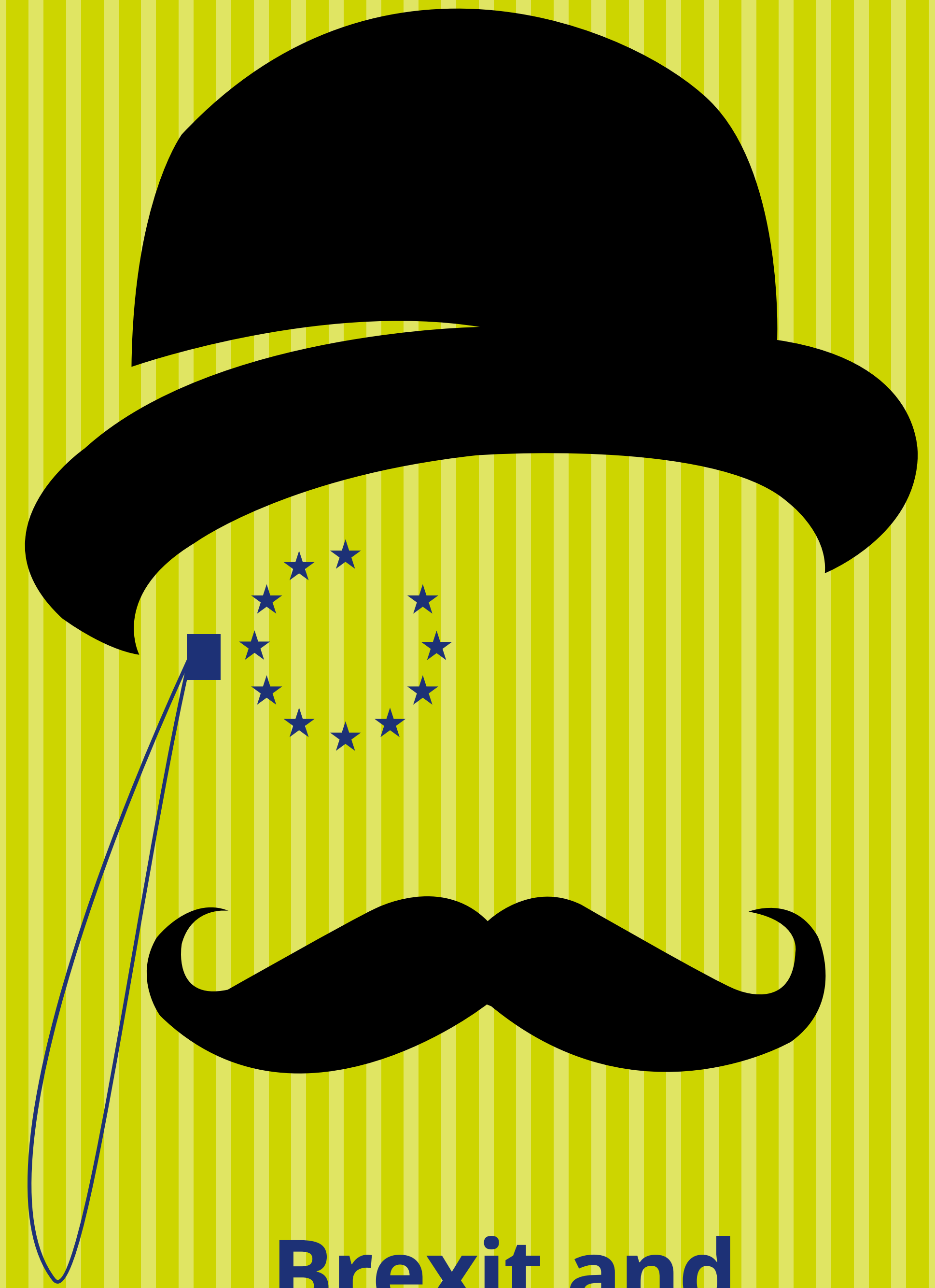

Brexit and the real estate market

A new tax operating model?

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REflexions magazine issue 6

Whilst speculation on the political process of Brexit is hard to avoid, the real estate market is primarily focused on the short-to-medium term effects on the UK economy, as the outcome of the negotiations, and to some extent the on-going uncertainty as to what the outcome will be, are impacting on investment decisions and the UK consumer. Any impact on both the ability to conduct the business of investing in real estate is currently a second order consideration, affecting only those who operate or invest via regulated vehicles, for whom the loss of passporting rights under EU financial services regulation may require an adjustment to their business model. For real estate investment managers, there has yet been little sign of a rush to relocate functions and individuals as many are waiting until the shape of any transition arrangements are clear; this is in contrast to banks and insurers who are already starting to enact their contingency plans.

We expect, however, that asset managers will start to move into a higher gear before the end of the year as they consider how to respond to the reality of the UK as a third country to the EU. For most in the alternative or private assets space, including real estate, the range of options as to where to domicile activities and people in a new regulated structure is quickly boiling down to a choice between Ireland and Luxembourg, with other jurisdictions only really entering the fray where there is a significant existing business there already.

Whilst legal and regulatory issues have tended to be front-of-mind to date, in practice it is likely that a combination of ESMA and the natural competitive tension between fund domicile jurisdictions will ensure that the scope for regulatory arbitrage between jurisdictions is limited. As a result, other issues, such as the impact on a group's tax profile, and the costs of staffing and running an office, will also be key to the decision.

Relocating significant business functions and management fee streams from the UK to another jurisdiction brings with it two major tax considerations—the one-off cost of transfer and the on-going impact of a firm's effective tax rate on its fee revenues.

For businesses in the sphere of investment management, most of these issues are similar across asset classes, and the article below is based on the recent analysis put forward in the last edition of Performance magazine, a Deloitte publication dedicated to IM.

Relocating significant business functions and management fee streams from the UK to another jurisdiction brings with it major tax considerations.

Brexit restructuring

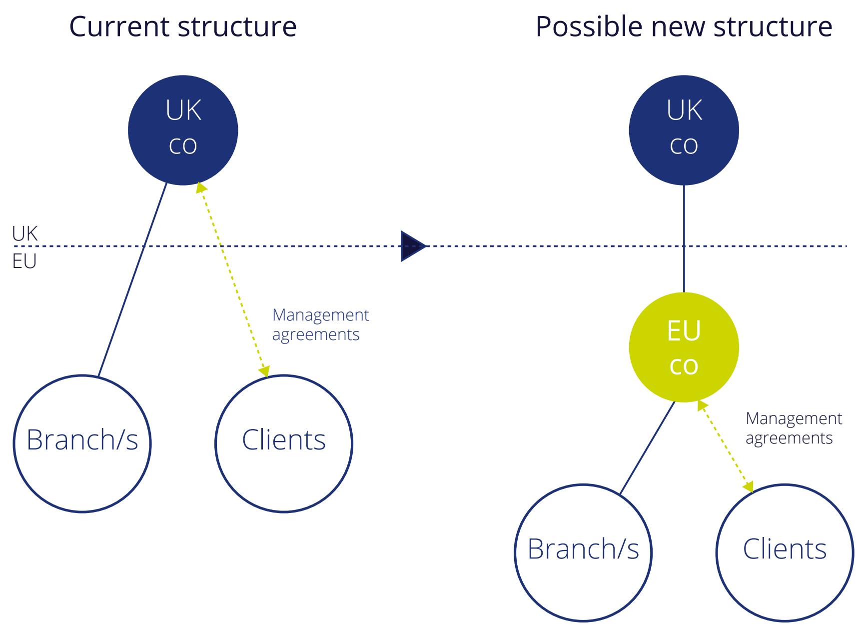
The UK's departure from the EU could have a significant impact on how UK-based asset managers operate within the single market.

The EU's UCITS, MIFID, and AIFMD rules currently allow UK-regulated companies to passport across the EU. UK-based asset managers may currently rely on these passporting rights in order to distribute products in the EU, for example through EU branches, and manage EU-domiciled funds or segregated portfolios directly from the UK.

The precise impact of Brexit on these arrangements (and on so many things) is currently unclear, and it is likely to affect different managers in different ways. It will depend in particular on the types of product that are managed, the manager's client base, and how the various EU directives are relied upon. Fund vehicles for pan-European exposure to direct real estate are domiciled in a variety of jurisdictions, often depending on source of capital, but Luxembourg has been the increasingly common choice of managers as a venue for fund formation likely to appeal to the widest range of investors. This has not to date required the formation of a Luxembourg-based manager, however, and many such funds are managed under passporting rights from the UK.

There are also many managers, particularly those in the real estate private equity space who will continue to use a Delaware or English limited partnership model.

UK asset managers are less affected by Brexit than, for example, banks. However, it is likely that some will need to make important structural changes to continue operating across the EU, particularly if they are to continue to manage funds formed in Luxembourg. These changes are likely to include undertaking more activity through companies established in the EU, which we refer to as "EUco" in this article.



In practice, many of the larger institutional real estate investment managers already operate via AIFM-regulated management companies within the EU, many in Luxembourg. Even these, however, are likely to need to increase the size of their operations within the EU relative to the UK, not least in response to ESMA's ongoing review of the level of delegation of responsibilities from EU managers to third countries.

The transfer of distribution and portfolio management activity from the UK to EUco could have a number of significant tax consequences. Key questions that managers need to consider include:

- Should tax have a bearing on where EUco is located?
- Will the transfer of branches or management agreements to EUco give rise to taxable disposals, or VAT-able supplies? If so, is relief available?
- What are the ongoing tax consequences of operating EUco?

In this article, we discuss some of the considerations that are pertinent to these questions.

Where to establish EUco

Legal and regulatory considerations, together with the location of existing operations, are likely to be the key drivers of where EUco is located. Nonetheless, the impact of the tax regime that applies to EUco should be assessed.

Corporate tax regimes

An obvious question is whether the activity that is transferred to EUco will be taxed at a different rate to the UK's. The UK corporate tax rate is currently 19 percent, and will fall to 17 percent by 2020. These rates are significantly lower than the rates in many of the UK's neighbors in continental Europe. Will performing distribution and portfolio management through EUco lead to significantly higher corporate tax liabilities? This is likely to depend on a few factors, including:

1. How much activity is transferred to EUco, and what profit the transferred activity generates. This in turn is likely to depend upon what EUco's regulator will require in terms of substance and local presence (i.e., people "on the ground"), and the transfer pricing policies that are applied to EUco.
2. The treatment of any branches transferred to EUco. If EUco is in a jurisdiction that exempts branch profits from tax, those branch profits will only be taxed in the branch jurisdictions. There will be no additional tax on branch profits in EUco's jurisdiction, and EUco will only pay tax on their "head office" profits.
3. Local tax rules, including what expenses can be deducted from taxable income and what tax incentives and allowances are available.

The UK's departure from the EU could have a significant impact on how UK-based asset managers operate within the single market.

Of course, if EUco is based in jurisdictions with a lower tax rate than the UK's, such as the Republic of Ireland, the new structure could generate tax benefits. However, anti-avoidance rules would need to be reviewed, such as the UK's controlled foreign companies and diverted profits tax rules.

Repatriating profits

Currently, the EU parent and subsidiary directive can prevent withholding tax from being applied to dividends paid from an EU subsidiary to its EU parent. This means that a dividend received by a UK company from an EU subsidiary should currently be free from withholding tax.

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Once the UK leaves the EU, this withholding tax exemption may no longer apply, and UK companies may need to look to the UK's tax treaties for withholding tax relief. Not all tax treaties provide a full exemption from dividend withholding. For example, the UK-Germany tax treaty reduces the withholding tax rate to five percent, rather than zero. Therefore, unless the rules change or the tax treaty is renegotiated, transferring activity to a German company could lead to withholding tax leakage on dividends.

VAT rules

As with any structure that involves the cross-border provisions of services, VAT should be examined carefully. This is particularly important where EUco will be operating through branches. At the moment, charges between overseas branches and their head office are normally VAT-free. However, in response to the CJEU's Skandia judgement, many EU jurisdictions are changing their rules to impose VAT on certain transactions between a head office and its branches. Whether (and how) the judgement in Skandia will be adopted in EUco's jurisdictions could have a significant impact on the VAT treatment of any new structure.

Different jurisdictions also have different rules on how VAT exemptions are applied, when entities can form a "group" whose members do not need to charge VAT to one another, and the way in which input VAT can be recovered. They also have different rates of VAT. All of these factors will have an impact on VAT costs in a post-Brexit structure involving EUco.

It is worth remembering that VAT rules are governed by EU legislation. This means that, post-Brexit, the VAT landscape will change, adding an element of uncertainty to any assessment of how VAT will impact business operations in the future.

Transferring operations to EUco

Having decided where to establish EUco, the next key decision relates to how operations should be transferred to it. Tax is absolutely key to this decision-making process. This is because the transfer of assets from one company to another is normally a market value disposal for tax purposes, and possibly a supply for VAT purposes too. Where the assets are valuable, there is the risk of creating significant tax liabilities.

Fortunately, relief can mitigate these liabilities in many situations. However, complex conditions must often be met, and relief does not apply to every situation.

Transferring branches from the UK to EUco

The transfer of branches from a UK company to EUco can be complex, because two layers of tax need to be considered: one in the branch jurisdictions, and a second in the UK.

In the branch jurisdictions, relief may allow the branch assets to be transferred to EUco in a way that is neutral from a local corporate tax and VAT perspective. However, this will be subject to satisfying the local requirements. It may also be necessary, or advisable, to obtain a ruling from the local tax authority

Interestingly, in some EU jurisdictions, the relief permitting tax-neutral transfers could potentially be clawed back if the transferor ceases to be an EU company within a defined period after the transfer takes place. This means that, when the UK leaves the EU, taxable gains could potentially crystallize on previously transferred branch assets.

In the UK, companies can elect to treat overseas branch profits as exempt from UK corporation tax. Where this choice has been made, the transfer of branch assets to EUco should not be treated as a taxable disposal. While in principle this should make things simple, there are a few complexities to watch out for, including where an exempt branch has made tax losses and where there have previously been transfers of assets between the branch and its head office.

If a branch profit choice has not been made, the transfer of branch assets will be a disposal for UK tax purposes, although any UK tax liability can be reduced in proportion to the tax paid by the branch on the same gain. However, if relief applies at branch level, there may be no branch tax to "credit" against the UK liability. In this case, UK tax creates a cost.

Helpfully, there are special forms of relief that can defer or eliminate the UK tax that would otherwise arise on the transfer of branch assets to EUco. These relief systems are subject to a number of detailed conditions. One form of relief is also subject to a clearance procedure.

Some UK managers operate in the EU through representative offices rather than branches. Applying the rules and relief to the transfer of representative offices can cause difficulties that need to be worked through.

Transferring management agreements from the UK to EUco

The transfer of management agreements to EUco can also be problematic. A cross-border transfer of a UK asset, on the face of things, is a market value disposal by the UK management company, and potentially a VAT-able supply too.

Some managers may therefore consider terminating existing agreements and putting new agreements in place with EUco. If the existing agreements contain terms that permit such a termination, there is an argument that there has been no disposal of value, or supply. However, this approach does entail risk. The clients could choose not to appoint EUco, or could use the termination as an opportunity to renegotiate terms. It would also be necessary to consider whether the UK management company had played a role in EUco's appointment, which under transfer pricing principles should attract a reward.

Operating EUco

Any decision to relocate will naturally involve considering other specific needs relating to a manager's business, including that of supporting its funds' own holding companies via local managers and support staff. For real estate, headcount is becoming increasingly significant owing to the need to evidence economic substance and non-tax reasons for placing a holding company in a given jurisdiction.

The cost synergies of establishing a regulated management business alongside an existing operating and holding company platform in, say, Luxembourg, may carry significant weight, with the ability to share floor space and support staff constituting a key benefit. There is as yet, however, no certainty that tax authorities in the jurisdictions where a fund invests will give too much weight to the location of a fund's manager in considering the entirely separate question of whether to grant treaty benefits to a holding company.

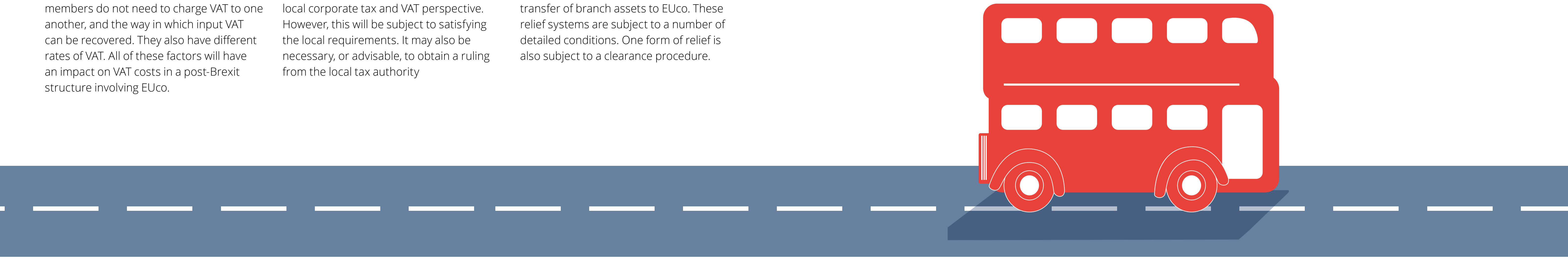
Once EUco have been established and activity has been transferred to them, the focus will be on operating them as efficiently as possible. Ideally, these operational considerations should have been assessed as part of the jurisdiction selection process.

As noted previously, key issues are likely to include VAT leakage arising on cross-border charges, exposure to different rates of corporate tax, and the risk of withholding tax on profit repatriation.

Where staff need to be relocated or will be travelling between the UK and EUco's jurisdictions, managers will need to have policies and frameworks in place to meet business requirements and also comply with the applicable tax, social security, and immigration rules.

Managers will also need to consider strategies for rewarding and incentivizing EUco staff. They will need to understand the local regulatory requirements on remuneration, how to structure local pension arrangements, as well as legal issues pertinent to participation in global incentive plans, the transfer of employee data, and employment rights.

The more practical day-to-day consequences of operating EUco (e.g., tax registrations, filings, and other compliance obligations) should not be overlooked either.



1 A representative office is an operation which does not create a taxable presence, or "permanent establishment" in its local jurisdiction