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Impact of BEPS on Real Estate Investment Structures

Keith O'Donnell, Samantha Schmitz-Merle and Fanny Bueb
Taxand Luxembourg

While not initially focusing on real estate investments, the OECD's BEPS Action Plan proposals threaten to affect real estate investment structures, which would result in investors having to adapt their current business models. Real estate investors and real estate investment managers should take note of the potential implications.

Keith O'Donnell is Managing Partner, Samantha Schmitz-Merle is Knowledge Director and Fanny Bueb is Senior Tax Associate, Taxand Luxembourg

I. Background

With the support of the G-20, the OECD has over the last two years focused on base erosion and profit shifting ("BEPS"), and created an Action Plan (the "Action Plan") of proposed global legislative change to combat real or perceived tax avoidance.

Real estate has become a global asset class, where investors from multiple jurisdictions come together to invest in multiple assets across multiple jurisdictions. Initially, real estate investments were not the focus of the BEPS Action Plan, which was focused on multinational enterprises.

However, many of the proposals made as part of the Action Plan will have an impact on real estate investment structures. In this sense, the real estate investment industry risks becoming collateral damage of the BEPS Action Plan. Real estate investors and real estate investment managers ("REIMs") will have to adapt and amend their existing investment structures and business models. The purpose of this article is not to re-examine the BEPS Action Plan in general, but rather to focus on its impact on real estate investments, both from the perspective of investors and REIMS. This article, which assumes a certain level of BEPS knowledge on the part of the reader, will review:

- typical real estate investment structures—BEPS impacts;
- the evolution of BEPS as it relates to the real estate investment industry;
- REIT regimes—the BEPS dimension; and
- what's next? An action plan for the Action Plan.

II. Typical Real Estate Investment Structures—BEPS Impacts

The chart overleaf illustrates how BEPS is relevant for the real estate investment sector. It highlights some of the key areas of concern and shows that at each level of a typical real estate investment structure, BEPS issues may arise.

Action 6 of the Action Plan, "prevent treaty abuse," is perhaps the major area of concern for real estate investors and REIMs. This action is aimed at companies who use conduit companies and low-taxed foreign branches to artificially shift income. Companies operating across multiple jurisdictions will come under scrutiny due to their use of investment vehicles to collect money across different countries to invest in

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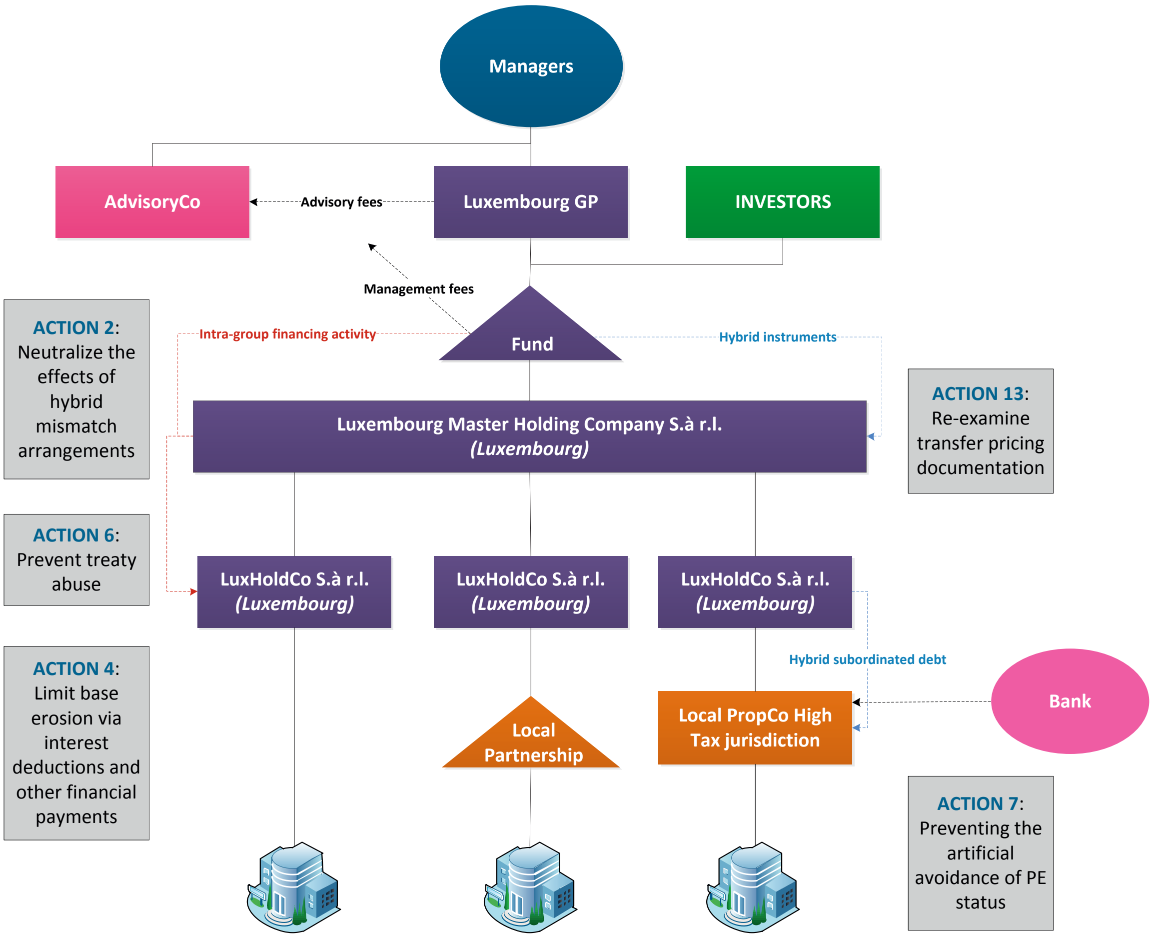

properties located in other jurisdictions. While the aim of Action 6 is quite clear, the current proposals, especially the so-called limitation on benefits ("LOB") clause may have unexpected negative effects on structures and investment vehicles which are not used for treaty shopping purposes but are in place for sound economic reasons. On its most simple reading, the LOB clause can be seen as treating as "suspicious" any corporate structure other than the most basic case of a company owned by residents of its own jurisdiction. Any structure with investors from multiple countries investing in multiple jurisdictions can be challenged in its access to double tax treaties, and then needs to qualify, if at all, under one or more exceptions, not all of which are agreed at the date of this article.

Action 13 on transfer pricing documentation may create new needs for country-by-country reporting and transfer pricing documentation which, at a very simple level, will increase the cost of operating cross-border investment programs. For funds with companies in multiple jurisdictions, "country-by-country" reporting requirements are to be implemented, making funds responsible for filing one report of their global structure, which would automatically be passed to local tax authorities in each country where they are active. Beyond the simple cost consequence, there is also likely to be a medium-term compliance consequence. One of the main "macro" objectives of BEPS is to align taxation and relevant substance. One means of meeting this objective will be a greater focus on substance and particularly the use of registered office headquarters in tax-favorable jurisdictions where these are merely "brass plate" companies. One of the ways the OECD plans to combat the use of these structures is through increasing transparency, particularly around transfer pricing. A typical real estate fund structure will use many legal entities for many non-tax reasons, such as regulation, legal security, bank requirements, investor reporting, etc. Many of these legal entities will, by necessity, have very limited substance. A typical example is the fund vehicle itself, where risk limitation considerations will strongly limit the capacity to have own personnel or premises. Once the country-by-country reporting is made, investors and REIMs can expect to spend considerable time explaining to tax authorities why certain legal entities have high profits but low substance.

Action 2, "neutralise the effects of hybrid mismatch arrangements," will also affect some investment structures. It will be important to understand whether structures create a situation of so-called double non-taxation, i.e. no taxation in both the jurisdiction of source and the jurisdiction of residence of the parent company, or whether the effect is merely a timing effect, often the case in cross-border structures.

Action 4, "limit base erosion via interest deductions and other financial payments," may change the economics of leverage, widely used to enhance returns. The primary aim of Action 4 is to reduce the amount of taxable profits shifted through intra-group interest-bearing loans. However, it also countenances more broad-based interest limitations which could impact third-party interest charges too. Many jurisdictions have already introduced these types of rules on a unilateral basis and the implementation of BEPS may cause these rules to become the norm. This will have clear effects on the long-term effective tax rates in typical investment structures that use multiple layers of debt from both third parties and related parties.

Action 7, "preventing the artificial avoidance of PE status," may create taxable presences for REIMs where none existed before. While the primary focus was multinational enterprises "avoiding" permanent establishments, the wording of the discussion draft and commentaries to date are broad enough to create concerns for asset managers or investment managers operating cross border.

III. The Evolution of BEPS as it Relates to the Real Estate Investment Industry

Since the first publication of the Action Plan in 2013, it has evolved rapidly, as the OECD sought to meet its very ambitious timeline (September 2015, with some extensions for specific projects) and its objective of making the process as transparent as possible.

Public comments on the various discussion drafts released (running into thousands of pages), including comments of representatives of the real estate industry, evidence that the proposals in the Action Plan may have many unexpected negative effects.

Proposals were made in the public comments that numerous real estate investment vehicles should be granted treaty benefits because, like public companies, they are either widely held or are held by investors who would have been granted similar treaty benefits had they invested directly. Several comments were made proposing that collective investment vehicles ("CIVs"), real estate investment funds as well as real estate investment trusts ("REITs") should be considered per se as qualified residents under the LOB clause.

Initial discussion drafts did not expressly cover CIVs in general, nor real estate investment vehicles. The OECD soon woke up to the tension between its earlier work on CIVs and initial discussion drafts of the Action Plan. The Action Plan has begun to encompass CIVs and "non-CIV funds" (which would include real estate investment funds); however, much still remains to be done, as discussed below.

The revised discussion draft ("RDD") on Action 6 released on May 22, 2015 includes some recommendations with respect to real estate investment structures, and more especially regarding REITs, in order to make sure that they will still be granted treaty benefits in the post-BEPS environment. The purpose of this RDD is to respond to the comments made on the discussion draft on Action 6 released in March 2014. It indicates that further work will have to be performed on a number of areas, notably in order to make sure that the conclusions achieved in the past in the REIT report "Tax Treaty Issues Related to REITs," which deal with the treaty entitlement of REITs, will be taken into account in the final BEPS recommendations to be released later this year. In addition, the RDD acknowledges that further work will be required on non-CIV funds (including real estate funds).

One of the key mechanisms proposed to relieve the rigors of a strict LOB test is the concept of an equivalent beneficiary, broadly allowing treaty benefits to be claimed by a company not only if its shareholders are residents of its own jurisdiction, but also if the shareholders are "equivalent beneficiaries," i.e. would benefit from equivalent treaty benefits in their own residence jurisdiction. This concept, used extensively already, looks sensible from a business perspective, but raised treaty shopping concerns among certain OECD members. The RDD, as a way of addressing these concerns, suggests including a new concept into the OECD Model Tax Convention: the concept of "special tax regimes."

According to the proposal, income which falls under one of these regimes would be denied the benefits of some treaty provisions, i.e. Article 11 (interest), Article 12 (royalties) and Article 21 (other income). However, a "carve-out" from the denial of benefits has been inserted, among others, for vehicles that facilitate investment in widely-held entities that hold real property and that are subject to investor-protection regulation in the contracting state in which the investment entity is established. Thus, real estate investment funds may qualify for treaty benefits, but subject to their being regulated, which is not always the case.

The 15 discussion drafts were due to be finalized by September 2015. Some areas for further work have already been identified that will need to continue after this date, so practically speaking, further evolution can be expected over at least the next 18 months. The real estate industry will need to continue to make its voice heard during this period at OECD and national levels.

IV. REIT Regimes—the BEPS Dimension

A. REIT Regimes in General

A REIT is a vehicle which owns or finances income-producing real estate, typically real estate assets, mortgages loans or other real estate related assets. Broadly modeled on mutual funds, REITs provide investors with regular income streams, diversification and long-term capital appreciation. REITs typically pay out all of their income as dividends to shareholders. They often have to distribute almost all, if not all, their real estate income in order to benefit from the favorable REIT regime. To provide a few examples, the Belgian REIT regime requires a minimum distribution of 80% of the corrected net result, the French REIT regime requires a minimum 85% distribution of the real estate income; the regimes in the U.S., U.K., Spain, Germany, and Hong Kong require a minimum of 90%, and the regime in the Netherlands even requires a 100% distribution. Provided these distribution requirements are met (together with several additional conditions which vary from country to country), the REIT will be exempt from tax on its income derived from real estate assets. The idea is that since the return is almost automatically repatriated to investors who will be taxed on the income received, no additional level of taxation should be created at the level of the REIT. For foreign investors, a minimum withholding tax is generally applied.

REIT regimes have become widespread and exist in some 40 jurisdictions around the world with new regimes being added yearly. A number of jurisdictions are also making their REIT regimes more flexible, for

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example allowing a higher level of control by a small group of investors, allowing cross-border investment, etc. Depending on investor profile, REITs can offer an attractive after-tax answer and there is the perception that they offer a form of "state-sponsored" tax planning which may be more sustainable than some traditional forms of tax planning.

B. REITs and BEPS

The ongoing work on preventing treaty abuse, especially the work in connection with the LOB clause, seems to conclude that using REITs to invest into real estate should not be considered as abusive.

However, the proposal to limit treaty benefits in respect of "special tax regimes" mentioned above could, based on its current wording, have negative implications for REITs. A REIT is a tax regime which applies to a vehicle, provided it fulfils certain conditions. Since the "carve-out" mentioned above for widely-held entities that hold real property is conditioned on the entity being subject to investor-protection regulation, REITs would not necessarily qualify for this carve out. This would mean that they would be considered as a special tax regime and would thus be excluded from the benefit of the provisions of Articles 11, 12 and 21 of the OECD Model Tax Convention. Regulated real estate investment funds would however, to the extent they are widely held, not fall under the scope of special tax regimes.

This is why EPRA and NAREIT industry bodies have recommended that if the OECD decides to include the concept of special tax regime in its final Action Plan, the Commentary should expressly state that European REIT regimes qualify for the exclusion for legislation that facilitates investment in widely-held entities that hold real property.

It appears from the above that BEPS looks at the use of REITs in a cross-border investment context only, i.e. the use of REITs by investors to perform real estate investments in another country. REITs regimes, as such, are not called into question, however.

C. REIT in a Post-BEPS World

In a post-BEPS environment, given the new constraints in the process of being introduced at OECD level (especially those on Action 6 dealing with preventing treaty abuse), REIT structures should be subject to a lower risk of being challenged by tax authorities than traditional real estate investment structures which will have to be robust in order to survive in the new environment. This may boost the number of REIT structures implemented in a post-BEPS context.

The new challenge is now to create cross-border REITs or cross-border REIT portfolios. In an EU context, it is interesting to note that if an EU REIT in Member State A decides to invest in real estate located in EU Member State B which has a REIT regime in place, the REIT in Member State A should in principle be able to benefit from the REIT provisions in force in Member State B. A number of REIT regimes in the EU recognize this and we have seen the emergence of the first "proto EU REITS" as a result.

V. What's Next? An Action Plan for the Action Plan

The current BEPS work will have many practical implications for traditional real estate investment structures. The new tax environment will impact both the investors on their net of tax returns and the REIMs. Both will have to adapt their structures in order to become BEPS-compliant.

The Action Plan and the possible evolution of its subsequent implementation leave many questions open, both technical and political. What can be done in the meantime? Real estate players could make an inventory of structures that may be impacted and then plan along the following lines:

- Investment structures should be strengthened with more substance.
- Accounting systems should be adapted to cope with additional reporting and transfer pricing requirements.
- Management structures should be reviewed in light of the increased risk of having a permanent establishment.
- Financing structures should be reviewed in light of challenges to both deduction of interest and treaty benefits.
- REIT-type vehicles should be tabled as they offer an interesting alternative in many countries.
- Underwriting and valuation models should be reviewed in light of potential volatility in effective tax rates.

In addition, given the continuing evolution, industry players should continue to make their concerns known to their representatives in both industry bodies and their political representatives. When the dust settles, BEPS will have profound effects on the real estate industry and not many of them will be positive. However, with appropriate communication and management, hopefully the collateral damage can be limited, and the specificities of an international asset class that has been delivering quality returns to investors over the years will be recognized.

Keith O'Donnell is Managing Partner, Samantha Schmitz-Merle is Knowledge Director and Fanny Bueb is Senior Tax Associate, Taxand Luxembourg.

The authors may be contacted at keith.odonnell@atoz.lu, samantha.merle@atoz.lu and fanny.bueb@atoz.lu.