



REAL ESTATE FUND STRUCTURES

Impact of EU and US interest deduction limitation rules

TAXAND GLOBAL
Evert-Jan Spoelder (NL)
Gerriet Nagelhout (NL)
Francesco Cardone (ITA)
Petya Dimitrova (LUX)
Claire Lambert (UK)
Jay Helverson (US)

Your global tax partner

AGENDA

1. Introduction
2. EU ATAD2: general aspects
3. Country specifics
 - a. NL
 - b. LUX
 - c. UK
 - d. ITA
4. US interest deduction limitation rules
5. Closing remarks / Q&A

Evert-Jan Spoelder

Gerriët Nagelhout

Evert-Jan Spoelder

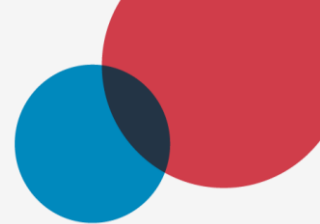
Petya Dimitrova

Claire Lambert

Francesco Cardone

Jay Helverson

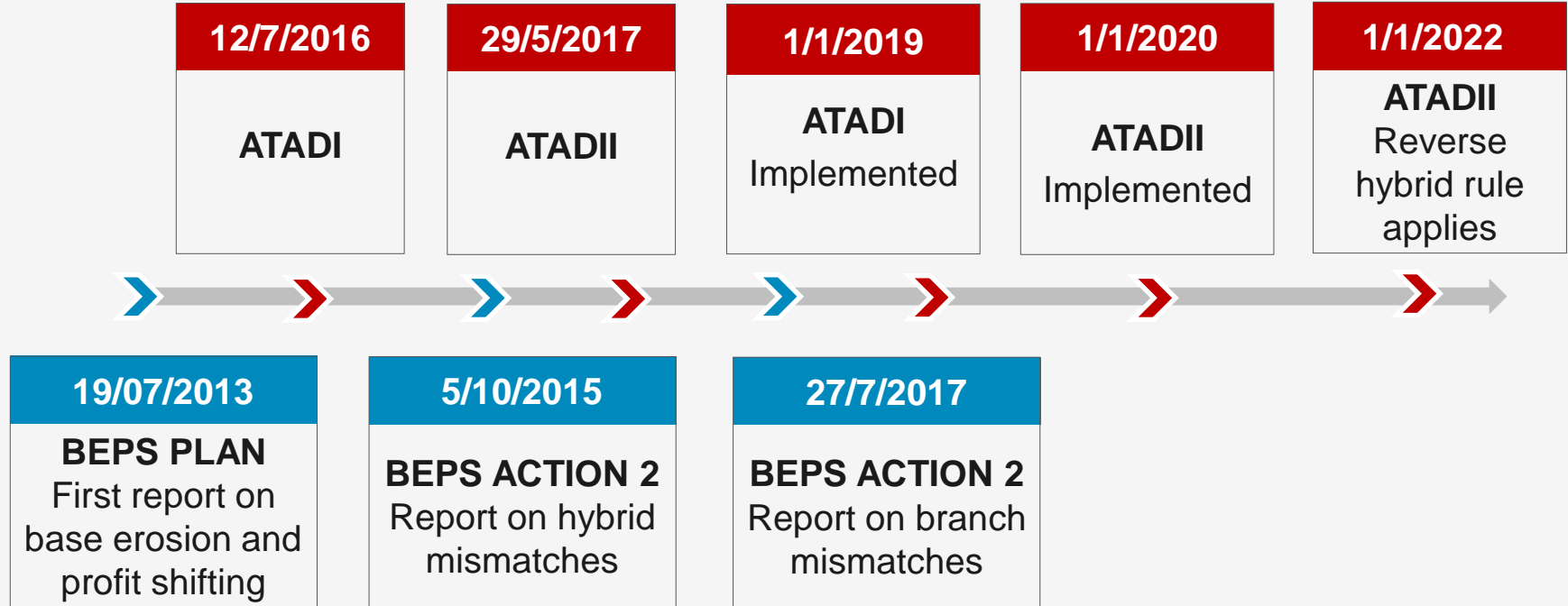
Evert-Jan Spoelder





1. INTRODUCTION

TIMELINE



HYBRID MISMATCHES



ISSUE

Non-taxation due to hybrids:

Differences in tax treatment of an entity or instrument in 2 or more jurisdictions

OECD SOLUTION

Neutralise tax effects by:

Changes to domestic law or changes to tax treaties

EU RESPONSE

ATADII:

To coordinate changes to domestic law of EU member states

US RESPONSE

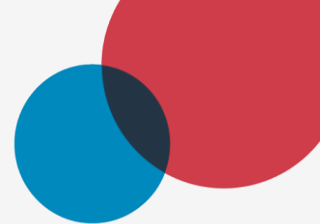
Regulations on hybrid arrangements:

Incorporation in Internal Revenue Code



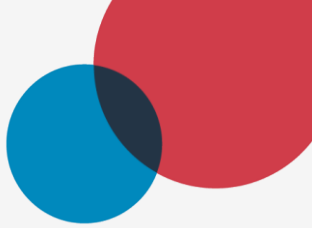
2. EU ATAD2

KEY FEATURES



- ❖ Eliminating tax benefits due to **hybrid mismatches**
- ❖ Difference in qualification (instrument) or allocation (entity)
- ❖ **Deduction of cost** and **no inclusion of income**; or a **double deduction of costs**
- ❖ Only applies to:
 - affiliated structures (including companies acting together)
 - head office and permanent establishment / permanent establishments
 - structured arrangements
- ❖ Solution: **denial of tax-deduction (primary rule)** or **income inclusion (secondary rule)**

KEY FEATURES



- ❖ Categories of mismatches:
 - Hybrid entity
 - Hybrid financial instrument & hybrid transfer
 - Hybrid permanent establishment
 - Imported hybrid
 - Dual resident

- ❖ Reverse hybrid rule

KEY FEATURES

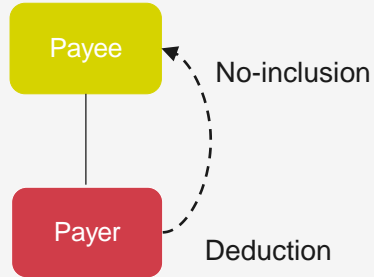


- ❖ Only in case of a hybrid mismatch, not in case of
 - timing differences
 - transfer pricing adjustments
 - tax status of the payee
 - tax exempt
 - resident in a no tax jurisdiction or a jurisdiction with a pure territorial tax regime

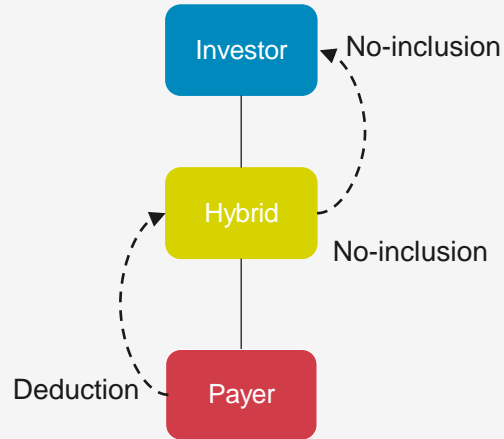
RELEVANT CATEGORIES OF MISMATCHES



HYBRID FINANCIAL INSTRUMENTS



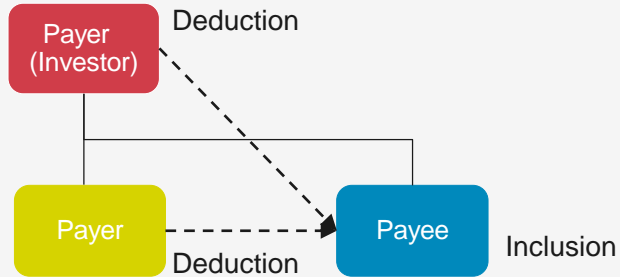
HYBRID ENTITIES



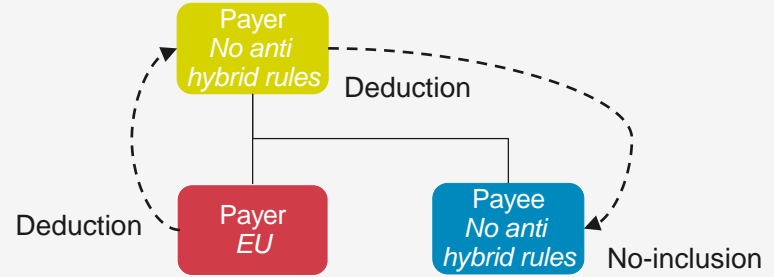
RELEVANT CATEGORIES OF MISMATCHES



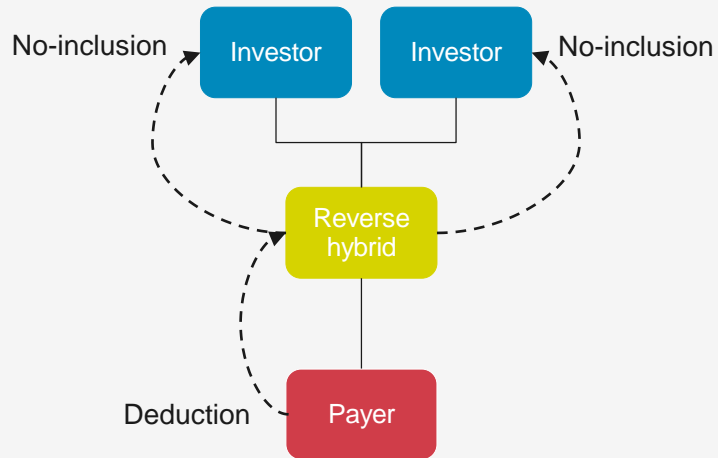
DOUBLE DEDUCTION



IMPORTED MISMATCH



REVERSE HYBRID



- ❖ Main rule of ATADII is eliminating the tax benefit
- ❖ As per 2022 exception to main rule by way of eliminating the cause of the mismatch
- ❖ Treated as taxable person in country of residence



3. COUNTRY SPECIFICS

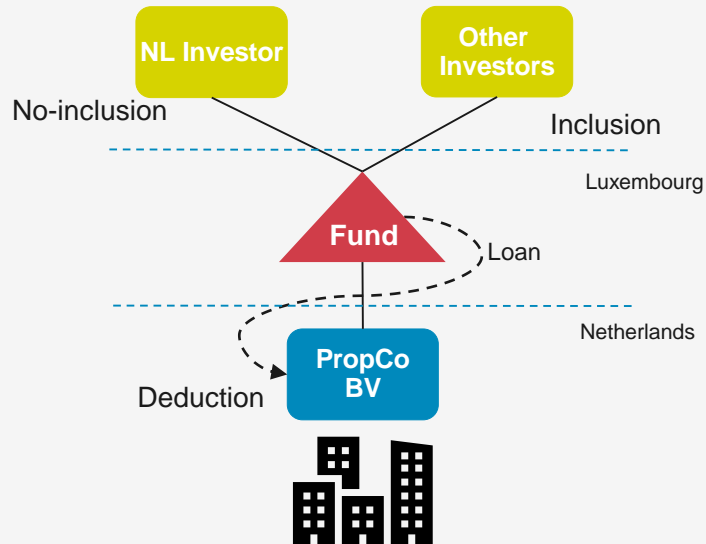
THE NETHERLANDS

DUTCH NUANCES TO ATAD II



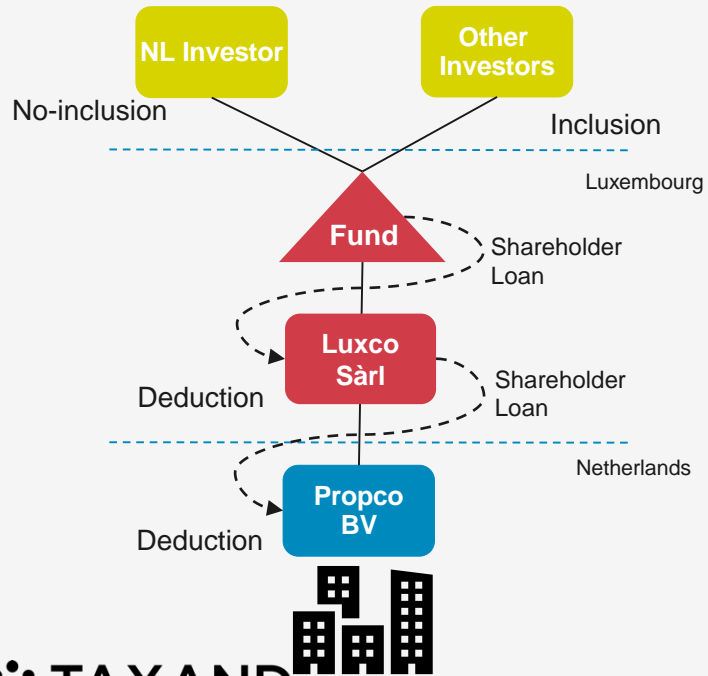
- ❖ Strict implementation
- ❖ No 50% threshold for affiliated entities, but 25%
- ❖ Dutch government introduced an obligation for taxpayers to document their anti-hybrid positions under ATAD II
- ❖ Wide application to **Dutch structures involving foreign partnerships**
 - ❖ Foreign partnerships: typically **non-transparent** from Dutch tax perspective
- ❖ Uncertainty when partners are considered **acting in concert**
- ❖ Documentation requirement

CASE STUDY: REAL ESTATE FUND



- ❖ Dutch partnership qualification rules: 'unanimous consent' on LP admission and transfers.
- ❖ Foreign partnerships > typically **non-transparent hybrid entity**.
- ❖ ATAD2 could apply in the case of a payment to foreign partnership: **no-inclusion** by NL investor.
- ❖ Complexities arise as a result of 'imported mismatch' (next slide)

CASE STUDY: REAL ESTATE FUND



- ❖ **Imported mismatch:** restriction of tax deductibility at NL BV level, *to the extent* not restricted at higher level
- ❖ Example:
 - ❖ Fund = hybrid entity
 - ❖ NL Investor: no-inclusion
 - ❖ Fund investors: ‘acting together’ for NL but not for Lux purposes
 - ❖ NL Investor: affiliated entity
- ❖ Conclusion:
 - ❖ NL BV impact on tax-deductibility of interest payments to Lux Sàrl
 - ❖ To the extent no adjustment is made at Lux level.
- ❖ Advance tax ruling



3. COUNTRY SPECIFICS

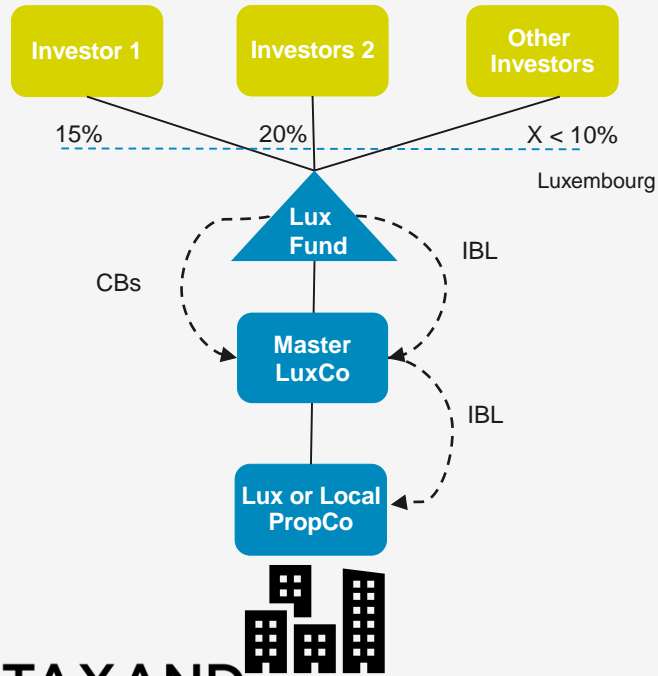
LUXEMBOURG

LUXEMBOURG NUANCES TO ATAD II



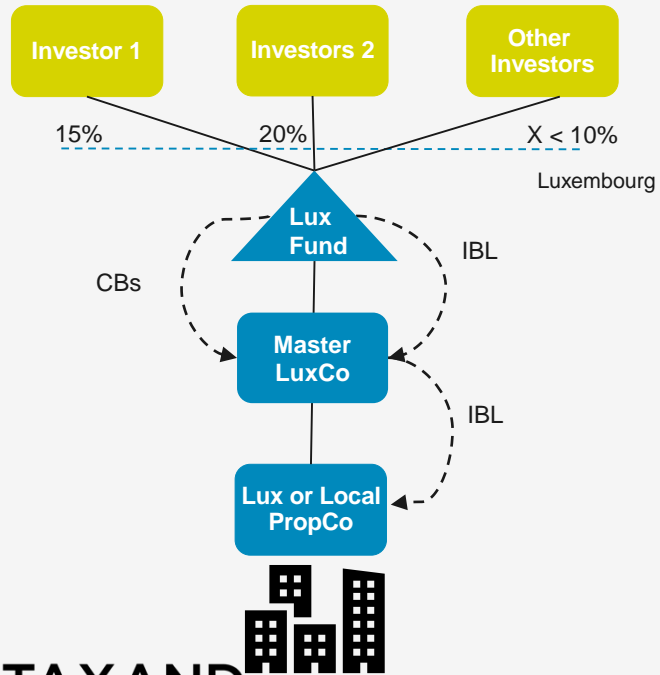
- ❖ Generally strict implementation of ATAD II rules into Luxembourg law.
- ❖ Definition of the concept “associated enterprises”:
 - 50% (directly or indirectly) link in terms of voting rights, capital ownership or profit entitlement
 - Entities that is part of the same consolidated group for financial accounting purposes
 - Concept of significant influence on the management
 - Reduced threshold of 25% in case of payments under a financial instrument
 - Potential aggregation of interests in accordance with the concept of acting together: Luxembourg has introduced a “de minimis rule” in a Fund context. Funds are defined as collective investment vehicles which are created for the purpose of gathering investors’ capital and investing that capital in a portfolio of assets in accordance with a defined investment policy for the benefit of those investors.
 - Where an investor owns $x < 10\%$, it is assumed that investors are not acting together, unless proven otherwise (burden of proof is on the tax authorities).
 - Where an investors owns at least 10%, it has to be analysed on a case-by-case basis (burden or proof is on the taxpayer). However, there is no presumption that investors with 10% or more investments would be acting together.

CASE STUDY



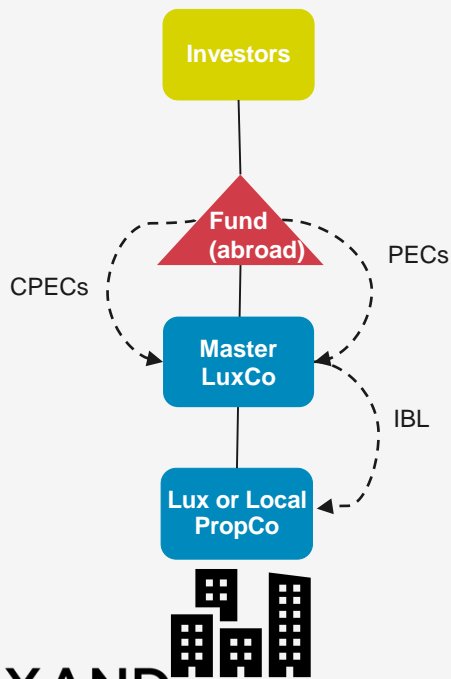
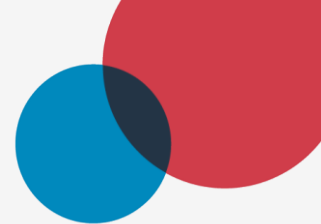
- ❖ Luxembourg Funds in the legal form of a SCS(p) or FCP may give rise to a hybrid mismatch when the vehicle is classified as opaque from the perspective of the investors
- ❖ Is the related party test met (including acting together analysis)?
 - ❖ No presumption that the investors are acting together exist but the analysis are to be carried out on a case by case basis. Investor 1 and 2 should demonstrate that they are not acting together with the other investors.
- ❖ Is the payment included in ordinary income at the level of at least one payee (including application of the CFC rules)?
- ❖ Tax status of the investors (tax exempt taxpayer, resident in a no tax jurisdiction or a jurisdiction with a pure territorial tax regime)?
- ❖ Taxation upon a future distribution by the Fund may not suffice to discharge the application of the hybrid mismatch rules

CASE STUDY



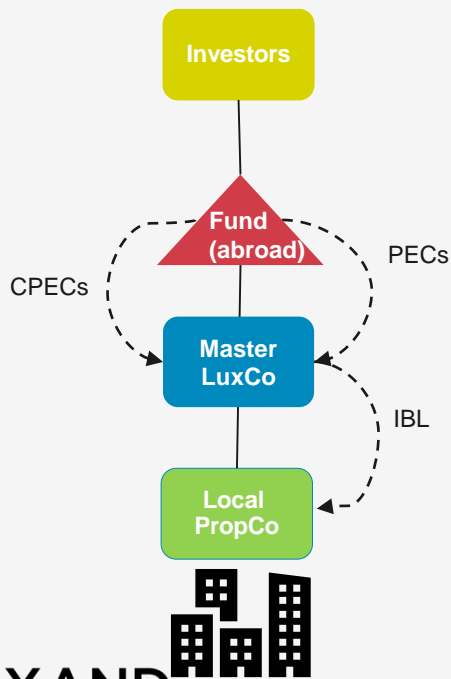
- ❖ Excluding the application of the hybrid mismatch rules:
 - ❖ Investors are exclusively resident in jurisdictions that classify the Luxembourg fund as transparent?
 - ❖ Investors are not associated enterprises that own 50% or more in the fund?
 - ❖ Does the tax status of the investors discharge the application of the hybrid mismatch rules?
- ❖ When the hybrid mismatch rules apply, the tax adjustment should not be more than necessary to neutralize the hybrid mismatch outcome
- ❖ Imported mismatch rule is to be monitored in the investment jurisdiction

CASE STUDY



- ❖ Foreign fund structures are often driven by US investors
- ❖ Given the particularities of US tax law such investment structures may involve different types hybrid mismatch arrangements
- ❖ Financing through hybrid financing instruments such as CPECs and PECs
- ❖ Hybrid entities in view of check-the-box elections for US tax purposes

CASE STUDY



- ❖ Example:
 - ❖ US investors hold together more than 50% of the Fund
 - ❖ Fully taxable status of US Investors
 - ❖ MasterLuxCo and PropCo elected to be disregarded for US tax purposes, therefore are considered as hybrid entities
 - ❖ Income included in the US taxable basis is rental income, financing instruments being disregarded.
- ❖ Hybrid mismatch consequences in Luxembourg:
 - ❖ Risk of non-deductibility of interest expenses at the level of MasterLuxCo
- ❖ Exclusions from the hybrid mismatch rule – Dual inclusion income?
 - ❖ Rental income included in the US and interest income included in Luxembourg
- ❖ The imported mismatch rule is to be monitored in the investment jurisdiction



3. COUNTRY SPECIFICS

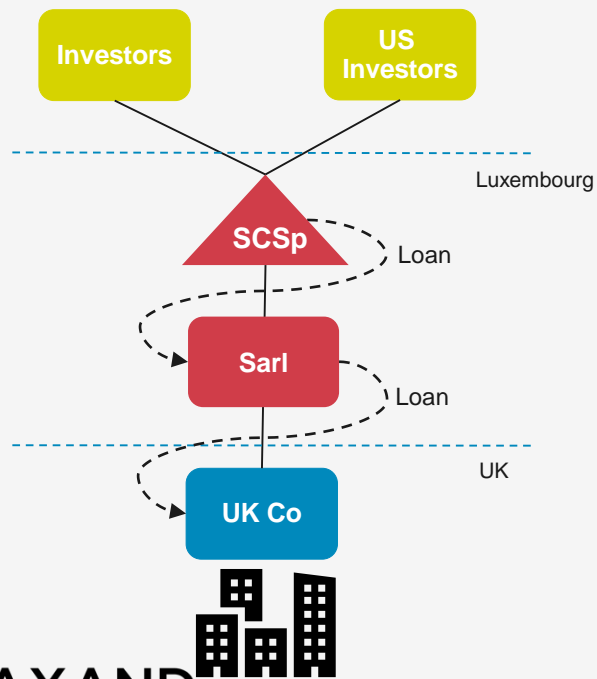
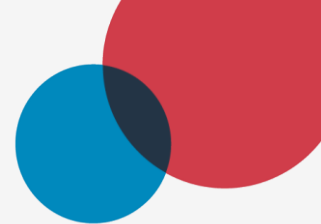
UNITED KINGDOM

UK NUANCES TO ATAD II



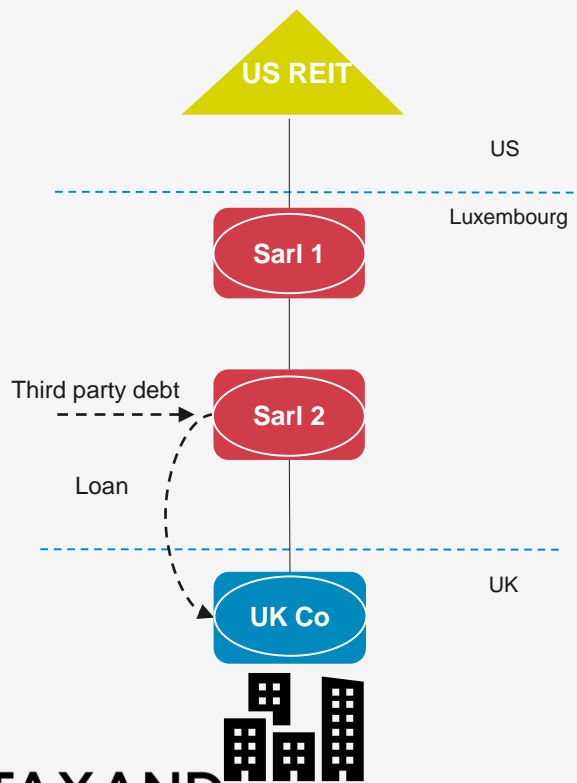
- ❖ The UK actually implemented anti-hybrid rules as a result of the BEPS recommendations (so prior to ATAD) effective 1 January 2017
- ❖ Comprehensive implementation including imported mismatches and reverse hybrids from the outset (nearly 50 pages of legislation and 460 pages of guidance)
- ❖ Minor amendments made to provisions to be compliant with ATAD
- ❖ Related person - 25% test – applies to hybrid financial instrument test
- ❖ Control group - 50% test – applies to all other tests
- ❖ Comprehensive acting together provisions
- ❖ In a real estate context, these rules only apply to non UK resident corporate owners of real estate from 6 April 2020. UK resident corporate real estate owners have been in the rules since 1 January 2017.

CASE STUDY



- ❖ Imported mismatch: restriction of tax deductibility at UK Co level, *to the extent* not restricted at higher level
- ❖ Example:
 - ❖ SCSp = hybrid entity for US investors if treated as opaque
 - ❖ US Investor: no-inclusion
 - ❖ Control group definition applied to the relationship between the UK Co and the “payer” under the imported mismatch – so Sarl
 - ❖ Irrelevant that US investors may only own a small percentage (regardless of any acting together provisions)
- ❖ Conclusion: UK Co impact on tax-deductibility of interest payments to Sarl, to the extent no adjustment is made at Lux level.

CASE STUDY



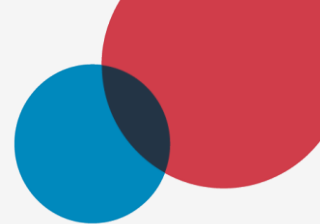
- ❖ Imported mismatch: restriction of tax deductibility at UK Co level, *to the extent* not restricted at higher level
- ❖ Example:
 - ❖ UK Co, Sarl 1 and Sarl 2 are hybrid entities as checked transparent for US tax purposes
 - ❖ Sarl 2: “double deduction” as Lux and US taking deduction on interest on external debt
 - ❖ Can fall outside rules if double deduction set against dual inclusion income
 - ❖ Lux sets against interest income relating to on-lending but US sees it all as transparent so no dual inclusion income
- ❖ Conclusion: UK Co impact on tax-deductibility of interest payments to Sarl 2, to the extent no adjustment is made at Lux level.
- ❖ May be possible to fix for US exempt REIT investors (but not if taxable businesses due to anti avoidance)



3. COUNTRY SPECIFICS

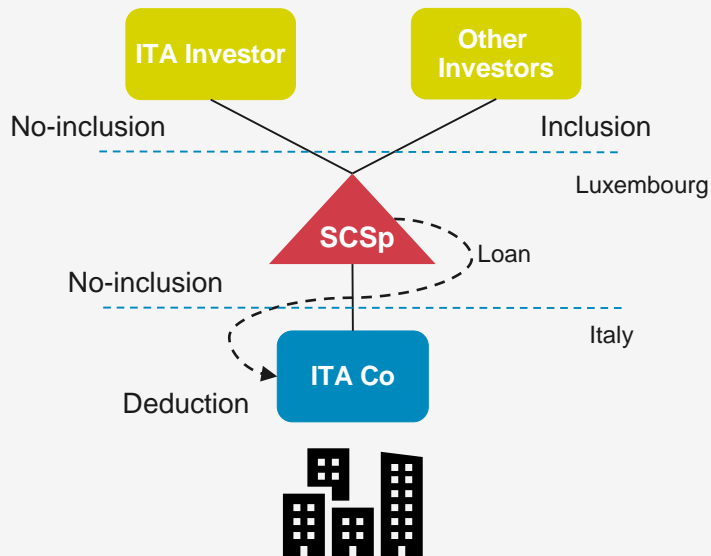
ITALY

ITALIAN NUANCES TO ATADII



- ❖ **Implementation in Italy:** in line with ATADII. Italian tax authorities' guidelines not published yet
- ❖ **Main departure:** the notion of taxpayer is broader since it includes also business partnerships (transparent under Italian tax law) and individual entrepreneurs
- ❖ **Associated enterprise:** 50% threshold reduced to 25% for hybrid financial instruments
- ❖ **Acting together:** for the purposes of the associated enterprise definition, voting rights or capital ownership of persons acting together shall be aggregated
- ❖ **No reverse hybrids in Italy:** the reverse hybrid mismatch rule should not apply in Italy because income related to transparent entities established in Italy is attributed to the non-resident investors and taxed in Italy in their hands
- ❖ **Potential foreign reverse hybrids:** Italy considers foreign entities with or without legal personality as taxable entities
- ❖ **Documentation requirements**

CASE STUDY

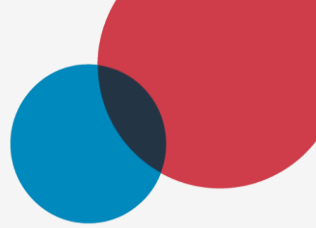


- ❖ Hybrid mismatch: restriction of tax deductibility at ITA Co level, *to the extent* not restricted at higher level
- ❖ Example:
 - ❖ SCSp: hybrid entity
 - ❖ ITA Investor: no-inclusion
 - ❖ SCSp Investors: 'acting together' for ITA but not for Lux purposes
 - ❖ ITA Investor: associated enterprise
- ❖ Conclusion: ITA Co impact on tax-deductibility of interest payments to SCSp, to the extent no adjustment is made at Lux level
- ❖ The application of hybrid mismatch rules should result in an outcome that is proportionate and that does not lead to double taxation
- ❖ Documentation requirement



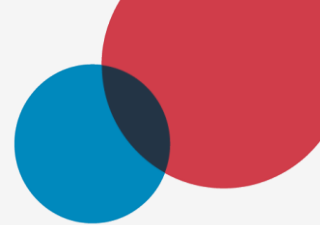
4. US INTEREST DEDUCTION LIMITATION RULES

US ANTI-HYBRID RULES



- ❖ Statutory changes were made as part of US tax reform in December 2017. Final regulations in place April 2020 with retroactive effect for many provisions. Regulations track BEPS Action 2 to a great extent.
- ❖ Deductions for Amounts Paid or Accrued Pursuant to Hybrid Arrangements. No deduction is allowed for any disqualified related party amount (interest or royalties) paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. Focused on deduction / no-inclusion outcomes (D/NI). Examples:
 - Hybrid Transactions. Instrument treated as debt for US purposes but as a dividend to the foreign shareholder with a corresponding participation exemption.
 - Hybrid Entities or Branches. Interest or royalty is paid by an entity that is treated as disregarded for foreign purposes; or the income is otherwise not included; or where a deduction is available under fiscal unity or similar principles.
 - Recipient must be related (>50%) unless the recipient is a party to a “structured arrangement.”
 - The hybrid mismatch is priced into the terms of the arrangement; or the hybrid mismatch is a principal purpose of the arrangement. Principal purpose may be evidenced by marketing the tax-advantage; targeting investors from certain countries; a below-market return absent the hybrid benefit.
 - General Anti-Avoidance Rule. Payment is not included in income of a tax resident; and a “principal purpose” of the plan or arrangement is to avoid the purposes of the regulations

US ANTI-HYBRID RULES



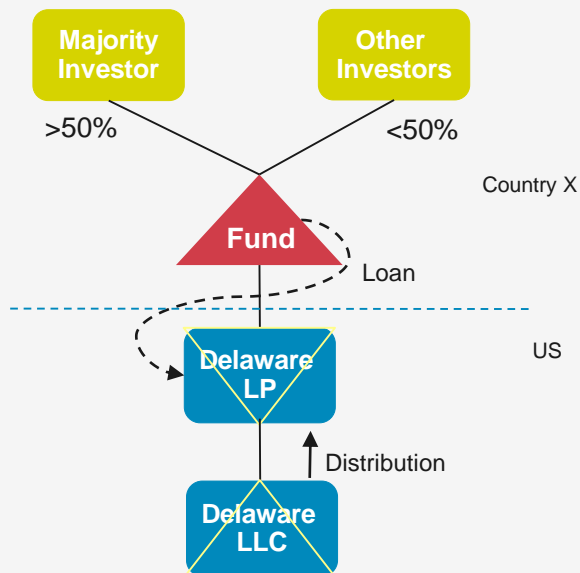
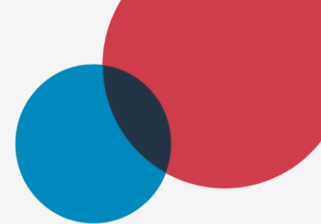
- ❖ Payments by Domestic Reverse Hybrids. May result in the denial of a deduction and/or the inability to use a loss carryforward.
 - 2002 Regulations. If: (i) a DRH receives a payment from a related party that is treated as a dividend under either US tax law or the tax law of a foreign interest holder; and (ii) the DRH makes an otherwise deductible payment (e.g., interest) to a related foreign interest holder – then the payment by the DRH is recharacterized as a dividend – which is nondeductible and potentially subject to a higher treaty rate of withholding.
 - 2020 Regulations. If a domestic pass-through entity elects to be treated as a corporation under the “check-the-box” rules, it is deemed to consent to be treated as a “dual resident corporation” under the existing “dual consolidated loss” (DCL) rules. This means:
 - If a foreign related owner uses or can use the loss outside the US, then the DRH may not use the same loss to offset income from another US corporate entity (e.g., in a consolidated group).
 - The DCL also cannot be used against income in a transparent entity that flows up to the DRC if the entity is opaque for foreign tax purposes (e.g., often the case with US LLCs).

US ANTI-HYBRID RULES



- ❖ Hybrid Dividends. May result in the denial of a deduction and/or the inability to use a loss carryforward.
 - If a US corporate shareholder receives a hybrid dividend from a CFC then no dividends received deduction (akin to a participation exemption) is allowed.
 - A hybrid dividend may arise where the CFC can claim a deduction or other tax benefit with respect to an instrument issued by the CFC and treated as stock for US tax purposes

CASE STUDY



- ❖ Delaware LP has elected to be treated as a corporation for US tax purposes; Delaware LLC is by default treated as pass-through for US tax purposes.
- ❖ If Loan is treated as equity for Country X purposes, interest deduction may be denied with respect to the amount allocated to the >50% (related) Investor; deduction may also be denied if Country X applies another no-inclusion principle based, for example, on the pass-through treatment of Delaware LP.
- ❖ Deduction may be denied entirely if there is a structured arrangement.
- ❖ If LLC is opaque for Country X purposes, interest may be recharacterized as an outbound dividend.
- ❖ Dual consolidated loss rules may prevent Delaware LP from using NOLs against income of LLC if LLC is opaque for Country X purposes.



5. CLOSING REMARKS

-
Q&A