TAXAND

REAL ESTATE FINANCING – CRITICAL TAX ASPECTS

Input from Taxand Switzerland, France, Germany, Spain and Luxembourg based on new developments under OECD Guidelines

Webinar
30 September 2020

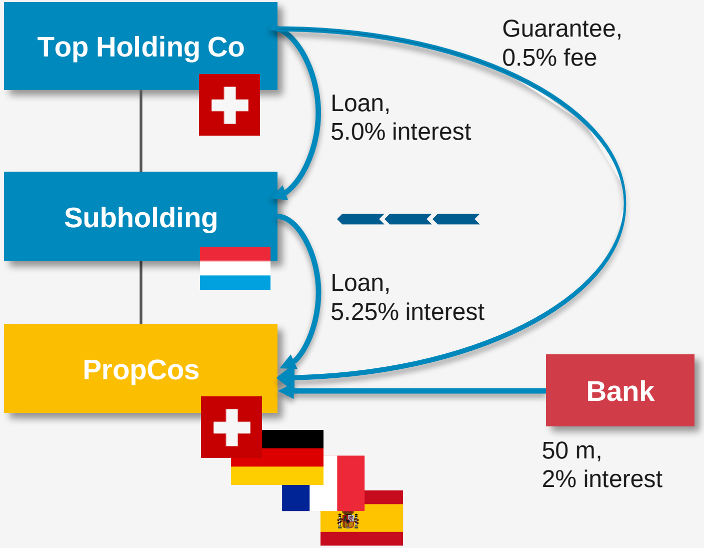
Your global tax partner

INTRODUCTION

AGENDA

1. Introduction
2. Presentation of base case: intra-group real estate financing
3. Key tax issues for PropCos and reference to OECD Guidelines on Financial Transactions, e.g. in Switzerland
4. News on OECD Guidelines on Financial Transactions
5. Handling of issues for PropCo Borrower in France
6. Handling of issues for PropCo Borrower in Germany
7. Handling of issues for PropCo Borrower in Spain
8. Handling of issues for Lender in Luxembourg

CASE STUDY


Top Holding Co
Subholding
PropCos
Bank
Guarantee,
0.5% fee
Loan,
5.0% interest
Loan,
5.25% interest
50 m,
2% interest

Characteristics of the IC Loan	
Issue date	1 January 2020
Maturity	1 January 2025
Amount	50 m
Schedule of repayment	Bullet
Interest rate	Fixed
Seniority	Subordinated, 2nd rank after Bank
Collateral	None, unsecured
Business sector	Real estate

- Retail property FMV 100 m
- Top Holding Co provides guarantee to Bank with respect to 50 m mortgage loan, guarantee fee: 0.5%.

BIRD‘S EYE VIEW – POTENTIAL TAX ISSUES

- Shareholder loans are often under scrutiny of tax authorities.
- Tax disputes range broadly from tax authorities deeming the character of shareholder loans to be equity rather than debt challenging the interest rates and/or deeming the guarantees rendering no benefit to PropCo.

- Subholding Co’s loan to be reclassified into equity?
- Guarantee provided by Holding Co to be a shareholder transaction?
- Pricing?
  - How to determine arm’s length interest rate
  - How to determine arm’s length guarantee fee

CASE STUDY – REAL ESTATE FINANCING IN SWITZERLAND

CASE STUDY – Switzerland

Preliminary remarks on local regulations

- Financial transactions under the Swiss Tax Authorities’ radar:
  - Swiss Tax Authorities increasingly focus their attention on intercompany financial transactions.

- Swiss regulations based on two pillars: Safe Harbour vs Arm’s length principle
  - **Thin capital:** Maximum debt financing of commercial property is 80% of market value, as per Circular letter issued by Swiss Federal Tax Administration = safe harbour ratio.
  - Excess IC loan after taking into account all liabilities of PropCo as per its statutory balance sheet is treated as deemed equity. No interest deduction on loan qualifying as deemed equity. Deemed equity is subject to annual capital tax.
  - Thin capitalisation rules aim to avoid tax evasion with respect to set-up of sufficient equity.
  - Higher IC debt financing may be accepted for tax purposes if tax payer proves that such financing is at arm’s length, e.g. bridge financing.

CASE STUDY – Switzerland

Preliminary remarks on local regulations

- Swiss regulations based on two pillars: Safe Harbour vs Arm’s length principle
  - **Interest rates:** Circular letters issued annually by Swiss Federal Tax Administration foresee maximum IC interest rates for property financing (for commercial property / CHF loan in 2020): 1.5% on LTV up to 66%, as of LTV 67% 2.25% p.a.
  - IC loan = loan from related party or loan from third party secured by IC guarantee collateral.
  - Interest rates as per Circular letters = safe harbour rates.
  - Tax payer may apply higher interest rates but carries burden of proof for rate being at arm’s length.
  - **Guarantee fees:** No safe harbour rules regarding guarantee fees. Commercial justification of fee may only be proved by bench mark study, e.g. study comparing market interest rate on loan with and without guarantee fee. Market guarantee fee equals delta between the two options, as a maximum.

CASE STUDY – Switzerland

Preliminary remarks on local regulations

- Arm’s length test
  - The Swiss Tax Authorities are significantly challenging the benchmarking studies performed by taxpayers and refuse – first of all – studies provided by foreign specialists.
  - However, Swiss federal court decisions support benchmarking studies based on OECD guidelines as a proof for commercial justification of financing charges.

- Swiss tax rules in connection with real estate financing in theory very clear, in practice difficult to handle with tax authorities.
- It should be recommended to strengthen transfer pricing studies justifying the remuneration of intercompany financial transactions.

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NEW OECD GUIDELINES ON FINANCIAL TRANSACTIONS

FOCUS ON INTRA-GROUP LOAN PRICING

OECD Guidance

The Transfer Pricing Guidance on Financial Transactions (TPG FT) is an update of the 2017 OECD Transfer Pricing Guidelines (Guidelines). The report's focus is on loan transactions, financial guarantees, cash-pooling, hedging and captive insurance companies. It includes analytical framework which should result in the delineation of the financing transaction (delineation) and it provides guidance on how to price the financial transaction.

Subholding Co's loan to be reclassified into equity?

- Guidance on how to characterize **debt versus equity**
  - Loan Characteristics,
  - Ability to bear debt,
  - Reasonable alternative and
  - Ongoing behavior of the Parties.
- However, it is also acknowledged by OECD that there may be other approaches (e.g. D-E ratios) to address the debt to equity of an entity under domestic legislation. The OECD guidance does not prevent countries from implementing these other approaches.

Guarantee provided by Top Holding Co to be reclassified as shareholder transaction?

- Evaluation similar to an original borrower
- Economic Benefit:
  - Enhancement of the terms of the borrowing?
  - Access to a larger amount of borrowing?
- Is guarantor able to bear the risk (financial capacity)?

OECD Guidance

Shareholder loan from Subholding Co to be reclassified into debt instrument with different characteristics?

Guarantees?

- Detailed transactional analysis is starting point
- Consider both the perspective of borrower and lender and all options realistically available to each of them
- Analysis includes:
  - An assessment of the borrower's credit risks (e.g. Covid) and the risks related to that particular loan
  - The borrower's considerations in optimising its cost of capital and in having the right funding available to meet both short-term and long-term needs
  - A comparison with other realistic alternative funding options available
  - Similar analysis guarantee => benefits guarantee - Financial Capacity Guarantor

Pricing

- The determination of the arm's length interest rates ultimately requires the identification of so called comparable transactions:
  - Internal comparables preferred
  - External comparables
  - Comparability adjustments often needed
- Guarantee fees: Various methods are mentioned: CUP Method/ Yield Approach/ Cost Approach/ Valuation of Expected Loss/ Capital Support Method

OECD Guidance

- OECD provides a detailed analytical framework
- To determine the arms length price a detailed transactional analysis as well as an interest rate analysis are required
- The detailed guidance benefits tax payers AND tax authorities
- Country views/experiences?

CASE STUDY – REAL ESTATE FINANCING IN OTHER COUNTRIES: FRANCE, GERMANY, SPAIN AND LUXEMBOURG

CASE STUDY – France

Preliminary remarks on local regulations

- **French current tax context**
  - The French governments / French tax authorities recently increased their focus on intra-group financial flows:
    - Pre ATAD regulations that are challenged based on EU principles
    - Post ATAD regulations is still under review and comments
  - Tax audits and reassessments are growing in regularity, accuracy and aggressivity, in particular in the RE&PE sectors where the Funds do not really have their own financing structures using public notes or bonds and easy access to comparables. This reveals also the lack of knowledge of our Tax services as regards the fund industry.
  - French tax rules are very unstable but looking into the future should tend to closer harmony with effect of BEPS/ATAD reforms.
- The deduction of financial costs is limited by several mechanisms in France (Anti-hybrid provisions, business interest requirements, etc) with two main focuses as regards related party debt structuration.

CASE STUDY – France

Preliminary remarks on local regulations

#1 – Looking for the right level of Interest rate

- Deductibility of interest paid on loans from related parties (owning more than 50% debtor's share capital) is generally limited to the higher of:
  - ✓ The average annual interest rate applied by credit institutions (e.g., 1,32% for FY 2019); or
  - ✓ The interest the company could have obtained from financial institutions in similar circumstances:
    - Tax Authorities practice: tending to require a prior and binding offer of a loan from a bank in order to justify that the interest rate applied is at arms' length (term sheet signed by the bank). One of the main difficulty comes from the burden of proof (of the interest rate applied being in line with market conditions) which relies on the taxpayer and therefore the FTA are quite systematically challenging TP studies. In particular the credit rating of the borrower and comparables, asking for strict similarities (principal, market, nature of projects, duration, date, etc.) which are quite difficult to obtain and even more when it comes to added value – high to medium risk real estate projects.
    - French Supreme Court position: a recent advice of the Supreme Court provides that the elements of comparison used in the transfer pricing study, such as bonds, could constitute a realistic alternative to an intra-group loan to determine an intra-group remuneration;
    - Our Position: the last decisions from the Courts following the position of the Supreme Court have not yet closed the discussion with the FTA in the context of tax audits, in particular in the RE and PE sectors. However, our advice is that a) binding offers from banks are not realistic but should still be sought at least to show good faith, b) a specific transfer pricing with comparables properly selected (see below) can be used in front of the FTA and in case of litigation accepted by the Courts.

CASE STUDY – France

Preliminary remarks on local regulations

- **#2 – Looking for the good level of debt**
  - Deductions for net financial expenses are limited to the higher of the following amounts: (i) EUR 3 m over 12 months or (ii) 30% of the taxable income generated by the company before tax, interest, impairment and depreciation ("EBITDA")
  - Companies have the possibility (i) to deduct the net non-deductible financial expenses on the income carried out over the subsequent tax years (with no time limit) and (ii) to employ the unused deduction capacity during the five subsequent FYs
  - The latter rule shall cease to apply if the company is thinly-capitalized, *i.e.,* its amount of loans granted by related parties is higher than 1.5 times its equity, at the beginning or the end of the FY (depending on the company's choice). In this case, other rules and thresholds would apply, further limiting the deductibility of net financial expenses.
  - The French tax rules do not provide the possibility to demonstrate that the leverage ratio is at arm's length to avoid the adverse tax consequences attached to a thin-capitalization situation.
  - A *case-by-case* analysis should be performed on each operation to carefully manage the interest deductibility attached to such mechanism.

- The correct application of French tax rules in connection with real estate financing is highly scrutinized by tax authorities and arm's length topics are quite complex to manage with them.
- They should all be analysed thoroughly in consideration of the structuring contingencies.
- It is strongly recommended to add a transfer pricing study justifying the applicable interests rates.

CASE STUDY – Germany

Background of local regulations

- Intercompany financial transactions are exposed to several **recent developments in Germany**, in addition to the OECD's view:
- German tax courts have issued a **series of landmark TP cases** on the application of the arm's length principle for shareholder loans.
  - The decision concerns the re-classification of a loan into equity, the scope of German transfer pricing rules (price adjustments only vs. alteration of all terms or conditions), the presumption of security for actually unsecured loans and any implicit group.
  - **Further cases are pending at German tax courts**, which concern the choice of an appropriate transfer pricing method for shareholder loans and loans granted by financing companies (external CUP vs. internal CUP vs. cost of funds), the use of bond issuances, credit ratings (stand-alone rating vs. group rating) and the timing of preparing benchmark studies are also at dispute.
- **New draft TP rules were published**, which concern the deduction of interest expenses from intercompany financial transactions. The completion of the legislation process is expected by the end of this year and the new TP rules should be applicable as of 2020.
  - It must be demonstrated that both the German taxpayer could have provided the capital service for the entire period of the loan and the loan is economically necessary and used for the business purpose of the debtor.
  - The arm's-length nature of the applied interest rate must be demonstrated if that rate exceeds the interest rate at which the entire group as such could finance itself vis-à-vis third parties (= safe harbor rule).
  - In case of a finance company or the funding will be merely passed through, the interest rate is limited to the risk-free interest rate.
- In practice, intercompany financial transactions are closely scrutinized in **German tax audits** and often disputed.

CASE STUDY – Germany

Implications for real estate financing

- Critical aspects of German TP rules in connection with **financing German real estate**:
  - **Re-classification of shareholder loans into equity** is often argued by German tax authorities, in particularly in cases where the PropCo would have been unable to obtain a loan from a third party because the total amount of PropCo's debt heavily affects its creditworthiness. The tax treatment of such loan should be however that of debt financing, if the repayment obligation is intact.
  - **Choice of transfer pricing method:** The choice of the external CUP method (benchmark study) is often rejected by the German tax authorities and German tax courts due to the existence of third party bank loans. The authorities often argue for the application of the 2%-interest rate for the bank loan to the shareholder loan (instead of the 5%-rate based on benchmark studies).
  - **Deemed security and implicit group support** for the shareholder loan must be often considered in the view taken by the German tax authorities and German tax courts and thus shall justify lower interest rates.
  - **Guarantee fees for bank loans** must be at arm's length and normally amount between 0.125% to 0.25% after negotiations with the German tax authorities.

- German TP rules are currently evolving, which results in legal uncertainty in connection with the pricing of funding real estate.
- The transfer pricing study justifying the arm's-length nature of intercompany financial transactions should be enhanced. In future, the conduct of a benchmark study alone will no longer be sufficient to document the arm's-length nature of real estate financing.

CASE STUDY – Spain

Preliminary remarks on local regulations

Snapshot of the legal framework:

- Spanish TP regulations are based on the **arm's length principle (ALP)**.
- OECD TP Guidelines and EU-JTPF are the most important sources of interpretation.
- There are **no safe harbour rules in place**.

It is paramount to properly document the TP analysis to prove the fulfilment of the ALP and avoid penalties.

Historical key controversial areas with the tax authorities:

Conceptual delineation

- Debt vs Equity
  - **LTV analysis** based on market references, taking into account the borrower's global debt volume, type of asset, guarantees and debt subordination. Periodical compliance review (at least, annually).
  - Borrowing capacity analysis based on the **borrower's solvency and liquidity** to pay back the debt under the conditions agreed (cash flow generation according to the business plan, comparison of borrower's ratios with industry ratios: Interest Coverage Ratio or Debt-to-EBITDA).

Conditions applied

- Pricing analysis: interest rate, commissions for guarantees and other services fees (i.e. asset management, acquisition fee, development fee, etc.).
- Reasonableness of other characteristics (i.e. time horizon, covenants, subordination, commissions, grace period, etc.).
- **Would informed and willing third-parties have accepted similar conditions?**

Covid-19's market forecast. Expert's opinion

Different demand behaviors expected depending on the type of assets (logistics, malls, offices, hotels)
(CBRE, EMEA Real Estate Market Outlook 2020: midyear review)

Drops in rental income and occupancy, downgrading in asset valuations and downward revision of industry debt rating.
(Bankinter, Sector inmobiliario 4.27.2020)

Financing should be more difficult to obtain
(Amundi Asset Management - Investment Insights Blue Paper, Covid-19: Short-term pain, long-term opportunities for European commercial real estate)

CASE STUDY – Spain

Preliminary remarks on local regulations

Conditions applied

- Performance of a TP analysis following the OECD TP Guidelines:
  1. Analysis of the existence of **internal potential comparable transactions** (i.e. debt with independent financial institutions).
  2. In case of rejecting the internal potential comparable transactions → Identify **external comparable transactions (benchmarking)** using specialized databases:
     - Criteria: type of product (loans / bonds), granted amount, term and repayment conditions, borrower's region, credit rating[1], inception date, currency, subordination, covenants, fees (upfront, arrangement, annual, etc.), and guarantees.
     - In case of sufficiently large sample, possibility of applying additional criteria (i.e. industry).
  3. Make **comparability adjustments** if necessary (e.g. rates equalization considering the repayment conditions -APR-, "notching down" the borrower's credit risk to reflect specific asset higher risks, adjustments for periods of non-income generation [vacancy or development asset vs operational asset], or interest rate swap from variable to fixed).
- **Check the results** with the **overall market situation**:
  - Regardless an accurate application of the selected approach, it is strongly advisable **to check whether the results are sound and reasonable to the market situation at the time**. In case of relevant differences, those should be properly explained.
    - ✓ Special attention to build-up methodologies (initially selecting far more different products and making several adjustments), whose results could substantially differ from the ones obtained by initially selecting the most comparable transaction (usually observing higher and likely inconsistent results with the former than with the latter).
    - ✓ Substantially high interest rates (conceptually justified arguing higher risks) could lead to delineating issues, as the tax authorities can consider that a third-party would have not granted a loan under such high risks, requalifying the transaction into equity.

Covid-19's market forecast. Expert's opinion

Long-term interest rates will remain at historically low levels.
(CBRE, EMEA Real Estate Market Outlook 2020: midyear review)

[1] *Difficult to determine in new real estate companies without track record.*

CASE STUDY – Spain

Preliminary remarks on local regulations

- Also watch out **Spanish financial expense deductibility rules**:
  - Spain has had rules restricting the deduction of interest payments as from 2012, several anti-hybrid provisions as from 2015, and a general anti-abuse rule as from 2003, which are all deemed to comply with ATAD 1 (while the implementation of ATAD 2 is still pending).
  - Particularly:
    - **EBITDA rule**: Net financial expenses deduction for both third parties and related parties financing is limited to 30% of the borrower's EBITDA. Net financial expenses not exceeding (on a yearly basis) EUR 1 m are fully deductible. Excess may be deducted in subsequent tax periods with no time limit, always within the overall limits.
    - Specific restrictions on interest deduction apply to certain leveraged acquisitions of participations.

CASE STUDY – Luxembourg

Transfer pricing rules for intermediary financing activities

Snapshot of the legal framework:

- Luxembourg general TP rules are enshrined in the tax law. Specific guidance for entities that are engaged in intra-group financing transactions is also provided by circular n° 56/1 – 56bis/1 (the “Circular”) on the tax-treatment of intra-group financing activities. The Circular provides more guidance on the application of the arm’s length principle to intra-group financing activities, ensuring consistency with recent Luxembourg legislative developments and OECD transfer pricing standards.

Conceptual delineation

- Debt vs Equity
  - Analysis based on the economic and legal features of the instrument (voting rights, subordination, mandatory conversion, etc.)
  - For financing of participations, debt-equity ratio of 85-15 based on administrative practice (possibly subject to change further to the OECD new guidelines)
  - For financing activities, only LTV limit is the equity at risk determination under the Circular

Financing activities

- Pricing of arm’s length margin in a TP report
- Equity at risk determination depending on borrower/asset quality (ideally based on data supporting the interest rate determination)
- Substance requirements (BoD composition and competences, risk management process, etc.)
- Simplified regime for mere intermediaries

Q&A

SPEAKER PROFILES

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- Stephan Pfenninger has over 20 years of experience in local and international tax. His career path commenced as a corporate lawyer in Zurich. Later he moved as a tax advisor to Ernst & Young.
- Stephan has been a Partner at Tax Partner since 1998. Besides national and international corporate tax law, Stephan's activities are mainly focused on real estate tax matters. He is a tax advisor for listed and non-listed Swiss and foreign institutional real estate investors as well as for individual investors. Stephan is a speaker and lecturer at significant tax seminars, and has published various articles on international and national real estate taxation.

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- Hendrik Blankenstein is a Partner of Tax Partner AG and leads its Transfer Pricing team.
- Hendrik has been working as in-house tax counsel for a Swiss-based big multinational for almost ten years and has been providing transfer pricing advice for more than 15 years to Swiss and foreign multinational clients in a variety of industries, covering design of transfer pricing systems as well as negotiation and conclusion of unilateral / bilateral APAs.

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- François Lugand has been a partner at Arsene Taxand since 2005, where he manages the Real Estate department.
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- Miguel Hernández Ruiz is a principal associate in Garrigues' transfer pricing practice in Barcelona.
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