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Real Estate investment industry facing BEPS – Any tangible update to share at this stage?

The OECD published the 13 final BEPS reports on 5 October 2015 confirming most of the options already discussed in the past. A significant portion of the recommendations made are either subject to further discussions in 2016/17 or left to local tax authorities' own initiative.

Even if real estate investments are not the main drivers of the BEPS project, these actions could affect all areas of business. Our view is that only a few BEPS actions may directly have an impact on the real estate fund industry.

We have summarized the BEPS actions that may directly have an impact on the real estate fund industry below. BEPS actions linked to additional documentation and reporting obligations are not covered in this article.

BEPS action 2 - Hybrid Mismatch Arrangements

BEPS action 2 in connection with hybrid mismatch arrangements aims at eliminating the possibility for taxpayers to benefit from an (unintended) double non-taxation and/or long-term tax deferral (i.e. a deduction in one country without equivalent income recognition in the other country).

Although hybrid mismatch arrangements are relatively uncommon within European real estate investment structures, anti-hybrid rules may affect some of the standard structures especially when certain hybrid vehicles or specific financing instruments such as CPECs are used. However, subject to a review of the final implementation of this BEPS action at a local level the impacts on real estate structures should be rather limited in practice (i.e. where for example there is no tax arising in the hands of the recipient as a result of its own status e.g. as a tax-exempt pension fund) and alternatives should be available.

BEPS action 4 - Limit base erosion via interest deductions

Action 4 focuses on the design of rules to prevent base erosion and profit shifting using deductions for interest expenses and other financial payments economically equivalent to interest and is therefore relevant for the real estate industry.

The recommendations for interest restrictions provide clear guidance indicating that countries should limit interest deductions to a fixed percentage of earnings before interest, tax and depreciation (EBITDA). The cap should be in the range of 10%-30%. Countries could also opt for an additional allowance as long as the interest deduction does not exceed a group ratio.

This level may be however still very much below that typically seen in a real estate investment structure where interest deductions may be at 70% of EBITDA or more.

Major European economies have already upgraded their legislation in the recent years by introducing various "earnings-stripping" limitations to interest deduction. The outcome on BEPS action 4 itself may nevertheless impact further real estate investment structures since funds could expect additional interest restrictions in some countries that would ultimately affect the return to investors. It is too soon to say exactly what will change in each jurisdiction but now is the time to begin reviewing the levels of taxation that could be suffered if a hard cap on interest deductions is introduced.

BEPS action 6 - "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances"

BEPS action 6, which aims to limit access to the benefits of the tax treaty, could be of particular relevance for the real estate industry. In practice, these rules are to be introduced into all treaties either via a multinational agreement (to be completed by the end of 2016) or via domestic law or a renegotiation of treaties.

The final BEPS recommendations remain broadly unchanged compared to the earlier drafts. In particular, the ability of real estate funds to meet the Limitation Of Benefits requirements as proposed remains very limited.

Given the specific nature of real estate investments and for diversification of investments reasons , it is common for investors to gain exposure to real estate assets via different sorts of Collective Investment Vehicles ("CIV") gathering funds from investors of different types and in multiple jurisdictions to invest in assets located in distinct jurisdictions. Therefore, a key concern of real estate players and institutions relates to treaty entitlement of such funds:

- The treaty entitlement of CIV funds will not be automatic and, depending on the options chosen by contracting states, may be subject to conditions which could limit in practice the ability to rely on treaties.

- The situation of non-CIV funds are not yet fully addressed and will be subject to further work being undertaken in 2016.

The effectiveness of these recommendations will depend on each country. As with other actions, a significant number of jurisdictions already have existing rules that are aligned with these OECD recommendations.

Based on the current OECD treaty model, real estate income is always taxable in the jurisdiction where the property is located. Dividend or interest distributions by a property company located in a country with a favourable domestic regime (i.e. no withholding tax under local law) will not be targeted by Action 6 since there is no reliance on treaty provisions. Where there is local WHT, however, the impact may again be negative unless the recipient holding company or fund is able to meet the relevant tests.

Finally, the indirect disposal of real estate through share deals is increasingly being addressed through the renegotiation of existing double tax treaties and the insertion of 'land rich' provisions into the 'capital gains' article. There may therefore be few benefits left to lose in this regard.

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[1] A mismatch in the qualification of a financial instrument or an entity in two different jurisdictions might arise where each country generally applies its own set of rules and characteristics

[2] The limitation will be via notably the insertion of a so-called "Limitation Of Benefits" clause and/or a "Principal Purpose Test"

[3] E.g. different asset classes and geographical areas to ensure risk spreading

[4] E.g. pension funds, family offices, SWF, corporates, individuals, etc.

[5] Non UCITs funds which includes REITs, real estate and pension funds.

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