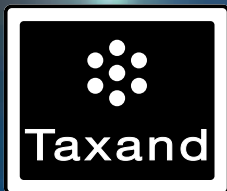




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FOR THE WORLD'S PRIVATE REAL ESTATE MARKETS



THE 2012 GLOBAL GUIDE TO TAX

A special supplement to *PERE* magazine

IT'S COMPLICATED

Taxanders see more joint ventures and club deals in Europe

TAX ANGST

Capital gains, beneficial ownership issues to cause anxiety

TOTAL TAX TAKE

Taxand's T3 data evaluates even more markets

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Experts in your corner



Welcome to the *2012 Global Guide to Tax*, our third annual supplement on tax issues around the globe. Once again, we have combined our editorial resources with the expertise of Taxand to provide you with in-depth analysis from key markets around the globe and an overview of the biggest issues concerning private equity real estate and the tax man.

As you will discover from this year's guide, it seems there are forces at work – unstoppable ones, at that – conspiring to make governments scrutinise almost every real estate transaction. The ultimate aim, of course, is to derive as much revenue as possible and bolster national banks' coffers. Indeed, those vaults are looking mighty empty in many jurisdictions, and they are not going to fill themselves!

In this guide, however, you will find indispensable intelligence on what is happening on the ground in numerous jurisdictions around the globe. Not only do we provide overviews of tax issues in select major markets, we also bring you insight from regional leaders on issues across multiple jurisdictions. All that insight and analysis is capped off by Taxand's proprietary T3 research, an easy-to-digest comparison of the world's tax-take for commercial and residential properties.

One of the key themes – beneficial interest – can be found throughout our coverage. It is introduced by Keith O'Donnell, Taxand's global head of real estate, on p 2 and figures most prominently in our feature on capital gains, starting on p 14. In some cases, the hard-line approach of local tax authorities has dictated that the ultimate 'beneficial interest' in a company belongs to a limited partner in a fund thousands of miles away from the actual asset. In appropriate cases, unfair, illegal or just plain-wrong stances are being challenged by Taxanders on behalf of clients.

Within this guide, there are various other issues of which the modern-day private equity real estate firm needs be mindful, but let's be realistic: the firms that operate in this theatre do so because they firmly believe they can outperform peers and deliver on promises made to investors. By nature, they are confident, glass half-full people, and they won't let tax issues get in the way of successful investing. Still, more so than ever, they need to be cognisant of it.

We are confident this guide will help provide that extra edge over the competition and help fund managers to keep the tax man at bay.

Enjoy the guide,

Robin Marriott
Editor, *PERE*
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Force majeure

Keith O'Donnell, head of real estate at Taxand, explains how forces beyond Taxand's control have been driving the nature of its work

Keith O'Donnell, Taxand's head of real estate, may be overseeing a global team that is successfully finding solutions to minimising tax for real estate investors and their fund managers, but there is one thing he can do little about: the force of the market.

Luxembourg-based O'Donnell, who is in charge of a team whose global reach covers nearly 50 countries worldwide, said many regions around the globe are in financial distress. It is little wonder then that countries are working overtime to challenge tax structures that may work within the law but are designed to get as close to zero percent tax as possible.

Another factor the team can do little about is the way fewer classic blind-pool opportunistic real estate funds are being created at the moment. Instead, Taxand's global real estate tax team has been presented with structuring vehicles that behave more like individual mandates. Typically, these might concern a sovereign wealth fund enlisting the help of a manager to manage a portfolio. Certain structures might involve a handful of large pension funds glued together in a quasi-club vehicle.

O'Donnell says: "Four years back, we were designing fund structures that were made to appeal to the widest range of people. You couldn't please everyone, though we found something that worked reasonably well for most investors from a tax perspective. There were various standard models that developed in the market, from Luxembourg fund structures to UK limited partnerships. I think what has happened now is that investors are saying, 'We can't have something that is good on average; we want something that works for us.'"

As a result, Taxand has been involved in some fairly complex tax structures (the details of which can be found in the European feature, beginning on page 7). For the uninitiated, here is a teaser: if you thought it would be easier to structure a tax-efficient club deal than a large closed-ended real estate fund with 20-plus investors, think again. Instead, such structures need the pilot to punch a lot more buttons in the tax cockpit.

Club deals (notwithstanding the possibility they might be a short-term trend) are something that Taxanders are having to manage but can do little about in terms of the reasons why they have become popular. Similarly, they cannot stop the way tax jurisdictions are going to some lengths to prevent tax-free investments in some cases.

One example is the way some countries are dealing with 'beneficial ownership'. Ordinarily, an investor in an underlying fund would be able to claim exemption from a withholding tax on its dividend, assuming the existence of a treaty involving the country where an asset is located and the coun-

try where the fund is located. But in an ugly development for investors – and therefore fund managers – jurisdictions are rearing up on this issue if they perceive that the 'company' claiming it is the beneficial owner of the dividends isn't really the beneficial owner at all. Instead, the tax jurisdictions might argue the beneficial owner would be the underlying investor from, say, a Middle Eastern country, which has no tax treaty benefit with the country where the asset is located.

This is an area where Taxand is stretching the rubber band. Says O'Donnell: "Beneficial interest is written into most treaties dealing with dividends and interest, and there has been quite a bit of litigation concerning international structures."

Such issues make nonsense of 100 years of global capital markets, but at least transactions are happening to invite such scrutiny. As transaction volumes begin to pick up, even



"There is a simple equation to master: cash-strapped governments + real estate = a need for early tax planning."

Keith O'Donnell
Taxand

emerging markets are seeing some activity. Russia is perhaps the clearest example, although Taxand also has advised on a transaction in Slovakia and is working on another in Hungary.

"There is evidence that people are prepared to go back to markets where the yields are attractive enough," says O'Donnell. That said, a recent focus on government finances around the globe is shifting the perception of what is considered a 'safe' country to invest in. Combined with a healthier pipeline of deals in the more traditional markets of Asia, the US and Western Europe, it means that fund managers and their investors are going to want to find ways to squeeze every last tax point out of a deal in these challenging times.

The key message is that there is a simple equation to master: cash-strapped governments + real estate = a need for early tax planning. □



Tax window still open in distressed

Governments are raising rates and closing loopholes, but opportunities remain for now

With governments around the globe undecided on how best to craft tax policy for distressed real estate, many are moving to raise rates or close loopholes. However, those efforts are just getting under way, and they are opposed by those who argue tax incentives could foster development and rehabilitation in many areas. While the debate accelerates, advisors are urging investors to sharpen their pencils and find the best opportunities while they can.

In the US, the problem is not that tax law and policy hamper investment in distressed real estate, rather it is that law and policy have fallen badly behind the rapid advances in financial markets. “There is no intention to discourage investment, but tax is definitely a limiting factor in that a lot of policy issues related to troubled property have been on the books for a long time,” says Frank Walker of Taxand US. “Much of it comes from the 1980 Bankruptcy Acts. Some of the provisions that have to be interpreted never envisioned the financial changes that exist today.”

For example, Walker reports that there have been legislative relief efforts in the area of treating cancellation of debt as income. Mostly, that has come as part of efforts to clear the huge overhang of foreclosed houses, but he says there could even be some benefit to commercial real estate. “The temporary work-out provisions expired last year, and neither lenders nor borrowers are as far along as they would like to be in the residential side,” he adds.

With Congress at loggerheads, Walker commends the staff at the Treasury Department for doing what they can to keep

current with distressed property. “The department and the Internal Revenue Service have made an effort to provide some limited relief through notices and revenue procedures,” he says, “because there is not much hope for a legislative solution.”

There would be more regulatory relief, Walker adds, except that officials are always cautious about unintended consequences. “Giving guidance in what might seem like a clear case could give some unwanted benefit somewhere else.” It is a classic case of the persistence of interim solutions.

In previous downturns, offshore buyers have often come to the rescue, but that has been less prevalent in this crisis in part because “foreign investors in real property can find long-term capital gains taxed in the US even if they are not in their home country,” Walker explains.

One other snag, Walker notes, is that the IRS “is taking a very broad interpretation of what it considers public debt. Instruments bought and sold among many types of entities are being included, even if the instruments are not traded on a registered market.”

Hampered by harmonisation

Germany is another nation with a large volume of distressed real estate, but Ulrich Siegemund of Taxand Germany says tax burdens there are not as great as in other countries. “There may be even more than is perceived because the banks have held back on delinquency notices. Taxand Germany has been involved in quite a few transactions.”

For many years, the German real estate market has been

dominated by pension funds, especially on the commercial side, so the most common distressed properties are large portfolios and, more recently, hotels. “There are eight to 10 urban centres around the country with distressed properties,” says Siegemund.

Investors doing business in any member nation of the European Union benefit from the harmonisation efforts of recent years, but Siegemund notes that there have been some missteps. “Germany had a provision where loss carry-forwards for corporations were retained in changes of ownership, but the EU called that discrimination so the law was voided.” Now losses are lost at transfer.

Another area of complication, Siegemund explains, is in additional equity or reduction of liabilities. “If the benefits come from a third party, that is clearly treatable as income. But in some cases, additional equity from shareholders or forgiveness of liabilities is considered income for tax purposes.”

There is little initiative to change the current rules, Siegemund reports, even though there are rough patches like the two cited. Quite to the contrary, he adds that the recent trend has been to increase tax rates, especially transfer taxes.



“The main trend to solve government revenue problems is to collect more tax overall.”

Francois Lugand
Taxand France

“It used to be that there was a set federal rate of 3.5 percent,” says Siegemund. “That tax was shifted to the states, and now 12 of the 16 have increased the rate. It now ranges from the old 3.5 percent up to 5 percent.” He notes that 150 basis points may not sound like much of a change, but it amounts to a 40 percent increase and on multi-million dollar deals it certainly can add up.

While distressed real estate in the US and EU has gotten extensive coverage, the economic crisis in Greece has gotten blaring headlines. “There are indeed opportunities in Greece as values are very low,” says Marina Allamani of Taxand Greece. And while there are distressed properties in every city and region of the country and every category of real estate, the focus for the government at the moment is the priva-

tisation of public properties.

“Public buildings that are no longer in use are being offered to investors from anywhere in the world,” Allamani says, adding that the tax laws neither discourage nor encourage investment in distressed properties.

There are two impediments, however, to investors snapping up the deals—and bringing much-needed capital into the struggling country. One is the reticence of banks to lend, even to well-capitalised borrowers. “In 95% of cases, a bank is involved, and they have just stopped offering loans,” Allamani says. “Some have begun to be more active, but not many.”

The other problem is simply identifying properties and then finding the owners. There are no central listings or clearinghouses even for real estate on the market. And even for buyers willing to drive around to spot likely properties, “it is a very complex legal practice to check on properties and get to the point of making a deal,” Allamani says.

Seoul survivors

On the other side of the world, the problems are the opposite. Korea has a well-ordered financial and real estate market, so finding suitable investments and getting to the table are not a problem. It’s just that not many people, even in the country or across Asia, know that there is a pool of distressed properties in Korea.

“Project financing has gone sour and quite a few savings banks are in trouble—mostly because they invested in real estate projects,” says Stephan Kim of Taxand Korea. “The government has tried to lift the whole real estate market, but it has not gotten specific in areas like tax treatment.”

Overall, there is not much special treatment one way or the other for distressed real estate, with one important exception. “Historically the government has discouraged individual investment in real estate,” says Kim. “The maximum tax rate on most sources of income is 38 percent, but it was 40 percent to as high as 50 percent on individuals who realise a capital gain on anything more than a second property. Just recently, that was changed to eliminate the tax penalty.”

There are other countries where the real estate markets are not in big trouble, but savvy investors always seek diversification and can find bargains almost anywhere. Most markets in France are doing well, says Francois Lugand of Taxand France. That said, Paris is grappling with steep deficits as are most other governments on the Continent, and that creates pressure to increase tax collections; if not actual rates, at least through enforcement and closing loopholes.

“The main trend to solve government revenue problems is to collect more tax overall,” Lugand says. “There is a special commission on loopholes and tax incentives. It has been estimated that the government loses €1 billion per year through those.”

In another case, the spectre of harmonisation strikes again: French tax law currently offers rather flexible rules on operating losses. Lugand reckons that new limitations on the use and

transferability of those losses are likely. Germany tightened rules on use and transfer of operating losses several years ago, and France is likely to come into alignment.

In the commercial sector, the retail segment has over-performed, but there is some distressed property in a few areas. “Rates were very high before the recession,” Lugand notes. “Also, there are many new regulations on environmentally friendly buildings, which mean many offices are not in compliance.”

Despite the lack of bargains, Lugand emphasises that France has “strong and concentrated markets that are very transparent, a secure tax and legal regime and rules that allow international investors to minimise what seem to be heavy rates at first glance.”

De-Lux accommodations

If France offers a concentrated market, then Luxembourg is the refined essence. Indeed, both French insurance companies and German pension funds consistently are major investors. To be sure, there is not a lot of distressed property in the duchy, simply because there is not a great deal of geography in the tiny nation.

“The government is very aware of their international position and is quite careful,” says Keith O’Donnell of Taxand Luxembourg. “They do not feel it is legitimate to impose a large tax burden on investors. Distressed real estate is just another investment under the tax regime, whether for an income stream or capital gain.”

Conservativeness has served the country well, but O’Donnell notes that some questions are arising, if only because financial developments are happening so fast. “There are new vehicles where investors are paying 10 cents on the dollar and realising 60 or 80 cents. It is difficult to figure a suitable way for the government to pick up a layer of gain without imposing what could be an arbitrary tax.”

Furthermore, the *mélange* of international investors makes for a nest of interlocking tax laws, O’Donnell explains. “We have US rules for cancellation of indebtedness, UK rules for prudent investments by pensions and German insurance regulations. It can be tricky not to fall afoul of any rules.”

O’Donnell urges investors to “exercise caution in designing an exit strategy from any investment in light of tax consequences. Do your best to be sure that what looks like a suitable investment today is not going to have a government take a chunk on the way past later.”

Mexico might jump to mind as a nation with a considerable pool of distressed assets, but Manuel Tamez of Taxand Mexico says that, despite the lurid headlines in US newspapers, the violence perpetrated by drug gangs has been a tragedy for many people but has not had a major impact on trade, commerce and investment.

“People are carrying on with their lives and their business,”

Tamez says. “In fact, the luxury real estate market is booming.” He cites development from Cancun down to Tulum along the Mayan Riviera. There are some smaller resort areas where developers overextended, but not a lot of distressed properties overall.

In an ironic switch, Mexican investors are actively moving on distressed properties in the US, especially parts of California, Texas and Florida that have been badly hit by the recession. “I have several clients involved in multiple properties, and I was offered opportunities in Miami,” says Tamez.

Small countries, big ideas

In Belgium, where there is no current slant to tax policy on distressed real estate. “We have legislation to encourage renovation and, on the other hand, legislation to ‘punish’ owners that have empty or dilapidated real estate,” says Frederic Kransfeld of Taxand Belgium.

Kransfeld notes that Belgium is struggling with budgetary concerns, but chronic divisions in government between the Flemish north and the Walloon south make any major tax incentives unlikely in the near term.



“We have legislation to encourage renovation and, on the other hand, legislation to ‘punish’ owners that have empty or dilapidated real estate.”

Frederic Kransfeld
Taxand Belgium

Cyprus is another small country battling both budget blues and sectional disputes, but Chris Damianou of Taxand Cyprus says tax policy on the island state is indirectly encouraging investments in distressed real estate because “this will greatly facilitate maximisation of return on investment.”

Damianou explains: “A major advantage for the international investor wishing to acquire properties outside Cyprus is that Cyprus offers very low taxation. Thus, tax incentives exist if a Cyprus company is used to acquire distressed real estate internationally.”

In fact, that statement just may sum up the best piece of advice for anyone investing in distressed properties today: take advantage of current rules and loopholes before they disappear. □

Leading the way

Most countries in Europe haven't raised their real estate transfer tax but Germany has, much to the chagrin of investors

If one wants to look at the way cash-strapped governments and public authorities around Europe are making decisions that hit real estate investors in the pocket, one should look at Germany.

In other parts of the world, there have been some noteworthy changes. Hong Kong has increased transfer tax quite aggressively (as high as 15 percent) on speculative sales, while China generally is increasing taxes on property to reduce speculation. But apart from the Netherlands – which recently broadened its base, thereby capturing more share transactions, but reduced the rate on certain residential transactions – it is Germany that is leading the way in Europe.

Ulrich Siegemund, Taxand's real estate expert in Germany, says real estate transfer tax is going up across all the regions, although power was delegated to each one as long ago as 2006. Given that Germany always has been one of the biggest real estate markets in Europe, such a move is something global fund managers need to be aware of.

This is especially the case since Germany's economy, which until just recently has been growing at a fast clip, has been a magnet for core property investors. Perhaps the poster child of this real estate cycle was the December purchase of the landmark OpenTurm skyscraper by JPMorgan and the Government of Singapore Investment Corporation for €500-600 million from Tishman Speyer and UBS. It is even more pertinent given the number of German open-ended funds with property to sell.

With more deal flow, Siegemund says the rising real estate transfer tax in Germany is a real issue that should be highlighted so as not to become a nasty surprise for those that have put the country on their investment destination map. It also means that deals need to be structured appropriately from the outset.

Siegemund explains that transfer tax upon buying a property in Germany is 3.5 percent, but it is increasing to 5 percent. It doesn't take much to work out that the tax bill on transacting a €100 million asset therefore will be significantly higher.

In 2006, the German government made a decision to hand over control of setting the real estate transfer tax to the regions that make up the country. "States have fiscal needs, so the trend to increase the tax began in the poorer states, such as Berlin and those in eastern Germany," says Siegemund. This autonomous right to change the rate was taken up by Berlin and Hamburg in 2007 and 2009, respectively, when they raised the rate from 3.5 percent to 4.5 percent.

"After the previous elections, however, one of the richest – if not the richest – states have begun evaluating it," Siegemund continues. Among those states thinking of increasing or already having increased the tax to the maximum of 5 percent are Brandenburg, Thuringia, North Rhine-Westphalia, Schleswig-Holstein, Rhineland-Palatinate, Saarland, Bremen and Niedersachsen (Lower Saxony). In Baden-Württemberg, which includes Stuttgart, Mannheim and Karlsruhe, there also has been an agreement between the parties of the new government to increase the tax to 5 percent.

The issue, according to Siegemund, is that the transfer tax is applied to those buying property, so it creates pressure to orchestrate the more time-consuming and complicated way of buying an asset – via share sales. Then again, it seems that the government feels that real estate transfer tax avoidance



"The rising real estate transfer tax in Germany is a real issue that should be highlighted so as not to become a nasty surprise for those that have put the country on their investment destination map."

Ulrich Siegemund
Taxand Germany

structures, such as share deals of a company up to 95 percent of the shares, are unfair. "Those structures might be challenged going forward by the legislator or the tax offices," Siegemund says.

Understandably, this tax increase is not going down well among real estate folk looking at Germany. After all, the law prescribes that the transfer tax is payable on the transfer, which falls to both buyer and seller.

Siegemund speaks for a lot of people when he says: "In a way, it doesn't make a whole lot of sense. Though states have a fiscal need, it makes it more difficult to do transactions if one wants to sell a property. I think this is now well known in Germany, but perhaps less well known to potential foreign investors." □



A joint effort

Joint venture deals and investment clubs in Europe have risen to the fore, giving Taxanders the task of structuring these more complicated vehicles

On Valentine's Day this year, the UK property company Hammerson announced the acquisition of SQY Quest, a 31,000-square-metre shopping centre located south-west of Paris. A run-of-the-mill investment you might say, but it was close to hearts of Taxand because they advised on it.

According to Francois Lugand of Taxand France, the deal demonstrates an important trend that Taxanders all over Europe have been talking about – the rise to the fore of joint venture deals and club investment structures. Indeed, Hammerson purchased the property through a €38 million joint venture with French developer Codic France.

That isn't the only time Taxand France has structured a deal involving partners or investment clubs. Last year, it advised Hammerson on ensuring German insurance company Allianz could take a 75 percent stake in the Espace Saint Quentin shopping centre near Paris in a tax-efficient manner. In addition, Hammerson sold a 51 percent stake in the O'Parinor shopping centre near Paris to the National Pension Service of Korea, which acquired the asset through a separate account managed by Rockspring Property Investment Management.

One would have thought that investment deals involving just two parties or at the most a small club of investors would be a lot easier to manage from a tax perspective compared to deals by commingled investment pools containing several dozen investors. However, Lugand says that, recently, it's actually the other way around. A greater concerted effort is needed to get the investment structures right in order to please all the participants, he explains. Joint ventures involving a UK REIT, a German insurance company and a Korean pension fund bring extra tax complexity to the transaction.

Taxand's projects are not limited to Hammerson, rather they extend to plenty of other players seeking joint venture structures. "What is really difficult is to align the interest of the all the different investors," Lugand says.

How times have changed

Four years ago, Keith O'Donnell, head of global real estate at Taxand, and his team were busier setting up various standard models for commingled funds ranging from Luxembourg fund structures to UK limited partnerships. Now, mandates revolve more and more around investment 'funds,' in which one, two or maybe five large investors such as pension funds invest alongside each other in conjunction with a fund manager to manage the investment.

Says O'Donnell: "I think what has happened now is that investors are saying, 'We can't have something that is good on average; we want something that works for us.' One investor might have a particular tax profile, where if it invests directly in a certain country it can get a substantive break on tax, so you need to design for that investor a parallel structure so that its investment enters into the deal in a different way to all the others. Four years ago, a fund manager would have said this was too complicated, but now they say, 'Okay, we will find a way to do it somehow.'"

O'Donnell explains how an investment vehicle might wish to invest in multiple European countries: the vehicle might have three investors, with one being a UK pension fund. If that fund finds a suitable investment in the UK, the UK pension fund would say it wanted to invest directly to gain exemption from tax on the rents and the gains (upon sale) from its investment.

However, the wider fund investment vehicle itself would be investing via some block or entity – let’s say it is a UK company. For the fund, the effective tax rate for the UK property, after deduction of depreciation of interest, might be 10 percent. The UK pension fund, though, gets a rate of zero.

Jonathan Hornby, Taxand’s UK expert based in London, says joint ventures are very straight forward for the most part in that the structures exist to make sure these parties benefit from their own tax profile. “A very common vehicle through the years, which still holds today, is the use of the UK limited partnership as a co-ownership vehicle. One of the obvious benefits is that the LP is tax transparent for income and gains purposes,” he relays.

The problem is that the other investors might be upset about an approach where one investor out of a small number enjoys a tax break. More to the point, it also might be unfair under Europe’s free movement of capital and anti-discrimination rules.

Taxand currently is doing a lot of work in this area, trying to argue on behalf of clients that, in a structure like the one described above, a Dutch pension fund, for example, should enjoy the same tax break as the UK pension fund. The same argument

Dutch market suffers from huge office oversupply in unproven locations, which is one reason why they are looking at redevelopment,” he adds.

As an aside, de Graaf notes that VAT charges for conversions or transformations of buildings that are no longer occupied are stifling activity. It has become a political hot potato in the Netherlands, he adds.

Taxand Belgium’s Frédéric Kransfeld is working together with Henk De Graaf on one particular real estate investment structure involving a Dutch fund manager. The structure is based in the Netherlands, but it is buying Belgian and Dutch real estate. He notes that most investors at the start will be Dutch individuals and/or companies, but participants also might be from Belgium.

“It is very complex because you have to take into account all the different parties and their specific needs and requirements, but this certainly also applies to the purely Belgian investment funds we have been working on,” says Kransfeld. “It is very common for several nationalities to come to the table and need the ins and outs of Belgium explained several times because it simply is not obvious at all, not even for tax lawyers.”



“If a certain number of partners are involved, a collective investment vehicle can be set up to be more tax efficient than an ordinary joint venture.”

Stephan Pfenninger
Taxand Switzerland

Issues of complexity

Assuming more than one investor can successfully move out of a fund structure into a parallel structure, this can certainly give rise to the challenge of complexity. Taxanders says the result can be a very tailored for an individual investment, for which it is advisable to perform a cost-benefit analysis.

Such complex structures raise the question of how one allocates the costs of designing a more complex structure, as well as potential governance issues. For example, does the new structure give the UK pension fund a de facto veto right over future decisions to dispose of the property?

Club structures indeed might be popular, but not every country is geared up for them. “Sometimes, club deals or joint ventures give opportunities to

save real estate transfer tax or advantages in the interest deduction area, but normally this requires that each member of the club purchase separately and this is not what they usually want,” says Ulrich Siegemund of Taxand Germany. “Usually, they want one vehicle.” Taxand Germany has advised on such deals, but more often it has worked on structures involving a common vehicle, normally located outside Germany.

While investing in German real estate generally is advantageous because of its economy, Siegemund points out that the tax environment is unstable. “Maybe it is the same in other countries, but not in Luxembourg – the typical location for such vehicles – where it very much considers the needs of investors,” he says. “In contrast, Germany has a battle between taxpayers and the government, which wants to close loopholes.”

In neighbouring Poland, real estate also is keenly in demand given the way the economy didn’t crumble like many others in Europe did during the global financial crisis. Local Taxander Pawel Toński points to the recent investment figures coming out of the country as evidence of that. Indeed, on 4 August, property broker Savills said investment levels were

about a Dutch pension fund being exempt from UK tax on a UK deal could just as easily apply to a UK pension fund investing in France. The UK pension fund could argue it should be entitled to the same break as the French pension fund.

O’Donnell explains: “We have been involved in tax litigation of a similar nature in France. The result suggests there may be scope to get something comparable in France.” In essence, Taxand has mobilised to lobby Europe lawmakers to arrive at some sensible conclusions on this issue.

Local policy shifts

In general, when it comes to direct investments by pension funds, European countries should allow tax exemption to EU-resident pension funds, although some countries are still flying in the face of anti-discrimination rules. France is being challenged on its stance, but the Netherlands already has changed its approach to comply with the thrust of European policy.

Henk de Graaf, who works in Taxand’s Netherlands office, says he is seeing local developers setting up strategic alliances with investors to develop and/or redevelop properties. “The

on track to reach €2 billion by the end of 2011 – a return to 2007 levels.

Unsurprisingly, the country has witnessed joint venture deals as part of that volume. The Spanish developer and manager Neinver, for example, struck up two joint venture structures in Poland last year.

In one, Neinver teamed up with London investment firm Meyer Bergman to develop a €200 million mixed-use project at Katowice railway station. Meyer Bergman, which has been raising its debut retail property fund, and Madrid-based Neinver said they would hold a majority stake in the project, with a minor stake being held by Polskie Koleje Panstwowe, the Polish National Railway company. In another instance, Neinver entered into a deal with Heitman European Property Partners, the European wing of the US investment firm, for a 75 percent stake in Galeria Malta in the city of Poznan.

There are even some new asset classes to get excited about in Poland. For the first time, condo hotels have been introduced in the country, which Toński points out has led to some confusion about how they should be taxed.

It is the same story in Russia, where Taxand's Andrey Tereschenko is seeing more deal activity, and in Switzerland, where Stephan Pfenninger has structured real estate joint ventures. Pfenninger says investors use joint venture partners in order to better manage and diversify their investment risks. But if a certain number of partners are involved, a collective investment vehicle can be set up to be more tax efficient than an ordinary joint venture, he adds.

Tereschenko says property investment funds usually try not to have a joint venture structure in Russia. If they do create a JV, it often would be with a Russian partner. However, the JV would be structured to be governed by UK law, for example, since Russian corporate law is less developed.

Famine over feast

Of course, not every Taxander has been lucky enough to see real estate transactions go through. In Ireland, Taxand worked



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Martin Phelan
Taxand Ireland

tirelessly last year to organise a structure for New York private equity real estate firm AREA Property Partners and partner F&C REIT Asset Management to buy the 475,000-square-foot Liffey Valley shopping centre for a reported €350 million.

The deal kept falling through because of concern over Ireland's bailed out economy and a threat by the last government to retrospectively tear up upward-only rent reviews, which by some estimates would wipe 20 percent to 30 percent off real estate values immediately. It is no wonder then that Ireland has seen not one commercial real estate investment deal this year as of press time. Nevertheless, Martin Phelan said Taxand had structured something that was nearly good to go for AREA and F&C.

The idea, Phelan explains, was to put the shopping centre into a qualified investment fund, which was a limited partnership established in Ireland. The benefit of the structure was that the rental income and gains upon future sale would have been tax free, as would have the distributions out to the foreign private equity funds. The idea of forming a limited partnership, meanwhile, was to minimise the 6 percent stamp duty cost on acquiring the building, as Ireland has quite a high transfer tax at 6 percent, compared to the UK at 4 percent.

“It was quite a good structure, but a difficult project involving many steps,” laments Phelan, who can only hope that the investment market for private equity real estate players will return. In the meantime, he has been working with retailers such as Tesco and Disney to help them open up outlets in Ireland. That, as well as advising on Kennedy Wilson's takeover of Bank of Ireland Real Estate Investment Management, has been keeping Taxand Ireland busy.

In the hotter investment markets such as France, Germany, Poland and the UK – and to some extent Belgium, the Netherlands and Switzerland – there certainly is more work to be done on behalf of private equity-style investors. With no sign that joint ventures or club vehicle structures have run out of steam, Taxanders will be busy working on more of these complex structures for a while yet. □



“Property investment funds usually try not to have a joint venture structure in Russia. If they do create a JV, it often would be with a Russian partner.”

Andrey Tereschenko
Taxand Russia

Beyond tax issues

Taxand's US real estate expert points out that due diligence in foreign investment is crucial for private equity real estate firms, but it's really only half the battle

Investing in real estate in the US, Canada and Mexico has become both increasingly attractive and increasingly worrisome to foreign investors over the past three years. It is attractive because of strong economies and lucrative opportunities and worrisome because of changing tax rules and regulations for each North American country. Not only that, some investors are still a bit “gun shy” about investing large chunks of capital overseas in the wake of the global economic crisis.

Foreign investors want to make sure that they're minimising the amount of taxes they're paying on income gained from real estate investments. However, Frank Walker of Taxand US says that, when it comes to investing in real estate in the Americas, “the taxes are only one factor.”

In fact, Walker points out that a big factor from an investment standpoint is governmental uncertainty – both in terms of legislation and regulation. The reason for this is because governmental uncertainty directly impacts job creation.

“That's what really drives the real estate market,” says Walker. “Whether it is jobs for people buying residential property or shopping at retail centres or working in offices, it drives so much of the economy.”

Now, as opportunities seem to be picking up in the years since the global economic crisis, capital that previously sat idle is looking for a place to go. According to Walker, this means investors are going to decide if they want to resume investing with firms and people they've worked with before or if they want to start looking at alternatives. “That can be a function of previously committed funds remaining idle or human nature, including investor concerns about prior investments not performing,” he says.

As it stands now, each North American country currently is experiencing its own issues, according to Walker. This means that each nation – the US, Canada and Mexico – has its own unique set of perks and challenges to its real estate landscape. So it's essential for foreign investors to find out what makes each nation appealing and what makes each problematic for the effort (see related feature on the Americas).

For example, what makes the US attractive is the abundance of commercial properties and nonperforming loans that can lead to both long-term revenues and high rates of return due to the risk, according to Walker. One red flag, of course, is the increased scrutiny the US Internal Revenue Service is placing on foreign investment, which is something foreign investors aren't used to. For Canada, the appeal is low tax rates and a very stable government, while the challenge is high prices and a low amount of product. For Mexico, it's the profusion of all sorts of property types, with the challenge of an extensive and

pricey tax system.

“In any type of real estate investment, people do a lot of tax planning to try to maximise income treated as capital gains,” Walker says. “So if you have some place like Mexico that that does not have favourable treatment for capital gains, you have to determine what else makes it attractive versus another country. It's pretty much a cost-benefit analysis.”

That said, Walker adds that it's always a good idea to diversify, not just with the type of investments but with the geography as well.

Being consistent with the economic structure of the plan from inception to exit also is more important than ever when investing in the Americas, with the IRS demanding more transparency and Mexico seeing changing tax laws. Private equity firms, Walker says, need to make sure that the initial structure



“In any type of real estate investment, people do a lot of tax planning to try to maximise income treated as capital gains.”

Frank Walker
Taxand US

of the deal makes economic sense and that it is not going to take short cuts that disregard that structure in the future.

In the long term, Walker says cost might be another big factor. While investors and private equity firms figure out how new tax systems in the US, Canada and Mexico affect them, “there may be a temporary chilling effect.”

Although cost is a factor that could slow down investors and private equity firms seeking opportunities in the Americas, Walker thinks it's unlikely that it will stop them. After all, having to pay taxes is the inevitable cost of doing any sort of business, anytime and anywhere.

The bottom line: if you want to make a small to large fortune investing in real estate, you need to be fine with spending some money on domestic and foreign taxes. And if you can't, then you may be playing the wrong game. □

Land of opportunities – and challenges

Despite strong investor confidence in real estate in Canada, Mexico and the US, private equity real estate investors still need to be wary of potential pitfalls



Despite recent stock market jitters surrounding the US debt ceiling showdown and America's subsequent credit rating downgrade, economies throughout North America have stabilised considerably since the global economic crisis. This means that investor confidence generally is strong for markets in Canada, Mexico and the US.

Although the economic, tax and real estate landscapes for the three North American countries are obviously – as well as markedly – different, they each offer advantages to private equity firms seeking real estate investment opportunities. However, when investing in real estate in those markets, firms still should be aware of a number of red flags within each country's tax laws.

According to Taxand, there are a number of ever-changing tax laws and pitfalls that private equity real estate investors need to be wary of within the three nations. Some of these potential risks include Internal Revenue Service scrutiny in the US, high prices in Canada and the flat tax in Mexico.

Still, Taxanders believe that these tax challenges are far from insurmountable. Investors exercising some caution, tolerating some additional levels of transparency and creating a coherent exit strategy well in advance can help lead to profitable investments.

Closer tabs, tighter leash

Although real estate investment activity in the US hasn't

reached 2007 levels, it has grown slowly and steadily since its precipitous drop in 2008. And although transactions for acquisitions are on the rise, there are still some things investors need to take note of about investing in real estate in the country, according to Frank Walker of Taxand US.

"The climate is getting better and clearly the activity level is picking up quite a bit, but there are still a lot of issues in the US," says Walker of the US' current economic environment. "The biggest issue is perhaps the additional IRS scrutiny."

Indeed, the IRS has developed a "managed fund approach" to auditing private equity real estate firms and funds. In the past, the IRS would select either a private equity firm or particular fund to audit. Now, it is organising a coordinated approach to managing related taxpayers in the private equity space. In addition, the IRS is trying to work with other foreign governments to offer a more coordinated audit on international funds.

Currently, the IRS has made a deal with Australia and is in the middle of making deals with the UK and Netherlands. Therefore, foreign real estate investors need to pay closer attention to the cross-border fee structures and whether charges are at "appropriate arm's length."

Regulatory compliance cost is the other major area of concern for investors seeking opportunities in the US, due primarily to the passing of the Foreign Account Tax Compliance Act (FATCA) in early 2010. FATCA came about due to

concerns about US investors having funds hidden in overseas accounts. The IRS announced that enforcement would be delayed in order to provide additional guidance to affected businesses, which should enable investors to “understand how much this regulation is going to cost.”

Because of FATCA, certain foreign financial institutions must enter an agreement with the IRS by June 2013, stating that the firms are in compliance with these reporting requirements. Otherwise, they’re going to have to start withholding payments they make to investors beginning in 2014. The IRS has not finalised guidance on which foreign financial institutions may not need to comply with these rules.

This increased scrutiny from the IRS and increased regulation in the US also could lead to cold feet from investors or intermediaries, as some may be unsure whether to continue seeking real estate opportunities in the US or wait for more specific guidance. So, although the US has plenty of investment opportunities, the country may see some change in the

Lower rates, higher prices

In contrast, Canada has a different set of rules, perks and problems for potential investors. For one thing, the country is substantially more stable, economically, than the US. In addition, it has comparatively low tax rates.

Vince Imerti of Taxand Canada says: “In terms of tax rates, the US and Canada are going in different directions.” In fact, the two countries are almost polar opposites, according to the Canadian tax lawyer. “Canada currently is driving down tax rates, while I suspect there will be pressure in the US to squeeze [as many] tax dollars out of these private equity funds [as possible],” he adds.

In addition, there aren’t huge capital gains issues for investors seeking Canadian properties, as foreign investments are taxed at half rates. “The new conservative government wants to keep taxes down,” Imerti notes.

Canada is not really seeing many beneficial ownership or debt restructuring issues. This does not mean, however, that Canada is the land of consequence-free milk and honey for the would-be real estate investor.

In fact, Imerti says all these low tax and interest rates within Canada have caused a fairly predictable consequence – namely, higher prices. “Prices haven’t really come down in Canada, so purchasers are a little reluctant to pay top dollar,” he adds. “Interest rates are low enough that vendors feel they can continue asking those prices.”

Another problem private equity real estate investors are facing in Canada is quite simply, as Imerti put it, “a lack of product in the market”. He points out that, despite seeing a stable economy and strong investor confidence, “the market is very tight.”

As a result, whereas the US is seeing a great deal of investment activity in distressed and foreclosed properties, Canada is seeing a great deal of foreign investment activity in real estate

development. Imerti also notes that financial stability and low tax rates in Canada lead to low-risk investments. However, that also may mean low rewards.

“Canada’s very stable,” Imerti says. “The US is very unstable, which means that there’s a lot of foreign interest in the US markets because people are buying debt and foreclosing on properties.”

This doesn’t mean there aren’t opportunities for lucrative real estate investment deals in Canada– or that there’s no product. As *PERE* recently reported, New York-based private equity and real estate giant The Blackstone Group recently sold a portfolio of 29 refurbished office buildings located throughout Canada to Dundee Real Estate Investment Trust for C\$831.8 million (\$881 million). These types of deals aren’t common in Canada, but they do exist.

Ultimately, Canada’s tax laws make real estate investment an enticing low-risk endeavour for private equity firms and institutional investors alike. “Canadian pension funds and



“The IRS is focusing hard on whether there’s real substance to the structure of an investment and determining whether the fund operates in accordance with that structure on an ongoing basis.”

Frank Walker
Taxand US

sourcing of capital for these investments in the near future, Walker pointed out, adding that it may be too early to tell at this stage in the game.

There also are a number of private equity firms looking to purchase nonperforming loans – something of which the US has an overabundance. “You’re seeing a lot of movement to clean up some of that, but there’s still a long way to go,” says Walker. Some strategies for these nonperforming or bad loans could involve restructuring of debt or consensual agreements instead of foreclosure. “But there’s still a lot that has to happen,” he added.

Ultimately, Walker asserts that foreign real estate investment in the US requires considerably more planning of late in order to make the deals as consistent and tax efficient as possible. “You need to know the procedures,” he says. “The IRS is focusing hard on whether there’s real substance to the structure of an investment and determining whether the fund operates in accordance with that structure on an ongoing basis.”

sovereign wealth funds are flush with cash – I’m talking billions of dollars – and need to deploy it,” Imerti says.

Long arm of the (tax) law

On the flip side, whereas Canada may have a lack of product, there currently are several eyes on Mexico for real estate investment opportunities. Mexico has seen a great deal of appetite for real estate from foreign investors of late, as evidenced by the meteoric rise in residential, commercial and industrial construction taking place in the nation.

Manuel Tamez of Taxand Mexico points out that perhaps the biggest hurdle for investors seeking opportunities in Mexico is the country’s long-reaching tax system.

Mexico considers revenue from a foreign firm taxable if the majority of its investments are in the country. For example, if a US investor were to sell shares of a Japanese firm that does the majority of its real estate investment deals in Mexico, that investor would be hit with a Mexican capital gains tax.

Because of this, it would be wise for firms looking for short- or medium-term investments in Mexico to have an exit strategy placed well in advance of any and all projects. “This is a very significant issue in tax planning,” Tamez says. “Because of the Mexican tax system, you need to consider a potential exit.”

One solution to this situation is doing business with a Belgium- or Luxembourg-based firm, as these nations have double-taxation treaties with Mexico and therefore have been granted exceptions. However, this obviously isn’t a solution for all firms and investors.

The flat tax is another issue of concern for investors in Mexico. When real estate is purchased in the country, the



“Because of the Mexican tax system, you need to consider a potential exit.”

Manuel Tamez
Taxand Mexico

owner is given a deduction. This deduction, however, will be used against income gained on that property. If the owning entity decides to sell the property, all the income obtained from the sale is taxable because it used the deduction upfront instead of sheltering capital gains.

Considering that the rate for the flat tax is quite high – 17.5 percent – this can turn into a serious issue if the private equity firm doesn’t execute thorough due diligence on the investment plan.

“There’s no shelter for this tax,” says Tamez. “If you take the deduction in advance when you purchase the investment, then that’s going to be used against current rental income going forward.”

To avoid the flat tax, in some extreme cases, some firms owning Mexican real estate that want to sell off assets have migrated to other countries to avoid the flat tax, as it is only paid by Mexican residents. “This isn’t very common,” Tamez notes. “It’s not illegal, but it’s still a bit aggressive.”

At the end of the day, Tamez points out that a great number of the tax issues that can besiege foreign investors can be mitigated and possibly even outright avoided by thorough preparation and having a good exit plan. In other words, it’s all about planning ahead.

“You want to structure the deal in a way that the exit optimises taxes in Mexico,” Tamez says. In fact, this advice could apply to just about any investment plan for any nation.

Despite the pitfalls, Taxand believes the North American markets are flush with real estate investment opportunities. Taxes need to be taken into account, but they are not the only consideration. “Taxes are only one factor,” says Walker. “If there’s an opportunity to make a profit, you can afford to pay some taxes.” □



“There aren’t huge capital gains issues for investors seeking Canadian properties, as foreign investments are taxed at half rates.”

Vince Imerti
Taxand Canada



Tax angst

Over the coming months, changes to capital gains tax treatment and beneficial ownership issues around the globe are likely to cause anxiety for private equity real estate firms

While tax treatments remain favourable to private equity real estate GPs in some jurisdictions, a number of recent changes in tax law could impact investment strategies.

Changes to capital gains tax treatment and beneficial ownership issues are likely to remain two of the key areas of tax for private equity real estate firms to grapple with in the coming months. When combined with governments looking to challenge tax structures and possibly introducing new rules, tax advisors face the possibility of having their hands tied in reducing the tax burden of investing.

Many jurisdictions treat capital gains on equity investments favourably, applying some form of “participation exemption” to dividends and or gains on significant shareholdings. The theory is that the underlying profits already have been taxed at the level of the company.

This means a lot of grey matter is going into constructing the right platform to invest in assets in order to escape being taxed too highly on the expected pick-up in values. Though huge profits have been made in the past, the additional challenge of real estate investing is that domestic tax laws and regulatory frameworks have been changed, and in some cases delayed.

Carrying on

The US has been faced with much back and forth regarding a tax hike on carried interest. However, the conversation came to a grinding halt after contentious debt ceiling negotiations

failed to include carried interest tax changes, a victory for private fund managers.

Debate over carried interest tax designation has raged over the past few years with Republicans defending the capital gains rate and Democrats arguing a carried interest tax hike could help address the deficit. In 2009, the government estimated that taxing carry as ordinary income would raise nearly \$26 billion in tax revenue. While that would be a drop in the bucket in terms of paying down the \$14 trillion national debt, Congress remains under intense pressure to increase revenue by all means necessary.

In April, Obama unveiled his budget proposal, which directed Congress to require executives of private equity firms to pay ordinary income tax rates as high as 35 percent (39.6 percent after 2012) on the profits they receive as compensation. Carried interest currently qualifies for lower capital gains tax rates of 15 percent (20 percent after 2012).

Many industry players were sure the momentum in the US for a carried interest tax increase picked up as Republicans were being forced to make difficult decisions during ongoing debt ceiling negotiations. Indeed, Congress and President Barack Obama were locked in a bitter battle, with various tax increases expected to be part of the final agreement. After several attempts to put carried interest tax on the table, however, the debt ceiling negotiations closed with capital gains firmly off the table.

“The discussion around capital gains has indeed been part

of the larger tax debate,” says Frank Walker of Taxand US. “However, an observer might say that Congress has bigger issues to deal with now.”

As a result, private equity real estate managers have nothing to fear – until the next round of discussions in the fall.

Reworking the system

Proposals underway in India to rework the nation’s domestic tax system could lead to a 30 percent tax on carried interest. India is about to change its domestic tax code, replacing the current law with a new direct taxes code, which will go into effect in April 2012.

What does this mean for the private equity real estate managers? Unlike most other countries, India taxes even non-residents on the sale of Indian shares, therefore this change could impact all offshore funds whether investing directly into India or through an onshore fund. The apprehension has been that once this new tax code comes into effect, all the structures set up in low-tax jurisdictions such as Cyprus and Mauritius, where the primary motive is to avail a favourable tax treaty with India, could come under detailed scrutiny.

At present, the ordinary income tax rate is 40 percent for foreign companies and 30 percent for others, whereas the capital gains tax is 20 percent, so there is a 10 percent differential. Under the new tax code, there will be a uniform 30 percent rate for all taxpayer on all income, as per the current proposal.

There will be certain deductions, however, for capital gains. For example, if one were to sell listed company shares on the floor of the stock exchange after holding them for one year, then there will be 100 percent deduction from the capital gains tax. So essentially, there will be zero tax.

The impact on real estate has been swift. Fund managers are now exploring alternative jurisdictions where they have a better chance of meeting the substance test. Many fund managers are exploring Singapore because India also has a favourable treaty with the Asian city-state, the difference being that the Singapore treaty already has some anti-treaty shopping provision built into it. So, somewhere there is an expectation that it might sustain even after the new tax code comes in.

Secondly, Indian fund managers are more concerned if they are controlling the fund from India. In such cases, the protocols that are put in place for the investment decisions are likely to face more scrutiny. Many fund managers also have started exploring structures where they can pass on the tax credit to their investors.

A UK exemption

Meanwhile, UK tax authorities made it easier in May for offshore private equity real estate investors to preserve returns as capital gains after once fearing an income tax rate treatment. Indeed, realisations made by funds in investments structured offshore will be treated as capital gains and not as offshore income.

Without the exemption, UK-based private equity real estate investors and GPs potentially faced an income tax rate as high as 50 percent on their returns generated from investments held through offshore entities. The UK capital gains tax rate for high earners currently is 28 percent.

To gain the exemption, at least 90 percent of the assets of the offshore special purpose vehicle (SPV) must be in unlisted trading companies. The exemption originally stated the SPV had to maintain the 90 percent threshold right up to the date of disposal, but UK tax authorities have since relaxed the standard to allow assets to be realised before then, even if doing so would mean the SPV dipped below the 90 percent floor.

The issue arose in late 2009, after the UK government devised new rules to clamp down on investors avoiding tax through the use of offshore investment vehicles. The revisions potentially could have captured private equity funds using offshore SPVs to structure their investments, which the new offshore funds tax regime will cover.



“Realisations made by funds in investments structured offshore will be treated as capital gains and not as offshore income.”

Jonathan Hornby
Taxand UK

Dutch exemption upheld

Positive developments continued in the Netherlands, as capital gains are mostly 100 percent exempt under the Dutch participation exemption. The participation exemption, which exists in a handful of European countries, relates to the exemption from taxation for a shareholder on dividends received and potential capital gains arising from the sale of shares. A Dutch Supreme Court case reaffirmed that exemption.

“An interesting development in this respect is that, as a result of a Dutch Supreme Court decision, capital gains on certain derivatives on shares (convertibles, option rights and warrants) under certain circumstances also are covered by the participation exemption,” says Henk de Graaf of Taxand Netherlands.

Other capital gains that are taxable at the statutory rate have been consistent as well. “An important way of deferring taxable gains is contributing the gain to a so-called reinvestment reserve,” says de Graaf. “In broad terms, if a property held for investment is sold and one intends to replace this property by a new investment, the capital gain may be deferred by reducing the tax basis of the new property.”

Over the last few years, tax authorities have challenged the

use of the reinvestment reserve by taxpayers, stating that all relevant criteria are not met. “This position was taken in respect of the requirement that the replacing property would not have the same economic purpose,” says de Graaf. “However, the Dutch Supreme Court ruled in many cases in favour of the taxpayer stating that the reinvestment reserve should be applied broadly.”

Clarifying beneficial ownership

The term “beneficial owner” has given rise to different interpretations by courts and tax administrations. Given the risks of double taxation and non-taxation arising from these different interpretations, several governments have developed proposals aimed at clarifying the interpretation.

For example, the Netherlands historically has applied a very legal interpretation to the term beneficial owner. In fact, the owner of the legal title is in principle also considered the beneficial owner.

However, the new Organisation for Economic Cooperation and Development (OECD) discussion draft on beneficial ownership may change this view since the Netherlands refers to the OECD commentary for the interpretation of its tax treaties. “Since the Netherlands applies a dynamic interpretation of their tax treaties, new commentaries may have an effect on how treaties are interpreted,” explains de Graaf.

The three key points in the discussion draft are as follows:

First, a treaty-based approach to interpreting the term is used, although it recognises that a domestic law interpretation may be applicable if consistent with the general guidance of the commentary. A narrow technical interpretation of the term based on domestic law is not appropriate.

Second, the recipient of a payment is the beneficial owner if he has the full right to use and enjoy the income unconstrained by a contractual or legal obligation to pass the payment to another person. Such an obligation will normally derive from relevant legal documents, but it also may be based on facts and circumstances that show that the recipient does not have the



“An important way of deferring taxable gains is contributing the gain to a so-called reinvestment reserve.”

Henk de Graaf
Taxand Netherlands

full right to use and enjoy the payment. The use and enjoyment of a payment must be distinguished from the legal ownership.

Finally, the fact that the recipient qualifies as the beneficial owner does not guarantee reduced withholding tax rate based on the treaty. Other anti-abuse rules can be included in a treaty that may restrict the use of the treaty.

Taking the issue to court

In the beneficial ownership debate, Denmark’s court system has taken centre stage. In January, a ruling from the Danish Tax Tribunal considering the concept of beneficial ownership was published. That ruling is the third from the tax tribunal regarding beneficial ownership rules, which initially were issued last year.

“There is a very aggressive stand on beneficial ownership in Denmark,” says Anders Oreby Hansen of Taxand Denmark. “There are a number of court cases running, and it will be a fierce battle for the next six to eight years.”

A recent tax case in Denmark considered the meaning of beneficial ownership of interest and dividends paid by Danish companies to Swedish holding companies, which then paid the interest to a Jersey holding company.

Danish tax law levies withholding tax on interest at a rate of 25 percent to payments made to non-resident holding companies unless the taxpayer can benefit from a reduced rate under a tax treaty, the EU parent subsidiary or the interest and royalty directives. To benefit from the tax treaty, the taxpayer generally must be the beneficial owner of the interest income.

“Clients are concerned about investing in Denmark,” says Hansen. “They are worried about being caught in the crosshairs.”

In the meantime, many will be keen to gauge the reaction of the large global firms, for which these tax rulings are intended. Whether their interest levels in certain markets will remain the same in the face of such uncertainty remains to be seen. □



“Beneficial interest is written into most treaties dealing with dividends and interest, and there has been quite a bit of litigation concerning international tax structures.”

Keith O'Donnell
Taxand Luxembourg

An emerging market for emerging markets

When it comes to zero tax on capital gains from selling Eastern European real estate, Cyprus is king

For more venturesome fund managers and investors, the countries of Eastern Europe (which roughly pass for emerging markets) has held greater allure in recent months thanks to economic stability.

Even the smallest markets, such as Estonia in the Baltics, have seen some action of late. In July, the Norwegian-based firm BPT Asset Management bought an office complex in Tallin for a new property fund.

Against that background, Chris Damianou of Taxand Cyprus says the Mediterranean island nation is still the leading place to structure holding companies that make investments in the region. That is because of the double taxation treaties that Cyprus has with many of those Eastern European countries.

Reflecting the findings of a Market Update report by Cushman & Wakefield in July, which highlighted Russia as a country seeing good demand from 'risk-taking office buyers', Damianou says Russia tops the list in terms of the markets his clients are active in. Russia is then followed by the Ukraine, India, Romania and other Commonwealth of Independent States countries as investment destinations.

The most important event to plan for is the sale of the investment, and real estate fund managers typically will be able to pay practically zero in capital gains tax if the asset is sold via shares in a specially created company. "These sales are mostly tax free where the real estate is located and tax free in Cyprus as well," Damianou says. "Real estate funds can utilise the double taxation advantages that Cyprus has with other countries."

If the fund manager ultimately is from the US, there certainly is still scope to keep the tax close to zero. The proceeds from a property sale structured through Cyprus will attract no taxation in the country where the investment has taken place or in Cyprus. Furthermore, when repatriated to the US, the profits will not be subject to any withholding taxes either. "It is a powerful tool in the hands of a US corporation," adds Damianou.

Taxand Cyprus currently is working on a plentiful supply of deals in Russia, almost as many as it was working on prior to the global financial crisis. It has three full-time advisers that work on Russia/Cyprus affairs and 99 percent of the work is real estate-related.

Even though Russia has renegotiated its tax treaty with Cyprus, Damianou says the real estate element of the new treaty will only come into effect in 2016. Even then, the organisation is experienced enough to provide proper advice on how to mitigate the effect of this change in the taxation of real estate.

Underlining that point, Taxand currently is in the midst of advising on the sale of an asset in Russia, on which it performed tax planning advice several years ago.

Despite the activity in Russia, the largest transaction Taxand Cyprus has been involved with so far has been the sale of real estate in Poland and Romania.

Around two years ago, Taxand Cyprus began tax planning for a US real estate conglomerate that owned a substantial portfolio of shopping malls in various countries in the EU via other European subsidiaries. In deciding how best to exit those investments, it worked with five Taxand colleagues from other countries to restructure the property holdings. By using the EU Merger Directive, which is designed to affect tax free mergers in Europe and is valid in Cyprus, the organisation was able to transfer the property to a Cyprus company.



"Real estate funds can utilise the double taxation advantages that Cyprus has with other countries."

Chris Damianou
Taxand Cyprus

When the Cyprus company itself was sold to another investor, the US manager of property paid no tax.

The EU Merger Directive allows companies to restructure their holdings without paying tax anywhere, not even stamp duty or transfer fees. In this case, it was really a structure to limit the tax upon a sale rather than a straight-forward merger and acquisition, yet the directive still allows this.

"It was really challenging and complicated because we had six countries involved," explains Damianou. "We needed a very well-organised, step-by-step approach leading to court decisions from each country." The deal finally was completed this February when the Cypriot company was liquidated.

It is good example of how Cyprus seems to be the place to be when investing in Eastern Europe and other emerging markets. □



Asia's moving goalposts

As Asia's markets evolve, so do its tax implications. Taxandlers from three of the region's biggest markets – China, India and Korea – tell of what is happening in their particular jurisdictions

Forward planning one's capital gains tax exposures is a tall order at the best of times. For those international private equity real estate firms engaged in unlocking as much value from Asian real estate as humanly possible, the challenge becomes much more complicated when the tax authorities move the goalposts.

Take India for example. In 2009, *PERE* reported that the country's Draft Direct Taxes Code (DDTC), part of India's plans to overhaul its entire tax system for corporations and laymen alike, would come into effect this year. Of high relevance to private equity real estate firms, the DDTC is expected to lay down a blueprint from which tax-cognisant investment strategies can be better executed. Unfortunately for those waiting, that wait is going to continue, with a revised date for implementation of 1 April 2012.

"Rumours suggest even this date will be missed," says Abhishek Goenka of Taxand India. Currently, the DDTC is in the second draft stage and with a parliamentary committee (their recommendations pre-empt when it can be considered ready for enactment). Although implementation of this "more watered down" version remains uncertain, firms must keep tabs on how its content is evolving, he notes.

Of particular concern within the DDTC are the proposed anti-avoidance provisions, which give Indian tax authorities sweeping powers, including the ability to deny treaty benefits in cases of alleged tax avoidance. These anti-avoidance provisions are particularly likely to impact the eligibility of investors to take shelter under the provisions of India's tax treaty with Mauritius, for many years a favoured domicile for investors seeking to release profits from Indian investments while circumventing the country's standard 20 percent capital gains tax.

According to a report by *The Times of India*, more than 40

percent of total foreign direct investments into India come from Mauritius entities. Therefore, Goenka says it was little wonder when news surfaced earlier this summer that the India-Mauritius treaty could be "de-negotiated," that India's stock market "tanked by a few percentage points." Still, he counters by saying: "Our take is that the negotiation is more about introducing a limitation of benefits clause, which essentially means only genuine structures operating out of Mauritius are entitled to benefit from the treaty."

Exasperated by an ongoing legal feud between telecommunications giant Vodafone and India's tax authority, the latter of which is pursuing the former for failure to withhold tax on its acquisition of Indian peer Hutchinson Essar in 2007 via a Cayman Island-domiciled entity, scrutiny on what constitutes substance for a Mauritius company has never been higher. With no concrete guidelines available, Goenka suggests firms setting up entities on the island could avoid them being labelled 'paper' or 'shell' companies by ensuring they are responsible for meaningful activities, such as the pooling of capital in the case of a fund manager. In addition, he recommends having local resident directors with adequate financial backgrounds and suggests carrying out fund administration and accounting work through local employees.

Goenka also notes that Singapore is fast becoming a competitive alternative treaty destination for firms investing in India. As with Mauritius entities investing in India, there are no capital gains taxes under the treaty between the two jurisdictions, and firms increasingly are coming around to the belief that the city-state also benefits from better staffing potential. After all, Singapore is recognised as a financial hub in its own right.

Predictably, however, Goenka warns that setting up in Singapore comes with potentially more onerous hurdles than do-

ing so in Mauritius. “There are challenges in the Singapore jurisdiction in terms of determining substance, registration tests and so on,” he points out. “The place works for some funds, like closed-ended ones, but it doesn’t work for other kinds.”

Classification of 2012

Under the current treaty, private equity real estate firms are enjoying no capital gains taxation on the transfer of securities or shares in an Indian company to a Mauritius company. Firms have long established Mauritian entities to acquire shares in Indian companies that own underlying real estate. Indeed, ownership of the real estate comes with buying the shares of the owning company.

However, Goenka says an emerging paradigm shift in respect to the scope of capital gains taxation, as classified in the latest incarnation of the forthcoming DDT, could have significant ramifications on taxation of income from the sale of shares. That is because the definition of what constitutes a capital asset is changing.

“Essentially, any assets used for or in conjunction with the business of a company are no longer a capital asset,” Goenka says. “It is treated as a business asset with an exemption only in the case of securities held by foreign institutional investors, which would continue to be treated as a capital asset.” As such, the question of how tax is calculated on the income of such assets has surfaced.

Goenka demonstrates using a hypothetical situation: “An offshore investment company based in a tax haven owns a particular project through a special-purpose vehicle, holding 100 percent of the shares. The question that arises is whether the income from the sale of those shares is taxable as business income or as capital gains under the domestic law. It seems, under the revised definition, it is going to be business income.”

Such a situation would give rise to several complications regarding the eligibility of the onshore company to rely on capital gains tax relief under various tax treaties, and that could depend on the specific language used in the individual tax treaty, Goenka says. However, he also suggests such an interpretation could offer some advantages. For instance, as business income



“Essentially, any assets used for or in conjunction with the business of a company are no longer a capital asset.”

Abhishek Goenka
Taxand India

for international firms operating through a treaty country is not taxed by the country unless such income is linked to a permanent establishment, income earned by international firms from the sale of shares may not be taxable and the need to route their investments from jurisdictions such as Mauritius may no longer be necessary.

Goenka says: “If the income from the sale of shares by a private equity real estate fund is indeed treated as business income, a US entity could very well invest directly into India and still not suffer any taxes on the income from the sale of its shares, even without routing the income through jurisdictions such as Mauritius.”

Exit blocking

Another jurisdiction to see its taxation goalposts shift is Korea. Of indirect concern to international investors is how the Korean tax authorities recently have moved to block exits en-masse by corporations holding non-commercial land or residential properties situated within its three designated speculative regions in Seoul – Gangnam, Seocho and Songpa. Korea’s National Tax Service (NTS) stipulated that, from March 2009, an additional 10 percent tax on capital gains made on sales of properties in these regions be added to Korea’s standard 22 percent (24.2 percent with resident surtax) corporate tax rate. Previously having extended the hike to December 2010, the additional levy has been further extended to December 2012.

From its offices in Star Tower, which sit in one of the designated speculative regions that would be subject to this sales deterrent, Stephan Kim of Taxand Korea explains that international private equity real estate firms have not been popular with Korea’s taxman since the Asian financial crisis, when firms like Morgan Stanley Real Estate Investing and Lone Star Funds were able to take advantage of distressed market conditions – and subsequently distressed sellers – to extract huge profits. For him, it is the shift in how tax obligations are interpreted stemming from those instances where the more meaningful goalpost movements could come.

Recalling the late 1990s, when many US firms made their Korean entries, Kim says: “Once the In-



“The [Korean tax authorities] are quite aggressive, particularly when it comes to foreign investors.”

Stephan Kim
Taxand Korea

ternational Monetary Fund lent to Korea, it effectively dictated fiscal policy, namely that many of Korea's banks had to be restructured. Many debt-ridden corporations with trophy commercial buildings also had to be restructured, and that's when a lot of foreign buyers came in."

Indeed, the Star Tower itself was one such example of that. When Lone Star eventually sold the property to the Government of Singapore Investment Corporation (GIC) for \$350 million in 2004, the Dallas-based firm recorded a capital gain of approximately \$250 million.

In addition to the extension of the extra tax on capital gains in Seoul's designated speculative regions, Kim suggests attention should be paid to the ongoing dispute between the NTS and Lone Star over which jurisdiction ultimately had the authority to tax the gain in the Star Tower sale – Korea or Belgium, which has a double taxation treaty with Korea. That is because Belgium was where Lone Star had incorporated the entity that it used in the acquisition of the Star Tower. It was that Belgian holding company that subsequently sold the asset

that sifting through court rulings." To best circumvent issues, he recommends having the entity perform other functions for which Belgium's taxman could benefit. That, he says, could go some way to proving substance.

The risk of being seen

The similarities between Korea and India continue with respect to the effectiveness of each jurisdiction's tax authorities of actually doing their job – that is, collecting the capital gains tax. "They are quite aggressive, particularly when it comes to foreign investors," Kim points out. Goenka says the same of India's authorities. In India, there are "reasonably stringent provisions," including a one percent per month levy on the transaction cost from the buyer of the shares of an asset.

In China, however, escapees of the taxman's net apparently are commonplace. According to Kevin Wang of Taxand China, many international firms investing in Chinese real estate have been able to extract profits from the country without paying capital gains taxes at all. "Sometimes in China, there has been little enforcement," Wang admits. But he too says the goalposts are changing, with China's Tax Bureau becoming more astute, particularly to "below the radar" transactions.

"As an advisor, I would say these firms should voluntarily pay, but often they wait to be approached," Wang says. As such, his advice today is that all firms should, at the least, budget for a capital gains tax bill.

Of course, as might be imagined, the penalties for tax avoidance in China can be severe. As Wang points out, one penalty is an 18 percent per year interest charge on the unpaid tax, and another is a one-off, more arbitrary penalty of between 50 percent and 300 percent of the tax bill. "Sometimes, it's both," he warns.

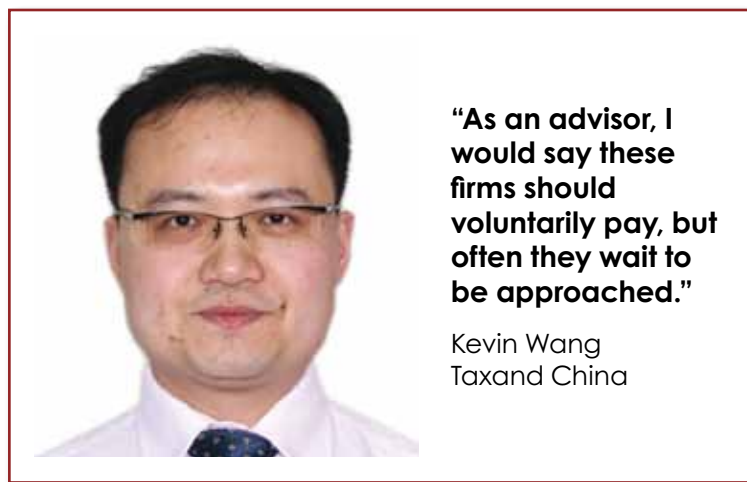
When asked what currently makes for the most tax-efficient investment structure for international private equity real estate firms seeking to invest in

China, Wang recommends the use of entities domiciled in either Hong Kong or Singapore as these jurisdictions charge a low dividend withholding tax, typically 5 percent of profits after Chinese tax authorities have taken their standard 25 percent.

Wang offers a hypothetical: "If you buy a property, you pay 25 percent tax on the profit in China. Then to repatriate the remaining profits out of China, the charge is another 5 percent of the remaining 75 percent original profit." That compares with repatriating profits out of China directly into the US, for example, for which the repatriation tax would be 10 percent of the remaining 75 percent original profit.

That is fairly clear, but less so is exactly what sort of gains made by private equity real estate firms in China are subject to those rules. The State Administration of Taxation has put out various explanatory notes on the current rules defining the administration of income tax on non-resident enterprises, the latest coming in March, but Wang suggests the picture remains disputable. As such, he warns that firms should be prepared for future changes.

In other words, prepare for more moving goalposts. □



to GIC by transferring the shares of the Korean company and took the position that the gain from the sale of the shares was not taxable in Korea under the Korea-Belgium tax treaty.

The NTS, however, argued that the Korean-Belgium tax treaty was inapplicable because the Belgium holding company was merely a conduit for Lone Star entities in the US and Bermuda, which were the actual beneficial owners of the income, and assessed tax on the gain. In that instance, while the court agreed with the NTS's conduit theory, a wrong description of Lone Star's gain as a capital gain, a term normally used for individual taxpayers' gain from capital transactions, and not the more appropriate corporate income tax saw the NTS lose its original action. To add insult to injury for the tax authority, the statute of limitation had run out on the assessment. Kim warns, however, firms should not expect such a mischaracterisation of the nature of this kind of income again.

The case has reaped more scrutiny on the Korea-Belgium tax treaty and, like his Indian peer Goenka, Kim recommends that firms respond by further substantiating their Belgian entities. As in India, there is no firm guide to what constitutes substance, he says, adding: "You won't even find the answers to



The word on the street

Taxand's global real estate team offers a client- and industry-based perspective on property markets around the globe and the regulatory implications for them

When Taxand's global real estate team was asked to leverage their advisory skills and actively engage market participants in obtaining up-to-date input on the state of the industry, the impact of regulation and the ever-changing role of the tax function, the team found the exercise natural and rewarding. After all, keeping up with market trends and constantly searching to better understand the private equity real estate industry and the various influencing macro and micro factors is nothing new for Taxanders.

The resulting report represents a summary of the key take-away points of multiple interviews with Taxand clients, trade representatives and industry influencers.

How do you see sovereign debt concerns affecting yields on existing assets and the pricing of future deals?

The process of pricing future deals has not changed: it is driven by product profile and the availability of financing, which for core-based assets remains competitive, both Taxanders and interviewees agree.

Australian residential is one example of a "red hot" product. There are robust discussions about the risk curve for value-added and opportunistic investments. Some see a shift to value-added and opportunistic from core, which depends on the interest / capacity to manage risk and the position in terms of the life cycle of the fund. Interviewees also point to the direct correlation of the sovereign debt crisis and financing costs leading to overall increased pricing on deals.

Another factor to consider is the traditional use of sovereign bonds as a "risk-free" rate from which to price real estate off. **That "affects cross-border investors more than domestics one,"** notes Simon Mallinson, director of European research at Invesco Real Estate. **"A cross-border manager with local, on-the-ground teams is able to price the market like domestic buyers and sees through the medium-term sovereign debt issues."**

While some of the interviewees could not name safe havens,

they remarked on spotting real estate bubbles developing in markets like London and New York. "It would be interesting to closely monitor and see what happens when inflation kicks in," they note.

Will recent stock market volatility encourage investors to reduce allocations to real estate equities and potentially increase unlisted real estate allocations?

While many of the interviewees didn't see a significant allocation shift to unlisted real estate and overall found it was too early to confidently say, INREV, the trade association representing the non-listed real estate industry in Europe, reported a noticeable shift. According to a recent survey prepared by the association in conjunction with ANREV (INREV's Asian counterpart), the majority of investors (in Europe and Asia) currently see and "anticipate increasing their allocations to non-listed products such as real estate debt funds, mezzanine debt, separate accounts and joint ventures." The survey reports that this trend is driven by the desire for more control, the anticipated outcome of regulatory initiatives, access to expert management, returns and diversification.

"It's all about income at the moment. Real estate, either listed or unlisted, delivers an attractive cash yield that meets long-term liabilities," says Mallinson. **"It depends on the type of investor."** Short-term investors might reduce their equity exposure overall, but not the real estate component of it; long-term investors are focused on the return over time and are willing to ride out the volatility. "We are seeing an increase in unlisted real estate allocations, however, this appears to be new capital allocated rather than swapped from real estate equities," he concludes.

A representative of one of the largest real estate fund managers in Europe says: "We are seeing some re-allocation but consider that a short-term trend. Everyone is re-thinking their strategies and taking the volatility of equities under consideration." Another interviewee of similar stature adds, "What we

are concerned about is the “denominator effect,” which may reduce the absolute allocation to unlisted real estate, penalising the latter for the volatility of listed securities.”

Indeed, real estate equities, such as listed REITs, still may be the big winners once inflation and capital markets return to stability. Taxand research shows that listed REITs have outperformed the S&P 500 for the first half of 2011, as well as over a period of 12 months (June 2010 – June 2011). “Transparency, liquidity and alignment of interest with capital players will remain the leading reasons behind the continued interest in listed real estate,” according to both INREV and interviewees.

The macroeconomic climate is one of fiscal difficulty for most governments. The same climate has created pools of distressed assets, which slowly are becoming available on the market. Do you see the two being connected, i.e. governments trying to plug their deficits by targeting foreign investors in local distressed assets?

Representative of large European fund managers note seeing some sale-leaseback transactions and disposals of institutional properties, which they attributed to the current macro climate. “At the end of the day, it’s about improving the bottom line for most governments, i.e. reducing expenses and increasing income.”

Those managers were of the opinion that, once governments realise there is no longer growth outside inflation, they will seek to broaden the tax base. “Prepare for an increased level of scrutiny from the regulatory authorities,” most contributors agree, noting that tax authorities are becoming smarter overall and doing a better job of talking to one another.

“[Tax authorities] will most likely focus on enforcing existing policy on transfer pricing and substance,” interviewees point out. Tax on management fees in countries where assets are located could be another easy target. One large fund manager wishing to remain nameless adds: “While we are concerned about the transfer pricing of our recurring management fees, the elephant in the room is the allocation of carried interest.”

Do you walk away from an asset if the structure gives rise to an effective tax above a certain rate or is it just another expense line?

While tax is not the driver behind an investment decision, it certainly is a significant factor. Industry influencers agree across the board that, while they have not yet walked away from an asset because of a structure that gives rise to an effective tax above a certain rate, they have backed off assets when the after-tax returns are below the targeted IRR.

“When it comes to structures, simple is better,” says Demetri Rackos, managing director of tax at LaSalle Investment Management, the Chicago-based real estate investment giant. An industry veteran, Rackos stresses the importance of employing a cost-benefit analysis in evaluating complex structures and the fiduciary duties to the investors. **“A simple deal, even if it does not produce the lowest possible effective tax rate, is still acceptable so long as it produces good after-tax returns.”**

While tax would not drive the decision for investments, it is an important factor. All parties involved (i.e. deal, financing and operations teams) need to understand the value of smart

tax planning in this difficult environment.

What is your approach to tax litigation: do you handle each case on its own principled merits or take a portfolio approach and seek to settle cases based on probabilities regardless of merits? Who drives the decisions: a centralised tax function or the individual asset managers? Do you sense a drift in any jurisdictions you are active in that goes against real estate investors and is it particularly focused on foreign as opposed to local investors? Which jurisdictions do you regard as being especially worrisome in this regard?

The contributors to this piece found this point tough to explain as it is “not always black and white” and usually needs a case-by-case approach. “It’s like looking into a dark room with sunglasses and figuring out the shade of grey,” one of them quips. Most of the firms are pragmatic and would look at the merit of the case and the impact on the fund or the asset: they would fight against big amounts and likely settle on small ones.

As for who drives the decision, Taxanders received a unanimous answer: “It’s a team decision.” The leading tax functions work closely with deal leaders and the CFOs of platforms to identify the best solutions for the particular fund. It’s a system of collaboration and checks and balances across the industry, Taxanders found. In most cases, neither function has the authority to settle on its own.

The participants, who on a daily basis act as foreign direct investors, felt as if the tax man was coming after them. Although the process appears to be arbitrary, France, Germany, India, Japan, Korea, Mexico, Russia (e.g. VAT recovery) and the US were mentioned by the interviewees as some of the jurisdictions where they are experiencing heightened sensitivity.

Have you been engaged with pension funds seeking an individualised structure in order to be able to access tax benefits particular to pension funds, even if it requires specific structuring for that individual investor? Is there a particular level of equity commitment below which you are not prepared to facilitate the pension fund?

Deciding on when to customise a structure to accommodate pension funds for tax benefits would depend on the situation. The industry leaders that Taxanders spoke with have both seen and designed tailored structures for individual groups. The most often-quoted structures were parallel structures for US investors into Japan and the reverse: REITs for non-US investors into the US and increasing numbers of European parallel structures for European tax-exempt institutions investing cross border.

Germany is one example. **“We have been actively involved in these types of solutions for both individual funds and fund of funds structures,”** says Stefan Rockel, managing director with Universal-Investment, the largest independent investment company in the German-speaking countries. **“Furthermore, we currently are involved in industry discussions on adding rules to the German Investment and Investment Tax Act, as the need for regulated, cross-border pension pooling structures has been acknowledged by the German authorities.”**

Evaluating facilitation of an individual pension fund based on a level of equity commitment appears to be another example

of a case-by-case approach. Some of the participants admitted to no stringent threshold requirements, while others quoted specific limits (not considered if below \$20 million and certainly if above \$100 million) and numbers of investors.

How do you manage/ model the risk of future tax law changes in such an uncertain environment? Are there particular jurisdictions where you regard the risk as being especially acute? Are there particular proposals that you view as especially favourable or unfavourable?

“Modelling and managing the risk of future tax law changes is the most difficult part of my job,” admits LaSalle’s Rackos. **“It requires continuous engagement with deal teams, tax advisors and lawmakers.”** Striking a balance between structuring sophisticated structures and keeping them current with the ever-changing tax codes is a delicate job, the interviewees agree.

While risk is material in all jurisdictions, most participants segmented their approach using the maturity of the jurisdiction as a base.

- (i) In established jurisdictions, the risk is factored only on the basis of the existing tax laws. For example, Germany and even the US represent markets where participants rarely have seen a large impact of changes. Hence, the risk factor is between 10 and 40 and the structures used usually are fairly straightforward.
- (ii) Emerging markets present greater risk. Often, if the proposed tax changes are unclear or offer something under stress, the participants agree they may underwrite more than 50 percent in terms of cost for change. India (i.e. the case of Vodafone) is a prime example of that. Other jurisdictions in this category include China, Mexico, Brazil and Korea (i.e. the evolving treatment of beneficial ownership).

The bottom-line feedback on this point is to not only constantly follow and communicate the impact of the tax law developments, but also to prepare to modify existing structures before the tax law changes take effect.

Do you centralise tax management with a centralised tax function or decentralise it to the teams making the investment decisions? Do you manage group tax risk on management fees, carry, etc. with the same teams that manage the investment-level tax risk or separately? What’s the proper balance?

To centralise or not to...that is the question. As a general rule, the internal tax functions appear to have a hybrid reporting line – technically centralised, but operationally decentralised. The tax leaders that Taxanders spoke with are spending the majority of their time providing advice on new deal structures, communicating risk and managing controversy. In these cases, the tax functions involved with operating matters sit with the finance teams but report to the centralised tax lead function. This top-down / bottom-up framework provides agility and efficiency.

In a few cases, Taxanders discovered firms with a decentralised approach to the internal tax team. Some of them actually consider their structure “more centralised” because the tax team is considered a part of the deal team, which ultimately produces the returns. This approach is very results-oriented and focused.

Where does the tax function spend the majority of its time: transactions, transfer pricing, effective tax rate planning, compliance, litigation or risk management? Have there been significant shifts over the last 24 months?

There have been significant shifts over the last 24 months, which reflect the changing times. During the period of 2007 to 2008, the majority of those interviewed agree that they were occupied with heavy transaction volume. Over the last two years, they have seen a shift to risk management, and today they find themselves balancing risk, controversy and on-going tax management. Time allocations among the three tasks depend on the region and economics, Taxanders report.

Do your external advisers work with deal teams directly or do they go through internal tax, finance or legal teams for “translation” purposes?

Taxanders found that firms are using another hybrid approach in selecting when and whom to employ. That decision is driven by the quality of the advisor, the complexity of the product and the need to ask tough questions. The latter two points tend to call for involvement of the internal tax function and, when an external counsel is involved, it’s normally one with a well-established relationship with the firm – trusted advisors, one might call them.

How are you managing substance/ beneficial ownership issues in your investment structures and what are your interactions with investors on the subject?

Taxanders discovered that, as a result of the heightened sensitivity of investors and the increased scrutiny of complex structures, firms are managing substance and beneficial ownership issues by involving external counsel to guide them through the specificities of certain jurisdictions, amplifying their focus on jurisdictions with strong platforms and avoiding those with administrative functions only and, overall, shifting to a more conservative policy.

“This always has been a substantial part of prudent administration of investment structures for us, but the focus is even greater today,” says Andreas Walter of Universal-Investment. **“We are encouraging our asset managers to invest in attracting board members with the most appropriate credentials and experience. We are setting up processes to ensure that all parties involved understand the importance of this issue and have real substantial conversations at the statutory seat of the company, while managing the need for a fast, goal-oriented decision process triggered by the investment advisor.”**

Taxand’s take

In conclusion, there are several pieces of advice that private equity real estate firms should consider when dealing with the global property markets and the ever-changing regulatory and tax regimes surrounding them. They are: prepare to pay more for core properties; balance your listed and unlisted real estate products; prepare for an increased level of scrutiny from the regulatory authorities; match your organisational structure and tax approach to the business model and strategy of the firm; and constantly follow and communicate the impact of tax law developments. It also helps to modify existing structures before the tax changes take effect. □

A method for all

Taxand's proprietary T3 research paints an easy-to-digest picture of the world's tax-take for commercial and residential property. Taxand experts discuss some of the key findings

For the third year running, Taxand has extracted then analysed the year's tax movements across multiple jurisdictions, with a view to presenting the most coherent and relevant data possible. The result is Taxand's T3 research, a tool to help global real estate investors understand total non-recoverable tax exposures as they determine investments.

This year's research – comprising 29 jurisdictions, including some new entries not present in the data of the past two years – throws up some interesting findings. Chief among them is the expectation of an increase in government taxes over the past three years due to the global economic crisis. Surprisingly, however, the T3 research shows that increases have been limited and can largely be explained by increases in VAT rates in certain countries.

Interestingly, income tax rates have had a lesser impact on total tax takes than non-recoverable transfer taxes. The simple explanation is that income tax is charged on the net result, while transfer taxes usually are imposed on gross turnover. Therefore, an investor also should focus on analysing the transfer tax system of a given country, as well as looking at the income tax rate.

According to Taxand Poland's Pawel Tonski, who was responsible for leading this year's data collection and analysis, significant transfer taxes on the sale of homes in Austria (4.6 percent) and India (8 percent) have made the two countries the most taxed among those researched (see scenario 1), contrasting sharply with the zero percent transfer tax in Poland. "In addition, there is 20 percent VAT at the point of sale in Austria, which is non-recoverable," he says. "In any sale then, you would have 24.6 percent of non-recoverable taxes – that really stands out."

Colombia and Russia take top spots as the most tax-exposed destinations for rental residential properties. In Colombia, for example, there is a high capital duty of 7 percent on the financing of investments. "They also have a high income tax rate, to-

gether with unusually high real estate taxes," Tonski points out. Russia's high VAT rate of 18 percent pegs it as the second-most tax onerous country.

In terms of commercial real estate, Norway is the most expensive country for property sales as its construction VAT is non-recoverable (see scenario 4). "That has a huge impact," Tonski says. Meanwhile, Japan's lofty 42 percent income tax, together with high taxes on capital and property, explain its elevated standing despite a low, recoverable VAT. At the bottom of the



"Significant transfer taxes on the sale of homes in Austria and India have made the two countries the most taxed among those researched."

Pawel Tonski
Taxand Poland

scenario, you have Russia and the Netherlands, where VAT is recoverable and other taxes remain relatively low.

Japan also is an expensive country for rental real estate due to high income and real estate taxes, whereas Indian rental investments benefit from recoverable VAT on both the construction and rental side. The country also has high depreciation rate, "which in our model impacts the results by reducing the income tax burden," Tonski says.

As you will see when scouring through the data, there are plenty of other takeaways besides. Be sure to check them out before making that investment decision. □

Methodology

Year on year, Taxand has refined the methodology for its T3 research. This year is no exception, as the organisation has made two key changes, which readers should bear in mind when comparing this year's data to last year's.

First, with the intention of presenting an apples-to-apples comparison, results were produced using a standardised currency and set of property sizes. Specifically, Taxand has adopted the euro as the currency of choice and has updated the average sizes of residential houses and flats to ensure the data is universal, globally.

Second, Taxand included transfer taxes (other than VAT) as chargeable at the exit point of an investment. "Normally, if VAT is included in a sale, there is no transfer tax, but there are exceptions to this rule," Tonski says. That step change is important as it has a

material bearing on the ultimate expense of a property acquisition.

Overall, the methodology considers four main areas of taxation. In order of most impact, they are: VAT, transfer tax at acquisition of land, capital at the point of exit and income and real estate taxes, which are subject to various country-specific assumptions and modifications. Administrative fees, notary fees and court fees are excluded due to a relatively low impact on the overall tax take, and certain data has been fixed, such as size of the building, investment costs and returns and noninterest-bearing equity financing, to ensure comparability of the results. The model then is adapted to local law.

For more information about the methodology or for further findings from the Taxand T3 research, please contact Abigail Tarren at atarren@taxand.com or Lynne Sandland at lsandland@taxand.com.

Ranking of countries by scenario

This chart shows a country-by-country ranking of the most expensive places in terms of the tax burden to sell or rent residential and commercial properties

Scenario 1 Home for sale		Scenario 2 Flat for sale		Scenario 3 Home for rent		Scenario 4 Commercial sale		Scenario 5 Commercial rent	
Austria	27.14%	Austria	25.15%	Colombia	46.00%	Norway	22.72%	Japan	43.04%
India	25.24%	Romania	23.15%	Russia	44.00%	Malta	18.31%	Colombia	42.51%
Cyprus	24.41%	India	21.97%	Norway	40.00%	Japan	17.19%	Argentina	41.00%
Romania	24.22%	Norway	21.80%	USA	39.00%	India	16.35%	USA	40.67%
Portugal	24.03%	Portugal	21.62%	China	38.00%	Colombia	15.01%	Canada	36.06%
France	22.66%	Cyprus	21.61%	Malta	38.00%	Mexico	14.28%	Norway	35.88%
Turkey	22.40%	Germany	21.23%	France	37.00%	Cyprus	14.05%	Romania	34.34%
Netherlands	21.59%	Turkey	20.96%	Spain	36.01%	China	13.46%	UK	33.98%
Philippines	21.26%	France	20.91%	Argentina	36.00%	Portugal	13.36%	Russia	33.61%
Russia	20.81%	Mexico	20.19%	Philippines	35.00%	USA	13.30%	China	32.51%
Germany	20.72%	Netherlands	19.32%	Japan	35.00%	Italy	12.29%	Spain	31.10%
Mexico	20.71%	Russia	18.12%	Mexico	34.00%	Germany	11.96%	Italy	29.07%
Norway	19.85%	Philippines	17.83%	Italy	33.00%	Austria	11.75%	Malaysia	27.26%
Argentina	19.58%	Argentina	16.95%	Netherlands	33.00%	Spain	11.19%	Malta	27.21%
Canada	18.36%	Malta	16.71%	Portugal	33.00%	Average	11.04%	Mexico	27.19%
Spain	18.09%	Spain	16.45%	Average	31.59%	Argentina	10.91%	Average	25.81%
Average	17.83%	Average	15.63%	Austria	31.00%	UK	10.37%	Portugal	24.69%
Italy	16.61%	China	14.79%	Canada	31.00%	Philippines	9.75%	France	22.90%
Malta	16.52%	Italy	13.81%	Romania	31.00%	Finland	9.56%	Netherlands	20.42%
Korea	14.78%	Korea	12.51%	Turkey	31.00%	Canada	9.44%	Philippines	20.14%
Japan	14.28%	USA	10.95%	India	29.00%	Switzerland	8.80%	Austria	19.20%
China	13.78%	Japan	10.85%	Germany	26.00%	Malaysia	8.36%	Turkey	18.07%
Finland	12.71%	Switzerland	10.84%	Malaysia	26.00%	Turkey	8.08%	Poland	16.33%
USA	12.63%	Canada	10.51%	Finland	24.00%	France	7.61%	Luxembourg	16.01%
Switzerland	11.98%	Poland	10.34%	Korea	24.00%	Romania	6.09%	Korea	15.74%
Poland	11.85%	Finland	8.14%	Poland	24.00%	Luxembourg	5.97%	Germany	14.53%
Luxembourg	11.53%	Colombia	7.46%	Luxembourg	22.00%	Netherlands	5.58%	Switzerland	13.99%
Colombia	11.51%	Malaysia	7.46%	Switzerland	22.00%	Korea	5.33%	Finland	11.88%
UK	9.48%	Luxembourg	6.81%	UK	21.00%	Russia	4.62%	India	11.19%
Malaysia	8.41%	UK	4.86%	Cyprus	17.00%	Poland	4.41%	Cyprus	8.05%

KEY: **NEW COUNTRIES FOR 2011** **AVERAGE TAX RATE**

Comparison of 2010 to 2011

Taxes are constantly changing, and this chart how they have changed from last year in select jurisdictions. The methodology changes adopted by Taxand when determining 2011's figures should be considered when making comparisons with data from 2010

Country	Scenario 1 Home for sale		Scenario 2 Flat for sale		Scenario 3 Home for rent		Scenario 4 Commercial sale		Scenario 5 Commercial rent	
	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011
Austria	22.24%	27.14%	20.77%	25.15%	31.00%	31.00%	5.93%	11.75%	22.08%	19.20%
Brazil	14.12%	—	14.92%	—	33.00%	—	14.86%	—	33.53%	—
Canada	17.11%	18.36%	13.18%	10.51%	44.00%	31.00%	13.87%	9.44%	53.85%	36.06%
China	17.58%	13.78%	14.01%	14.79%	50.00%	38.00%	13.37%	13.46%	32.90%	32.51%
Cyprus	16.00%	24.41%	15.10%	21.61%	19.00%	17.00%	2.74%	14.05%	11.40%	8.05%
Finland	17.71%	12.71%	17.45%	8.14%	31.00%	24.00%	5.37%	9.56%	8.99%	11.88%
France	22.03%	22.66%	20.15%	20.91%	37.00%	37.00%	6.88%	7.61%	23.09%	22.90%
Germany	16.80%	20.72%	16.02%	21.23%	26.00%	26.00%	6.16%	11.96%	13.70%	14.53%
India	16.88%	25.24%	14.44%	21.97%	36.00%	29.00%	15.50%	16.35%	24.85%	11.19%
Italy	15.70%	16.61%	13.63%	13.81%	25.00%	33.00%	6.60%	12.29%	22.07%	29.07%
Luxembourg	11.68%	11.53%	5.22%	6.81%	22.00%	22.00%	5.78%	5.97%	14.14%	16.01%
Malaysia	5.34%	8.41%	5.23%	7.46%	29.00%	26.00%	5.21%	8.36%	33.70%	27.26%
Malta	17.28%	16.52%	16.10%	16.71%	38.00%	38.00%	18.93%	18.31%	28.14%	27.21%
Mexico	15.75%	20.71%	14.54%	20.19%	30.00%	34.00%	8.59%	14.28%	25.36%	27.19%
Netherlands	21.25%	21.59%	19.66%	19.32%	38.00%	33.00%	5.27%	5.58%	17.67%	20.42%
Norway	18.58%	19.85%	18.34%	21.80%	41.00%	40.00%	21.18%	22.72%	36.34%	35.88%
Poland	11.04%	11.85%	9.62%	10.34%	24.00%	24.00%	4.28%	4.41%	15.67%	16.33%
Portugal	21.77%	24.03%	21.21%	21.62%	33.00%	33.00%	12.00%	13.36%	22.48%	24.69%
Romania	22.51%	24.22%	21.60%	23.15%	40.00%	31.00%	4.02%	6.09%	24.76%	34.34%
Spain	17.53%	18.09%	17.39%	16.45%	36.32%	36.01%	8.02%	11.19%	31.22%	31.10%
Switzerland	13.07%	11.98%	10.97%	10.84%	23.00%	22.00%	8.80%	8.80%	13.28%	13.99%
UK	6.39%	9.48%	4.37%	4.86%	22.00%	21.00%	10.42%	10.37%	33.80%	33.98%
USA	13.87%	12.63%	12.11%	10.95%	39.00%	39.00%	14.75%	13.30%	41.17%	40.67%
Average	16.18%	17.84%	14.61%	15.85%	32.54%	30.23%	9.50%	11.33%	25.40%	24.29%

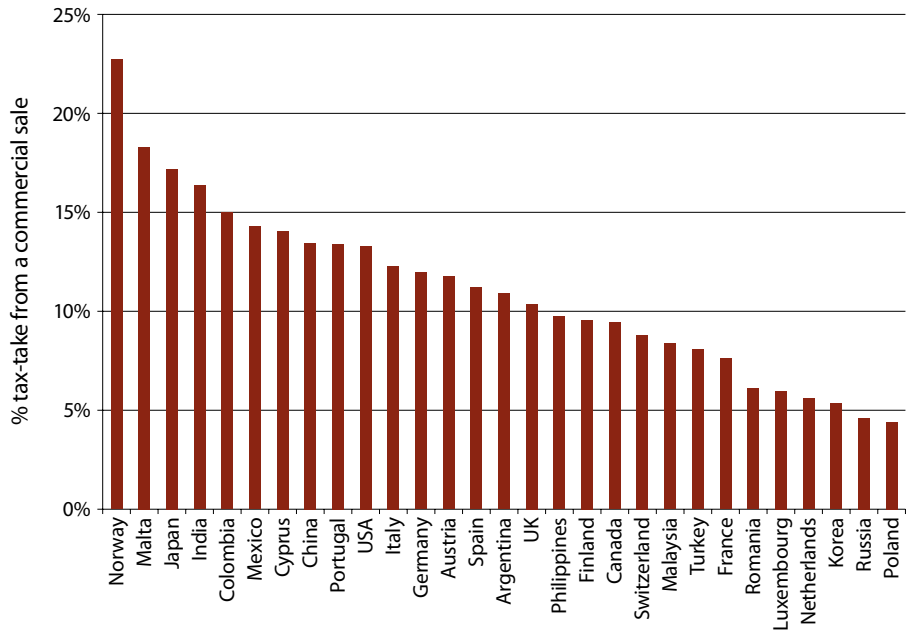
KEY: **TAX RATE > 30% COMPARED TO 2010** **TAX RATE < 30% COMPARED TO 2010**

Tax on a commercial sale

With its 25 percent VAT on construction not recoverable, Norway is the most expensive country in which to sell a commercial property. Meanwhile, Japan's lofty position is due to a high 42 percent rate of income tax, as well as a high transfer tax on land acquisitions. Low rates in Poland and Russia are explained by the low rate of income tax and a lack of transfer tax on sales.



Offices in Norway: nearly 5 percent higher tax on a sale than the next closest country

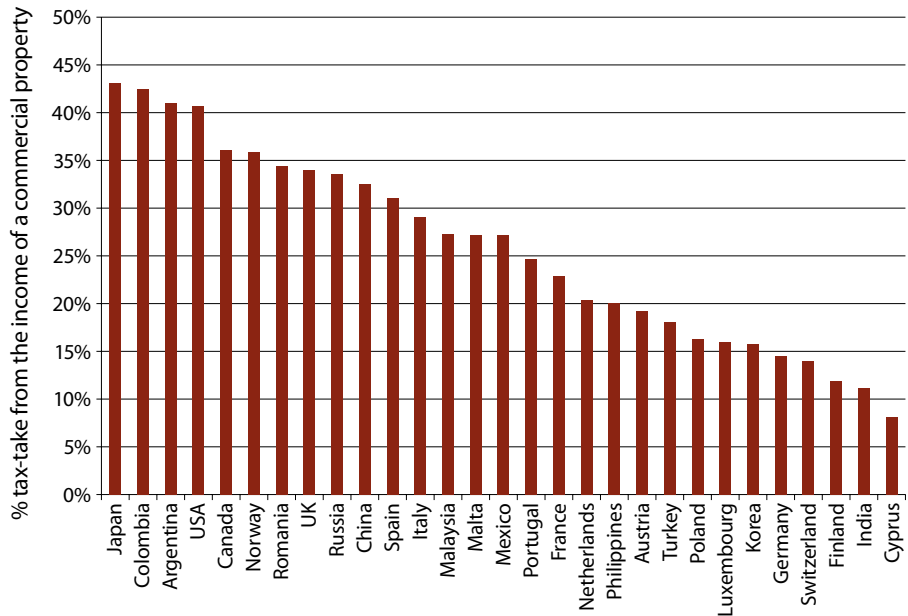


Tax on commercial rent

Japan tops the ranking when it comes to tax on commercial real estate rental income. Once again, that comes as a result of the high income tax and transfer tax on land acquisitions. Argentina's high rate is explained by its high income tax rate of 35 percent and a non-recoverable VAT on construction. Low rates in Cyprus can be attributed to its low income tax rate of 10 percent, while India benefits from a high rate of annual depreciation.



Commercial property in Japan: highest tax-take on rents

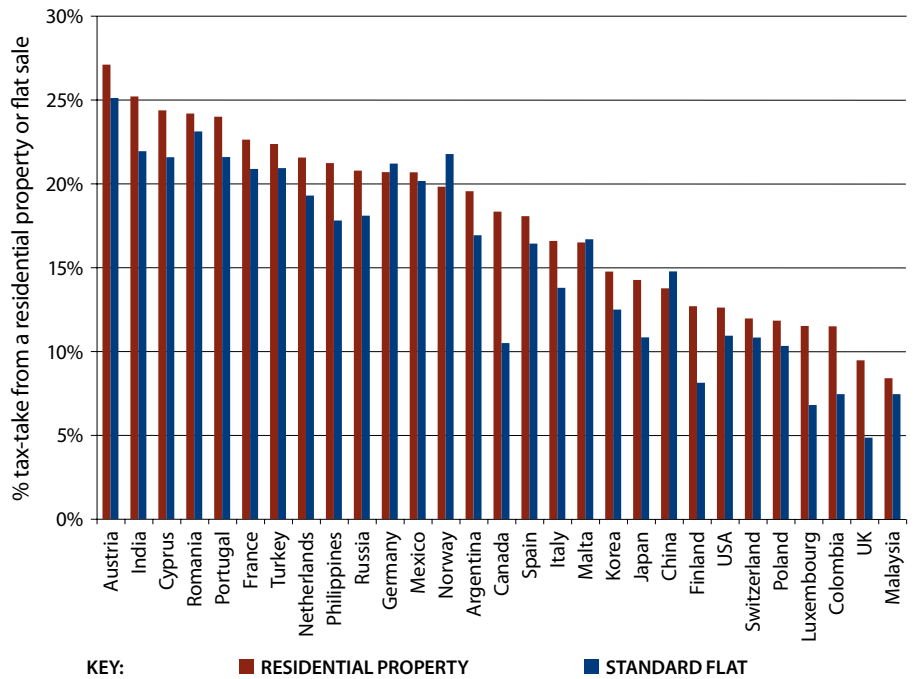


Tax on a residential sale

When it comes to selling a home, Austria and India take the top two berths on account of their exposure to significant transfer taxes: 4.6 percent in Austria and 8 percent in India. Both countries also impose a high VAT of 20 percent and 10 percent, respectively, on the sale of a residential unit. At the opposite end of the spectrum, Malaysia and the UK offer a lack of VAT on residential sales.



Apartments in Austria: highest tax on a sale

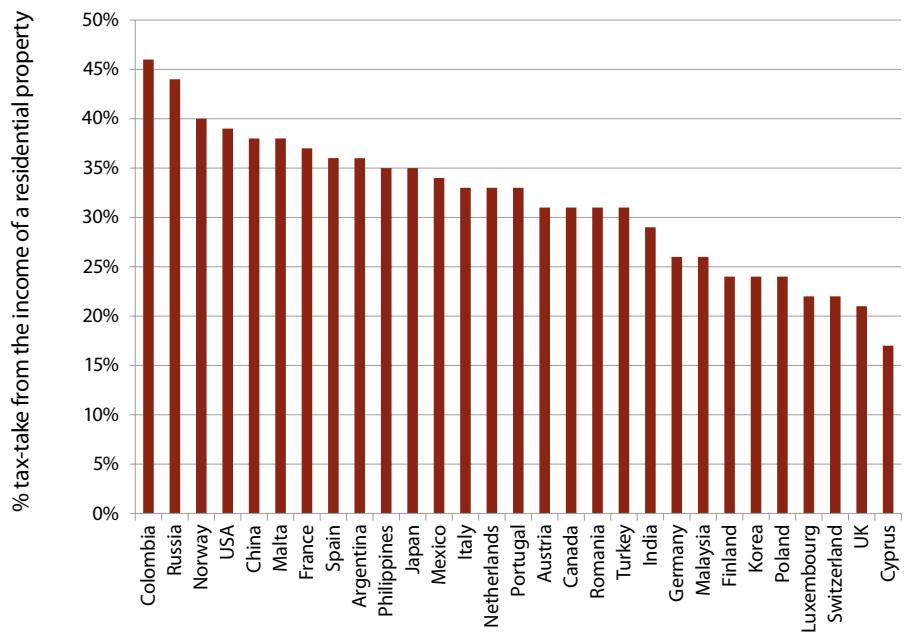


Tax on residential rent

In Colombia, 46 percent of residential rental income is absorbed due to a high tax rate on land and building, as well as a high capital duty of 7 percent on financing. Russia's position on the chart can be explained by its high VAT rate of 18 percent on the rental of residential units. Conversely, the UK sits low on the ranking, thanks to a lack of VAT and an average income tax rate.



Residential property in Colombia: highest tax-take on rents





About Taxand

Taxand provides high-quality, integrated tax advice worldwide. Our tax professionals, nearly 400 tax partners and more than 2,000 advisors in nearly 50 countries, grasp both the fine points of tax and the broader strategic implications, helping you mitigate risk, manage your tax burden and drive the performance of your business.

We're passionate about tax. We collaborate and share knowledge, capitalising on our collective expertise to provide you with high-quality, tailored advice that helps relieve the pressures associated with making complex tax decisions.

We're also independent, ensuring that you adhere both to best practice and to tax law and that we remain free from time-consuming audit-based conflict checks. This enables us to deliver practical advice responsively. We provide the services our clients seek at a global level and on a global scale. Wherever you face tax issues, we can help – by providing high-quality advice that addresses your strategic concerns.

Taxand's approach to global real estate advice

Real estate has become an international

asset class, and real estate transactions have become more complex than ever before. To make sure your investments in property achieve the best possible after-tax performance, you need dependable, practical cross-border tax advice throughout the entire lifecycle of your investment.

The extreme sensitivity of real estate makes quality tax advice paramount. The effective tax rate on an otherwise profitable deal can exceed 80 percent with poor counsel, while good advice can push that rate below 10 percent. The models for owning, developing and holding real estate are changing around the world. Increasingly, investors require liquidity in an asset class that traditionally has been illiquid. Taxand advisors help you profit from shifting market dynamics by minimising the tax obstacles to real estate transactions.

Taxand's understanding of the tax advantages for sellers and purchasers gives you the advantage in negotiating prices and closing deals. Our approach is tailored to every circumstance – for example, we facilitate the acquisition of properties through corporate structures to protect capital gains on disposal and

optimise income flows to owners. At every turn, our objective is to maximise the value of your investment.

Our extensive real estate tax experience gives you the advantage in negotiating prices and closing deals. We draw on specialist transaction-level knowledge and create acquisition and holding structures that make business sense and keep tax costs down. We help you determine the best ways to address the current market conditions of today and the future.

Taxand's independence means we can act quickly to deliver the answers you need and avoid audit-based conflict.

Our global real estate tax focus

At Taxand we deliver:

- Tax efficient real estate structures, including investment funds and REITs
- Tax advice surrounding transactions, disposals and spin-offs
- Construction and development project-related tax strategies
- Tax neutral financing arrangements
- VAT planning
- Tax due diligence
- Tax litigation
- Tax compliance

Taxand's global real estate tax team guide contributors

This guide is brought to you by Taxand's global real estate tax team, comprising expert advisors from nearly 50 countries worldwide. We provide well-considered tax advice to a wide range of clients, including listed and non-listed real estate companies, developers, financial institutions, pension funds, real estate investment trusts and funds, management companies and high-net-worth individuals.

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