# Investing through a new world of tax complexity

## Real estate investment vehicles face new tax challenges

**With business activity becoming ever more global, tax authorities are increasingly focused on multi-national organisations and the opportunities they can give to optimise corporate tax charges and obligations.**

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Inevitably, national governments are now looking to international bodies – for example the OEDC and the EU – to combat these threats. While the non-listed real estate industry may not be one of their primary targets, some of the changes they are instigating could have a significant impact on how real estate vehicles are structured and managed in the future.

These initiatives have the potential to change the underlying principles of taxation as much as how they are applied in practice. More than anything, this is about closing the perceived loopholes that are considered to allow tax avoidance to take place. The innovations seek to prevent companies locating purely on the basis of tax advantage rather than economic need and from using excessive borrowing as a way of avoiding tax, while there is also an impetus towards much fuller disclosure of firms' cross-border activities.

There are six particular developments that may have significant, albeit sometimes unintended, implications for non-listed real estate:

### THE MULTI-LATERAL INSTRUMENT ('MLI')

Instigated by the OECD, MLI aims to update double tax treaties to prevent multi-national companies organising their tax arrangements to unduly take benefit from double tax treaties. Pan-European real estate funds may be affected as they are typically structured with a number of legal entities located in several jurisdictions, and often rely on double tax treaties to mitigate the risk of double taxation on income, gains or distributions. Perhaps most relevant, the MLI introduced a principal purpose test ("PPT") under which foreign tax authorities may deny treaty benefits when an investment structure lacks substance. 2017 commentary on the OECD Model suggested that real estate funds would meet this requirement for substance when properly organised, but this interpretation may not be fixed.

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### ATAD – GAAR

The EU's Anti-Tax Avoidance Directive ('ATAD') introduced domestic General Anti-Abuse Rules ('GAAR') in order to challenge the corporate structure of artificial arrangements put in place for tax reasons. Again, it implies that all legal entities have to be set up for sound commercial reasons, be properly managed and have good corporate governance.

### ATAD – INTEREST DEDUCTION LIMITATIONS

Under the EU's tax avoidance directive, member states are also required to put a limit on the amount of borrowing costs that companies can set against their tax bill, either 30% of EBITDA or €3 million per year. This could impact real estate investments and underwriting models that rely on leverage to enhance returns and optimise the allocation of capital, although the precise level of additional tax will depend on the domestic legislation in place.

### ATAD AND ATAD 2 – HYBRID MISMATCHES

Under ATAD, if a real estate fund is seen as fiscally transparent in its nation of domicile, but tax opaque in states where investors reside, it may be considered as 'hybrid', meaning that it may be liable to tax on certain payments between subsidiaries and the fund. This implies a need for greater transparency by both GPs and LPs, including constant monitoring of LPs' domestic tax status, to ensure the most suitable structures are in place.

### COURT OF JUSTICE OF EU – JUDGEMENT ON BENEFICIAL OWNERSHIP AND ABUSE OF RIGHTS

Based on a case brought by the Danish tax authorities, who refused to apply a withholding tax exemption, the issue of 'beneficial ownership' has been put in the spotlight once again, although the interpretation was not conclusive. This may increase legal uncertainty and give tax authorities more reasons to challenge the beneficial ownership position of certain real estate fund structures in the future.

### MANDATORY DISCLOSURE RULES (DAC 6)

Of all the changes, EU directive DAC 6 may have the biggest practical implications, as it mandates that all cross-border arrangements that could be seen as potentially aggressive tax planning have to be disclosed. Such disclosure could come under the responsibilities of banks, advisors, service providers or in-house tax functions. Tax intermediaries and taxpayers will have to implement a DAC 6 policy to track such cross-border arrangements, implying a substantial administrative burden and risks of diverging interpretations of each stakeholder's obligations. There may therefore also be a delicate balance to strike in maintaining confidentiality conditions in contracts with service providers.

All of these initiatives reflect the commitment of international institutions to close tax loopholes and clamp down on perceived avoidance. Given the complexity of the area, there is always likely to be the chance of collateral damage to those with legitimate aims for their financial structuring. In the case of non-listed real estate vehicles, the most important lesson is to keep abreast of developments and put in place the relevant review processes to anticipate the impact and potential cures. The interaction of all these changes in corporate taxation is already having and will continue to have significant effects on the way private real estate investments are structured and managed. ●

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