

Building opportunities

The real estate crash is creating tax opportunities for Luxembourg, writes Pierre Kreemer, of KPMG

The current financial and economic turbulence has direct consequences for real estate fund structuring. Meanwhile, trends in investment strategies have generated tax-planning opportunities.

The previous years have been characterised by one main mechanism of financing for real estate investments: the so-called maximum leverage. Real estate promoters/investors used to have recourse to extensive external funding, with banks eager to lend.

In twelve to 18 months, however, the economic environment has changed dramatically and completely deteriorated. Real estate is currently seen as a deflation sector.

The dislocation in the global financial market and loss of faith in banks' capacity to lend are two reasons bringing about a reassessment of the design and tax efficiency of real estate investment structures. Although investors may have cash available, they are all waiting for good opportunities to invest. In such an environment, where availability of credit is no longer guaranteed, making cash available – being 'cash-able' – has become the top priority.

Companies best positioned to respond to market changes will be those which will take advantage of the opportunities thanks to their ability to make cash available. This is really becoming a strategic competitive advantage for real estate funds as some of them have suffered from redemptions and banks seem to be very concerned by the ability of borrowers to generate sufficient cash flows.

Restructuring

Given current circumstances, and to remain competitive, real estate funds are obliged to restructure so they are ready to invest as real estate prices become more attractive. To stay competitive is difficult for some real estate funds; due to the crisis, tenants are trying to negotiate lower rents and at the same time the cost and ability to obtain finance is extremely challenging.



While waiting to fully benefit from the opportunities that will arise when cash is available, funds are finding new ways of diversifying their financing sources

Therefore new behaviour is emerging. Some real estate funds intend to collaborate with their competitors through joint ventures in order to strengthen the equity base for new projects. Other funds have decided to implement their structures in different steps: initially investing through equity funding the project, and then looking to obtain external financing as soon as the credit market becomes attractive.

While waiting to fully benefit from the opportunities that will arise when cash is available, funds are finding ways of diversifying their financing sources. Many funds are looking to expand the number of banks providing financing. Some funds intend to use new financing instruments such as Sharia-compliant debt instruments available on the Islamic market.

Sovereign wealth funds (SWFs), savings companies and pension funds are becoming key actors for the real estate market as a source of equity. These investors, who do not necessarily need external sources to invest, definitely conform to a long-term perspective. Even the credit market could be impacted. SWFs, pension funds and savings companies could, under certain circumstances, act as banks as a source of financing for real estate projects.

Deleveraging transactions (where part or all of the external debt is replaced by internal financing or equity funding) are becoming common as they respond to the commercial need to reduce funding costs from external lenders.

Acquiring or restructuring real estate debt is certainly also an area of focus. There is an increasing trend towards products being developed that have real estate debt as their asset class. Opportunities will be seized to buy real estate debt at a good price from struggling banks. These new projects frequently take the form of securitisation vehicles.

The activity on the commercial mortgage-backed securities (CMBS) market has drastically reduced, but is becoming more attractive due to the dramatic fall in value of some real estate assets.

Tax opportunities

For real estate funds, efficient tax structuring is more than ever at the heart of the debate, being clearly part of the overall return of real estate projects.

In an environment where profitability is not guaranteed, investors are focusing on possibilities to reduce real estate transfer tax; however, it will often remain a significant direct cost.

Share-deals – where rather than selling the property directly the asset is held by a company, special purpose vehicle (SPV), and the shares in the SPV are sold – will undoubtedly continue to be one of the most frequently used means of changing ownership of real estate.

The move from less external debt towards internal funding, as well as profit repatriation (exit) mechanisms, should be closely examined to ensure that thin-capitalisation rules are respected.

Investing in real estate distressed debt with the view to improving the borrowers' financial situation leads to tax planning opportunities as it will be important to manage current income tax as well as any future realised gain from the distressed debt.

Luxembourg's role

Luxembourg will remain an attractive place for business, both for regulated and non-regulated real estate funds. Due to recent events, some investors may seek more regulation, while opportunistic funds and investors wishing to keep regulation costs down may prefer to keep the flexibility and reduced costs of unregulated structures.

Among the Luxembourg regulated vehicles, specialised investment funds (Sifs), under the form of Sicav or FCP, and perhaps to a lesser extent Sicar, will continue to be launched.

The Luxembourg securitisation vehicle, being widely used for investment in distressed

debt, should be particularly attractive for structuring the acquisition of real estate debt at a discount. It will be important to analyse, monitor and follow during implementation the specific VAT and regulatory aspects of these securitisation structures.

The Luxembourg fully taxable company (the Soparfi) also has a bright future. The Soparfi remains an efficient vehicle for unregulated funds, and also when combined with Sif, Sicar and securitisation vehicles. Investors in a Soparfi (either directly or indirectly through a regulated Luxembourg vehicle) should continue to benefit in a flexible and tax-efficient manner (mainly through debt funding of the Soparfi) from regular revenues and realised gains without suffering withholding tax.

If the main part of a real estate structure were to be financed via equity by fully taxable investors, the use of convertible instruments could also be interesting. Such instruments would under certain circumstances allow a tax deduction in the hands of the borrower and be tax exempt for the Soparfi, in application of the 'substance over form' tax principle.

From 2009, the reduction of the income tax rate from 29.63% to 28.59%, the abolition of capital duty, as well as the introduction of withholding tax exemption for dividends distributed to corporate taxable shareholders located in treaty jurisdiction (should the receiving company be subject to an effective rate of at least 10.5% for 2009), are positive measures, which improve Luxembourg's pro-business and investor-friendly tax regime. The impact of such measures for real estate funds is, however, likely to be limited.

Luxembourg's ever expanding double-tax treaty network should positively impact the attractiveness of Luxembourg, especially for the regions which remain interesting for real estate investments. Asia continues to be an attractive place for business to the extent that it is predicted to grow, even if such growth is less rapid than foreseen. The recent ratification of the double tax treaty with Hong-Kong should lead to increased tax planning opportunities.

As so often in times of crises, only investors who have the capacity to innovate and adapt to the market conditions as well as asset managers who have a proactive asset management strategy, will be the best positioned to extricate themselves from the crisis. ■

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