BEPS implications for the real estate investment industry
What is on the horizon?

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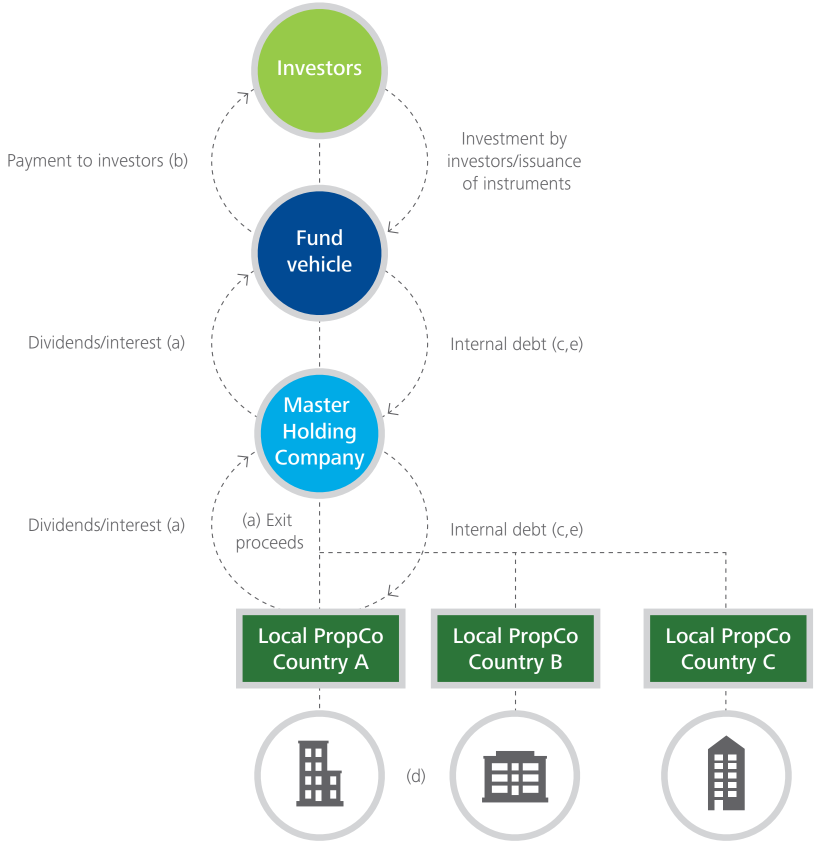
On 5 October 2015, the OECD published the 13 final BEPS reports, which confirmed most of the recommendations discussed in the past. A significant part of these recommendations are either subject to further discussions in 2016/2017 or left to individual taxing authorities' own initiative. Whilst BEPS could generally have an impact on all sorts of businesses, it is clear that only some of the recommendations raised would directly target real estate investment structures.

The 2015 Final Reports recommend changes to domestic laws, the OECD Model Tax Convention (the OECD Model), and the OECD Transfer Pricing Guidelines (TPG). They propose to accelerate the incorporation of recommended changes into existing bilateral treaties through a multilateral convention to be entered into by interested countries.

Given the significant volume of real estate transactions, particularly cross-border investments, and the strategic importance of real estate for the global economy, the impact that these final reports may have on the tax structuring and associated treatment of real estate investment structures may have real economic consequences for investors and managers. That being said, it is important to emphasize that real estate investments are not the main drivers of these BEPS Actions—as they are heavily focused on multinational corporations—and there is consequently limited information to share at this stage within the industry. The real impact will be felt as the Actions are implemented at national level.

Whilst BEPS potentially and theoretically brings change to all sorts of businesses, only a few Actions in the final BEPS report may directly have an impact on the real estate fund industry as depicted in the chart on the right, representing an example of widely used real estate investment structures.



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

In this publication, we will therefore focus on Action 2 "Hybrid Mismatch Arrangements", Action 4 "Limit base erosion via interest deductions" and Action 6 "Preventing Treaty Abuse" which may directly affect the way real estate investments are structured.

Action 2 - Hybrid mismatch arrangements

A mismatch in the qualification of a financial instrument or an entity in two different jurisdictions might arise due to the fact that each country generally applies its own set of rules and characteristics. These so-called hybrid mismatch arrangements are directly targeted by Action 2, which 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).

The final BEPS report recommends the development of model treaty provisions and furthermore includes a long list of recommendations to countries when it comes to the design of domestic rules to neutralize the effect of hybrid instruments and entities. Based on the final recommendations, it should be sufficient to have one country enacting an anti-hybrid rule in its own legislation to neutralize hybrid arrangements.
Hybrid mismatch arrangements (of the type targeted by BEPS) are relatively uncommon within the European real estate investment structures, although many funds will have entities treated as hybrids (as a result of check the box elections) and/or use hybrid instruments. Such arrangements have already been the subject of anti-avoidance rules.

For example, on 20 June 2014, the ECOFIN adopted a proposal to amend the Parent-Subsidiary Directive to prevent the use of hybrid financing instruments . Some EU countries—such as Germany and Denmark—have already existing legislations in place targeting hybrids.

Notably, however, anti-hybrid rules may have an impact on some of the standard structures and financing instruments such as the so-called CPECs currently used particularly by U.S. investors to defer taxation. However, these instruments should not be specifically targeted by Action 2 (where for example there is no tax arising in the hands of the recipient as a result of its own status, e.g. as an exempt pension fund).

Subject to a review of the final implementation of this Action at a local level, the impacts on real estate structures should be rather limited and alternative solutions should be available.

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 firm guidance 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 to 30 percent.
The Action also anticipates that local implementation of this rule may include a softening of the EBITDA cap by allowing interest deductions in excess of the 10-30 percent ratio where the group was able to demonstrate a higher level of interest deductions at a consolidated level. Each taxpayer would be allowed to deduct the highest result of the two tests, the principle being that genuine third party interest should typically be considered as deductible.

This level may, however, be very much below that typically seen in a real estate investment structure where interest deductions may be at 70 percent of EBITDA or more.
Critically, this Action is billed by the OECD as a "best practice", leaving national tax authorities with greater latitude as to how to implement it into local law.
Major European economies have upgraded their legislations in the recent years by introducing various "earnings-stripping" limitations to interest deduction (and also on the level of tax losses to be carried forward in some instances). Hence, some jurisdictions may consider that their existing rules now broadly satisfy the Action.
A de minimis threshold could also be an option for contracting states (as it is currently under legislation in Germany for example).
The UK has, however, already launched a consultation following the publication of the final BEPS report on this Action and it may be expected that other jurisdictions will follow suit.

As a result, the outcome of Action 4 may have a significant impact on the real estate investment structures, and funds could expect additional interest restrictions in some countries that would ultimately affect the internal rate of return to investors. Whilst it is too soon to say exactly what will change in each jurisdiction, now is the time to start considering the levels of taxation that may be suffered if a hard cap on interest deductions is introduced.

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

Action 6 could be of particular relevance for the real estate industry. Its main objective is to limit the access to the benefits of the treaty via notably the insertion of a so-called "Limitation Of Benefits" (LOB) clause and/or a "Principal Purpose Test" (PPT).

1 *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).*

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, albeit the latter option may be impractical/ time consuming. If the motive test is not respected or the LOB applies, treaty benefits would be denied. The final BEPS recommendations remain therefore broadly unchanged compared to the earlier drafts. In particular, the ability of real estate funds to meet the LOB requirements as proposed remains very limited (as they bear little resemblance to the types of entities, typically multinational listed corporations, considered by the existing drafting of the LOB test). REITs that are listed in their headquarter's jurisdiction should, however, have a greater prospect of retaining entitlement to treaty benefits under this provision.

Given the specific nature of real estate investments, it is common for investors to gain exposure to real estate assets via different types of Collective Investments Vehicles (CIV). These gather funds from investors of different types (e.g. pension funds, family offices, SWF, corporates, individuals, etc.) and in multiple jurisdictions to invest into assets located in distinct jurisdictions so as to diversify their investments (e.g. different asset classes and geographical areas to ensure risk spreading). Therefore, a key concern of real estate players and institutions relates to treaty entitlement of such funds:

- There is a general support by the OECD to consider that CIVs (broadly those funds investing in securities) should be able to qualify for treaty benefits but under circumstances which remains left to each contracting state. Based on the final BEPS report, the access to double tax treaties for CIV funds will depend on how these funds are treated under the respective conventions in each contracting state. In a nutshell, the treaty entitlement of CIV funds is not automatic and, depending on the options chosen by contracting states, subject to conditions which could limit in practice the ability to rely on treaties.
- The situation of non-CIV funds—which includes REITs, real estate and pension funds—are not yet fully addressed and will be subject to further work being undertaken in 2016. Recently, asset managers have become more and more attracted to domestic REIT regimes that are promoted by major investment jurisdictions to attract foreign investors. Whilst these regimes are not targeted by BEPS, since it is mainly focusing on cross-border tax optimization schemes, the ability to access tax treaties is also critical to maximizing returns by cross-border investors into such local structures. As a result, the further work on the OECD on this topic is likely to be highly relevant and closely watched.
- Specific investment and financing structures (e.g. intermediary companies such as Special Purpose Vehicles (SPVs)) are typically implemented below investment funds for genuine financial, pro-business, operational and regulatory reasons. The use of intermediate SPVs should be analyzed in the light of the "active trade or business" test or the "derivative benefits" test proposed (or in concert with the position of the fund in the follow-up work on non-CIVs).

The effectiveness of these recommendations will depend on how they are implemented in each country. Similarly to the 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. Dividends or interest distributions by a property company located in a country with a favorable 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 by 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 on this point.

Conclusion

Our view is that the final BEPS report is likely to have an impact on the return offered to investors as the interest deduction Action, in particular, may lead to more effective restrictions on cross-border debt financing structures than we have seen to date.
The upcoming work on Action 6 will hopefully recognize the importance of fund vehicles (or non-CIVs) in encouraging cross-border investment and these entities will therefore hopefully remain eligible for treaty benefits.