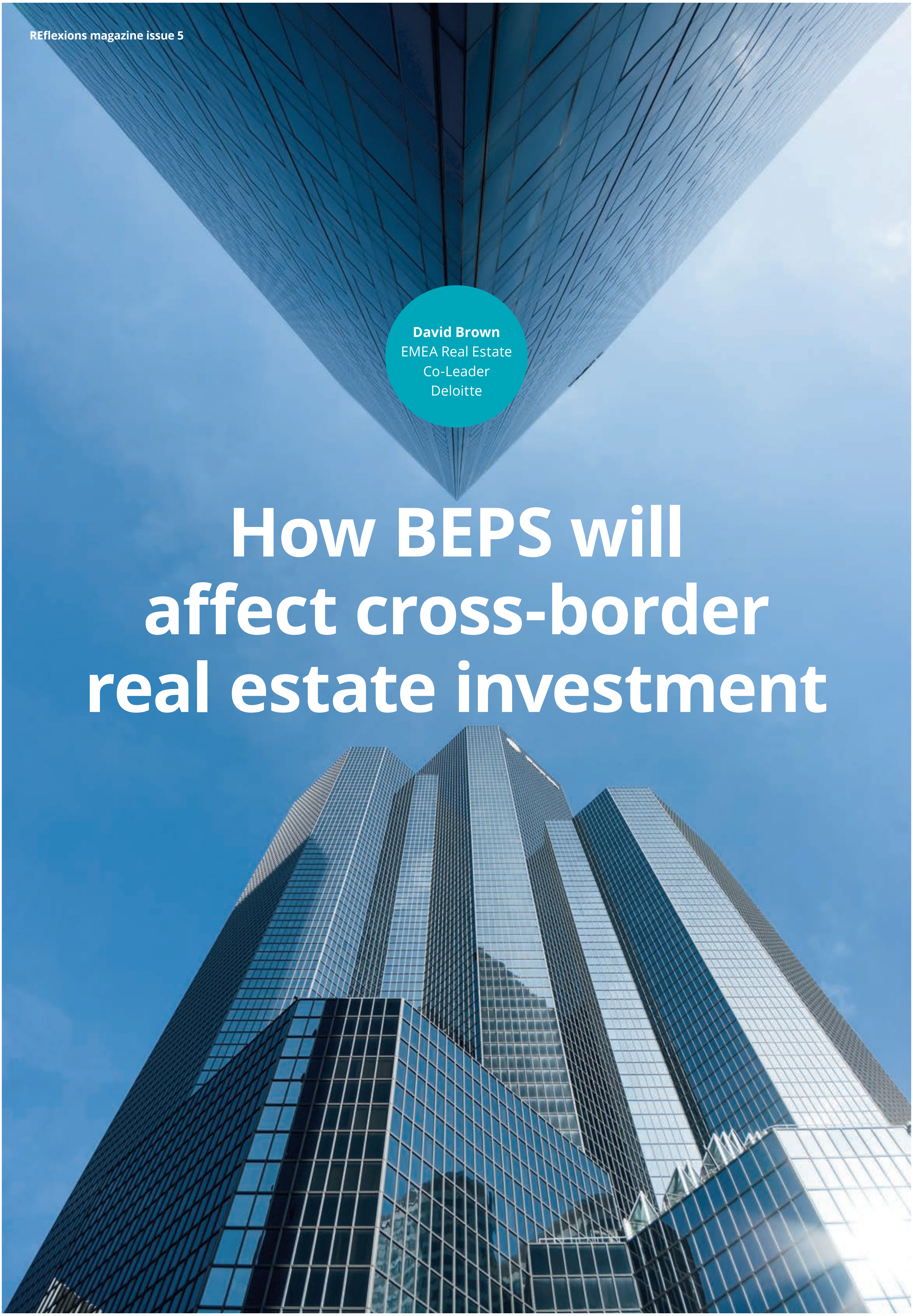

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How BEPS will affect cross-border real estate investment

For real estate investors and developers, certainty about the long-term tax costs of a project or investment is critical to accurate underwriting and pricing. Where tax costs move significantly, there is likely to be a knock-on effect on the returns achieved on individual investments, which will ultimately feed through to real asset pricing. An example of this is the impact of the recent changes of the UK stamp duty land tax regime, which has added three percent to the acquisition cost of residential property (for those who already own a home). The regime has dampened activity, and anecdotally is reducing values both for completed stock and for land, particularly in London. The impact here is readily apparent as the tax cost is clear and the additional bill falling on buyers easily computed.

The real estate investment market is, however, also facing a number of tax changes where the impact is less easy to calculate. Investors therefore need to think hard as to the likely effects and how any increased tax costs may bear on investment underwriting.

The two changes on which this article will focus arise principally from the OECD's Base Erosion and Profit Shifting (BEPS) initiative, which was put in train by the G20 in 2013 and is starting to work through into legislation. While there are 15 separate themes, or actions, within the BEPS project, some touch on real estate investment only tangentially. The focus is therefore on the two main areas—BEPS Action 6, which relates to tax treaty access, and the series of actions that touch on relief for interest expenses, including those actions relating to interest deduction restrictions, and hybrid instruments. We will cover transfer pricing in a future edition.

It is well understood that cross-border real estate investment has relied extensively on fund and corporate structures as the industry has evolved over the last 20 years or so. Most structural elements have clear non-tax purposes—a fund vehicle for example is the legal vessel that regulates relations between a manager and multiple investors, typically allowing investors to diversify their portfolio, and benefit from an increased scale of investment and specific, expert, and often local management teams.

In order to make the returns work for investors, however, fund structures tend to have the overall goal of mimicking the tax position of an investor if it was to invest directly. Sometimes this can be done by using tax transparent vehicles—the Jersey Property Unit Trust flourished for investment in the UK for just this reason. Replicating the effect of direct investment in other markets has, however, generally involved creating a tiered structure of property and corporate holding entities, which must then seek to benefit from tax treaties (or EU Directives) in order to minimize the tax drag on profit repatriation (largely a result of withholding taxes).

Through the BEPS Action, however, the OECD has sought to minimize the abuse of tax benefits by setting out minimum standards for treaty access. Within Europe, the key tool is likely to be a "principal purpose test," introduced either directly into tax treaties or through the BEPS Multi-lateral Instrument, which will restrict benefits to those entities whose creation was not principally tax driven or which have substantial operations in the country in which the taxpayer seeks to benefit from treaty access.

At present, few funds of any kind—whether real estate, private equity, or infrastructure—have such substantial operations anywhere. Further, very few holding companies are created without the benefit of tax advice and, while non-tax reasons for their creation and location may exist, it is not clear that any of these reasons will be sufficiently robust to withstand tax audit from a payer jurisdiction. As a result, treaty access could be denied and withholding tax costs increase dramatically. To what extent is likely to be determined by the approach in each investment location.

While the OECD has responded to lobbying with a set of specific examples for funds (or "non-CIVs" in its slightly topsy-turvy terminology), treaty access for real estate funds may still be hard to obtain. The OECD is currently considering responses to the non-CIV consultation that ran until early February 2017, although the winding-down of the project team as a whole may lead to the conclusion that significant change to the current examples is unlikely.

We are not yet at the end of the road but it is starting to become clear that treaty access in a fund context, if available at all, may ultimately rely on disclosing the identities of investors, and the investors' own treaty positions, in order for fund entities to benefit from treaty access. This may have a significant effect on who will invest and how the fund manager deals with fund tax affairs in the future.

As a result, changes to the current "model" fund may include:

1. **Investors being required to disclose detailed treaty status prior to subscription**, and maintain up to date treaty or residence certification as required

2. **Restricting fund access** solely to investors who benefit from broad tax treaty access (or, conceivably but not certainly, having a maximum percentage of non-treaty investors)

3. **Segregating investors** into separate fund pools or partnerships so that "good" investors are not tainted by non-treaty co-investors and any withholding tax costs may be ring-fenced

4. **Redrafting distribution waterfalls** to ensure that withholding tax leakage (even within underlying fund entities) can be streamed solely to those investors whose status gave rise to the tax

5. **Indemnification of the fund by investors** who fail to disclose accurately or maintain properly their tax status or certification

The non-CIV examples cover "good" entities who may be expected to garner treaty benefits. Local implementation of treaty charges to include PPT provisions, and the process of implementing these changes through the multilateral instrument, is likely to take another few months more.

Funds now in formation need to at least communicate how changes are likely to affect fund documentation and may ultimately affect returns. Early movers are even now bolstering operations in key holding jurisdictions such as Luxembourg, or else planning to move holding companies into those territories where they have substantial operations, such as the UK.

The changes to interest relief are going to move quickly—for example, UK and Denmark have already enacted anti-hybrid legislation, which may deny interest (or even rental) deductions in certain structures. The presence of hybrid entities is prevalent among larger PERE funds that file US check-the-box tax elections for fund entities, by creating an entity that is typically transparent for US tax purposes. Working through the effects of these rules is complex and results are frequently non-intuitive, i.e., the rules may apply even where the hybrid nature of an entity or investment does not result in a loss of tax. The UK rules came into effect for taxpayers subject to corporation tax from 1 January 2017; those changes are likely to hit non-resident landlords who, owing to a peculiarity of UK tax law, are subject to income (rather than corporation) tax, during 2018.

A second wave of changes, concerning earnings stripping rules, is also underway with the impact in the UK likely to be most significant at first. The UK is moving from a "pure" transfer pricing approach—where, broadly, interest was deductible if on arm's length terms—to an approach where deductions will be limited by reference to a ratio of 30 percent of tax EBITDA (or the group's overall:EBITDA ratio if higher). The effect is likely to be quite dramatic in terms of tax cost although the impact on most real estate investment (that from non-UK resident investors) is not expected before 2018 at the earliest (as the law is relevant for corporation tax only). The rules are expected to apply from 1 April 2017 for UK corporation taxpayers, however, which includes many "operating real estate" sectors such as hotels, serviced offices, and self-storage.

Many funds have already built the 30% limit into underwriting assumptions and distribution projections and those who have not need to move quickly. The knock-oneffect on asset pricing is harder to read and, with tax rates likely to reduce to 17%, may not be as great as may be feared.