The real estate investment industry in the face of BEPS

Potential impacts, opportunities and threats

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Innovation, new technologies such as the internet, and economic globalisation have changed the way corporates and investment funds operate and invest. International exchanges, investments and trades have grown significantly, creating new challenges for national tax authorities worldwide. Many consider that current international tax rules and approaches are no longer in tune with the realities of doing business in a globalised world and hence do not guarantee a non-discriminatory tax system.

In this context, on 19 July 2013, the OECD issued an action plan on 'Base Erosion and Profit Shifting' ('BEPS' and the 'Action Plan') describing 15 distinct initiatives or action points. The primary objective of this plan is to provide guidelines and actions to secure increased synergies between global economic integration, international cooperation and national taxation rights. Timing objectives centre on finalising recommendations by the end of 2015.

While it is true that the timetable of the BEPS project might seem over-ambitious, it has already prompted changes in approach from many national tax authorities and at EU level. For example, France implemented unilateral anti-hybrid measures by introducing specific legislation regarding disallowance of interest deduction on a loan granted by an affiliated company in some specific circumstances, while on 27 January 2015, an anti-abuse rule was formally inserted into the EU Parent-Subsidiary Directive.

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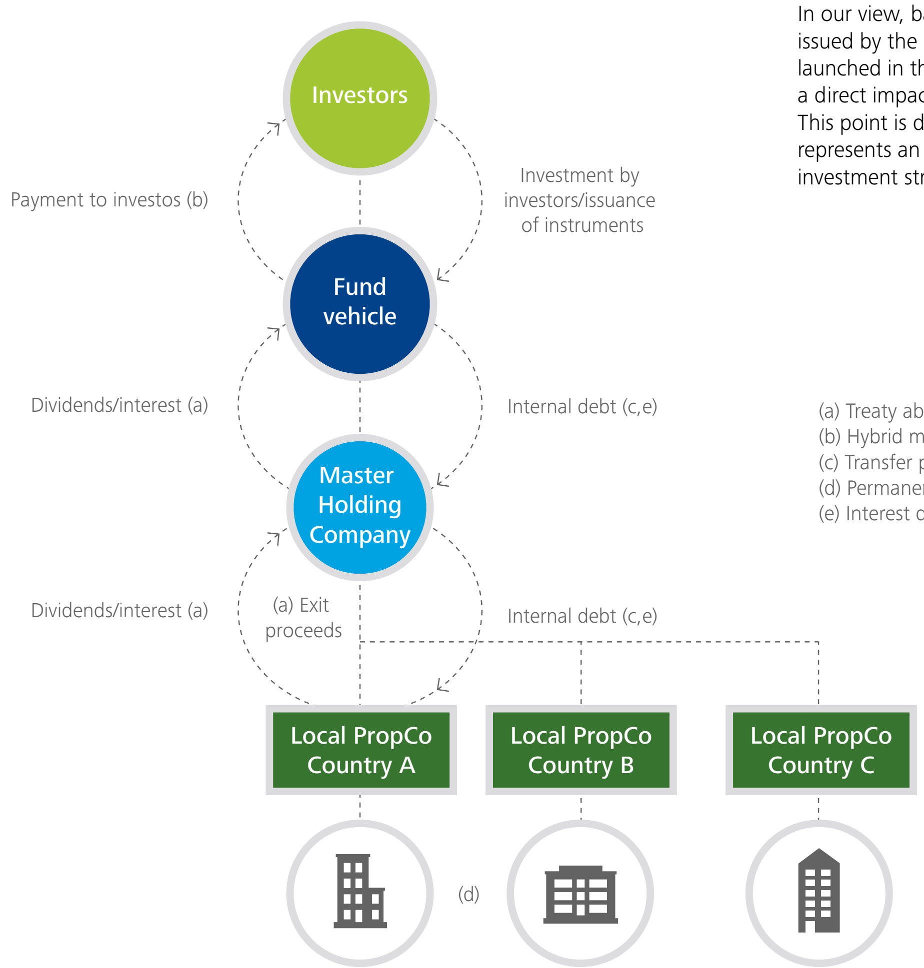
Major market players anticipate that global direct commercial real estate transaction volumes could range between US$730 billion and US$750 billion in 2015, making it the sixth consecutive year of volume growth, although the pace of economic recovery across the globe varies. In light of its strategic importance for the global economy, we will review whether the current BEPS proposals will have a negative impact on real estate investments and related sectors and whether there is a need to react.

Indeed, although real estate investments are not the main drivers of these new developments, upcoming changes in international tax standards, coordination and domestic tax legislation considered in the BEPS initiative might have an impact on the tax structuring and associated treatment of real estate investment structures.

In our view, based on available preliminary reports issued by the OECD, only a few actions (2, 4, 6 and 13) launched in the context of the BEPS initiative could have a direct impact on the real estate fund industry. This point is depicted in the chart below, which represents an example of a widely used real estate investment structure.



(a) Treaty abuse
(b) Hybrid mismatches
(c) Transfer pricing documentation
(d) Permanent establishment
(e) Interest deductions

This article will focus on Action 2 'Hybrid Mismatch Arrangements' and Action 6 'Preventing Treaty Abuse', which, as outlined above, may affect the way real estate investments are structured. We will address Action 4 of the BEPS Action Plan in a future issue of this magazine. Indeed, Action 4 focuses on drafting rules to prevent base erosion and profit shifting using interest and other financial payments economically equivalent to interest, and is therefore relevant for the real estate industry.

Each country generally applies its own set of rules and characteristics when analysing whether a financing instrument should qualify as debt or equity. This means that a mismatch whereby an instrument would be considered as debt in the master holding's jurisdictions (meaning tax deduction would be granted) and equity in the investors' jurisdictions (making income exempt from taxation of tax deferral) could arise in some cases. Such a mismatch may also be introduced via specific hybrid entities having different qualifications depending on their jurisdiction.

Action 2 of BEPS aims to neutralise the effects of such hybrid mismatch arrangements, either via certain types of entities or financial instruments, that could be used to achieve unintended double non-taxation and/or long-term (as opposed to reasonable) tax deferral. This Action[1] therefore calls for the development of model treaty provisions and recommendations regarding the drafting of domestic rules to neutralise the effect of hybrid instruments and entities.

The OECD has recommended several rules to be applied in the event that a hybrid mismatch arrangement is identified. The primary response should in most cases be that the borrower's jurisdiction denies the indirect tax deduction. In addition, the OECD's Action 2 set of rules also recommends that 'defensive' rule be adopted by the respective jurisdictions to be applied whenever a counterparty jurisdiction refuses to disallow a tax deduction in line with the primary response suggested.

The above could directly impact some of the standard structures and financing models currently being used. For example, nowadays, in the case of U.S. investors, it is common to see financing instruments qualifying as debt in the borrower jurisdiction and as equity from a U.S. tax perspective. This ensures that taxation for the U.S. investors is deferred until actual payment is made on the financing instrument by the borrower.

1 *See Action 2 – Neutralise the effects of hybrid mismatch arrangements (OECD, 2013a), pp. 15-16.*

This suggested OECD recommendation might therefore lead to a situation where the investors' jurisdiction would disregard its national tax rules for exemption or tax deferral and instead ensure that the revenue on the hybrid financial instrument concerned is taxed as ordinary income.

However, in this particular example, taxation for U.S. investors would only be deferred until actual payment on the financing instrument occurs. Although BEPS Action 2 includes an exclusion of the suggested new rules in the event that the mismatch is only due to a timing difference in recognition of the income and its taxation, the current report is unclear as to what could be considered as a reasonable timing difference. This point should be monitored once clarifications have been provided.

It is worth mentioning that hybrid mismatch arrangements are already rare within European real estate investment structures and that on 20 June 2014, ECOFIN adopted a proposal to amend the Parent-Subsidiary Directive in order to prevent the use of hybrid financing instruments. As a result of this amendment, the participation exemption may only be applied insofar as the payment is non-deductible in the country of payment, i.e. not tax deductible in the subsidiary.

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Another aspect to mention for the real estate industry in relation to Action 2 is directly linked to the definition of hybrid mismatch arrangements, which includes: “where that mismatch has the effect of lowering the aggregate tax burden of the parties to the arrangement”. In most jurisdictions, investment funds are tax exempt, transparent or subject to very low taxation. However, payments to real estate funds should not fall within the scope of Action 2 since they do not reduce the overall tax burden of the investment structure.

In summary, real estate stakeholders should be aware that there is likely to be a requirement to identify hybrid entities, financial instruments or arrangements that lead to a mismatch in the tax outcome (i.e. deduction, non-inclusion or double deduction) and whether an exception could apply (e.g. timing differences). However, as described above, current changes in legislation in particular should mean that the impact on real estate structures should be limited and alternatives will be available.

Action 6 of the BEPS initiative – ‘Preventing the Granting of Treaty Benefits in Inappropriate Circumstances’ – could be of particular relevance for the real estate industry. Its main objectives are to limit access to the benefits of the treaty, notably via the insertion of a so-called ‘Limitation Of Benefits’ clause (LOB) and/or a ‘Principal Purpose Test’ (PPT) that would be introduced into all treaties either via a multinational agreement or via domestic law or renegotiation of treaties. The latter option may be impractical or time consuming. Insofar as the motive test is not met or the LOB applies, treaty benefits would be denied.

Given the specialised nature of real estate investments, it is common for investors to gain exposure to real estate assets via different types of Collective Investment Vehicles (‘CIVs’) collecting funds from investors resident in one or several jurisdictions (pension funds, family offices, SWFs, corporates, individuals, etc.). They invest these funds in assets located in distinct jurisdictions so as to diversify their investments e.g. by using different asset classes and geographical areas to ensure risk diversification.

One important concern of many real estate players and institutions therefore relates to the planned policy considerations regarding the treaty entitlement of CIVs. Indeed, while the proposed wording is not final, the suggested definition of CIVs (notably referring to the 2010 OECD report on CIVs) for the purposes of LOB provision is too narrow, as it would restrict treaty access for most European non-listed alternative CIV and non-CIV funds (including AIFs) as currently structured.

Therefore, since the publication of the OECD Public Discussion Draft ‘Follow-up Work on BEPS Action 6: Preventing Treaty Abuse’ dated 21 November 2014, many players in the real estate world have been lobbying to include CIV and non-CIV funds under ‘qualified persons’ as defined in the proposed LOB provision. This is a point to monitor going forward once final guidelines have been issued by the OECD.

Furthermore, specific investment and financing structures e.g. intermediary companies – Special Purpose Vehicles (‘SPVs’) are usually implemented to ensure that the tax burden of end investors is similar to the level of taxes that would have been paid had they invested in the real estate assets directly (i.e. funds must be tax neutral compared to direct investment). This is also the case for genuine financial, pro-business, operational and regulatory reasons.

Under the current LOB provision, an intermediary company would most likely only be entitled to the benefits of a tax treaty based on either the ‘active trade or business’ test or the ‘derivative benefits’ test. Some players are pushing for it to be included under ‘qualified persons’ or for the adoption of a milder LOB provision via a rather large and flexible ‘derivative benefits’ test. For the above reasons, the specific case of SPVs is clearly relevant for the real estate industry where, for example, application of a treaty might be important for capital gain taxation upon the sale of real estate investments via share deals.

Conclusion

As most of the recommendations are still draft versions and still being discussed, it is difficult to assess the actual impact that the BEPS initiative will have on the real estate industry. As it stands, only the recommendations in relation to Action 1 (‘Digital Economy’) of the BEPS initiative have been finalised and yet still do not reach firm conclusions and recommendations.

Based on the above and ongoing discussions, our view is that the impact should be limited, but real estate investment funds should also ensure they consider overall interactions between BEPS recommendations and other international or national actions such as CFC rules, GAAR, transfer pricing policies, etc.

Real estate investment funds should in particular ensure that important aspects such as substance, transfer pricing, risk management, changes in domestic tax laws and double tax treaty networks are monitored properly in light of their investment structures.