BEPS

Update for Real Estate Funds

Introduction

It is now almost a year since the Organisation for Economic Co-operation and Development (OECD) issued its recommendations to tackle perceived tax avoidance by multinational corporations. The recommendations seek to address base erosion and profit shifting (BEPS), and contain 15 action points which member nations of the OECD and Group of Twenty have agreed to address.

Although real estate funds were not the main target of the BEPS initiative, they may be significantly impacted by changes in jurisdictions' tax laws in response to the BEPS recommendations. In our initial paper in 2015, *Base Erosion and Profit Shifting (BEPS): Key considerations for real estate funds*, we highlighted four key action points which we considered might have a negative impact on the returns that real estate funds were able to obtain:

- Limiting treaty benefits
- Restricting interest deductions
- Restricting the use of hybrid instruments
- Expanding the definition of 'permanent establishment'.

In the months since our initial report, national governments have been working to implement the proposals, and we are now starting to get a picture of how things are progressing. This paper looks at progress across various jurisdictions around the globe, examines the changes and proposals they have made, and looks at what impact this may have on real estate funds.

The pace of change is not consistent around the world. While Europe is embracing the BEPS project enthusiastically, and putting through changes at both a European and national level, other parts of the world are perhaps following the spirit more than the details of the proposals. In particular, this can be seen with regard to restrictions on the deductibility of interest, and methods of tackling so-called treaty abuse.

Action 2

Hybrids

This action broadly seeks to tackle occasions where a payment is deductible in one country without being picked up in the charge to tax of another. Of particular concern to real estate investors is a recommendation by the OECD that could impact real estate investment trust (REIT) regimes. While the OECD accepts that nations may develop tax incentives for particular sectors, they consider that a dividend should be included in the recipient's taxable income to the extent that it is deductible in the location of the real estate. In response to this, some countries where REIT-like instruments are common, such as Japan, have been amending their treaties to restrict the availability of treaty relief on such dividends, and it is likely that this trend will continue.

Another area that will require consideration on a case-by-case basis is the use of hybrid instruments as part of the financing of a fund vehicle. Key issues here are whether the instrument is a cross-border instrument, and what the tax treatment is in the hands of the recipient.

Action 4

Interest deductions

This is the area where we currently see the greatest divergence of views. The European Union (EU) has introduced minimum standards, and member states are all committing to an interest deduction of no more than 30 percent of earnings before interest, tax, depreciation and amortisation (EBITDA). The effect of this will vary according to the investment structures used – most Luxembourg structures relying on income exempt under the participation exemption or back-to-back debt should not be affected.

In the UK, the rules will not currently apply to non-resident landlords (who pay income tax rather than corporation tax), and the changes will have limited effects for REIT-like structures such as French OPCIs (Organismes de Placement Collectif Immobilier). For other countries, where the ability to obtain an interest deduction remains important, the change could be significant. However, it is worth noting that countries like Germany and Spain have had similar legislation for several years and that the combined effect of de minimis limits and revised structures mean that the increased tax leakage has been at an acceptable level for most investors.

Outside the EU, enthusiasm for the detail of the OECD proposals has been distinctly more muted. The US is attacking excess interest deductions in a very different way by looking to reclassify related party debt as equity in certain circumstances. Meanwhile, Australia and China all seem content with the rigour of their existing thin capitalisation rules, while Japan already limits interest deductions to 50 percent of an EBITDA-type amount and has not yet made any move to tighten this further.

Action 6

Treaty abuse

The proposal to limit access to treaty benefits such as lower withholding taxes may be the most significant risk to returns for many funds. Two different approaches were built into the action point on treaty abuse because the governments were unable to agree on a single approach, but the OECD recommendation sets a minimum standard for countries to combat treaty abuse. The last nine months have seen a number of new or renegotiated treaties, and these have continued the trend of imposing either a principal purposes test (PPT) or a limitation of benefit (LOB) clause limiting the availability of treaty benefits.

The application of the revised rules to investment vehicles that do not qualify under the OECD definition of collective investment vehicles (i.e. widely held, regulated vehicles with a diverse portfolio of securities) is still not clear, and there is a wide variety of approaches among investment locations. Further, the OECD explicitly rejected a substance-based approach in favour of a PPT or LOB. However, many countries, particularly in Asia, are continuing to focus on premises and employees, a test that it is almost impossible for a holding company to meet on a stand-alone basis as there are strong commercial reasons why they typically do not have employees or premises. We are also seeing some holding company locations, such as Hong Kong and Singapore, protecting their reputations by refusing to issue tax residence certificates for companies with low levels of substance.

Action 7

Permanent establishment status

The OECD is proposing to expand the range of activities which can give a non-resident company a taxable presence in a jurisdiction. This is important for real estate funds which frequently hold investments through one or more companies located in a different jurisdiction to the underlying real estate. The OECD published further guidance on the attribution of profits to permanent establishments (PE) on 4 July 2016. Like the recommendations on treaty abuse, the PE recommendations are expected to be the multilateral instrument, although a number of recently negotiated treaties have included the recommended provisions.

One country that has signalled enthusiasm for the new rules is China, and investors into China will need to revise their operating protocols to ensure that they are not creating a taxable presence in their holding companies. Germany has also included the revised PE provisions in its renegotiated treaty with Australia. The absence of a permanent establishment in Germany is frequently considered important to keep real estate companies outside the scope of trade tax.

Other actions

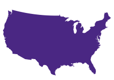
'Country-by-country reporting' and 'Transfer pricing'

One of the most advanced actions at this stage is country-by-country (CBC) reporting, which requires large groups to report their taxable profits and other information on a country-by-country basis. Many of the larger fund houses will find that their fund management vehicles may be subject to reporting, and this may focus the attention of tax authorities on any large profits being taken by management entities in offshore locations such as the British Virgin Islands or Cayman Islands. Coupled with an increasing interest in transfer pricing (TP) from many tax authorities, fund managers will need to ensure that they have adequate TP documentation in place to justify the global allocation of income and expenses.

The impact of CBC reporting on the funds themselves depends in large part on the accounting treatment of the fund and any subsidiary entities or holding companies. The OECD has indicated that investment funds should not be exempt from the requirements. Many funds will find that their annual revenue falls below the USD 850 million/ EUR 750 million a year limit, which may include increases in fair value under applicable accounting standards. Similarly, whether real estate funds form a 'group', which is typically defined with reference to consolidated financial statements, may also be open to question.

Conclusion

The following table sets out the current state of progress in eight key jurisdictions for real estate funds:

	Hybrids	Interest	Treaties	PE	CBC
Australia 	Implementation announced	Existing rules retained	PPT adopted, starting with the German treaty	Changes adopted, starting with the German treaty	CBC starts 1 January 2016
China 	Use currently limited, but the State Administration of Taxation (SAT) plans to roll out Action 2 in 2016/17	Existing rules retained	LOB & PPT adopted, starting with the Chile treaty	Changes adopted, starting with the Chile treaty	CBC being introduced – TP documentation requirements to be issued later this year
Germany 	Draft EU directive prepared – no German response yet	German law already followed OECD proposals	PPT adopted, starting with the Australian treaty	Changes adopted, starting with the Australian treaty	Draft CBC legislation put forward, although Germany does not support EU plans for public CBC
Hong Kong 	Limited use in Hong Kong	Existing rules retained	Committed to minimum standards; IRD reluctant to grant residence certificates without substance	No changes to date	TP law expected to be introduced later this year
Japan 	Restrictions on treaty claims for deductible dividends; deductible dividends excluded from foreign dividend exclusion regime	Existing rules retained	LOB/PPT common in treaties since 2003; expected to sign multilateral agreement	Already adopted a wide PE definition	New TP regime introduced, bringing in CBC reporting
Luxembourg 	Hybrid instruments excluded from participation exemption; will incorporate any further EU law changes	Will adopt 30 percent EBITDA with EUR 3 million de minimis and group ratio rule	Required to follow under EU law; will likely adopt only PPT as in recent treaty with Senegal	Expected to sign multilateral agreement, but exact position not yet clear	Draft CBC law published 2 August 2016
Singapore 	No changes proposed to date	Existing rules retained	Singapore is committed to minimum standards and will decide whether to join the multilateral instrument once it is finalised	No changes proposed to date	To be introduced from 1 January 2017
UK 	Anti-hybrid rules with effect from 1 January 2017	Will adopt 30 percent EBITDA with GBP 2 million de minimis and group ratio rule; does not apply to income tax at the moment	No significant progress to date	Domestic PE definition widened	UK has signalled commitment to CBC, and published regulations which may be amended later this year
US 	Legislative proposal issued	Alternative approach being adopted to reclassify some related party debt as equity	LOB has already been adopted in most US treaties; PPT is not expected to be adopted	Policy currently unclear – the U.S. Department of the Treasury has indicated that it is unlikely to adopt the revised provisions	Regulations on CBC issued, to take effect this year

Source: KPMG International 2016.

In terms of practical actions, fund managers need to ensure that they are up-to-date with the changes and are getting the appropriate advice to make sure their investment arrangements remain efficient. Where structures no longer work well, they should consider whether it is appropriate to make any changes. Fund managers will also need to work with investors to ensure that expectations regarding returns remain realistic, and consider any impact on carried interest in terms of their own remuneration.

We expect further evolution of the BEPS agenda over the coming months. As funds enter into new investments, they will need to consider how the tax landscape may change over the lifetime of the investment and ensure that the structures used are robust or flexible enough to withstand changes in local tax regulations.

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