By email: interestdeductions@oecd.org

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CREFC Europe response: OECD BEPS Action 4 – Discussion Draft on Elements of the Design and Operation of the Group Ratio Rule

The Commercial Real Estate Finance Council (**CREFC**) Europe is a trade association promoting a diversified, sustainable and successful commercial real estate (**CRE**) debt market in Europe that can support the real economy without threatening financial stability. Our core membership includes lenders and intermediaries who help connect capital seeking the risk and returns of CRE debt with real estate firms seeking finance.

The functioning of business in the wider economy relies on investment into CRE. It provides the accommodation businesses need, with the flexibility to adapt and relocate with changing economic conditions and commercial requirements. As a capital intensive and long-term business often involving very large, valuable and illiquid assets, CRE is dependent on the ready availability of debt finance. This dependency is driven principally by the very different risk and return expectations (and hence cost) of different types of capital. A typical CRE funding is likely to involve a mix of equity and senior debt (from third party finance providers), and may also involve mezzanine and/or junior debt (which could be from either a third party provider or a related party). Restricting the tax deductibility of debt will increase its overall cost to CRE businesses, in turn impacting on the deployment of equity capital and the viability of investment in the real economy.

It is important to remember that secured third party CRE debt poses very low BEPS risk. This kind of finance is commonly non-recourse, and a third party lender will generally want to lend to (and take security from) the entity that owns the collateral, and receives the rental income it generates.

For capital-intensive businesses, a sensible and fully developed GRR is essential to preserving the possibility of third party interest deductibility, because the fixed ratio rule will not ensure that straightforward third party debt expense is relieved. It is important (at both a practical and technical level) that there is a broad international consensus as to how the GRR should work across jurisdictions. We therefore welcome the opportunity to respond to the questions raised by the OECD in its Discussion Draft on Elements of the Design and Operation of the Group Ratio Rule (the **DD**).

In preparing our response, we have had the benefit of reviewing the response to be made by the British Property Federation (the **BPF**), which represents the views of those businesses in the UK that own, manage and invest in property. As a general matter, we firmly agree with the views expressed by BPF in its response to the DD: in particular we share with the BPF the concern that the GRR, as currently envisaged, is not capable of guaranteeing the deductibility of straightforward third party interest expense for CRE borrowers in situations where there is little or no BEPS risk.

We set out our key points and specific responses below. Please contact me if you would like to discuss.

Yours faithfully

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Key points

The GRR must work for commercial real estate (CRE)

The OECD has been clear that the BEPS4 measures should not prevent businesses from raising the debt finance necessary for their business. However, the GRR risks doing this. As the BPF illustrates in Appendix 2 to its response, the GRR does not reflect commercial reality for CRE businesses, so could distort behaviour and capital allocation.

The typical form of CRE finance involves negligible BEPS risk. This is because it generally involves non-recourse financing, secured on the underlying CRE asset: it is a specialised form of asset-backed finance, not traditional corporate lending, and the quantum and location of third party debt reflects that, leaving very little scope for BEPS. It is the cash flows from the underlying CRE asset (from third party tenants) that determine borrowing capacity, not the earnings of the borrower's group.

Like the BPF, we are concerned that the GRR may not be capable of striking the right balance between protecting against interest-driven BEPS and ensuring that low BEPS-risk businesses receive adequate tax relief for their genuine third party interest costs. Unless the GRR can be made to work sensibly within a CRE context, an additional safe harbour should be built into the proposals for non-recourse third party debt secured against immovable property. Otherwise, the CRE industry will be disproportionately and inappropriately affected by measures conceived as a means of combating MNE profit-shifting.

Volatility is best managed within the GRR

The GRR is based on accounting principles. This means that unrealised profits and losses could potentially result in significant movement in the GRR from one period to the next. Such volatility could lead to arbitrary results under the GRR, given the impact on a group's ability to claim deductions for the same amount of interest cost in different period.

While the OECD's BEPS 4 recommendations suggest measures to manage such volatility (through a mix of carry forward and carry back measures), both the optionality of these measures and their nature means that they are unlikely to enable companies to offset fully the effects of significant movements, whether in 'group net third party interest' or 'group-EBITDA', on their (tax) borrowing capacity.

It is important that the risk of volatility is adequately managed within (in such a way as to be effectively excluded from) the GRR itself. Fair value movements on derivative contracts should be excluded from the definition of 'group net third party interest', and the definition of 'group EBITDA' should exclude fair value movements arising from the revaluation of investment property assets. CRE businesses generally operate – and borrow – on the basis of stable and predictable cash flows. Their funding model should not be put at risk by material tax, or even administrative, costs resulting from tax rules intended to prevent avoidance by MNEs.

The importance of ensuring fair outcomes

The GRR is based on a seemingly simple idea: comparing interest cost with EBITDA. But the nature and number of adjustments the DD envisages within the GRR show that, in practice, the GRR will be far from straightforward. Balancing international consistency with fair outcomes may be very difficult.

We would encourage the OECD to set out a mandatory basic framework for the GRR but allow countries flexibility in its detailed interpretation and application. That flexibility should include allowing countries to find ways mitigating potentially unfair outcomes, including, for example, by applying a tax (rather than accounting) based EBITDA GRR, a balance sheet (debt:equity) rule or allowing specific safeguards for particular types of third party debt where BEPS risk is demonstrably low.

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?

The DD notes that an approach based on items in consolidated accounts may give rise to variances, whether because of differences between accounting standards or because of the way those standards are applied in particular circumstances. Ultimately, the difficulty with approach 1 is that a degree of control over the tax status of financing items is effectively ceded to accounting standards boards.

Q2: What issues might arise for groups if countries were given flexibility to apply any of approaches 1 to 3 to determining net third party interest?

We agree with the comment made in paragraph 5 of the DD that there are benefits in countries taking a consistent approach in how they apply the GRR, particularly given that a cross-border group is likely to find itself subject to the GRR in more than one jurisdiction. However, OECD member states have widely differing tax systems: consistent implementation of the BEPS4 measures in practice is not a realistic goal.

If countries have the ability to determine which approach should apply within their national GRR – which is probably inevitable – groups may be subject to different levels of restriction across their business, notwithstanding the constancy of underlying facts. In the DD, the OECD states that approaches 2 and 3 "should give rise to the same figure for a group's net third party interest expense". Even if this is correct in all cases (which is doubtful), it clearly would not be the case if one jurisdiction applies approach 1, and another approach 2.

Differences would even be likely to arise if, say, approach 2 were mandatory. This is because any adjustments required to accounting items in calculating the GRR under a particular country's rules are likely to be influenced by that country's own domestic tax rules (see for example the adjustment suggested at paragraph 39(ii) of the DD), particularly given the optionality inherent within certain aspects of the proposals. This could result in different interpretations of the amounts to be included/excluded as interest income or expense across jurisdictions.

We therefore concur with the OECD's recommendation to prefer approaches 2 and 3. We would however ask that the OECD's final recommendations on the GRR emphasise the importance of consistency in factual "inputs" used in a GRR calculation across different countries (and thus encourage acceptance of a single calculation of net third party interest expense as referred to in paragraph 20).

Q3: It is important that a country's tax policy goals can be taken into account in determining net third party interest expense. Are there any practical issues raised by any of the adjustments described in the discussion draft that are not highlighted in the draft?

We would ask that the OECD's final recommendations on the GRR provide meaningful guidance on the factors relevant to allowing an entity to apply an uplift and setting the amount of that uplift, with a view to encouraging consistency.

Q6: Are there any practical issues raised by the approach set out in the discussion draft to the items to be included in the adjustment for interest income and expense in calculating group EBITDA? If so, what are these issues and how could they be addressed by a country?

The DD recommends that countries "should" take measures to exclude related party debt from the GRR. From a third party lender perspective, it is key that that any definition of related party must be clear, unambiguous and easy to apply. This is particularly important within CRE finance given the nature of the financial models on the basis of which lending decisions are made: models which take account of rental income, interest, other property related costs and tax throughout the proposed loan term.

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?

We agree with the BPF that movements in the fair value of investment property should not be included within group EBITDA for the purposes of the GRR. If such movements were to be included, there would be increased volatility within the GRR, rendering unpredictable a group's ability to obtain a tax deduction for economically predictable interest costs, simply because of an unrealised profit or loss.

While the measures proposed by the OECD to manage volatility may partially address these concerns, they do not eliminate them. With countries permitted to choose which of these measures will be available to taxpayers, some may choose to curtail businesses' ability to manage the volatility problem created by the OECD's rules.

An example of an unhelpfully flexible approach is the EU's new Anti-Tax Avoidance Directive. This Directive is intended to set a minimum standard across EU member states for implementation of the OECD's recommendations in relation to BEPS Action 4. However, in terms of measures to manage volatility, the Directive allows member states to choose between (a) indefinite carry forward of restricted interest; (b) indefinite carry forward, plus a time-limited carry back (of up to 3 years), of restricted interest or (c) indefinite carry forward of restricted interest, and a time-limited carry forward of unused capacity (of up to 5 years). This "pick'n'mix" approach means that a EU based group cannot guarantee that it will have the tools available to it to manage volatility appropriately across the EU as a whole.

The OECD's mandatory basic framework for the GRR should therefore provide for volatility to be managed within the terms of the GRR itself. This should also help to ensure consistency between countries in their approach to the GRR and, as a result, fairness.

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?

In para 20 of its Final Report on BEPS Action 4, the OECD commented:

> "This approach [*the best practice approach set out in the Final Report*] should provide effective protection for countries against base erosion and profit shifting involving interest, but should not prevent businesses from raising the debt finance necessary for their business and commercial investments."

This principle should underlie the operation of the GRR, both generally and specifically in the context of the approach to including entities with negative EBITDA.

We therefore agree with the BPF that, where a group has a very high group ratio, tax relief for this level of interest should be allowed, given that this would appear to be in line with the policy objective. 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.

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 obtained?

The GRR seeks to provide a safe harbour for third party interest and so (in summary) takes account of the "real" third party borrowing capacity of a group, rather than imposing an arbitrary limit. It is therefore counterintuitive and inappropriate to apply a pre-determined cap to the group ratio.

We agree with the BPF that, if any cap were to be imposed, it would be more appropriate for it to be on the amount of third party expense (in effect allowing countries to permit a deduction for gross third party interest expense in specified circumstances where the GRR would produce an inappropriate result).

In the context of the largely non-recourse, asset-financed CRE sector, it is common for interest expense to be matched against rental income in the same country, rather than against interest income, which may (as the BPF points out) arise in a different 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?

We agree with the BPF that safeguards should be introduced to ensure that loss making entities are not penalised through the operation of the GRR.

In particular, we support the BPF's suggestion that, in the real estate context, a safe harbour should be provided allowing full deduction for third party interest in respect of non-recourse debt secured against assets in the same country. Given the interest deduction is naturally matched against the profits or income from the real estate, this debt poses negligible BEPS risk and, as such, should not be restricted.

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

The GRR is based on comparing interest cost with EBITDA. On the face of it, this approach has similarities with the types of interest/debt service cover tests that lenders apply when making lending decisions and in financial covenants used in loan surveillance. However, those similarities are superficial, because CRE lending focuses on the cash flows generated by the asset, rather than on the borrowing group's accounts. Adjusted EBITDA metrics used by the fixed ratio rule and the GRR are therefore very unlikely ever to be reflected in the commercial arrangements between lender and borrower.

There is therefore a real disconnect between what happens commercially and the proposed form of the GRR. That is likely to create practical difficulties for lenders using financial models to assess a proposed CRE financing – even though such financings pose negligible BEPS risk owing to their asset-based and non-recourse nature. The lender's model will generally test the borrower's ability to pay (through interest or debt service coverage tests) by reference to the rental income of the CRE collateral: the profitability of the corporate group of which the borrower is part is generally much less important. This is third party financing of real estate assets, not traditional corporate lending.

These difficulties are compounded because the GRR looks at the position of the broader group, whereas a CRE lender would tend to look just at that of the borrower. In practice, it will therefore be difficult for a secured CRE lender to feel confident about the tax assumptions in any model prepared based on expected cash flows: there are too many unknown, unpredictable – and commercially irrelevant – variables.

With the GRR so key to the ability of the borrower to obtain a deduction for its third party finance costs, it is therefore critical that the "final" GRR is as clear and simple as possible. The OECD will have failed in its policy goal if third party lenders and borrowers in respect of secured, non-recourse financings are unable quickly and easily to confirm that financing costs will be fully recoverable throughout the life of the loan. The GRR must unambiguously work as intended – such that parties to transactions can have a valid expectation that third party interest expense will be deductible.

As the BPF points out in its response, even though the GRR is intended to enable capital intensive businesses, such as those in the CRE sector, to obtain tax relief for the cost of straightforward third party debt, it is by its nature a blunt instrument. As a result, there could be instances in which the GRR, as currently proposed, fails to allow such groups full deduction for bona fide third party interest in circumstances where BEPS risks are negligible. Even where relief is not restricted, a considerable administrative burden risks being placed on businesses that are not be the target of BEPS 4.

The OECD's final recommendations on the GRR should be very clear in prioritising fair outcomes for low risk sectors, while allowing countries the flexibility to fine-tune the rules in whatever way best suits their particular tax system. The priority here is not to allow counties to take account of their tax policy goals in setting their GRR, but rather to ensure that the rules work fairly and appropriately in practice. This is essential if the GRR is to allow firms to raise the debt finance necessary for their business and commercial investments.

Most importantly, unless the GRR can deliver essentially the same outcome for CRE businesses, an additional safe harbour should be built into the proposals to preserve full deductibility of interest on non-recourse third party debt secured against a specific immovable asset in the same jurisdiction.