. This may include applying the GRR at a national group level rather than on an entity by entity basis.