Summer 2014

Real Estate Newsletter

Contents

Introduction

We are delighted to publish our Summer Real Estate Newsletter. Our newsletter seeks to provide an overview of some of the key accounting and tax related matters likely to impact our Real Estate clients in the near future.

While the industry has been experiencing significant uplifts in transaction volumes and available equity, the tail of the impact of the financial crisis is long and we are seeing an increasing burden arising from Government and Regulatory reactions to the crisis. Arguably the most notable for our industry are the OECD and EU's Base Erosion and Profit Shifting (BEPS) projects as the outcomes of these are likely to have a far reaching impact on the tax environment in which we operate and may lead to changes to widely used structures. To what extent remains to be seen but this is likely to give rise to increased uncertainty and costs at a time when investors and management teams alike are seeking to minimise both.

With nearly all stakeholders crying out for increased transparency, as they seek to better understand and manage risk, the finance and tax teams within our clients are facing an increasing administrative burden and increased scrutiny as they seek to do their 'day jobs', understand and navigate the raft of changes.

We understand you have a lot on your plates and we are here to help so please do get in touch if you would like to discuss any of the issues raised herein.

Best wishes

Richard White
UK Head of Real Estate & Real Estate Tax

Bill Holland, Partner
Real Estate Audit

Lease accounting

The lease accounting project continues to rumble along. Following the significant number of adverse comment letters on its previous Exposure Draft (ED), the IASB in conjunction with the FASB (the Boards) issued a revised exposure draft on its proposals for changes to lease accounting in May last year. Once again the proposals have generated much comment, a lot of it negative. Indeed some six hundred comment letters have been received on the revised ED by the two boards.

The key tenet of the project remains in place. Namely that with a few exceptions, such as for leases shorter than 12 months, all leases will come on balance sheet as a liability of the lessee, broadly at the net present value of the future lease payments. This principle has remained in place since the project started and it is hard to see the Boards deviating from this approach.

So where are we now:

The current ED has two categories of lease, called Type A and Type B leases. The reason for this is that one of the complaints about the first draft was that a property occupier would incur a lease charge in its income statement which would start high and then reduce over the period of the lease, following a typical finance lease curve. The complaint was that this did not tally with an equal usage of the property asset over the period of the lease. The IASB's solution to this has been to create Type B leases, for leases of property, under which the lessee can show a straightline charge in its income statement over the life of the lease.

The other subtle change to be aware of is that although property investors are no longer excluded from the requirements of the proposed standard, the vast majority of property leases will fall under Type B leases and the proposals allow the property owner not to derecognise the asset and to continue to show the asset at fair value, so IAS 40 accounting still applies. However, property investment assets are no longer fully outside the scope of the standard.

So how would the proposals affect the property industry:

- Lessees of property will have to bring all of their property leases onto the balance sheet, broadly at the NPV (Net Present Value) of the future lease payments. This will in many cases, such as the retail sector, very significantly increase their gearing. As most of these leases are likely to qualify as Type B leases, the charge in the Income Statement may not be significantly changed.
- Owners of investment property can rest assured that the proposed standard will continue to allow them to carry the property on the balance sheet at fair value and to recognise rental income over the life of the lease in the income statement.

At the time of publication of the previous proposals, there was much debate as to whether this would influence the terms which tenants would seek on property leases. In particular, there was an expectation that tenants would seek shorter leases so as to minimise the liability they bring onto their balance sheets. Anecdotally there were a few stories of tenants trying to use this as a bargaining chip. However, the implementation of this standard is probably still some time away and it is likely that there will be further revisions before this project is finished. Accordingly, it is unlikely to have an impact in the short term.

The IASB and the US FASB continue to debate these proposals, at recent meetings some difference of opinion has emerged with the IASB wishing to drop the separate categories of lease (ie A and B as above), with FASB wishing to retain them. We will see how this develops.

Making financial statements more relevant

Short-term clarifications to IAS 1

For a while now, preparers of financial statements have been voicing concerns about 'disclosure overload' – e.g. presenting 'at-a-minimum' disclosures, regardless of their materiality. They have asked for ways to de-clutter financial statement disclosures. Users, in turn, want preparers to provide more company-specific – rather than boilerplate – information, making the financial statements more relevant and telling a coherent story that is unique to their business.

> "These proposed amendments are a welcome first step, even if only a small one, in a bigger disclosure initiative.
>
> **David Littleford**
> KPMG's global IFRS presentation leader

The bigger picture

The IASB has factored these concerns into its 'disclosure initiative', which aims to improve presentation and disclosure in financial reporting.

One of the initiative's short-term projects is to address some of the perceived problems with current disclosure requirements through clarifications to IAS 1 Presentation of Financial Statements. On 25 March 2014, the IASB issued an exposure draft (ED) proposing narrow-scope amendments to IAS 1.

The clarifications would not require any significant change to current practice, but should facilitate improved reporting. In the meantime, those that choose to can already achieve those improvements under existing standards.

As is usual for an ED, the proposed amendments to IAS 1 do not suggest an effective date. However, early adoption would be allowed.

Key proposals to clarify IAS 1

- There is an emphasis on materiality. Specific single disclosures that are not material would not have to be presented – even if they are a minimum requirement of a standard.
- The order of notes to the financial statements would not be prescribed. Instead, companies could choose their own order, and could also combine, for example, accounting policies with notes on related subjects.
- It would be made explicit that companies:
  - should disaggregate line items on the balance sheet and in the statement of profit or loss and other comprehensive income (OCI) if this provides helpful information to users; and
  - can aggregate line items on the balance sheet if the line items specified by IAS 1 are immaterial.
- Specific criteria would be provided for presenting subtotals on the balance sheet and in the statement of profit or loss and OCI, with additional reconciliation requirements for the statement of profit or loss and OCI.
- The presentation in the statement of OCI of items of OCI arising from joint ventures and associates accounted for using the equity method would follow IAS 1's approach of splitting items that may, or that will never, be reclassified to profit or loss.

> "The real ask here is for behavioural change, from preparers, auditors and regulators alike.
>
> **Mark Vaessen**
> KPMG's global IFRS network leader

The road ahead

As part of the initiative, the proposed amendments to IAS 1 will be joined by two other short-term projects to address materiality and changes in debt.

In addition, medium-term projects are planned: to explore the possibility of a single 'disclosure framework' for 'presentation' standards such as IAS 1, IAS 7 and IAS 8; and to examine disclosure requirements in IFRS to identify conflicts, duplication or overlaps.

More broadly, the IASB is considering presentation and disclosure as part of its revisions to its Conceptual Framework. The disclosure initiative complements the Board's efforts in this respect.

Next steps

Comments are due to the IASB by 23 July 2014. For more information on the ED, please go to the IASB press release or speak to your usual KPMG contact.

IFRSs 10, 11 and 12

It is now over two years since the IASB issued its new suite of consolidation standards, IFRS 10: Consolidated Financial Statements, IFRS 11: Joint Arrangements and IFRS 12: Disclosure of Interests in Other Entities. The application of these standards in the EU was delayed by the EU's approval process, such that the standards became applicable in the EU from 1 January 2014, whereas the IASB's application date had been 1 January 2013. Each of IFRSs 10 and 11 has the potential to impact entities in the real estate sector, so it should not be assumed that the standards are the same as their predecessors. IFRS 12 is likely to add to your disclosure around investee entities, particularly if they are funds or other structured entities. Given the time since they were issued, it is worth a quick recap, because you should already be applying the changes that these standards will entail.

<table>
<tr><th></th><th>Accounting</th><th>Disclosure</th><th>Separate FS</th></tr>
<tr><td>Subsidiaries</td><td>IFRS 10 Consolidated Financial Statements</td><td rowspan="5">IFRS 12 Disclosure of interests in Other Entities</td><td rowspan="3">IAS 27 Separate Financial Statements</td></tr>
<tr><td>Associates</td><td rowspan="2">IAS 28 Investments in Associates and Joint Ventures</td></tr>
<tr><td>Joint ventures</td></tr>
<tr><td>Joint operations</td><td>IFRS 11 Joint Arrangements</td><td>IFRS 11 Joint Arrangements</td></tr>
<tr><td>Unconsolidated structure entities</td><td></td><td>IFRS 12 Disclosure of Interests in Other Entities</td></tr>
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Source: KPMG analysis

IFRS 10: Consolidated Financial Statements

This standard replaces the existing IAS 27 and SIC 12. IFRS 10 introduces a new control model which is likely to affect certain consolidation conclusions, particularly those involving special purpose entities. In our view, the real estate businesses most likely to be impacted are those involved in the fund sector and particularly those funds where the manager has a not insignificant stake in the fund.

Under the new model an investor is considered as controlling an investee when the investor:

- Has rights to variable returns from its involvement with the investee
- Has the ability to affect those returns through its power over the investee
- There is a link between the exercise of power and the returns

Under the previous model, control was the key determinant. In particular, where Entity A held a greater than 50% interest in Entity B, then so long as there was not some other mechanism restricting A's influence, then A was deemed to have control and consolidated B.

Under the new model, a situation can be envisaged where Entity A only owns 40% of Entity B's equity, but because it has power over the investee, it is required to consolidate. For instance, Entity B could be a property fund and Entity A could be both an investor and the manager, so with de facto control over day to day operations, with the other investors having limited scope to remove Entity A. In such situations additional consideration needs to be made as to whether Entity A is acting as principal or agent in its running of the fund.

For more on this topic, please read our guide: First Impressions: Consolidated Financial Statements – IFRS 10.

What is control?

Control = Power + Exposure to variability in returns + Link between power and returns

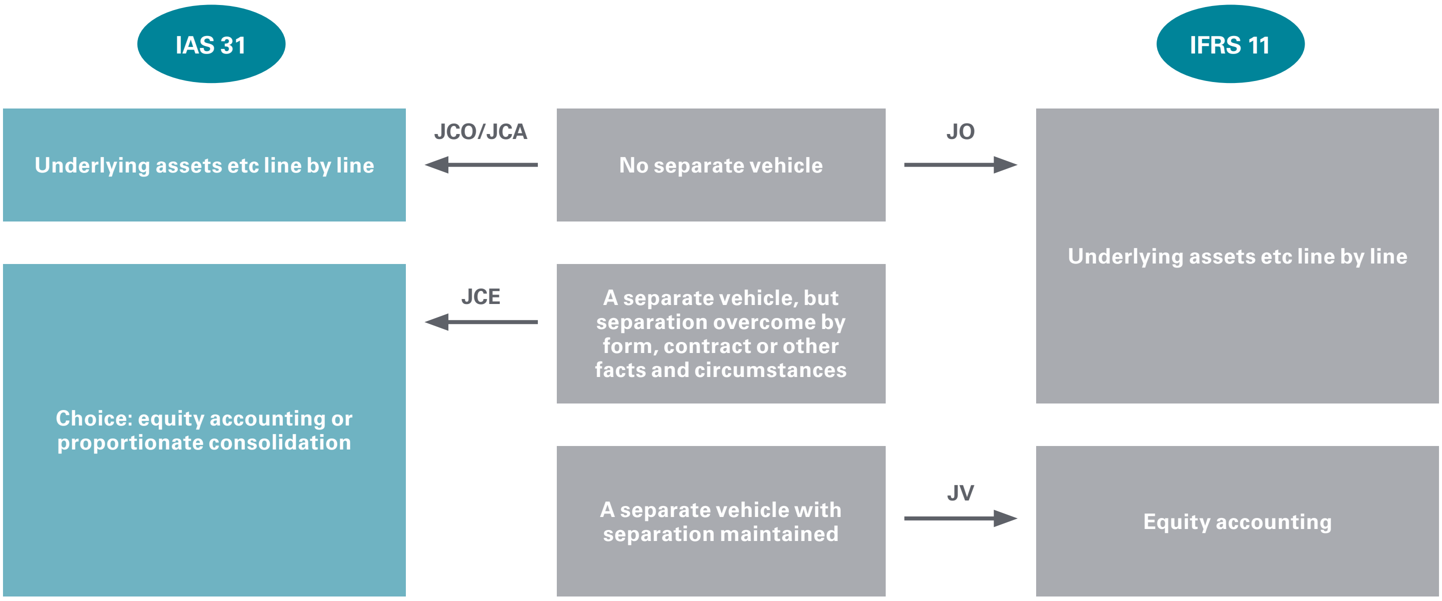
IFRS 11: Joint Arrangements

This standard replaced the existing IAS 31. If you are currently proportionately accounting for joint venture interests then this standard may well change your approach. Under IAS 31, the requirement was to identify if the vehicle was an entity. If it was, then you had a joint venture, if it was not, you either had a jointly controlled operation ("JCO") or a jointly controlled asset ("JCA"). For a joint venture you had a choice as to whether to equity account or proportionally consolidate. For a JCA or JCO you accounted for your share of each asset or liability, (i.e. proportional consolidation).

Under IFRS 11 there are now two types of joint arrangement, a joint venture and a joint operation. The focus now is on the way in which the business and its returns are shared. If the joint venturers effectively have a right to a share of the net assets and profits, then it is a joint venture and the requirement is to equity account. If the venturers have rights to the individual assets and obligations for the individual liabilities, then there is a joint operation and the requirement is to proportionally consolidate. There will be inevitable shades of grey around the interpretations as to how the rights and obligations are shared and this will be the key area of judgement. However, once that determination is made, under the new standard, there is no choice as to the accounting to apply.

For more on this topic, please read our guide: First Impressions: Joint Arrangements – IFRS 11.

Applying IFRS 11



Source: KPMG analysis

IFRS 12: Disclosure of Interests in Other Entities

IFRS 12 adds a number of additional disclosure requirements around investments. It covers both contractual and non-contractual involvement in an investee which exposes the investor to variability of returns from performance. It is important to note though, that this does not include typical customer relationships.

The broad objective of the new standard is to provide information that helps financial statement users to evaluate:

- The nature of and risks associated with interests in other entities; and
- Effects of interests on financial position, financial performance and cash flows.

The standard focuses in particular on structured entities and introduces a number of new disclosures for such entities. On that basis, if you invest in say property funds, and the holding is neither consolidated nor a joint venture, you are likely to need to disclose more than you have in the past on such an investment. Such disclosures might include:

- Nature of interests: Nature of the entity, its purpose, size, activities and financing; and
- Nature of risks: carrying amounts of assets and liabilities relating to the interests, maximum exposure to loss, comparison of the above, type and amount of support provided without contractual obligation.

So any party with investments in other entities is likely to be impacted by this new standard.

Investment entities

Before moving on from the suite of consolidation standards, we should just pick up on the investment entity standard. This is an appendix to IFRS 10 to deal with investment entities, e.g. a venture capital investor. This standard has similarities to the old UK GAAP "venture capital option", in allowing an entity whose business is to invest in entities, to carry those investments individually at fair value, rather than to consolidate or equity account for them. This also has similarities to the investment company guide in US GAAP. In the US there are certain real estate funds that take the option to follow the investment company guide and account for individual property SPVs at fair value, rather than a line by line consolidation. This is usually done for ease and speed of reporting. Under IFRS, the investment entity accounting then allows the investor to carry each individual investment at fair value through the income statement. The standard focuses on the investor's activities, the nature of the investors into the entity and whether the investments are managed on a fair value basis:

Activities	• **Investing in multiple investments for capital appreciation and/or investment income** • **Reporting financial information about these activities to investors**
Investors	• **Unit holders entitled to proportionate share of net assets** • **Investors pooled to access investment management services** • **Significant portion of units held by unrelated investors**
Fair value management	• **Substantially all investments are managed, and their performance evaluated, on a fair value basis**

We think that it is unlikely that such a route is open to many existing real estate investors. However, should they wish to follow this route, it may be possible to set up a fund to comply with the requirements.

For more on this topic, please read our guide: First Impressions:Consolidation Relief for Investment Funds.

IFRS 13: Fair Value Measurement

IFRS 13 is first applicable for 31 December 2013 year ends. This standard has maybe received less comment than certain other standards, but will have some impact on real estate investment companies.

IFRS 13 is not an accounting standard, but what it does set out is:

- the overall approach to apply to fair value measurement across IFRS, excluding IFRS 2 (share based payments) and IAS 17 (leases);
- the disclosure requirements for fair value measurement across IFRS, excluding IAS 19 (employee benefits), 26 (accounting and reporting by retirement benefit plans) and 36 (impairment).

With respect to IAS 40: Investment Property, all of the methodology and disclosure requirement paragraphs are now removed and dealt with under IFRS 13. There are some subtle changes to the wording around valuations; for instance under IAS 40 the fair value of investment property was defined as "the price at which property could be exchanged between knowledgeable, willing parties in an arm's length transaction", whereas IFRS 13 defines fair value more generally as "the price which would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". However, we think it is likely that the application of this new standard is only going to change the approach to valuation in a relatively few cases.

The standard also introduces new disclosure requirements. Those requirements vary depending on the level ascribed to the valuation. IFRS 13 introduces three levels of valuation:

For more on this topic, please read our guide: First Impressions: Fair Value Measurement

Level 1 - Quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the reporting date.

Level 2 - inputs other than quoted prices included in level 1, that are observable for the asset or liability, either directly or indirectly.

Level 3 - unobservable inputs.

IFRS 15: Revenue recognition - A single global standard.

The new revenue standard may affect the way you account for revenue. Issued on 28 May 2014, it replaces existing IFRS and US GAAP guidance and introduces a new revenue recognition model for contracts with customers. For some sectors, the new standard will have a significant impact on how and when they recognise revenue, but for others transition will be easier.

One model, two approaches, five steps

The standard contains a single model that applies to contracts with customers and two approaches to recognising revenue: at a point in time or over time. The model features a contract-based five-step analysis of transactions to determine whether, how much and when revenue is recognised. The five steps are shown in the diagram opposite.

All companies will need to assess the extent of the impacts, so that they can address the wider business implications, including communications with investors and analysts.

Basic facts

IFRS 15 Revenue from Contracts with Customers was issued by the IASB on 28 May 2014.

The standard replaces IAS 11 Construction Contracts, IAS 18 Revenue, IFRIC 13 Customer Loyalty Programmes, IFRIC 15 Agreements for the Construction of Real Estate, IFRIC 18 Transfer of Assets from Customers and SIC-31 Revenue – Barter Transactions Involving Advertising Services.

The new standard applies to contracts with customers. However this does not apply to lease contracts, which fall in the scope of other IFRSs. It also does not apply if two companies in the same line of business exchange non-monetary assets to facilitate sales to other parties. Furthermore, if a contract with a customer is partly in the scope of another IFRS, then the guidance on separation and measurement contained in the other IFRS takes precedence.

The standard is the result of a joint project between the IASB and the FASB and is converged with FASB ASC Topic 606.

The standard is effective for annual periods beginning on or after 1 January 2017, with early adoption permitted under IFRS.

1. Identify the contract with a customer

2. Identify the performance obligations in the contract

3. Determine the transaction price

4. Allocate the transaction price to the performance obligations

5. Recognise revenue when (or as) the entity satisfies a performance obligation

Revenue recognition may be accelerated or deferred

Revenue may be recognised over time, in a manner that best reflects the company's performance, or at a point in time, when control of the good or service is transferred to the customer.

For complex transactions with multiple components and/or variable amounts of consideration, or when the work is carried out under contract for an extended period of time, applying the standard may lead to revenue being accelerated or deferred in comparison with current requirements.

New estimates and judgements

New estimates and judgemental thresholds have been introduced, which may affect the amount and/or timing of revenue recognised. They include:

- estimating and recognising variable consideration;
- identifying separate goods and services in a contract; and
- estimating stand-alone selling prices.

Significant judgement may be required to determine how these estimates and thresholds apply to you. The new estimates and judgements might be particularly difficult to apply if you are launching a new business line or new products, or entering a new market.

Stage-of-completion accounting has been retained

The standard includes new criteria to determine when revenue should be recognised over time, addressing fact patterns such as construction contracts and contracts for services. Some contracts that are currently accounted for under the stage-of-completion method may now require revenue to be recognised on contract completion; but for other contracts, the stage-of-completion method may be applied for the first time under the new model.

Making this assessment based on the criteria provided will require a detailed review of contract terms and – for contracts to sell development property – property law.

Notable differences from current practice

- All guidance contained in a single standard
- Control-based model ('risks and rewards' concept is retained as an indicator of control transfer)
- Consideration measured as the amount to which the company expects to be entitled, rather than fair value
- New guidance on separating goods and services in a contract
- New guidance on recognising revenue over time

Limited guidance on costs

New judgements will be required when accounting for contract costs, as the new standard replaces existing cost guidance in IAS 11 Construction Contracts with limited new guidance on the costs of obtaining and fulfilling a contract. This will directly affect profit recognition, especially when revenue is recognised over time. You will need to evaluate the impact of the new guidance on the costs to be capitalised and also consider the period over which they can be amortised.

New disclosure requirements

The standard includes extensive new disclosure requirements. You may have to redesign, and in many cases significantly expand, the information captured about unfulfilled performance obligations in order to draft the notes to the financial statements dealing with revenue.

The new disclosures could convey important additional information about business practices and prospects to investors and competitors. No exemptions have been provided for commercially sensitive information.

Changes to systems and processes

The estimates, thresholds and disclosure requirements may lead to changes in systems and processes to capture and review the required data, for the current and, if applicable, comparative periods. These changes may be necessary even if there is no effect on the numbers.

You may need to reconsider your processes, to ensure that management judgement is exercised at the key points as financial information is prepared.

Transition options

The standard may be adopted retrospectively, or as of the application date by adjusting retained earnings at that date and disclosing the effect of adoption on each line of profit or loss (the 'cumulative effect approach'). Practical expedients are available to those taking a retrospective approach.

A first-time adopter of IFRS can choose to apply the standard using either the retrospective approach or the cumulative effect approach, from the date of transition to IFRS.

Historical analysis or retrospective application may require you to introduce new systems and processes well in advance of the new standard's effective date, and to run them in parallel with those already in place.

The impacts may be felt right across your organisation

All of your financial ratios may be affected, which could impact your share price or access to capital. Changes to the timing of revenue recognition may affect the timing of tax payments and the ability to pay dividends in some jurisdictions. Staff bonuses and incentive plans might also need to be reconsidered. You may wish to reconsider current contract terms and business practices – e.g. distribution channels – to achieve or maintain a particular revenue profile. Investors, analysts and other stakeholders will want to understand the impact of the standard on your business.

Impact on the real estate sector

We are currently assessing the detailed impact on the real estate sector. The new standard specifically excludes lease contracts so will not impact the recognition of rental income. However, there may be impacts on revenue arising from property sales, particularly in the development sector where stage of completion accounting may be available, and on the recognition of performance fees on property funds. These will require some detailed consideration.

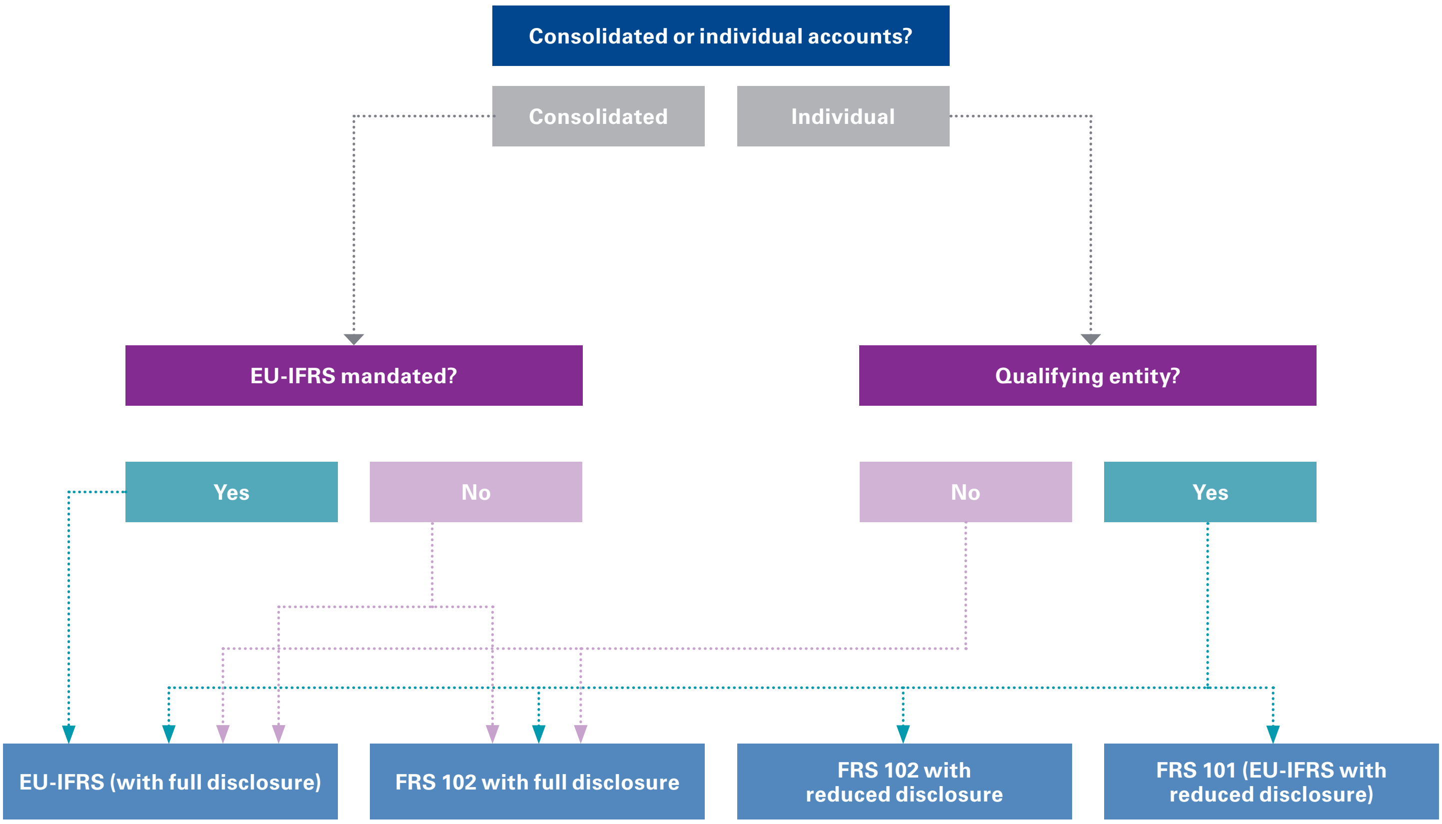
New UK GAAP

After some years of debate, a line has finally been drawn in the sand as to the date from which existing UK GAAP will cease. The Financial Reporting Council has issued a suite of new standards FRSs 100, 101 and 102 which will replace all existing UK accounting standards. The mandatory effective date is for periods commencing 1 January 2015.

In full the new standards are:

- FRS 100 – Application of Financial Reporting Requirements
- FRS 101 – Reduced Disclosure Framework
- FRS 102 – The Financial Reporting Standard applicable in the United Kingdom and Republic of Ireland
- The new standards provide a degree of choice, which will depend on the entity involved, with different requirements for consolidated accounts, listed companies, etc. In short the choices available will be:
- Full application of International Financial Reporting Standards as adopted in the EU ("EU IFRS")
- EU IFRS with reduced disclosures
- FRS 102 – which is based on IFRS for small and medium entities
- FRS 102 with reduced disclosures
- Financial Reporting Standard for Small Entities

Below is a flowchart of the choices available:



We strongly recommend that companies carefully consider the choices available to them and also approach this subject as early as possible. There are subtle accounting differences in some cases between EU IFRS and FRS 102 and these could impact your tax charge and your distributable earnings and hence can have material practical impacts on cash flows and the ability to pay dividends to investors.

We would suggest getting in touch with your usual KPMG contact to go into this subject in more depth. Further detail on the proposals is contained in here.

Further information

Further information can be found in our publication: Cutting Through UK GAAP

OECD and EU Update on BEPS Initiatives: Impact on cross-border real estate investment structures

Punit Nathwani, Senior Manager – Real Estate Tax

While the real estate industry is not a specific target of the Base Erosion and Profit Shifting ("BEPS") projects being undertaken by the OECD and EU, it is clear that the broad principle based changes will significantly alter the tax environment in which our clients operate and affect the choice of long-term investment vehicle. The OECD's Action plan is a 40 page document covering 15 specific Actions and here we endeavour to highlight the key OECD Action Points and EU initiatives most likely to affect real estate investment structures and provide a high level view of the practical consequences of these measures. The measures are continuously evolving through a process of consultations between EU and OECD member states and updates to each measure will need to be monitored as they evolve.

Background

On 19 July 2013, the OECD released an Action Plan on Base Erosion and Profit Shifting ("BEPS") which was presented to the meeting of G20 Finance Ministers in Moscow. Within the EU, a similar initiative is being undertaken by the European Commission aimed at combating Tax Evasion, Tax Avoidance and Aggressive Tax Planning. Together these are the most significant multilateral initiatives for modifying international tax rules in recent times.

The stated aim of the EU initiatives and the OECD Action Plan is "to prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from activities that generate it." The Action Plan is a 40 page document covering 15 specific Actions which are broadly to be achieved within a two year time frame (i.e. by the end of 2015). Despite the ambitious timeline, the EU and the OECD are on track and are expected to comply with the deadlines they have set themselves. We are also seeing Governments getting impatient and seeking to introduce their own unilateral measures, for example we have already seen changes in the tax treaties between EU countries such as Luxembourg and Poland in respect of taxing rights on the disposal of real estate rich entities.

OECD Base Erosion Profit Shifting Point Action Plan & timetable:

ACTION 1	Address the tax challenges of the digital economy (Sept, 2014)
ACTION 2	Neutralise the effects of hybrid mismatch arrangements (Sept, 2014)
ACTION 3	Develop recommendations regarding the design of the CFC rules (Sept, 2015)
ACTION 4	Limit base erosion via interest deductions/ other financial payments (Dec, 2015)
ACTION 5	Counter harmful tax practices Including compulsory spontaneous exchange of rulings and (Sept, 2014 - Dec, 2015)
ACTION 6	Prevent treaty abuse (Sept, 2014)
ACTION 7	Prevent artificial avoidance of PE status (Sept, 2015)
ACTION 8	Ensure that profits associated with the transfer and use of intangibles are appropiately allocated in accoradance with value creation
ACTION 9	Prevent BEPS by transferring risks, or allocating excessive capital to group members, align returns with value creation
ACTION 10	Other high risk transactions, recharacterise transactions, management fees and head office expenses (Sept, 2015)
ACTION 11	Establish methodologies to collect and analyse data on BEPS (Sept 2015)
ACTION 12	Recommendations for mandatory disclosure rules for aggressive tax planning and design model for exchange of information of tax schemes between tax administrations (Sept, 2015)
ACTION 13	Re-examine transfer pricing documentation and include CBCR (Sept, 2014)
ACTION 14	Make dispute resolution mechanisms more effective (Sept 2015)
ACTION 15	Develop a multilateral instrument (Dec, 2015)

Managing risks

The deliverables of the EU and OECD Action plan are likely to be "soft law" instruments, recommendations on domestic legislative changes (e.g. hybrids or interest deductibility), to agree on a common interpretation of the arm's length principle, a new Model Convention, the definition of PE and/ or to agree measures to improve Dispute Resolution.

From a risk management perspective, it will be important to have systems and procedures in place to ensure that there is an awareness of material tax (and reputational) risks that could be triggered as a result of EU and OECD Actions. A review of current real estate investment structures and financing instruments now would be worthwhile in assessing potential and unintended tax risks so that appropriate action can be taken to address or minimise these. Future real estate investments will need to be carefully structured to enable certainty over the tax treatment and minimise the erosion of profits through unintended tax consequences.

Key considerations when building future tax compliant structures

Continuity	Return	Corporate (social) responsibility/ corporate citizenship	Compliant
Business/ Commercial rationale	Creating shareholder value	Reputational risk	General compliance
Resource burden	Impact on financial statements	(Social) contribution	Minimum requirements
Flexibility	Return for employees and business partners	Relationship with authorities	Anticipation of new rules
Robustness		Transparency	

Source: KPMG analysis

EU & OECD Focus - measures most relevant to real Estate investment structures:

- Transparency and exchange of information
- International mismatches (hybrids)
- Transfer pricing
- Anti - abuse provisions
- Harmful tax practices
- Tax havens

Double non-taxation: Action Points 2, 3, & 6.

Cross-border real estate investment structures that have a presence in jurisdictions with favourable tax treaties or a low tax status could be perceived to have exploited inconsistencies in rules that were developed to prevent companies paying tax on the same income twice. Double non-taxation, or arbitrage, plays off different tax rules in different countries usually through the use of 'hybrid' financing instruments or 'hybrid' entities, including financing instruments, used in cross border investment structures. A common example in the financing of real estate acquisitions is the use of hybrid instruments where the country of the borrower allows a tax deduction for debt interest, but the country of the lender treats it as non-taxable dividend income such as a profit participating loan.

The EU and the OECD are looking at measures to neutralise the effects of such hybrids. Members could look to achieve this through an international protocol, or via individual treaty or domestic changes. Whilst any new rules will look to target 'inappropriate' behaviour, there could well be some impact on hybrid entities or instruments that are in place for commercial reasons and these may need to be looked at again in the context of the new rules.

The EU and the OECD are also looking at the implementation of additional anti-abuse provisions such as General Anti-Avoidance Rules ("GAAR"), Controlled Foreign Companies ("CFC") rules, subject-to-tax clauses, limitation of benefits clauses and other provisions which may be adopted in tax treaties for the purpose of preventing tax treaty shopping. Given that many real estate structures are not listed or established as trading structures, the impact of these proposals may remove the availability of treaty benefits. As a result many traditional real estate investment and developer structures, which are readily understood by the market, will need to be reviewed to ensure that it has sufficient substance and that the amount of taxes paid in a specific jurisdiction is not considered to be unfair.

Various industry groups such as the BPF and the BVCA have written to the OECD to highlight some of the unintended consequences the action points (particularly Action point 6) could have on returns to investors in collective investment schemes by relying on double tax breaches. The detrimental consequence could be a reduction of the pool of capital available for investment. Industry groups are lobbying the OECD to agree an approach to the Action 6 which accommodates the private equity industry and its diverse range of stakeholders, while implementing the policy of preventing the grant of treaty benefits in inappropriate circumstances.

Transfer pricing and profit shifting: Action Points 2, 3, & 6

Many governments feel they are losing their fair share of taxes because they think real estate investment structures choose to locate profitable operations in low tax locations. OECD guidelines for pricing of intra-group transactions on an 'arm's length' basis do exist, however there is an increasing feel that this is not working in the context of current global business. High profile media exposés showing 'brass plate' subsidiaries in tax havens, whilst sometimes not telling the whole story, do highlight that some companies continue to operate business models with little or no commercial substance or raison d'être.

Most real estate investment vehicles will have an underlying commercial purpose and rationale for its structure and should therefore already have a certain level of substance to ensure that the structure is compliant for the purposes of meeting transfer pricing requirements in each relevant jurisdiction. Real estate investment vehicles do not rely on global business models as implemented by large global businesses (which are the key focus of this measure), however it is evident that transfer pricing and substance are coming under increasing scrutiny within the international real estate context with a particular focus on: interest rates on shareholder loans; margins realised on intermediary financing activities; and the arm's length nature of investment and asset management services provided by connected companies.

Many measures have already been introduced in the transfer pricing world either through changes in domestic rules or through attempts to bring a level playing field on a regional basis, such as the EU. The two big trends are:

- **'Substance' and 'value creation'**: profits should follow functions where key people are active rather than just where decisions are made.The transfer pricing will follow the same principle. Simply locating a serviced office with no key employees in a low tax jurisdiction will no longer be accepted. Many real estate investment structures have parent companies based in low tax jurisdictions with no or few key employees permanently based in that jurisdiction. Going forward the analysis of substance for real estate investment structures may become more complex and the focus of tax authorities is likely to shift to value creation measures such as: financial substance, i.e. capital at risk; the conduct of how offshore entities are managed; the contractual arrangements between investment managers and real estate holding companies; and the business rational for the location of holding structures, including the access to beneficial tax treaties. Certain conditions may become a minimum requirement and indeed countries such as Luxembourg have already introduced requirements within their domestic transfer pricing rules, for example, a requirement for Luxembourg resident directors for Luxembourg financing companies.

- **Increased transparency**: The provision of better documentation to tax authorities should better equip them to review value chains. Although this is less likely to bite real estate investment structures, it could result in an increase in the administrative burden as detailed and up to date documentation requirement becomes (and to some extent already is) mandatory. On the flip side, the OECD in its action plan says it wants to make 'dispute resolution' mechanisms, like advance agreements on transfer pricing, more effective providing business with greater certainty.

Excessive deductions: Action Point 4

Real Estate investors fund their acquisitions via debt and equity and as a consequence receive tax deductions for interest on the debt portion. The effect of this is to reduce the taxable profits of operations in high tax countries while often the lender is in a low or no tax jurisdiction.

Some form of restriction on interest deductions already exists in many countries whether by reference to transfer pricing, thin capitalisation or "purpose" based principles. Some countries such as Germany impose formulaic restrictions by reference to a proportion of EBITDA or have minimum taxation requirements. We can expect to see more of these measures being introduced within the EU and by OECD members, but in practice it's likely this will remain a matter of domestic policy.

Transparency: Action Points 11, 12, 13, 14, & 15

Many Governments don't think they are getting the full picture of the tax affairs, or the amount of 'BEPS' in cross-border structures and therefore find it hard to enforce what the EU and OECD want achieve, which is a fair and appropriate level of taxation based on the level of economic activity in that country. This is less of an issue for real estate structures as income generated from real estate is almost always subject to tax in the jurisdiction in which the asset is located.

Country by country reporting will require disclosure of key financial information, taxes paid, location of key decision makers and intra-group flows. This will give tax authorities a clearer picture of where intra-group transactions are artificially reallocating profits to lower tax jurisdictions. Tax authorities are likely to share more information with other tax authorities so you should expect to see an increasing number of multi-country tax audits.

Within the EU, many of the preferential tax regimes have been tackled through the EU code of conduct by blacklisting certain jurisdictions (both within and outside the EU) that are perceived not to have sufficient tax transparency measures. Some low or no tax jurisdictions that fully comply with treaty requirements such as having information sharing agreements in place are still perceived by the media or governments to be tainted by their historic positions. This may lead to real estate investors abandoning the use of jurisdictions such as Jersey and instead establishing themselves in jurisdictions that are perceived to be less aggressive, e.g. the Netherlands.

Future trends in tax risk management and the to-do list for your tax team:

In the face of an evolving tax landscape it is clear that the structures we see today may not exist tomorrow. Historic assumptions may be at risk and there is a concern that this will negatively impact investor returns and investment pricing. In order to minimise the impact of these issues we are seeing the emergence of 4 key trends in tax risk management:

1. Increased focus on ensuring investment structures are sustainable, having regard to substance and transparency, whilst being flexible to accommodate changes if required in the future
2. Revisiting transfer pricing strategies and improving supporting documentation
3. Increasing tax transparency and CSR
4. Improving engagement and relationships with tax authorities

In the face of ongoing uncertainty, flexibility and knowledge are key to all stakeholders. By ensuring you regularly monitor your real estate holding structures, in the light of emerging changes, you should be able to arm yourself with sufficient time to identify issues, adapt and communicate your approach, thus avoiding surprises and mitigating any impact on value.

Further information

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Stamp Taxes – Round Up

Sean Randall, Head of Stamp Taxes

UK stamp taxes (ie, stamp duty, stamp duty land tax (SDLT), stamp duty reserve tax (SDLT) and annual tax on enveloped dwellings (ATED) continue to be a dynamic subject. This article draws together the main developments since the January 2014 Newsletter. It reflects the law and HMRC practice as at May 2014.

'High-value' dwellings

Two years ago a package of three measures was announced to tackle the perceived problem of individuals purchasing £2 million+ dwellings for personal occupation using corporate vehicles to avoid SDLT. The measures consisted of a new super (15%) rate of SDLT on the purchase of such a dwelling, a new tax, ATED, on the ownership of such a dwelling by a company (partnership with one or more corporate partners or a collective investment scheme) and an extension of capital gains tax (ATED-related CGT) on the sale of such a dwelling by a company (etc).

In this year's Budget, the threshold for the super rate of SDLT was reduced significantly from £2 million to £500,000.

An equivalent extension to ATED (and by implication ATED-related CGT) will be phased in. From 1 April 2015, the tax will be extended to dwellings worth over £1 million. And from 1 April 2016, it will be extended to dwellings worth over £500,000.

The current reliefs from both the SDLT super rate and ATED will continue to apply for companies (etc) purchasing and holding dwellings for specified business purposes.

The stamp taxes treatment of transactions in residential property has become complex. Relevant factors include: the use of the property on the effective date of the transaction, the potential for such use, the state of conversion and adaptation of the land or any buildings on it, the number of dwellings acquired, the amount of the price attributable to each and whether the interest acquired is subject to a lease that was initially granted for a long term.

For commentary on the proposed changes to CGT on disposals of dwellings by non-residents, see above.

Charities relief

As announced last year, this year's Finance Bill contains legislation to confirm that partial relief applies to charities purchasing land jointly with a non-charity.

This clarifies the eligibility for relief of charities, including Registered Providers of Social Housing, when acquiring land through joint ownership arrangements with developers, Local Authorities and funders.

It is debatable whether the principle on which this change is based applies to other SDLT reliefs.

SDLT case law

In July this year, the Upper Tribunal will hear Project Blue Ltd's appeal against the decision of the First-tier Tribunal (see *Project Blue Ltd v HMRC* [2013] UKFTT 378 (TC)). This case is interesting for a number of reasons, of which the most significant technically is the scope and application of section 75A (anti-avoidance). The decision is eagerly awaited.

The Supreme Court has refused DV3 RS Ltd Partnership leave to appeal. This means the decision of the Court of Appeal (see *HMRC v DV3 RS Ltd Partnership* [2013] EWCA Civ 907) is final. The case concerns an SDLT scheme involving a sub-sale to a partnership. It has limited impact following the changes made to the SDLT regime for sub-sales. Those that used the scheme (or a substantially similar version of it) should have received notices warning that the tax in dispute should now be settled.

Last year, apparently in an unpublished decision (*Portland Gas Storage Ltd v HMRC Comrs* TC/2012/10579), the First-tier Tribunal rejected a claim for a repayment of SDLT where the tax paid on substantial performance of an agreement for lease was more than the tax payable on completion of that agreement. The legislation expressly provides for the overpaid tax to be repaid by HMRC. But HMRC argued that this did not apply on the facts because more than twelve months had elapsed between completion and substantial performance and, in any case, their decision not to allow the claim was not appealable. The Tribunal accepted HMRC's arguments and Portland Gas Storage Ltd has brought an appeal against that decision. The result of that appeal is awaited.

This year, the First-tier Tribunal dismissed an appeal against a penalty for an underpayment of SDLT in respect of the purchase of a dwelling by a solicitor and his wife: *Mr & Mrs B v HMRC Comrs* [2014] UKFTT 256 (TC). The appellants accepted that they had incorrectly stated the purchase price on the SDLT return and the imposition of a penalty.

But when they understood that their names would nevertheless be published by HMRC on the list of deliberate tax defaulters, they sought permission to bring a late appeal against the decision to impose the penalty and anonymity of the decision.

SDLT reclaims

Two reclaim opportunities have emerged. The first is potentially very significant. It concerns the imposition of SDLT on VAT. There is a reasonable argument that the charge contravenes EU law, as it distorts the operation of UK VAT. For many real estate transactions, transfer of a going concern (TOGC) treatment will mean that VAT is not chargeable. But TOGC treatment is not available, eg, on a sale and leaseback or sub-sale of opted property, or the grant of a rack rent lease; hence, in these cases SDLT is payable on the VAT chargeable – currently a cost of up to 0.8% (or 4% of 20%).

The other relates to purchases of commercial woodlands. Provided that immediately before and immediately after the transaction the land is used commercially in the business of growing and felling trees, then, somewhat surprisingly, HMRC appear to accept that the trees may be treated as chattels and so the price attributable to them does not attract SDLT.

If you have paid SDLT in such circumstances within the last four years, do get in touch to discuss whether making a reclaim would be appropriate.

ATED compliance

ATED was introduced on 1 April 2013. It imposes an annual charge for ownership of dwellings worth over £2m by companies (etc) subject to reliefs for various specified businesses.

The deadline for filing an ATED return for the first chargeable period (1 April 2013 to 31 March 2014) was 1 October 2013. The tax was payable by 31 October 2013.

We are now in the second chargeable period (1 April 2014 to 31 March 2014). This means two things–

- where tax has been underpaid (eg, due to a change in use of the dwelling), a new return must be filed for the previous period adjusting the tax paid initially, and
- a return for the current chargeable period must be delivered and any tax payable must be paid.

In both cases, the deadline for notification was 30 April 2014.

Where tax has been overpaid for the last chargeable period, it may be recovered by submitting an amended return by 30 April 2015.

Last year's tax charges have increased by the rate of inflation: see table below.

Value of property	Tax charge 2013-14	Tax charge for 2014-15
£2 million to £5 million	£15,000	£15,400
£5 million to £10 million	£35,000	£35,900
£10 million to £20 million	£70,0000	£71,850
Over £20 million	£140,000	£143,750

SDLT lease duty compliance

A number of tenants of commercial property have inadvertently failed to re-notify HMRC in respect of grants of turnover leases. In such cases, SDLT should be self-assessed initially on an estimate of the total rent payable in the first five years of the term of the lease; and after five years the calculation should be redone (or 'trued up') using the actual rent paid – potentially causing the SDLT to be adjusted upwards or downwards. This obligation is easy to miss, especially for groups holding a large rented portfolio. If you are the tenant under a turnover lease, we would be pleased to help you check that you have complied correctly.

Abolition of stamp taxes on transactions in certain funds

The SDRT charge under Schedule 19 to the Finance Act 1999, for which fund managers were liable when investors surrender their units in UK unit trust schemes or shares in UK open-ended investment companies has been abolished.

SDRT is still charged, though, on an in-specie redemption of units or shares which is not pro-rata. This is where an investor surrenders their units or shares in a fund in return for receiving securities from the fund that are not in proportion to the assets they held in the fund.

The abolition of the Schedule 19 SDRT regime will help to level the playing field between UK authorised and unauthorised unit trust schemes on the one hand and offshore unit trust schemes (eg, JPUTs) on the other.

Stamp duty and SDRT on purchases of shares listed on 'recognised growth markets' have been abolished. To be recognised as a 'growth market', the majority of companies trading on the market must have market capitalisation of less than £170 million or the market's rules must require that those seeking admission demonstrate at least 20% compounded annual growth in revenue or employment for the previous three years. The London Stock Exchange has successfully applied for AIM to be treated as a recognised growth market.

For further information on how stamp duty changes will affect the investment management sector, see *The current state of UK property collective investment schemes* on page *20*.

This measure, together with the relaxation in the REIT rules, should encourage AIM-listed REITs for the same reason that the abolition of Schedule 19 should encourage PAIFs – transactions in such vehicles can now be effected without UK stamp taxes.

Follower notices and accelerated payment notices

The concept of follower notices and accelerated payment notices and applies to a number of taxes, including SDLT and ATED. They enable HMRC to require taxpayers to settle tax disputes where there has been a relevant judicial ruling and to pay the tax in such cases or where the arrangements were disclosable under the Disclosure of Tax Avoidance Scheme (DOTAS) rules or where HMRC is taking counteraction under the General Anti-Abuse Rule. The policy objective is that the disputed tax should be paid pending enquiries and litigation in relation to tax avoidance. It does not change the right of the taxpayer to bring an appeal or to continue one. If that appeal is successful, the tax is to be returned with interest.

What may not be immediately apparent is the extent to which the DOTAS trigger for accelerated payment notices is not apt for SDLT. This is because the SDLT DOTAS regime is different to the main DOTAS regime. It has a peculiar filter which to a greater extent fails to remove arrangements that could not reasonably be described as tax avoidance. The intent when the SDLT DOTAS regime was introduced was that HMRC would become aware of all arrangements designed to produce an SDLT advantage, including schemes, but they would not require the use of those arrangements to be notified. Promoters received reference numbers but were not required to give these to clients – in fact this was positively discouraged. This changed in 2010 when the concept of Scheme Reference Numbers (SRNs) was introduced to SDLT subject to a grandfathering provision. The proposed introduction of accelerated payment notices prompts two questions:

- do the existing SDLT filters provide adequate protection going forwards bearing in mind the consequences of accelerated payment notices; and
- do the arrangements disclosed before 2010 fulfil the condition that enables such notices to be made?

Lobbying on these areas is expected.

Consultations

We are waiting for consultations to start on–

- simplifying the administration of ATED,
- the SDLT treatment of the seeding of PAIFs and the wider SDLT treatment of co-ownership authorised contractual schemes,
- simplifying the SDLT treatment as it applies to transactions in and involving partnerships.

If you would like us to pass on your comments in the consultations or if you would like to be updated on progress generally, please let us know.

JPUTS

Finally, we are aware that one major corporate services provider is withdrawing from providing trustee services to unit trust schemes and has resigned as trustees of all such schemes it operates. This could have significant tax consequences: eg, the scheme could cease to be a collective investment scheme, resulting in a deemed land transaction for actual or deemed consideration for SDLT purposes. If you have received correspondence about the resignation of trustees, please contact us for advice on what this means and how to manage this.

Further information

For more information on these areas contact:

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Taxation of LLPs and Partnerships

Nicola Westbrooke, Partner and Michael Attfield, Assistant Manager - Tax

The 2014 Finance Bill proposed a number of changes to the taxation of LLPs and partnerships to combat what the Office of Tax Simplification called a "very real avoidance problem" in respect of taxing partnership members. This article addresses the two measures which are of most relevance to owners of real estate. These measures have been termed 'salaried members' and 'mixed partnerships' and came into effect from 6 April 2014.

In real estate fund structures, there are a number of instances in which partnerships will be used in which individuals will be partners, often in conjunction with a corporate. These measures have the capacity to:

1. Reallocate profits from a corporate to individual partners for tax purposes, if, on a just and reasonable basis, it is viewed that the corporate has excess profits which the individuals can enjoy; and
2. Treat partners as employees for tax purposes if they do not take the risks anticipated of partners. This will have NICs and PAYE consequences.

What is the aim of these measures?

The salaried members measure is designed to reinforce the Partnership Act 1890 so that the benefits of taxation as a partner are restricted to 'true' partners (i.e. those who bear the risk) rather than those who are effectively employees. HMRC are of the opinion that 'true' partners risk their own capital in setting up the partnership and therefore deserve favourable taxation rules (e.g. lower NIC, no PAYE and other tax benefits relevant to partnerships) whereas employees do not take on such risks and yet have been able to access partnership tax rules through what HMRC believe are artificial structures.

The mixed partnerships measure targets arrangements to arbitrage corporate and income tax rates by allocating profits from an individual partner to a non-individual (e.g. corporate) partner in which the relevant individual has sufficient interest to be deemed as having the power to enjoy said profits. In this way the individual is benefitting from corporation tax rates being significantly lower (21% and falling to 20% from 1 April 2015) than higher income tax rates (where the partner is likely to be assessed at 40 or 45%).

Who will be affected?

The salaried members legislation applies to all UK-incorporated LLPs. The measures contained within the legislation are intended to provide a quicker and more predictable outcome in determining whether an individual is a partner or an employee than the current case law principles. The new measures are, however, designed to complement the existing case law, which will remain the only test for any non-UK LLPs and other forms of partnership, whether UK incorporated or not.

The mixed partnership measures will apply to all partnerships that involve both individual and non-individual partners.

What are the key elements of the new measures?

Salaried members

The salaried member rules will tax partners as employees should all three of the following conditions be met:

A. The partner's remuneration is deemed to consist as to 80% or more of 'disguised salary';

B. The partner exercises no 'significant influence' over the affairs of the LLP;

C. The partner's capital contribution is less than 25% of the 'disguised salary' they can reasonably expect to received in the year;

The legislation terms 'disguised salary' as being remuneration that is either fixed or where variable it:

- is varied without reference to the overall profits and losses of the LLP; or
- is not, in practice, affected by the overall amount of profits and losses.

All forms of remuneration, whether drawings, awards or profit shares received by a partner are tested against these criteria.

For drawings it is important that any amounts received by a partner are clearly stipulated as either being repayable or set off against next year's profit, should the partnership not make sufficient profits to cover them.

Profit shares should not be guaranteed or be deemed as near-certain to be received because in both events HMRC will likely assess the partner as not being fully exposed to the fortunes of the business and therefore the partner is actually an employee and should be taxed as such. Any variable profit shares also need to be carefully considered. The variable element may be based on an individual's performance but the amount received should be varied according to the whole business' profits, rather than a particular department, as otherwise the partner will once again likely be deemed as not being exposed to the fortunes of the business but as being an employee of the business.

The same treatment applies to any discretionary awards. These may be based on personal performance but personal performance must not be the sole consideration and the performance of the firm should be taken into consideration.

Condition B makes reference to the partner's need to possess significant influence over the LLP's affairs. This refers specifically to the LLP as a whole and so the partner must have a role in making decisions at the strategic level (e.g. CEO, CFO, etc.) or perform a day to day operational role (e.g. head of IT). It does not cover a manager of one division or a major contributor to the firm's profits.

In addition merely holding an executive title does not guarantee fulfilment of this criteria should such a title be honorary. There has to be substance to the role.

Condition C is included so that individuals who have not staked sufficient personal capital cannot be considered as partners. This test is forward looking and every year the amount you are reasonably expected to receive is compared to your capital contribution. There is no reassessment with hindsight.

Mixed partnerships

The mixed partnership rules seek to reallocate profits from the non-individual to the individual partner where there is a tax benefit and:

- It is reasonable to suppose that the individual member's 'deferred profit' is included within the non-individual's profit share and that the resulting tax liability is less than it should have been; or
- The non-individual partner received a share of the firm's profit and:
  - This share exceeds the appropriate notional profit;
  - An individual partner has the power to enjoy said profit; and
  - It is 'reasonable to suppose' that this profit, whether in whole or part, is attributable to that power;

Where either of these conditions are met a just and reasonable portion of the non-individual's profit share is allocated to the relevant individual member for tax purposes.

The HMRC guidance specifies 'appropriate notional profit' as being either a 'notional return on capital' or a 'notional consideration for services'. 'Notional return on capital' considers non-individual members being rewarded for their contributions to the business by receiving an appropriate return on the capital they have invested, such as receiving a commercial rate of interest on any mezzanine debt lent to the partnership. 'Notional consideration for services' allows for a non-individual partner to receive reward for the services that they may have provided the business but that such rewards should be negotiated on an arm's length basis, which should be supported by appropriate documentation.

The guidance terms a 'power to enjoy' as applying in situations where an individual member is connected to a non-individual partner in ways other than as a partner in the relevant partnership, such as being a shareholder in a corporate member. The legislation is not specific in this area and is therefore likely to apply in most situations where an individual partner is connected to a non-individual one by more than just being a fellow partner.

Finally there is the definition of 'reasonable to suppose'. This is the most important condition of the mixed partnership rules as HMRC must be able to argue that it is reasonable to suppose that the allocation made to the non-individual partner was actually attributable to an individual member's power to enjoy that allocation in order for the second main condition to apply. This is a highly subjective test that will need careful consideration in order to assess whether there is sufficient evidence to counter a challenge by HMRC.

It is important to consider the mixed partnership rules because should HMRC judge a partnership to be breaching the rules and therefore allocate profits to an individual partner the increase in taxation will be significant (likely doubling the tax liability).

Next steps

KPMG can assist you with determining whether these new measures will apply to your business. Should this prove the case KPMG can also assist with structuring your partnership and in dealing with HMRC on your behalf.

Further information

KPMG's publication on the changes to the taxation of LLPs and partnerships can be accessed via our website: http://www.kpmg.com/UK/en/IssuesAndInsights/ArticlesPublications/Documents/PDF/Market%20Sector/Financial%20Services/taxation-of-llps-partnerships.pdf

The current state of UK property collective investment schemes

Matthew Roach, Senior Manager and Simon Hart, Manager - Tax

In March 2013 George Osborne signed a foreword to a treasury paper which outlined the government's 'comprehensive strategy' for making the UK one of the most competitive places in the world for the investment management sector. This document, while perhaps primarily aimed at the 'traditional' investment management industry, also encompasses the property fund management industry. However, whilst at the time we welcomed the keynote announcement, being the repeal of Schedule 19 SDRT, and we acknowledge the Government's effort to date, much still remains to be done.

Industry trends will also continue to shape the UK property fund landscape. In particular the inexorable shift from defined benefit pension schemes to defined contribution schemes, along with the need to move life company assets into widely held collective investment schemes will change the industry landscape.

This article discusses the current state of UK property collective investment schemes twelve months on; including the likely shift to certain types of fund vehicles and highlights where we think the Government could do more to promote and nurture the industry. We also make some predictions about how the funds landscape will look in future.

The demise of Authorised Property Unit Trusts ("APUTs")

APUTs have long been one of the dominant vehicles for holding UK commercial property. This is changing and over the next few years we expect that most existing APUTs will cease to exist in their current form. Instead it is likely that most will convert to become Property Authorised Investment Funds ("PAIFs"). The conversions of the M & G Property Portfolio and Standard Life Investments UK Property Fund last year, along with the conversions of the L & G Property Trust and Ignis UK Property Fund in May 2014, are an indication of this trend, one which other managers are sure to follow.

The simple reason for this is that PAIFs will allow product providers to have a single vehicle that is attractive to both tax-paying and tax exempt investors, unlike APUTs which impose a 20% sticking tax on tax exempt investors. Although tax exempt investors have been able to invest tax effectively in exempt Unauthorised Unit Trusts ("UUTs"), managers have not been able to offer these products to taxable investors as otherwise the UUT would lose its capital gains tax exemption. This has led to product duplication and the additional cost of running multiple funds. We therefore also expect that more UUTs will follow the lead of the AEW UK Core Property Fund, which converted to PAIF status this year, in order to access a greater potential pool of investors and reduce product duplication.

The growth of PAIFs

PAIFs were introduced in 2008 in response to the industry's demand for an onshore open ended collective investment vehicle suitable for retail and institutional investors. This was with the intention of these being used in place of APUTs, which are unattractive for tax exempt investors, and offshore vehicles such as Jersey Property Unit Trusts. However, due to the financial crisis of 2008, alongside tax and practical concerns, the number of PAIF launches and conversions since the introduction of the regime has been disappointing. This is now changing.

One of the main cited practical impediments to the launch of PAIFs was the lack of ability of administrator's systems to cope with the streaming requirements imposed by the tax regulations. While this potentially remains a factor, it is an impediment that the larger players have managed to overcome and we believe it to be only a matter of time before the issue is fully resolved. Likewise platforms and fund supermarkets did not initially invest in the necessary systems to treat streamed income received from PAIFs, which has delayed retail interest in PAIFs. However, several recent PAIF conversions have created momentum to encourage platforms to amend their systems to cope with the streaming requirements.

Therefore, we expect to see most of the existing APUTs, along with a number of UUTs, convert to PAIFs. However the outlook for new PAIF launches is not as promising. The principal reason for this is the SDLT cost associated with seeding a new PAIF. It has been increasingly hard since the boom years of the last decade to raise a 'blind pool' fund. As a consequence it is generally necessary for managers to have identified a pipeline of assets to seed the fund. Typically these assets need to be acquired prior to the fund's launch, warehoused and then transferred into the fund, which, absent complicated structuring, causes a double stamp duty land tax ("SDLT") charge of 8% (an initial charge of 4% on the acquisition of an asset and then a further 4% charge on the transfer of the asset to the fund). As it would take an exceptional manager to outperform these high initial costs, we expect that there will be very few new UK PAIF launches until either (i) some form of SDLT relief is introduced; or (ii) raising 'blind pool' funds (such that SDLT is only payable once) becomes commercially possible again.

Government action to date

The Government, to its credit, has responded to lobbying from the industry on certain tax matters, demonstrated by legislating to allow CGT free switching between a PAIF and a dedicated PAIF feeder fund. Over the past year the industry has made various representations for a wider SDLT seeding relief through trade bodies, such as the Association of Real Estate Funds. As part of the Budget 2014 announcements, the Government announced a consultation this summer on seeding relief, covering both PAIFs and Tax Transparent funds ("TTFs") Whilst there is currently SDLT seeding relief for conversions of APUTs to Open Ended Investment Companies ("OEICs") (which can then elect into the PAIF regime), there is currently no such relief for conversions of offshore vehicles or the transfer of existing assets into a PAIF. This is a potentially significant barrier to the 'onshoring' of many overseas property trusts which hold UK property. We consider that the quickest way for UK property collective investment schemes to grow would be through the creation of funds seeded with these assets. The lack of a wider SDLT seeding relief is therefore a significant roadblock for the creation of large new UK property collective investment vehicles. Whilst the Government may have memories of previous seeding relief being abused (prior to its repeal in 2006), in our view, fears of tax avoidance should not restrict the possibility of a relief being introduced as any measures could come with appropriate targeted anti avoidance provisions (or HMRC could counteract any abusive arrangements using the GAAR).

Tax Transparent Funds ("TTFs")

Since July 2013 the UK now has two new forms of collective investment vehicle, the co-ownership scheme and the partnership scheme. The partnership scheme is effectively an authorised limited partnership and not considered further in this article. The co-ownership scheme or TTF is an onshore authorised 'Baker' trust with tax features similar to that of a Luxembourg FCP or Jersey Unit Trust (i.e. transparent for income but opaque for capital gains). We expect property managers to be interested in using this vehicle because the tax profile generally should make it efficient for many different types of investor, although it is clearly designed for an institutional rather than retail market. In particular, this is an ideal vehicle for life companies seeking to shift their assets into widely held collective investment schemes.

However, the ability to utilise this vehicle efficiently for property collective investment is currently uncertain and untested. This is because the vehicle was primarily designed for creating tax efficient UCITS IV compliant master funds, and the real estate tax considerations, in particular the SDLT treatment, is not yet entirely clear. In order to make these a viable product for property the SDLT consequences need to be clearly defined, and ideally, accompanied by some form of limited SDLT seeding relief. If these issues are addressed, we expect a number of life companies to launch new TTFs into the market within the next year.

Summary

To date, the Government has implemented measures to support the property investment management industry in the UK, which have been welcome. They have been responsive to the industry's demands for vehicles such as PAIFs and TTFs. However, in our view there is more that could be done to promote the UK property collective industry, and to align it with the key trends shaping the industry. To encourage the growth of new funds, the industry would benefit from (i) a targeted SDLT seeding relief with appropriate anti-avoidance restrictions for UK collective investment schemes; and (ii) clear and sensible legislation/guidance on the SDLT treatment of transactions in or involving TTFs.

Further information

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Developing contaminated land

Harinder Soor, Partner – Capital Allowances Advisory Services

The property market is showing a welcome return in activity with the housing sector showing very promising signs and, by common consent, leading the recovery in the sector.

With the increased activity in the market, developers (whether house builders or commercial) will need to supplement existing land banks with new acquisitions in order to meet demand. Inevitably this will lead to the age old debate on where to build and the availability of suitable land. The development of contaminated or derelict sites is an area that requires careful consideration, not least to ensure any clean up costs do not make the development commercially unviable. What should be factored in, however, is that the government will actually pay you for clearing up brownfield sites (subject to a few conditions) through enhanced tax reliefs.

The relief is also available to investors, provided they are within the scope of UK corporation tax.

The rules

The remediation of contaminated and derelict land by companies may attract an enhanced deduction through the tax code. For a company that incurs expenditure to remediate contaminated land the relief given is a deduction of 150% of the eligible costs. This includes direct labour and material costs or subcontracted work. Associated costs such as preparatory works or related professional fees may also be eligible.

Given the rules are contained within the tax code there are, unsurprisingly, several conditions that must be satisfied in order to qualify. These include:

- Qualifying expenditure is the extra cost to remediate the land that would otherwise not have been incurred if the land had not been in a contaminated state
- The expenditure is not subsidised

- The pollution was not created or exacerbated by anything done or not done by the company
- The expenditure is not eligible for any form of capital allowances
- The company own either the freehold or a long term lease (>7 years) on the land when expenditure is incurred

So what is land in contaminated state?

The legislation makes clear that any contaminants must be as a result of commercial activity and there is a serious possibility that the contaminant could cause harm to living organisms, controlled waters or buildings. Typical contaminants include asbestos, creosotes and leaking fuel tanks amongst others. The relief is also available for Japanese Knotweed.

As noted earlier in this article the scope of the legislation also includes clear up costs for long term derelict land. Land is in a derelict state if it is not in productive use and cannot be put into productive use without the removal of buildings or other structures. To qualify as derelict land for these purposes the land has to have been derelict since 1 April 1998. If these conditions are satisfied the current list of qualifying work is:

- Removal of post tensioned concrete heavyweight construction
- Removal of building foundations and machinery bases
- Removal of reinforced concrete pile caps
- Removal of reinforced concrete basements, or
- Below ground removal of redundant services

The benefits

The benefit to developers is that the government effectively pay you to clean up the contaminated or long term derelict land. If, for example, £100,000 has been incurred on a qualifying expenditure a tax deduction of £150,000 will be available. Assuming a corporate tax rate of 20% this equates to an additional £10,000 of cash tax benefit. For investors the deduction would be worth £30,000 on the basis no capital allowances are due on this expenditure. If the company is loss making a cash tax credit of 16% is available. Using the example above this would give a cash repayment of £24,000.

Conclusion

There was a possibility a few years ago that the government would remove this relief from the statute book as it was felt the relief was not beneficial to the private sector. This proposal was dropped by the government after consultation.

Further information

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Real Estate going Green?

Karen Wordsworth, Director and and James Holley, Senior Manager - Climate Change and Sustainability

Real Estate's Green credentials are continuously subject to scrutiny. It effectively finds itself under pressure from multiple stakeholders including: Government, due to the size of the carbon footprint; Occupiers, who want to minimise costs; and Investors, who want to protect the value of their investments.

With the European Commission consulting on a 2030 framework for carbon emissions reduction, floating the prospect of an emissions reduction target of 40 percent, and the potential implications arising from the Energy Act there are few signs of a let up to the above pressures.

The incoming requirements for minimum energy performance standards for lease properties are likely to give rise to a number of issues for landlords. If the Energy Act proceeds as currently planned, from 2018 a minimum standard will be required across your Estate. Understanding the implications for an existing portfolio and the options available for poorly rated buildings will be key to protecting value, as will appropriate assessment of the EPCs during transactions.

One solution for poorly rated assets is clearly retrofitting. However, with the perception that 'Green' solutions require significant capital outlay balanced against the uncertainty as to who receives the benefit there is a fundamental blocker to major scale retrofitting of the existing and occupied UK asset base.

Large corporate real estate owners and occupiers are forcing the issue, as they consider their corporate social responsibility and seek to protect their brand through adopting an environmentally friendly agenda, and a number of large European real estate owners have formed the International Sustainability Alliance to benchmark, share problems and practices as they seek to become greener.

While some recent studies have shown that 'green' real estate can achieve higher sale and rental values, the most important factor is probably the ease of letting a building given the current market pressures. In Australia, where green leases have a longer track record, it is not necessarily the case that a green leased asset can obtain a premium, rather a brown leased asset will require a discount, implying that higher values may be a short-term factor linked more to the limited supply of 'green' assets.

While the benefits of having a more efficient and cost effective asset to occupy are clear, the affordability of a 7-10 year refurbishment cycle draining capital when, post-boom, there is uncertainty around the value implications of upgrading existing stock requires another solution.

So is it possible to navigate the landlord vs tenant issues and improve the 'greenness' of existing buildings? Simply put: Yes.

In our experience, through capturing the savings and tapping alternative revenue sources from your real estate, a business case can be built such that Banks will finance retrofit projects, easing the initial need for either the occupier or the landlord to provide the capital. And with cases out there where even relatively newly built BREAM standard buildings have had their specifications upgraded, creating significant savings and keeping tenants happy, there are a lot of assets to consider.

KPMG's Climate Change and Sustainability team are working with a number of clients as they seek to analyse and benchmark their estate and available options.

Further information

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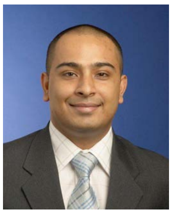

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