The OECD/G20 BEPS Project final package of measures: what does it mean for the Real Estate Funds industry?

23 November 2015

In brief

On 5 October 2015, the Organisation for Economic Cooperation and Development (OECD) published its long-awaited final package of reports on Base Erosion and Profit Shifting (BEPS). This marked the culmination of over two years work to complete the BEPS Action Plan. Finance ministers from the G20 group of countries endorsed the package during their meeting on 8 October 2015 in Lima.

Despite all the media comment, it is important to recognise that at this stage, the OECD/G20 BEPS Project output is not law. Although many countries are beginning to implement some of the measures that the BEPS Project has recommended, even now it is far from certain how far individual countries will go, and how quickly, to implement measures, especially those which may reduce tax competitiveness or tax revenues.

Policy has been formulated: it now has to be implemented. But what is already clear is that tax "climate change" is happening, and is beginning to have a significant behavioural impact on taxpayers in all industries, globally.

For the Real Estate Funds industry, the most significant changes are likely (eventually) to affect how funds are structured (and organised operationally) to be able to continue to return reward to investors in a tax-effective way; the extent to which the expense of debt can be tax-deducted within fund structures; and how Transfer Pricing is set within the fund manager's business as well as in financing the SPVs owning the asset portfolio.

This Bulletin summarises the key measures in the final package of reports, and seeks to assess the likely consequences, drivers and timing for change that these measures might bring about for the Real Estate Funds industry.

The background and framework

The package of Final Reports comprises 13 reports, totalling over 1,600 pages, together with a 14 page explanatory Statement. Every one of the original 15 points in the Action Plan has been covered.

How compulsory are these BEPS measures? And when are they to take effect? The Explanatory Statement confirms that all OECD and G20 countries "are committed to the comprehensive package". Four different sorts of measures are identified, as follows :

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(i) “Minimum standards” to tackle issues – here there is an explicit commitment agreed to by all countries to consistent implementation. The OECD sees this in terms of “levelling the playing field”. The “minimum standards” apply (among other areas) to the Action 6 anti-“treaty shopping” measures, and the Country-by-Country Reporting transfer pricing measures (part of Action 13).

(ii) “Updated existing standards” – these being the revised texts of the OECD Transfer Pricing Guidelines, and the parts of the Model Tax Convention Commentary other than those covered by “minimum standards”. Here it is recognised that not all BEPS participants have yet fully “endorsed” these standards – which suggests that implementation may be less mandatory.

(iii) “Agreed general policy directions” – these mainly being the BEPS recommendations on hybrid mismatches (Action 2), and on interest deductibility (Action 4). The OECD says here that, because a general policy direction has been agreed, countries’ rules are now expected to “converge over time” through the implementation of the “agreed common approach”.

(iv) “Guidance based on best practices” – at this time, there is no compulsion to introduce these measures.

Work continues on the development of the “multilateral instrument”. This would cause bilateral tax treaties to be modified in a synchronised and efficient way, thus making the various BEPS measures which involve treaty modifications to become effective, consistently, in many countries at once, and over a rapid timescale. The Explanatory Statement says that the multilateral instrument is to be open for signature by the end of 2016. The ad hoc group (bringing in up to 90 countries) set up to draft its text had its first substantive meeting on 5-6 November 2015 to progress this work.

The OECD and G20 countries have agreed to work to monitor the implementation process, through an as-yet-undefined peer review process. Compliance, in particular with the “minimum standards”, would be reviewed, via reports on what individual countries have done to implement the BEPS recommendations.

Political support for the BEPS Project is particularly strong in several EU Member States, and the EU Commission not only endorses the BEPS Project, but has also said that it wishes to build on these reforms. The EU Commission will be active in seeking to secure the implementation of BEPS measures uniformly across the EU, and all EU taxpayers should not underestimate the pressure that will come from this direction.

Conversely, the USA looks to be more lukewarm in its willingness to support the BEPS measures. Recent comment in technical journals has noted that US involvement in the OECD consensus might have been key in weakening some of the measures finally agreed, delaying them, or making them unnecessarily complex. To the extent that implementation in the USA would require significant legislative change, it currently seems unlikely that such measures would pass in Congress, even if they got that far. That said, US tax officials appear to believe that existing US legislation already includes most of the measures the BEPS Project recommends. Historically, some parties within the USA have flagged the likelihood that a full implementation of the BEPS Action Plan outside the USA could be very costly for the US economy, as extra taxes paid outside the USA would generate additional tax credits that US groups could use to offset US taxes.

Although the BEPS Project reports are now all in final form, it is clear that the “finish line” for the BEPS Project is still a long way away.

A summary - why the Real Estate Funds sector should care about BEPS

The use of financing techniques, resulting in interest expense offsetting in large measure rental yields, has always been an important factor in seeking to maximises returns to investors in Real Estate funds. The potential impact of the BEPS measures most directly concerned with debt financing, notably those **restricting the tax deductibility of interest expenses** but also those to do with **Transfer Pricing**, may thus be very significant for the Real Estate Funds industry.

The **strong anti-treaty shopping measures** in the BEPS package are still subject to further work at the OECD, and their impact on the Real Estate Funds industry is recognised as a specific topic for further consideration in 2016. If these measures do not end up being moderated, and in the longer term then begin to be implemented through tax treaty revisions, this could have notably negative consequences for Real Estate funds investor returns, due to increased withholding tax costs and taxes on exit gains. Even if a “worst possible” outcome is avoided, operating models will probably need to evolve significantly, as a greater degree of **operational substance** in any holding company location will usually be essential if tax treaty benefits are to be retained.

Also, the Real Estate fund manager’s own business is likely to have been set up and run in ways aimed at mitigating tax burdens at both business and owner levels. The BEPS measures will strike at this – notably by sharpening the focus both on the **Transfer Pricing** used by the fund manager group, and how it is documented. How fee income from funds being managed is allocated between the countries where fund manager activity takes place, and how internal service fees are set, will both be increasingly scrutinised. A genuine alignment between where profits are taxed, and where real value creation takes place, will be critical.

Aided by calls for action in the media (and in some cases also by increased government funding), tax authorities will be increasingly confident in challenging arrangements, even when they involve considerable financial and organisational complexity. This may cause some Real Estate fund managers to be much more cautious in their fund structuring. Also the need for added tax function management resources, and the costs of resolving disputes (even if little or no tax is conceded as due), will need to be paid for – with the question arising of how such expenses should be allocated between fund managers and investors.

Media pressure, and scrutiny of how the Real Estate Fund industry manages its affairs, is also likely to remain notably intense. Pressure groups will continue to be particularly alert to any instances that might come to light and that suggest that a Real Estate fund has engaged in what a pressure group perceives as aggressive tax avoidance.

This same issue of media concern and pressure group activity is also increasingly going to have a significant behavioural impact on institutional investors, especially those sponsored by governments or charitable foundations. Investor pressure may thus turn out be the single strongest reason for the BEPS Project causing the Real Estate Fund industry to make significant changes to the ways it manages tax, even though these changes might broadly cause reduced returns to investors.

The measures in detail

Action 2 – Hybrid mismatch arrangements

The BEPS measures

The Final Report on this topic covers no less than 454 pages. In principle, it confirms the approach agreed as part of the BEPS Project consensus in September 2014, recommending new **domestic rules** to neutralise outcomes otherwise arising from "hybrid mismatch" arrangements, involving either specific financing instruments or arising from how entities are characterised for tax purposes under individual countries' rules. The types of "mismatch" are categorised as follows:

- deduction with no taxable inclusion ("D/NI"),
- double deduction ("D/D"),
- "indirect" D/NI ("imported mismatch").

In the Final Report, there is very detailed guidance on both the implementation of the rules, and transitional arrangements. These cover the complex situations that may arise from appropriate "counteracting" measures. Each depends on the arrangement and its effect, so that in essence the payer jurisdiction denies a deduction for payment, or the recipient jurisdiction includes the receipt as taxable income.

A "rule order" is recommended, and is applied consistently throughout the text. The "primary rule" is for the paying country to deny a deduction to the extent that the recipient country does not tax the flow as ordinary income. If this treatment is not applied (perhaps because the paying country has not introduced the appropriate domestic legislation), a "defensive rule" should then come into play, and the recipient country should then either tax the income (if D/NI), or deny the deduction (if DD). On this basis, only one of the two (or three or more) countries involved in a potential hybrid mismatch arrangement would need to change its legislation in order to render an arrangement no longer tax-advantageous. Every country is nevertheless recommended to introduce all the recommended rules into its domestic legislation.

Many examples show how the recommendations might apply to structures involving "payments" of interest, or royalties, or for goods (but – importantly – not notional interest deductions). There are still outstanding issues for a number of matters, including in particular stock lending, hybrid regulatory capital and interaction with CFC regimes.

Some specific examples in the Final Report elaborate various situations that involve "imported mismatches". One example accurately describes a very typical Real Estate fund structure (although without making any specific reference to the Real Estate industry), with a fund vehicle and an intermediate holding and financing entity, both in countries that have not introduced effective "anti-hybrid" measures following OECD recommendations, but where there is an SPV owning a Real Estate asset in a country that has fully adopted the detailed rules recommended, and which is the ultimate user of internally-provided funding. If the financing of this funding between the fund vehicle and the intermediate company has created a "hybrid mismatch", then the SPV to which the hybrid financing is traceable as flowing will be denied the related interest deduction in the country where the real estate asset is located.

The Final Report also has a much shorter second **tax treaty**-related part, which deals with recommendations for amendments to the text of the OECD Model Double Tax Convention. One recommendation is to clarify the treaty position of income that is derived through **tax-transparent entities**. A new clause would be added to the basic "persons covered" Article 1, which confirms that income derived through any "tax transparent" entity (which in practice includes many types of partnership) is to be treated as income of the person deriving it. While the drafting of the new clause was thus designed in part as an anti-"hybrid entity" abuse measure, it should also helpfully clarify the tax treaty entitlement of investors in partnerships which own assets in "third" countries (i.e. countries other than that of the investor or the partnership). This has been explicitly confirmed by the OECD, albeit in the Final Report on preventing treaty abuse (Action 6).

Consequences and timeline

The OECD measures outlined above do not represent a required "minimum standard" under the BEPS package: they are recommendations that set an "agreed general policy direction". Countries are thus not obliged to implement these measures.

The EU has however already acted in this area. The July 2014 revision of the EU Parent/Subsidiary Directive (to be transposed into all EU Member States' laws, to take effect no later than 1 January 2016), requires the "defensive" rule outlined in the OECD recommendations to be applied, although only to any intra-EU "hybrid" financial instrument – if there is a deduction in the paying country, the EU recipient Member State must tax the income and not allow the participation exemption to apply.

Given the high level of political support for the overall BEPS Project, the general trend, certainly within Europe, is likely to be towards widespread action to bring these BEPS Project recommendations into domestic law, over the **medium term**. However, the rules will not be uniform, and the length and complexity of the final text of the OECD's recommendations may turn out to be a disincentive for individual countries to adopt the measures over a short timescale, or in a complete way.

Financing arrangements that potentially fall to be treated as "hybrids" within the scope of the OECD recommendations are common-place within Real Estate fund structures. Notably, instruments such as CPECs (convertible preferred equity certificates), and structures that involve entities with differing characterisation for tax purposes (such as companies subject to US "check-the-box" treatment as transparent) could potentially be affected.

Real Estate fund managers will need to monitor the progress of introduction of anti-"hybrid" measures in individual countries carefully, and examine the detail of draft legislation thoroughly. As it is unlikely that all countries (even within the EU) will move with equal speed, there will in particular be situations arising where highly-complex "imported mismatch" rules could come into play. Here, there will be a strong incentive to ensure that financing provided from a fund vehicle falls outside any "hybrid" classification unless this is absolutely essential, and restructuring of some financing arrangements at the top of fund structures may well be necessary to minimise the effect of new legislation coming into force elsewhere, especially in jurisdictions lower down the same structures where Real Estate assets are located.

As regards the proposed treaty change to clarify the tax treaty entitlement of investors via transparent entities, this could be helpful to some institutional investors in partnership-type Real Estate fund vehicles, who would more readily be able to use their own treaty entitlement status to secure treaty benefits on their share of income flows into the fund vehicle. However, before this becomes a practical reality, actual revisions to treaties will need to be ratified. As well, administrative mechanisms will need to be made to operate smoothly, so as to ensure that tax authorities in the countries where a fund invests grant reduced rates of withholding tax, ideally at source, and certainly without delay or unnecessary processes. Change here should however **not** be seen as **imminent**.

Action 4 – Interest deductions

The BEPS measures

The perceived risk of "base erosion" due to excessive interest deductions, highlighted as a key issue in the original BEPS Action Plan, has been addressed. This is to be achieved by linking net interest deductions to taxable economic activity. An entity's overall interest burden – i.e. interest and similar expenses incurred on **both related party and third party financing** – falls within the scope of the measures. The Final Report only recognises one recommended approach for achieving this aim. The primary rule is a "fixed ratio" rule, based on a **"net interest"/EBITDA ratio**. Countries are recommended to set this ratio capping the amount of interest that is deductible at between

10% and 30%. The OECD identifies various factors which it hopes will help individual countries set an appropriate ratio.

"EBITDA" is to be calculated using tax rules, meaning that tax-exempt income should never increase the amount of interest that can be deducted. (The 2013 BEPS Action Plan had identified as a specific concern companies using debt to finance the production of exempt or deferred income, and thus claiming a current deduction for interest expenses while deferring or exempting the related income.)

The OECD considers that as a minimum, the fixed ratio rules should apply to entities in multinational groups, although they may also be applied to domestic groups.

The recommended approach also allows a "**group ratio**" rule to operate alongside the fixed ratio rule. This would would allow for net interest expense above the cap set by a country's fixed ratio still to be deductible, up to the level of the net interest/ EBITDA ratio of its worldwide group. More work is anticipated in 2016 on defining this worldwide group ratio. Furthermore, the earnings-based worldwide group ratio rule could be replaced by different group ratio rules, as already applied by some countries whose existing domestic rules already follow the OECD recommended approach. The OECD appears to be offering a lot of flexibility, to allow existing regimes to continue.

The recommended approach also allows countries to supplement the fixed ratio rules and group ratio rules with other provisions. These include rules to permit the carry forward of disallowed interest expense and/or unused interest capacity, provisions applying thin capitalisation rules and the arm's length principle, *de minimis* thresholds, and exclusions for interest on loans to fund "public benefit" projects such as infrastructure works. Transitional measures are expected, to allow groups to restructure.

Consequences and timeline

Real Estate fund managers operating in Europe are likely to be already familiar with measures of this nature, as domestic regimes in several European countries have already gone down this route, and followed Germany in introducing sets of rules that have many similarities with the approach the OECD is now recommending.

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That said, as noted above, **several countries have already** decided that measures of this nature are an important and appropriate component of their tax regime, and **legislated** to this effect. Other countries are now moving promptly in the same direction – for example, the United Kingdom issued on 23 October 2015 a public consultation document regarding implementation, potentially from 1 April 2017, of measures that would closely follow the OECD's recommendations.

If the BEPS Project's recommendations for peer group review of implementation of the BEPS package come to fruition (as is likely, given the present level of international political consensus), then this will also speed implementation. Not only will there be a direct pressure to act, some countries may see that implementing interest deductibility measures are a "low hanging fruit" compared with other BEPS measures. Within the EU, measures to restrict interest deductibility are seen as one of the easier steps towards the recently-revived concept of the Common Consolidated Corporate Tax Base.

The general trend is thus likely to be towards **widespread implementation** of these BEPS Project recommendations, **over the short to medium term**. However, the rules will not be uniform, and the more precise way in which they will evolve in individual countries cannot yet be predicted. The OECD recommendations offer wide scope for variation, even in critical areas such as setting the level of the net interest/EBITDA ratio.

Hence, while recognising that change and further constraints in this area are probably inevitable, Real Estate fund managers will need to keep under close review the full details of the way in which each individual country invested in moves to implement measures, and their timing. Careful tailoring of financing structures, in order to minimise the adverse effect of new measures, will be essential. Indeed, how individual countries choose to adopt the measures could even affect decisions on where to make new investments, and when to exit existing ones.

There is a real risk that in the medium term, the overall degree of BEPS-driven change in tax systems in this area could end up having a notable negative effect on investor returns. Sharply defined and low fixed limits on interest deductibility, together with measures specifically designed to preclude the deduction of financing costs incurred to acquire shareholdings, are likely to increase materially the tax burdens for many Real Estate funds.

Action 5 – Harmful tax practices

The BEPS measures

As one of the "minimum standards" within the final BEPS package, there is a commitment by all participant countries in the BEPS Project to undertake **automatic exchange of tax rulings** between tax authorities, with appropriate safeguards for taxpayer confidentiality being put in place. A broader than originally anticipated range of rulings is to be within the scope of this practice, with all rulings in relation to various named areas of particular risk now being covered.

Exchanges are to take place between the country giving the ruling, the countries of the immediate parent and the ultimate parent, as well as residence countries of affected related parties (and those of the corresponding head office or PE for PE rulings).

Consequences and timeline

The OECD would like to see compulsory exchange taking place within three months of any ruling being granted, for all rulings issued after 1 April 2016. Rulings from 1 January 2010 still extant at 1 January 2014 ought to be exchanged by 31 December 2016. There is however recognition that countries may need more time before they can adapt their legal frameworks to implement this measure. While the measure is defined as being in effect compulsory, it would thus be surprising if in fact full implementation were to occur across the 44 countries signed up to the BEPS Project as rapidly as the Final Report specifies.

However, here again **the EU has anticipated** the OECD measures. In this area this is far from surprising, given that politically-motivated pressure has been intense since late 2014 for all "cross-border" rulings given by all EU Member States to be shared between tax authorities. The issue culminated on 6 October 2015, with political unanimous agreement being reached between all 28 Member States at ECOFIN to amend the EU Administrative Cooperation on Tax Directive. This will introduce sharply-defined procedures for automatic exchange of a basic set of information on all new advance cross-border tax rulings, to apply from **1 January 2017**. Additionally, existing post-2011 rulings are all to have been similarly exchanged by the end of 2017. While this timeline is longer (and some would say, more realistic) than that of the OECD, it is far more certain that implementation will take place in line with each of the deadlines written into the draft amendments to the relevant Directive.

Real Estate fund managers will need to assess the consequences of this increased visibility of their planning and structuring of financing and other arrangements where confirmed by tax rulings. At the very least, once exchanges begin during 2017 and 2018, this will focus the attention of tax authorities (notably in the jurisdictions where real estate assets are located) on the destination of many flows of dividends and interest, where these flows have been the subject of tax rulings in holding and financing "platform" EU countries.

Armed with this additional information, many more forceful challenges must inevitably be anticipated as coming from tax authorities in many EU countries. These will examine the wider implications of the subject matter of any ruling and the fact pattern it discloses, the sustainability of all transfer pricing arrangements unilaterally agreed in advance, as well as levels of "substance", or even beneficial ownership. Such challenges will of course look retrospectively at what was being done in prior years, and hence any action to reduce the risks inherent in a challenge should be regarded as a high priority for action as soon as late 2015 and early 2016.

Action 6 – Preventing treaty abuse

The BEPS measures

This Final Report confirms that all participants in the BEPS Project are committing to implementing measures that meet "minimum standards" in countering "treaty shopping". Indeed the OECD wishes there to be a particularly strong level of compulsion here. However, it is clearly recognised that there has to be flexibility built into the measures proposed – which centre on an entirely new article for inclusion in the OECD Model Double Tax Treaty text – in order to allow adaptation to each country's specific circumstances and negotiated bilateral tax treaties.

Three alternative approaches to forming the text of this new "Entitlement to Benefits" tax treaty article are outlined, as follows:

- A single-paragraph **Principal Purpose Test** (PPT), providing that benefits under a tax treaty shall not be granted, if it is reasonable to conclude that obtaining that benefit was one of the principal purposes of any arrangement that resulted in that benefit.

- A US-style **Limitation on Benefits** (LoB) set of rules, plus "anti-conduit" rules. Under LoB rules, only "qualified persons" are granted treaty benefits. The definition of "qualified person" could extend to two or three pages of treaty text, but in essence individual physical persons, quoted companies, their same country subsidiaries, and other companies that would still get the same level of treaty benefits if the income flow was direct to their owners would qualify. Sovereign wealth funds should also qualify, and (subject to final agreement in 2016) so should many pension funds. As they now stand however, these rules are not helpful for alternative investment fund vehicles, or the holding and financing companies they control.
(The OECD text for its LoB rules cannot be fully finalised until the USA decides in early 2016 what the US model treaty wording for its new model LoB clause will be, as the OECD wishes to have text that is consistent with this.)

- **Both** the LoB set of rules, and a PPT.

The Final Report also confirms that previous OECD work in 2010 dealing with the tax treaty entitlement of "Collective Investment Vehicles" (**CIVs**) - these being funds that are widely held, own a diversified portfolio of securities, and are subject to investor-protection regulation – remains valid. This means that to a greater or lesser extent such funds would be "qualified" under LoB rules, because the OECD approach is in principle to deem such funds to be "individuals", entitled to the same benefits as physical persons (i.e. often being granted a less advantageous withholding tax reduction on dividend flows).

The Final Report also notes that there are "**non-CIVs**" – fund vehicles that do not have all the features noted above, and which are explicitly noted as comprising most Private Equity and similar funds. Further work on the appropriate treatment of these non-CIVs remains to be done, and the OECD aims to publish its final conclusions in early 2016.

However, unless further concessions are made (notably to broaden and sharpen the definition of CIV in order to have it include at least a good part of the Real Estate fund universe), any tax treaty that in future is amended to include an OECD model LoB clause would be very likely to cause most Real Estate funds, as well as all companies that they control and that do not "actively conduct a business" other than the managing of investments, to be denied all treaty benefits (i.e. reduced rates of withholding taxes, protection from taxes on non-residents on exit gains made, etc.)

Consequences and timeline

As noted above, the OECD has yet to finally confirm the OECD/G20 consensus on the extent to which alternative investment funds (i.e. non-CIVs) and their investments should be entitled to treaty benefits in the post-BEPS environment. In the paragraph of the Final Report explaining the issues that need further work, particular concerns are raised by the OECD that non-CIVs could be used to allow persons not entitled to treaty benefits to access such benefits indirectly, and also that non-CIVs could be used as a way for investors to defer income recognition. During the next two months, Real Estate fund managers need to encourage industry bodies to continue to press the OECD for fair and clearly stated treatment, both for treaty access generally, and in the specific context of LoB clauses.

Implementation of the final version of these anti-treaty shopping measures will not come imminently, as the measures require changes to double tax treaties, and such changes need to be both agreed and ratified. Under the normal **bilateral processes** such changes could take **several years** to become effective, and the precise way in which the measures would then be implemented could be expected to vary significantly depending on both the tax policies and relative negotiating strengths of the two treaty partners concerned.

However, the pace of change could be **greatly accelerated**, and the degree of consistency in tax treaty wording strengthened, **if** the OECD/G20 work on the "**multilateral instrument**" intended to implement all of the tax treaty changes proposed by the various BEPS measures proceeds in 2016 and **is successful**. A major part of the worldwide tax treaty network could thus have these new measures in place and in force by **as early as 2018**. Given the number of countries involved, and their differing policy objectives and levels of desire to protect their own taxpayers, this process remains fraught with difficulty. That said, at present there does appear to be considerable political support internationally for the process to go forward. Also, some countries, which might by themselves not prefer to see new and strict measures introduced into their tax treaties, are likely to come under very heavy "peer group" pressure to sign up to the multilateral instrument. EU institutions are also likely to press EU Member States to commit.

Countries will of course have the choice of PPT, or LoB, measures when making treaty revisions, and this will be the case even under the "multilateral instrument".

If LoB measures are introduced, and it remains the case that Real Estate funds are not explicitly treated as "qualified persons" entitled to treaty benefits, then the prescriptive and binary approach of detailed LoB measures is, as noted above, likely to put many Real Estate fund vehicles and their underlying holding and financing platforms (as currently set up) almost automatically outside the tax treaty network.

This "worst possible" outcome could have major negative consequences for the Real Estate fund industry. Either all investors would find themselves deriving and sharing lower returns because of increased tax leakages (such as additional taxes on exit gains) within the fund structure, or fund vehicles and the structuring of investments would have to change perhaps quite radically to become totally tax transparent. Such changes might be hard to achieve, due to non-tax constraints – liability-limiting blockers are an important layer in many structures. But if they were somehow to be instituted, this would probably then mean that Real Estate investors who themselves are normally entitled to treaty benefits might not be as worse off (although they may still face some increased withholding tax leakage), but other investors would still see their returns hit hard.

Conversely, under the alternative of the PPT measures – the "principal purposes" test – a Real Estate fund vehicle with an underlying holding and financing platform that could satisfy the PPT would still be able to access tax treaty benefits. Of course, satisfying the PPT would entail ensuring that the platform had very significant "substance" – perhaps in effect becoming more of a group headquarters operation, than a holding company with less alignment with operational and strategy-setting activity.

Within the EU, there are some signs that policy could favour this alternative of the much more qualitative approach of the PPT measures. Also, a bilateral LoB clause consistent with all aspects of EU law might be difficult to achieve.

Indeed, **the EU has already moved** in this PPT direction, in introducing in January 2015 a "**common minimum anti-abuse rule**" – i.e. what is in effect an anti-"Directive shopping" measure – into the EU Parent / Subsidiary Directive. (In contrast to the longer timeline for implementing the OECD measures, EU Member States are required to transpose this Directive amendment into domestic law before the end of 2015, with the changes having to come into effect no later than 1 January 2016. Similar changes to the Interest & Royalties Directive are anticipated to be agreed at EU level in 2016.)

The amendment to the Directive was expressly BEPS-driven, and imposes a requirement for there to be "*valid commercial reasons which reflect economic reality*" within a holding structure, for Directive benefits to continue to be available. This requirement in effect paraphrases the PPT. It also means that a holding and financing platform with sufficient "substance" should survive these changes without seeing its tax burden increase.

There is hence a possibility that the EU Member States' response to implementing the OECD measures for countering treaty shopping could be to opt "*en bloc"* for the PPT. Indeed there may even be a case for EU countries to insist that the wording of the Directive amendment is sufficient also for inclusion as the wording for a PPT in all tax treaties. Denmark has indeed already confirmed its intention to apply this approach to the whole of its tax treaty network.

Were the "*valid commercial reasons which reflect economic reality*" test to become the *de facto* PPT, this might be a reasonable outcome for the Real Estate fund industry. Not only would such a test be perhaps less harsh than the PPT as outlined in the guidance on its application given in the OECD Final Report, Real Estate fund managers would only have to consider one set of rules across all their operations. While to begin with how the test would work would be rather uncertain, as EU jurisprudence and details individual country practices emerged and evolved, benchmarks and practical guidance would become clearer.

All of the above analysis shows that, for the Real Estate funds industry, enormous uncertainties caused by the BEPS Project's attack on treaty shopping still remain ahead for the whole of the short to medium term, and that in many ways it is **still too soon** to be embarking on **radical fund restructuring** measures, in order to place less reliance on tax treaty protection, or to shift entitlement of tax treaty benefits to the investor level. That said, trends towards the use of SPVs set up in the "platform" country (to lower the number of borders crossed by flows subject to withholding tax), and of REIT-type vehicles in the real estate asset territory being owned as fund vehicle subsidiaries, are already emerging as structures for new asset acquisitions.

What is however clear, and already becoming increasingly important as the EU "common minimum anti-abuse rule" is introduced into Member States' law to apply from 1 January 2016, is that within the EU at least business operational models that do not have adequate substance at holding and financing platform level will increasingly be challenged, and will become unsustainable in the short to medium term. **Substance will be key.**

Action 7 – Artificial avoidance of permanent establishments

The BEPS measures

One of the concerns flagged by the BEPS Action Plan was that some multinational groups were using the way in which double tax treaties define "permanent establishment" (broadly, a taxable presence) to step to the side of the line that meant their operations in a country were protected by treaty from being taxed. The Action 7 measures are thus centred on redrafting the **"**permanent establishment" article in the OECD Model Double Tax Convention, together with its relevant Commentary, to **widen its application** in **tax treaties**.

The Final Report proposes a widening of the "dependent agent" test, a narrowing of the "independent agent" exemption, and a tightening of the specific activity exemptions from PE status. The OECD now proposes to extend the scope of the "dependent agent" test so that it expressly includes certain contract negotiation activities (a draft proposal had simply included "negotiating the material elements of contracts"). However, the new test is arguably only a little less open-ended, given that it focuses on agency activities that involve concluding contracts, or playing "the principal role leading to the conclusion of contracts that are routinely concluded without material modification [by the principal]". The guidance on these tests is somewhat blurred, probably because of the last-minute nature of the agreement reached as consensus for this new approach. This explains why the OECD has indicated that the guidance will be further reviewed in 2016.

Consequences and timeline

While the OECD's main target has been perceived abuses by groups that are major players in the "digital" economy (with some cases receiving much attention in the media), the proposals (or the encouragement that that they give individual tax authorities to act using existing rules) could mean that the activities of Real Estate fund managers when prospecting for deals, or supervising investments, could be at much greater risk of creating tax "footprints" in more countries for the Real Estate fund manager group, or if such a "footprint" already exists, of having a much greater share of group profits attributed to it and taxed there.

While **treaty change** is likely only to come on the same **2018 or later** timeline as the "treaty shopping" measures, as the process is the same, **in the meantime more aggressive policing** of existing treaty exemptions by tax authorities should be foreseen. Real Estate fund managers should ensure that internal procedures covering marketing, capital raising, and deal sourcing, are carefully drawn up with this issue in mind. Both "fly-in" activity and local "rep office" activity need to be covered, and key senior staff (they being most likely to be involved in decision-making on contracts) made fully aware of the issues.

Actions 8-10 – Transfer pricing

The BEPS measures

The BEPS Action Plan had as one of its main themes ensuring that **transfer pricing outcomes are fully aligned with value creation**. The Final Report includes guidance on several key transfer pricing areas. Almost 200 pages of guidance is set forth, and this will in due course be integrated into, and almost completely rewrite, large parts of the OECD Transfer Pricing Guidelines. New key principles that have emerged include the following :

- The accurate delineation of intercompany transactions is paramount, and the conduct of the parties must prevail over contractual arrangements where there is a misalignment between the two.

- A six-step process for identifying risk is outlined, with the return for risk to be allocated to the party that controls the risk, and has the financial capacity to assume it.

- Returns from intangibles (which include know-how and industry expertise) must accrue to the entities that carry out the development, enhancement, maintenance, protection, and exploitation functions, and not necessarily to the legal owner of the intangibles.

- For low-value adding intra-group services, a "safe harbour" of a 5% cost plus mark-up percent is recognised.

Consequences and timeline

For Real Estate fund managers, this enhanced focus by the OECD on "where is value added?", "what are the intangibles in your business?", and "which entity is paying for your risk controls?" may have important consequences. Within the fund manager group, where profits are currently being booked will need to be carefully examined, and the transfer pricing methodology, the fact patterns on which pricing is based, as well as the benchmarks being used all revalidated, to ensure compliance with this new approach. Situations where the intangible of important expertise is being contributed by a group entity, but where it is rewarded purely on a "cost plus" basis, may need particularly careful review. Also, the importance of a fund manager's brand in terms of capital raising and deal sourcing will need to be recognised, and reward matched to where the activities that built the brand have been carried out.

All of the OECD guidance described above will form part of the next edition of the OECD Transfer Pricing Guidelines, currently expected to be published in mid to late 2016. However, Real Estate fund managers should act on the basis that these measures in effect **already apply**, and in practice have always been in place. The number, and intensity, of transfer pricing challenges by increasingly well-resourced tax authorities will inevitably increase. This type of challenge is seldom based on a narrow construction of law, and tax examiners are likely to regard the new OECD guidance simply as explicit confirmation of what had historically always been in their eyes a valid basis for making challenges.

Action 13 – Transfer pricing documentation

The BEPS measures

The OECD Transfer Pricing Guidelines are to specify a three-tier approach to transfer pricing documentation, as follows:

- A "master file", containing information relevant for all group members.
- A "local file", covering all significant related party transaction flows involving the local group member.
- A Country-by-Country Report (CbCR), containing explicitly defined items of data on the global allocation of income and taxes, and certain other measures of economic activity. This is intended to be used as a risk assessment tool by tax authorities.

The CbCR obligations apply only to multinational groups with a turnover above EUR750 million. (The definition of a "group" in effect includes all entities that are covered by a single set of consolidated financial statements.) The CbCR package, showing data for all countries where a group has a taxable presence, must be filed with the tax authority that has jurisdiction over the consolidated group parent.

This tax authority will then automatically exchange the entire CbCR data set with the tax authorities of all countries reported in the CbCR concerned. Strict taxpayer confidentiality measures are imposed, and this aspect has been a major issue for both businesses and tax authorities during the evolution of the BEPS measures.

Consequences and timeline

The enhanced content requirements, and defined methodology, for preparing transfer pricing documentation represent a notable **compliance challenge**, as the level of information newly required is substantial. This will affect both Real Estate fund management groups themselves, and the businesses they invest in that operate internationally.

The master file/local file methodology, and all the other Action 13 measures, will form part of the next edition of the OECD Transfer Pricing Guidelines, currently expected to be published in mid to late 2016. There will be a general expectation that FY 2017 transfer pricing documentation will need to comply with the new standard. Many countries treat the Guidelines as "soft law", and hence transfer pricing documentation that does not follow the revised Guidelines will potentially put its preparing company in difficulties, and possibly at risk of penalties, should a challenge to its transfer pricing be made. Countries are also recommended under the new measures to amend domestic legislation to require relevant transfer pricing documentation to be filed with each tax return.

For Real Estate funds, these stricter documentation rules are in particular likely to allow tax authorities, especially in countries where real estate assets are located, to examine more closely the justification as "arm's length" of both the rate of interest used, and the amount of debt finance in place. This will be particularly the case unless and until the "interest-capping" rules described above (see Action 4) are put in place.

Given the turnover requirement, few Real Estate fund management groups outside the large financial institutions should themselves be affected by CbCR, and it is very unlikely that any Real Estate Funds will have CbCR obligations.

Notes

Notes

Let's talk

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