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In your best interest: Understanding the new rules on interest deductibility

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Over the past few months, major governments have started to take concrete action to respond to profit shifting. Dealmakers will want to take notice: the implications for the infrastructure sector could be significant.

It has taken some time for the OECD's BEPS project to grow some teeth. But over the past few months, it has become increasingly clear that many of the major markets — including the US and the UK — are now intent on turning certain aspects of the BEPS Action Plan into actionable legislation.

Much of the recent activity has been focused on implementing Action 4 of the BEPS Action Plan. This is the part that deals with interest expense and deductions on debt structures. And this will cause deal-makers at infrastructure funds, pension funds and sovereign wealth funds to sit up and take notice.

Forced to take action

In part, Action 4 has heightened attention due to the spate of so-called 'inversions' in the US. Companies of all sorts — from tech giants and coffee chains through to pharmaceutical firms and investors — started to 'sell themselves' to foreign entities in lower-tax jurisdictions in order to take advantage of the arbitrage and avoid the high rates of double taxation on non-US income. To improve the value of the deal, many of these inversions were financed predominantly by debt, creating valuable tax deductions within the US while also reducing tax on domestic income.

The problem is that — in some cases — these deals were structured very aggressively and essentially amounted to profit shifting and base erosion. Tax authorities started to see a real impact in their revenues. A number of high-profile deals started to be reported in the mainstream media. And public pressure grew on governments to take legislative action.

And so they have. In the US, this has taken the form of section 385 regulations released by the Treasury Department and the IRS (in final form) on October 13, 2016. In the UK, HM Treasury and HM Revenue and Customs recently released its proposed rules on tax deductibility of corporate interest expense. Both contain challenges and complexities for infrastructure investors.

The US introduced section 385 Regs

The section 385 regulations cast a fairly broad net that drags in manufacturers, services organizations and infrastructure investors, among others. The intent of the regulations is to try to ensure that interest deductions being taken out of the US are in line with future profit expectations and do not dig into the actual equity pool of that US operation. The regulations do not ban interest deductions from flowing out of the country, but do require them to be commercially acceptable.

While this approach may make sense for sectors where development times often span a year or two, today's infrastructure projects often go for many years — sometimes up to a decade — without making any actual profits, which means that almost any interest deductions that are made during this time may now become liable to tax.

Certain foreign pension funds are frustrated. Many feel that the beneficial treatment they had only recently been offered on real estate in the US (including many infrastructure investments) is now being taken away. Qualified foreign pension funds are now starting to rethink the efficiency of their investments, particularly in the ramp-up phase.

Many are starting to question the competitiveness of the US's future infrastructure market.

The future of the section 385 regulations is unclear. On April 21, 2017, President Trump signed an executive order requiring an immediate review of all significant tax regulations since the beginning of 2016, and requiring an interim report within 60 days, followed by a report on specific actions to lessen the burden of the regulations identified in that interim report within 150 days. In response to that executive order, a large number of trade groups have written comments requesting the repeal of the section 385 regulations. While it is not clear what the result of the process will be, in the absence of further action, the section 385 regulations will continue to apply.

Imminent adoption of interest limitations in the UK

In the UK, following a public consultation process, the government put forward changes to the UK's interest deductibility rules. These rules, which were set to take effect on April 1, 2017, were removed from the Finance Bill 2017 following the results of the general election, but are expected to be enacted in the next Parliament.

Similar to the US's 385 regulations, the UK's strategy also creates potential challenges for infrastructure investors. The proposal to restrict deductible interest in a given year based on a 30 percent of Tax-EBITDA Fixed Ratio Method (FRM) or a Group Ratio Method (FRM) can result in limited (or substantially deferred) interest deductions for infrastructure, particularly in the earlier phases of the projects due to their high gearing and low, deferred profitability.

While the proposed rules do include a Public Benefit Infrastructure Exemption for certain qualifying infrastructure companies, this covers 3rd party debt only and comes with 'strings attached' (e.g. a 5 year lock-in period and in some cases the need to undertake permissible restructuring), unless the narrowly cast 'grandfathering' rules apply which would enable some investors in government auctioned infrastructure projects to shelter their existing shareholder debt. Therefore, notwithstanding the availability of such an exemption, the overall approach still creates uncertainty for investors and may erode the competitiveness of the UK.

More change on the way in the EU

In the European Union, adoption of BEPS measures has been accelerated by the adoption of the Anti Tax-avoidance directives (ATAD), which require member states to enact many of the BEPS measures into their domestic laws. In particular, the first ATAD, adopted 12 July 2016, requires members to put interest limitation rules into effect by January 1, 2019. Which would utilize FRR restrictions on interest deductibility. While member states are permitted to create exceptions for public infrastructure projects, these exceptions are not required to be included in legislation, which may result in limited or no availability of deductions for infrastructure projects.

Time to pay attention

Given these trends from the US and the UK, infrastructure deal-makers at institutional investor organizations will want to take notice. This is not a simple change in tax rates that can easily be calculated into the pricing. It is a major change to the way that infrastructure deals are structured and financed.

The reality is that none of the current legislative proposals properly account for the unique gearing and capital structures that underpin global infrastructure investment. And, as a result, few infrastructure investors have a clear understanding of how the rules apply to their particular sector and unique investment approach.

Deal-makers cannot afford to ignore these changes. Deals that fall afoul of these new rules will receive sharply limited interest deductions, or even no interest deductibility at all. Existing deals that are up for debt restructuring will also come into scope, requiring investors to think critically about the full lifecycle profitability of their investments.

Getting ready for the impact

Our work with institutional investors suggests that there are four things that deal-makers could be doing to prepare for these new changes to tax systems. First, they should spend some time trying to understand the impacts these new rules might have on their specific projects, markets and investment patterns. Be warned: the rules are far from clear when it comes to the finer details of infrastructure investment.

Next, they should be rethinking their models for future projects and restructuring projects. We have worked with a number of organizations to help their deal-makers develop new models based on proposed legislation. While the exact rules may not yet be clear, these organizations are already starting to manage their risks based on the clear 'direction of travel' indicated by the US and the UK.

Throughout, deal-makers will need to continuously assess the potential for other, similar legislative and regulatory changes in their key investment markets. The US and the UK are the first and most visible to move. Other markets, including the EU in particular, will soon follow their example. Additionally, possible large scale changes to the US tax regime under the Trump administration may develop and must be considered.

Finally, deal-makers should be working collaboratively with regulators and tax authorities to help ensure that any new rules are fair, transparent and applicable to the sector while also ensuring competitiveness in the market. Some firms are holding direct discussions with authorities through written public submissions. Others are working through consortiums — such as The Infrastructure Forum in the UK — to ensure their views are expressed.

At the very least, deal-makers now need to be aware of the potential risks and challenges these new rules will create. Future pricing and profitability will depend on it.

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