Hogan Lovells

Trends in cross-border Real Estate investment and the changing tax landscape

June 2017

Contents

Introduction 03

Part 1:The U.S. market 05

Beneath swirling uncertainties, bedrock made of solid fundamentals, capital flows 07

Part 2: The European market 17

European markets in 2016 18

Cash-strapped governments target real estate 20

European real estate in demand 29

New asset classes 32

The changing funding model: from debt to equity? 37

The current year 40

Conclusion 46

Introduction

Real estate markets in both the U.S. and Europe continue to attract significant overseas investment.

With interest rates at or near all-time lows, and dwindling returns in other asset classes, real estate has emerged as one of only a few reliable sources of potential returns and income for global investors. Interest rate increases in the U.S. may dampen moderately those investors' enthusiasm, but a tightening of monetary policy in Europe appears some way off.

However, it is also clear that the structuring of cross-border investment is being impacted by tax reforms in the U.S. and Europe. These tax changes have the potential to re-shape the nature of the U.S. and European real estate investment market. The U.S. Congress and the new Trump administration envision far-reaching tax relief that would be broadly favorable to real estate investors. European governments are making a number of substantive changes to their tax systems, partly driven by international tax initiatives, but also looking to raise additional revenues from the real estate sector.

In **Part I** of this report, we chart the impact of potential tax reforms on investment into U.S. real estate. We report on the role that tax reform could play in shaping real estate financing structures and encouraging inflows of capital into U.S. properties. We also analyze the effects of interest rates, market fundamentals and capital flows.

Part II considers the impact of tax changes on investments across Europe, and addresses trends in European real estate investment – including the rise of the REIT, the emergence of new asset classes and the shift towards equity rather than debt financing.

We hope you find our report engaging and useful.

The Hogan Lovells global tax team

Elliot Weston
Partner, London
T +44 20 7296 2658
elliot.weston@hoganlovells.com

Cameron N. Cosby
Partner, Washington, D.C.
T +1 202 637 3681
cameron.cosby@hoganlovells.com

> Tax changes have the potential to re-shape the nature of the U.S. and European real estate investment market

Part 1: The U.S. market

Beneath swirling uncertainties, bedrock made of solid fundamentals, capital flows

Despite strengthening market headwinds and troubling political uncertainties, the U.S. commercial real estate market is likely to remain the top destination for global real estate capital in 2017, and may even see a return to growth, according to a group of leading attorneys, investors, and operators.

Those experts agree that investors surveying the global real estate landscape will largely conclude that the U.S. continues to offer the strongest combination of principal protection and appreciation potential in the near future. No other market in the world offers a more appealing profile on key investment factors:

– Relative political and economic stability

– Strong market fundamentals

– Access to capital

– The potential for advantageous regulatory and tax reform

We chart here the impact of potential U.S. tax reforms on investment into U.S. real estate. In particular, we report on the role tax reform could play in shaping real estate financing structures and encouraging inflows of capital into U.S. real estate.

And while U.S. CRE prices have recently reached historically high levels, further growth could be fueled by the trillions of under-invested dollars held by institutional investors around the world. A significant portion of that capital is either likely or specifically allocated to end up in U.S. commercial properties.

"Compared to other destinations for global real estate capital, the U.S. continues to be very attractive," says Mark Eagan, head of Hogan Lovells real estate practice. "And the factors driving that are unlikely to change."

And even as the U.S. experiences extraordinary political turmoil, international investors see a broader context. *"Today we're all super-concerned with global politics,"* says William R. C. Tresham, president of Montreal-based Ivanhoé Cambridge, a CDN$55 bn institutional real estate investor. *"Business people ranking the places they want to invest still come back to the United States as the number one destination."*

Still, investors and developers will encounter a number of unsettled questions in 2017, especially in the areas of taxation and regulation. In hopes of providing a guide to this nebulous terrain, below we have summarized and analyzed the key trends driving the industry and the potential impact of U.S. tax reform.

Policy and tax reform

The election of President Donald J. Trump has drawn mixed reviews from real estate investors. On the one hand, Trump's outspokenness and inexperience have led many observers to preach an abundance of caution, and more than a little skepticism. Executives and investors alike are watching vigilantly for statements or actions that could impact international commerce and capital flows. On the other hand, it's hard to ignore the potential upside that could derive from having a property developer in the Oval Office. The President has espoused an aggressive tax and regulatory reform agenda that could boost domestic growth and the real estate market. Absent specifics, executives agree that the broad drive toward tax reform and reduced regulation would be positive for markets.

But in the administration's first months, investors are already growing anxious for concrete signs of what lies ahead. *"The market is long hope and short details,"* says Sonny Kalsi, founder and partner at New York-based GreenOak Real Estate. *"It's really unclear what's going on from a U.S. perspective on policy and economics."*

In Congress, tax reform enjoys particularly strong support from Republicans and many Democrats. Lawmakers widely recognize that the tax code is overly complex and many view it as a drag on the competitiveness of U.S. corporations. Such broad consensus, however, is not unusual at the early stages of a major legislative initiative. *"The disagreement typically emerges as soon as things start to get specific,"* says Hogan Lovells partner Jamie Wickett, a leading adviser on tax, energy, technology, and other compliance matters. Still, Wickett believes that in the current climate, tax reform has a high likelihood of passage. While some reform proposals will surely face resistance given the 60-vote legislative hurdle in the Senate, House Speaker Paul Ryan has indicated that Congress might advance tax reform using the budget-reconciliation process, which requires only a 51-vote Senate majority.

The "Better Way for Tax Reform Blueprint," released last year by Ryan and Rep. Kevin Brady (R-CA), provides the clearest road map for GOP-led tax reform. Wickett says House Ways and Means Committee staff began drafting legislative language based on the Ryan-Brady Blueprint in January. *"That will be the opening bid on tax reform,"* he says. A Senate proposal is expected later in the year.

Trump's views on tax reform are less clear. He released a tax proposal before the election, but it reads more like a campaign document than a policy framework. During his February address to Congress, he announced his intention to issue a reform plan (presumably in outline form) soon.

Although tax reform ranks behind health care reform and immigration on the GOP's agenda, Hogan Lovells believes Congress could take up tax reform in late 2017 or early 2018.

While the outcome of that effort won't be known for many months, commercial real estate executives and investors are best advised to engage immediately in the already-active debate on Capitol Hill. We believe reform could be broadly advantageous to the industry, but the current blueprint includes some provisions with the potential to impose fundamental structural change on the industry. And some provisions — such as the possible rollback of interest deductions — could impact both the tax burden on foreign investors and optimal deal structures. *"Anyone with exposure or investment in the U.S. needs to understand how*

significant the proposed changes could be," says Cam Cosby, a Hogan Lovells partner who advises on tax aspects of real estate transactions.

Below is a discussion of the proposed reforms.

Full expensing

Both the Ryan-Brady Blueprint and Trump's plan would replace the current multiyear depreciation deduction regime with so-called "full expensing" — allowing investors to write off a building's full cost the year it is purchased. The deduction would apply not just to buildings, but also to associated capital expenses, with the apparent exception of land. Any net losses generated by building purchases or other capital expenses could be charged against profits indefinitely, until the initial cost is exhausted, or fully expensed. And net operating losses could offset 90 percent of net taxable income under the proposal.

This change would allow investors to recognize costs far faster than under the current code. Moreover, it would provide a strong incentive to purchase real estate. *"A profitable corporation could wipe out almost its entire tax burden by buying a single building,"* Wickett says.

Interest deduction

In what could be a monumental shift for foreign investors in U.S. commercial property, the Ryan-Brady Blueprint proposes limiting interest-expense deductions. Property owners, under the proposal, would be allowed to deduct interest only when it did not exceed "net interest income," a term that has not yet been defined with precision, but which is believed to mean the difference between interest income and interest expense. If enacted, the proposal could significantly alter the optimal structure for foreign investments. It could have existential ramifications for a leveraged business model that is common in commercial real estate — and present a daunting challenge to those portfolios already operating under such a model.

It is not clear, however, whether Trump will support eliminating the interest deduction. Published reports have speculated that as a real estate executive, he would advocate preserving it — particularly given his historical predilection for using leverage.

Corporate tax cut

With U.S. corporate tax rates among the highest in the world, there is widespread belief in Washington that the tax code stifles growth, hurts U.S. competitiveness and drives both businesses and jobs abroad. So it's no surprise that both the Ryan-Brady Blueprint and the Trump proposal call for sharp corporate tax cuts. The blueprint would reduce the tax rate from 35 percent to 20 percent, and Trump called for it to be set at 15 percent. Should either proposal become reality, the commercial real estate sector would reap obvious benefits — though, as noted in the following section, the reduction in rates come with associated structural changes that could make real estate investment trusts (REITs) less attractive.

For starters lawmakers will need to find ways to pay for the proposed rate cuts. The blueprint calls for a "Border Adjustment Tax" (BAT) to offset corporate-tax revenue losses. But such a measure faces daunting political obstacles on the road to passage (for more information, see below). If the BAT fails, lawmakers would either need to retreat to a more modest corporate tax cut, or accept a larger deficit. The latter, which many observers view as more likely, would probably provoke growth, inflation, and higher interest rates.

Corporate tax cut impact on REITs

Taken together, the blueprint's proposed changes to corporate and dividend taxation could make REITs far less attractive — if those changes are enacted as currently described. In addition to a significant corporate tax cut, the blueprint envisions lower rates on individual dividend income, effectively reducing the highest investment income tax rate to 16.5 percent. For top tax bracket earners, for example, corporate real estate earnings would be taxed at 33.2 percent (20 percent corporate tax plus 16.5 percent tax on the remaining dividends), whereas REIT income would be taxed at the highest (proposed) income tax bracket, or 33 percent. Given other constraints faced by REITs, their appeal as pass-through entities could be diminished compared to C-corporations.

"This would be a gating issue for real estate investing," says Hogan Lovells partner David Bonser, who heads Hogan Lovells Equity and U.S. Debt Capital Markets Practice group. *"It could change the whole discussion around the best structure for holding real estate."*

Border adjustment tax

Among the Ryan-Brady Blueprint's most controversial ideas, the BAT is intended to encourage U.S. companies to export and to produce domestically. While details have not been released, Hogan Lovells understands that the proposal would exempt all export sales from taxation, while eliminating the deduction for import costs.

The BAT is an integral part of the Ryan-Brady reform, but it already faces uncertain, at best, prospects in the Senate and a battery of formidable opposition, including from retail and oil interests. However, in his February address to Congress, Trump echoed the rationale underpinning the BAT, without specifically endorsing the plan. Hogan Lovells expects him to propose, at minimum, a structure that would impose taxes on at least some imported goods.

Passage of the BAT would represent a profound change to the U.S. tax code, with impacts rippling throughout the economy, including in real estate. For example, by wiping out the advantages of locating operations and assets abroad, demand for domestic office and industrial properties could increase. Further, economists predict that it could increase the value of the dollar by as much as 25 percent, which would represent a daunting price increase on U.S. properties for foreign investors. (For more information on the BAT, see our recent update here).

Like-kind exchanges

Like-kind exchanges, which enable investors to defer capital gains taxes by exchanging a property they own for a similar property, have not been specifically addressed in the existing tax documents. Given the oft-stated goal of simplifying the tax code, some believe this mechanism could be limited or even eliminated.

Repatriation of foreign profits

Congressional leadership in both parties has expressed a general desire to lure back the more than US$2tn in earnings that American companies currently hold overseas. During the presidential campaign, Trump proposed a one-time, 10 percent tax on repatriated foreign earnings. The Ryan-Brady Blueprint states that *"American companies will be free to bring their foreign earnings home to invest in America without tax penalty."* If enacted, this could result in significant benefits to U.S. real estate firms with properties abroad. It could also relocate a huge amount of idle capital back to the U.S., stimulating additional investment.

Potential changes to FIRPTA

In late 2015, Congress passed the PATH Act, amending the Foreign Investment in Real Estate Property Act (FIRPTA) to free certain foreign pension funds from paying capital gains tax on the sale of U.S. real estate, bringing their tax treatment in line with their domestic counterparts. Intended to spur U.S. investment by cash-rich foreign pensions, the changes had little effect in 2016, as investors awaited regulatory guidance from the IRS and asked Congress to iron out technical details. As a result, foreign pension funds still lack confidence that they are on a level playing field, leaving a potentially significant capital source on the sidelines. *"Those investors make decisions based on after-tax returns, which will be very difficult to project until we get clarity on FIRPTA,"* says Hogan Lovells Cosby.

So far, neither the Trump plan nor the Ryan-Brady Blueprint has specifically addressed FIRPTA. However, both the President and congressional Republicans

envision significant changes to international taxation, opening the possibility for revisiting FIRPTA. Given the President's preference for "America first" policies, it is not clear that he would make FIRPTA reform a priority, nor whether he would back changes advantageous to foreign investors. Hogan Lovells will be monitoring the negotiations closely.

Interest rates

Aside from policy changes, interest rates represent the most pressing matter on the minds of commercial real estate executives and investors. With Federal Reserve guidelines suggesting two additional rate hikes following the quarter-point increase in March, industry leaders expect the cost of capital in real estate to climb as well — despite wishful speculation by some analysts that the two might decouple.

What matters most, executives say, is the pace and scope of tightening. *"The real question is whether businesses keep expanding and taking on space at a pace that keeps demand in line with rate increases,"* says Warren Gorrell, CEO Emeritus and partner of Hogan Lovells, who specializes in complex M&A transactions and IPOs for REITs. If business expansion slows, higher rates could inhibit property prices as well as REIT share values, Gorrell says. For the moment, investors are updating their models to account for expected higher capital costs.

But Gorrell, a 30-year veteran of commercial real estate industry, notes that even with a series of increases, the current cycle offers historically low interest rates. That, combined with solid fundamentals and the expectation that rates will climb slowly, with ample warning from the Fed, leads him to believe that capital costs do not appear poised to stifle transactions in 2017.

Real estate veterans further point out that rising rates can yield opportunities, triggering sales by firms that are over-leveraged or spooked by near-term price fluctuations. Some even see higher rates as good news. "*I'm of the view that interest rates rise because the world is getting better,"* says Ivanhoé Cambridge's Tresham. *"If the world is better, companies are taking more space, hiring more people, taking more risk, borrowing more money"* — all of which boosts long-term real estate returns. *"With the global financial crisis hangover still lingering,"* he continues, *"a healthy slice of North American corporate leaders are still not aggressively managing for growth, so business confidence has room to grow."*

Real estate fundamentals

Nearly a decade into the expansion that began in the depths of the global financial crisis, real estate executives are watching for signs that the business cycle is coming to a close. At more than 90 months, the current upturn is one of the longest in U.S. history. And while it far outstrips the 58-month cycles typical of the post-World War II era, the trend in recent decades has been toward longer expansionary periods. This one — characterized by slow growth, disciplined lending, and below-average development — appears to be extraordinary in its long-haul profile.

While there still appear to be attractive opportunities in select asset classes, there have undoubtedly been rough patches in recent quarters as well. Kalsi, of GreenOak Real Estate, contends that investors have been in "wait-and-see mode" since the June 2016 Brexit vote helped exacerbate the usual summer doldrums, which stretched into fall, when investors decided to await the outcome of the U.S. election. *"We saw a big slowdown in capital*

flows post-Brexit," Kalsi says. *"And the continued uncertainty is keeping U.S. investors cautious."* Nevertheless, Kalsi concludes that he's not *"super-bearish. We are still looking for opportunities."*

Data on large commercial real estate transactions support Kalsi's assessment of last year's activity. Year-over-year large-cap sales volume declined by 20 percent overall in 2016; apartments were the only large property type that posted a sales increase, at a modest 3 percent, according to data collected by Real Capital Analytics (RCA). Despite the sales decline, RCA reported that large-cap prices in the asset class were up by 9 percent, closing 24 percent above the prior 2007 peak. Meanwhile, the sector reported solid demand, rising construction and declining vacancy rates for most classes (other than multifamily). As for small-cap sales, notwithstanding concerns over tight inventory, both sales and prices were up, with volume increasing by more than 8 percent in every quarter last year. International sales accounted for 11 percent of small-cap volume.

Tresham, who is "very bullish about the fundamentals," says he and his colleagues at Ivanhoé Cambridge are finding good opportunities to purchase U.S. properties at attractive prices, below replacement value, in select asset classes and locales. Due to the demographic trend toward urban living, he sees inner-city properties in major cities like Los Angeles and Chicago as a good target. He also says that new developments are in demand, as companies seek updated architecture to accommodate technology and evolving work environments. Despite the maturity of the current business cycle, he argues that economic conditions — particularly underemployment, pent up investment capital, and a pro-growth regulatory environment — support continued strength in the real estate market.

Investors remain cautious on retail, given the competition from digital commerce, and on "trophy" properties, which currently command premium purchase prices that might prove unjustified. Likewise, while some investors view New York City as an attractive long-term core investment, the market appears to be experiencing some over-building, particularly in condos and hotels, and is laboring to wean itself off of the financial services industry.

In general, however, the outlook for 2017 is positive, with economists projecting moderately accelerated growth at 2.4 percent, payroll expansion at 1.4 percent, a decline in unemployment to 4.6 percent, and modestly stronger inflation.

Capital flows

The 2017 commercial real estate market appears poised to get a boost from the powerful, unprecedented influx of foreign capital. The trend is historic, and secular, driven by massive quantities of capital seeking secure but productive investment opportunities. Given the prospect of current return along with the chance of appreciation, institutional investors are increasingly looking to real estate as a necessary asset class. Many institutions around the world holding billions or even trillions of dollars in assets remain under-allocated in real estate.

The abundance of overseas capital pouring into commercial real estate clearly helps explain the persistence of the current growth cycle. *"Foreign capital changes the game,"* says Hogan Lovells Gorrells.

If there is a cloud on the foreign-capital horizon, however, it is drifting in from the East, with investors and executives expecting Chinese investors to be less active in the U.S. this year. Many Chinese firms are finding it increasingly difficult to invest abroad, constrained by uncertainties surrounding the Chinese economy, and by Beijing's strict capital controls — prompted by a rapid decline in foreign reserves. Moreover, some speculate that the Trump administration's hostile rhetoric toward China could be causing investors there to put U.S. investments on the back burner, at least for the moment.

But diminished Chinese activity is likely to be mitigated, if not negated, by stronger flows from elsewhere in Asia, particularly from Japan, South Korea, and other countries with huge under-invested institutional assets. Investors point out that Asian insurance companies, pension funds, and sovereign wealth funds tend to significantly trail North America in allocating to real estate. For example, Japan is awash with cash-rich investors carrying relatively small real estate allocations — Japan Post Holdings (with some US$2.5tn in assets), Government Pension Investment Fund, (US$1.2tn), and Pension Fund Association (US$100bn). Confronted with Japan's negative interest rates, weakening Yen, and aging, shrinking population, those investors are certain to diversify abroad.

Despite uncertainties surrounding the election of an unconventional president, industry leaders say the U.S. still offers many comparative advantages for overseas investors. However uneasy the political climate may be, no other nation can boast an equal combination of strong sovereign currency, pro-business regulatory environment and reliable legal system — not to mention an economy that appears vibrant and resilient compared to global peers. Following Brexit and the U.S. election, investors are particularly anxious about the elections in France, Germany, and the Netherlands this year, where anti-EU parties are polling strong. Further, political volatility in Italy and mounting pressure on the country's banks are also pushing capital toward the U.S.

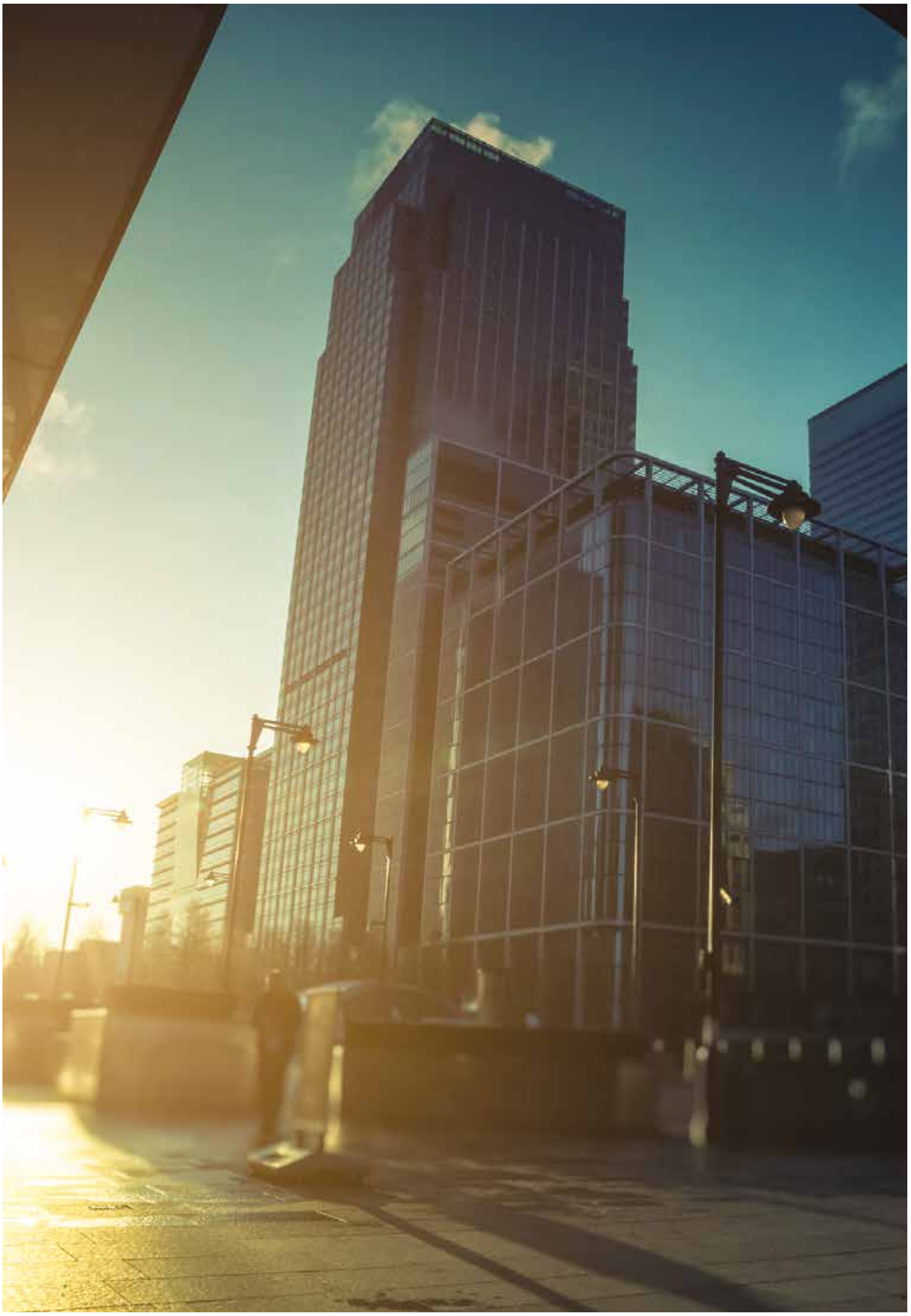
"If you're a foreign fund manager investing your client's money, you're not going to get fired for investing in the United States," says Hogan Lovells Bonser.

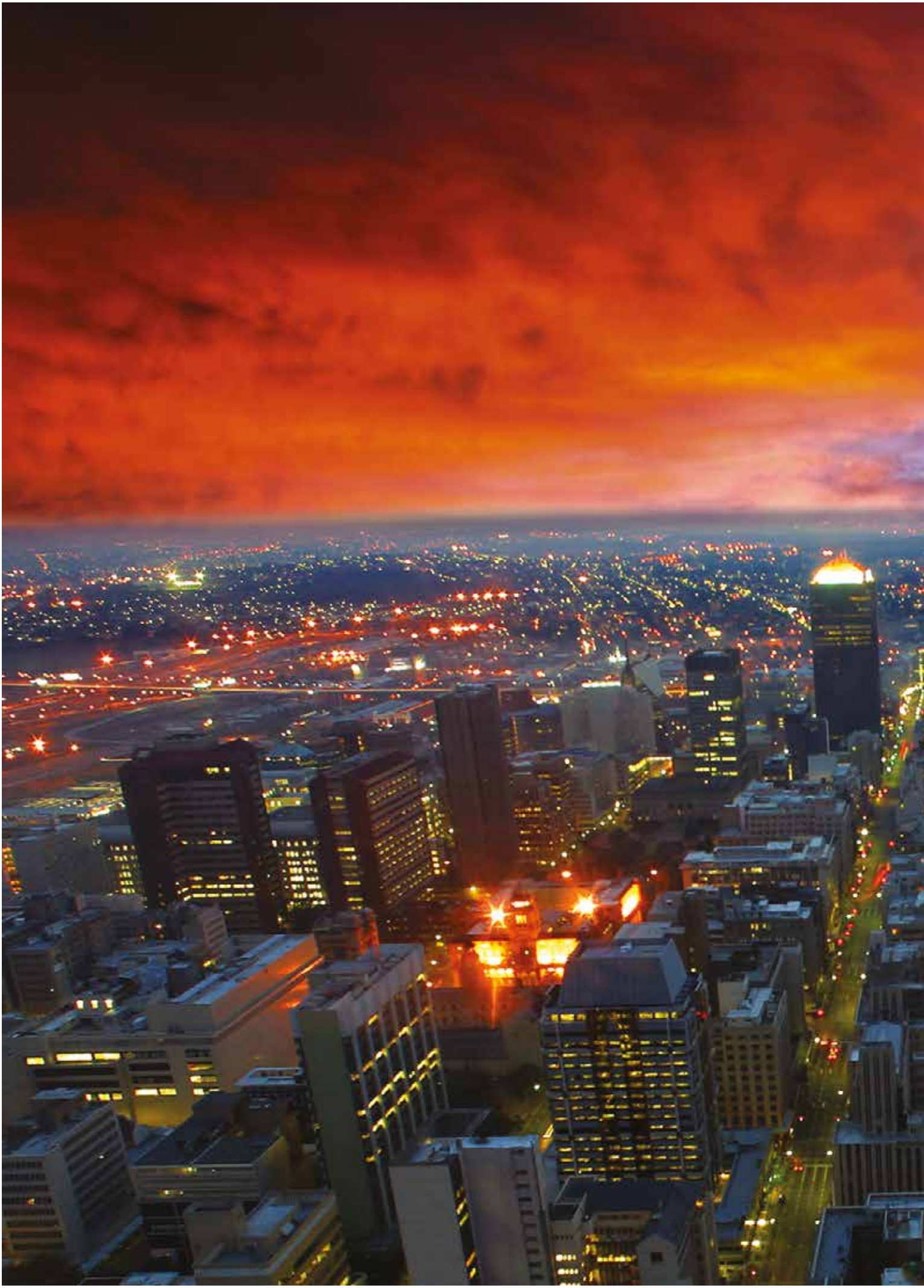
Conclusion

Nearly a decade has passed since the trough of the global financial crisis, which is fueling debate among real estate executives regarding the length of the business cycle. And the U.S. is clearly embarking on a cycle of monetary tightening. But with ample labor slack, idle capital, and the prospect for regulatory relief from Washington, leading real estate minds believe there is plenty of room for additional growth.

The impact of U.S. tax reform on U.S. real estate investment could be dramatic. Whilst restrictions on interest deductibility could negatively impact the after-tax returns of real estate investors, the real estate industry would be likely to receive a significant boost from moves towards full expensing of the acquisition costs of U.S. real estate, further clarification on FIRPTA and any incentives to repatriate foreign profits.

For 2017 in particular, there are many reasons to be optimistic, particularly for investors who are careful about leverage, target markets, and asset class selection.





Part 2: The European market

European markets in 2016

Despite considerable headwinds, Europe's real estate market showed resilience during 2016. Total investment in commercial real estate reached €251.bn over the course of the year according to analysis from CBRE[1] . While that was 10 per cent down on 2015, the deficit was largely a result of a slowdown in the first half of the year, with investment accelerating during the third and fourth quarters; indeed, fourth-quarter investment hit an all-time high.

Nevertheless, the headline figures mask significant variations on a country-by-country and sector-by-sector basis. The UK remains Europe's leading market for real estate investment despite a 37% fall-off in investment to €60.1bn during 2016; by contrast, Germany saw volumes that at €52.5bn were barely changed from 2015, and ran the UK a much closer second than in previous years. France, in third place, saw a modest decline, but the Netherlands and Spain both saw investment jump.

Similarly, while the office sector dominated investment once again last year, with total volumes of €108.4bn, that was a 5 per cent drop-off compared to 2015. Retail investment, at €54.0bn, was also down. Investment in industrial property assets, by contrast, rose 4 per cent to €24.4bn.

Elsewhere, meanwhile, investment was strong too. For example, residential property investment was strong, led by Germany and the UK according to JLL[2]. The growth of alternative property investments is also a continuing theme, with allocations having increased 25 per cent year-on-year, data from Savills[3] suggests.

The varied picture reflects the nature of the headwinds that buffeted the real estate sector last year; most obviously, the UK's vote to leave the European Union in June's referendum was a major destabilising factor, but political and economic uncertainty across many other parts of the world, as well as financial market turbulence in China, also resulted in reduced global investment flows. The UK figures, meanwhile, followed a record year for investment in real estate in 2015, and reflected a very significant depreciation of sterling in the aftermath of the referendum result.

Nevertheless, the real estate sector has continued to attract investors. With leading global economies maintaining interest rates at all-time lows and disappointing returns from other asset classes, real estate has been one of the few sources of potential value for global investors. Interest rate increases in the US under a Trump presidency that delivers a fiscal policy stimulus may change that dynamic somewhat over the year to come, but a tightening of monetary policy in Europe looks some way off.

That suggests appetite for European real estate is likely to continue. The market has already begun to see yield compression – yields on prime office assets fell to around 4 per cent by the end of last year - with investors competing for a limited supply of high-quality assets, and the relatively downbeat economic outlook in much of Europe suggests limited scope for rental appreciation. Still, investors' options are limited and the diminishing income is at least compensated for by the prospect of capital returns. Fidelity International, for example, is forecasting a total return of 8 to 10 per cent from continental European real estate during 2017[4].

> "In addition to BEPs reforms, we have also seen individual countries reform long-established tax rules over the past year."

Taxing times for real estate

Europe's governments are not blind to the revenue raising potential of real estate, of course, and are anxious to ensure an asset class so in demand generates the expected tax revenues, particularly in a climate of austerity and deficit reduction. For this reason, 2016 saw further action from governments to protect or increase the tax base, with real estate often in the firing line.

Part of that action stems from the base erosion and profit shifting (BEPS) recommendations published by the OECD in October 2015. As the OECD's member states have sought to implement those recommendations as part of their efforts to confront tax avoidance, real estate investors have inevitably been impacted.

The most obvious example is the OECD's recommendation that interest deductions should be limited to no more than 30 per cent of EBITDA (subject to a group ratio test), which for many real estate investors will be well below the interest payable on their gearing. In some cases – notably the UK – this reform will come into effect during 2017.

In addition to BEPs reforms, we have also seen individual countries reform long-established tax rules over the past year. In the UK, for example, non-resident investors trading in UK land became subject to UK corporation tax for the first time with effect from July 2016, and the UK Government is consulting on extending the scope of UK corporation tax to the taxable income of non-UK resident landlords. In Germany, long considered a stable tax jurisdiction, fundamental reforms to the taxation of investment funds will impact many real estate investors – adversely so in some cases, but beneficially in others; finalised last year, these reforms will apply from January 2018.

It remains to be seen to what extent tax reforms in individual jurisdictions will materially affect the relative attractiveness of those countries to cross-border real estate investors, particularly in isolation. However, tax reform adds an additional complexity into the mix as investors consider their options for 2017.

The effect of Brexit

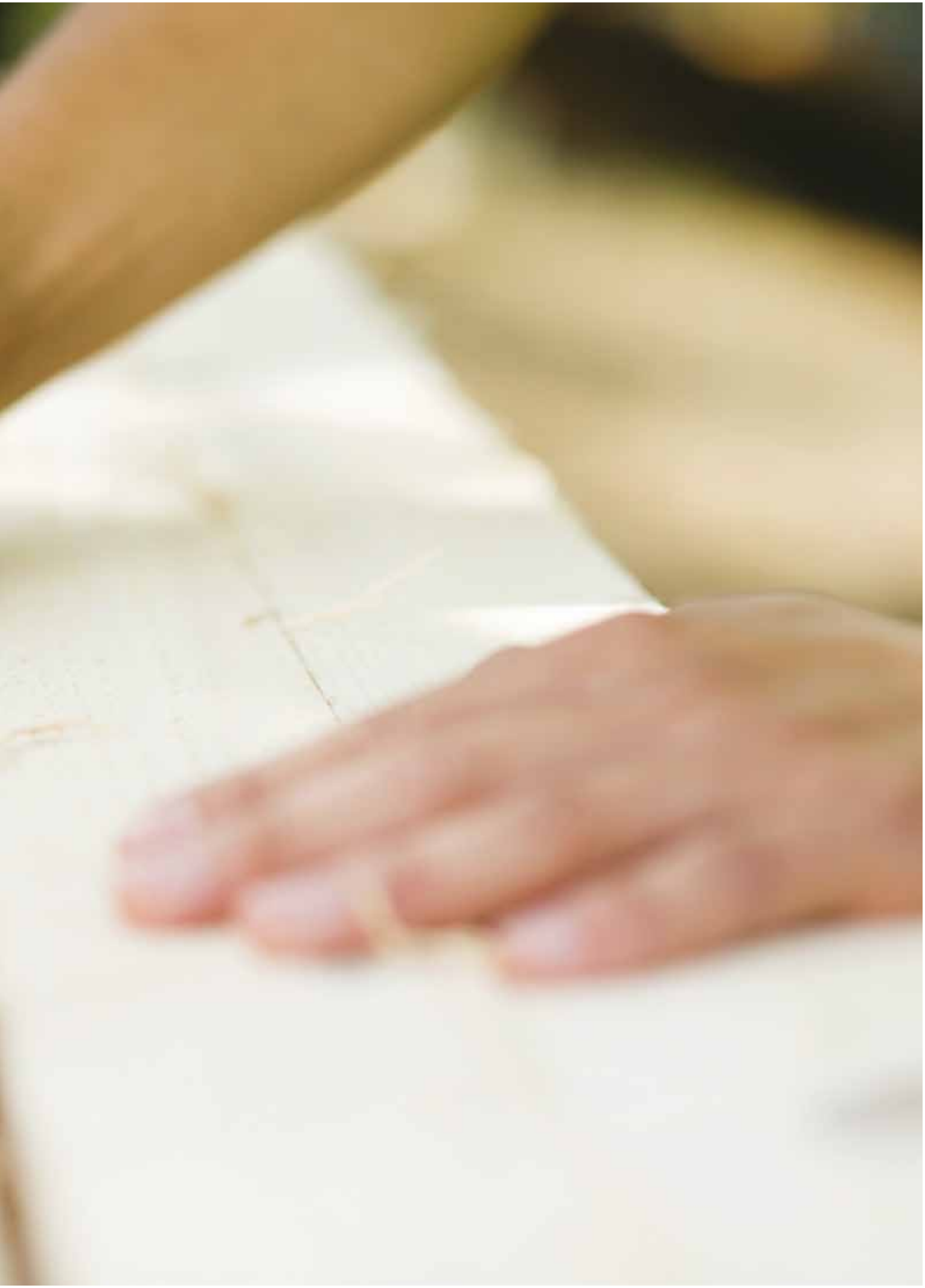
In the immediate aftermath of the UK's vote to leave the European Union, investors across much of Europe reacted with shock; in the real estate sector, several open-ended funds in the UK were subsequently forced to close to withdrawals for a period, as outflows threatened to force managers into unwanted disposals. Elsewhere in the industry, transaction volumes slowed as investors sought to get to grips with the implications of Brexit.

In the absence of a deal on the terms of the UK's withdrawal and its subsequent relationship with the EU, analysis of the medium-to long-term implications is speculative at best.
A disappointing outcome for the UK's financial services sector, for example, would inevitably damage confidence in London office space. Other European countries, notably Germany, could benefit from safe-haven status.

Equally, the relative freedom of the UK government to pursue an independent tax policy offers an opportunity for it offer a more attractive regime to international real estate investors than its EU rivals. It's already clear in early 2017 that overseas investors are returning to the UK market, seeking value from the decline in sterling since the referendum.

For now, the long term implications of Brexit are hard to assess, but we continue to see commitment to the UK. "*We believe in the strength of the UK and London in particular*," says Andreas Schultz, Managing Director of Warburg-HIH Invest responsible for Transaction Management International. "*London is an international, metropolitan city and it will survive as such wherever the negotiations between the UK and the remaining 27 countries in the EU end up*."

Cash-strapped governments target real estate



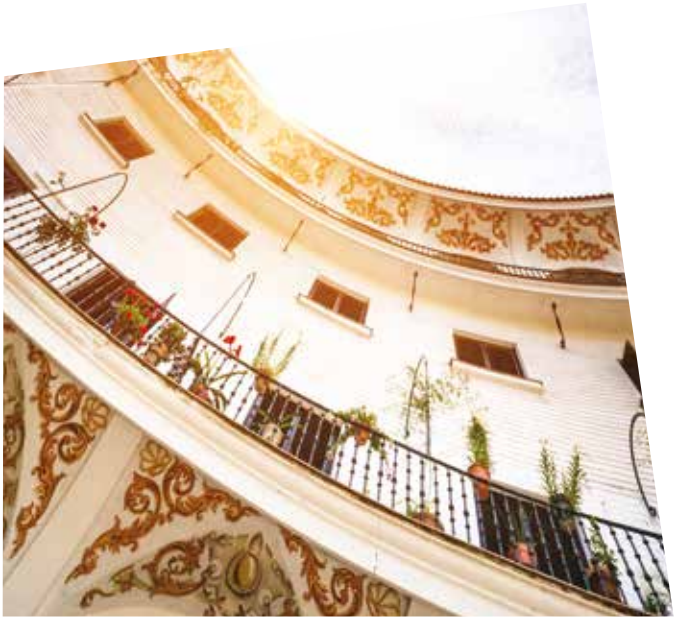
Cash-strapped governments target real estate

As Europe's governments have battled to get to grips with the deficits they amassed during and after the financial crisis, they have inevitably sought to widen their tax base. Moreover, during an era of growing public awareness of corporate tax avoidance and mounting adverse publicity – the authorities' focus has been on finding effective ways of raising revenues from businesses and institutions.

The real estate sector is an obvious target for governments looking for tax revenue. Its assets are physical – bricks and mortar – and generally immovable. By and large real estate investors do not have the option of shifting the source of their income to a jurisdiction offering a more generous tax regime, though such considerations may impact related party financing structures.

Still, while real estate investors cannot be surprised to find themselves at the centre of tax reform, it will be important for investors to look carefully at the potential impact on their businesses. All the more so given the double whammy of the international tax reform led by the OECD and individual reforms introduced in many countries throughout Europe.

The impact of the former could be seismic in some countries. In the UK alone, the British Property Federation has estimated that the Government's implementation of the BEPS measures on interest deductibility will cost the property sector £660m a year in additional tax[5]. In response, the UK Government has proposed a limited exemption for certain third party debt secured on UK real estate let for 50 years or less, but there will be substantial amounts of real estate finance in the UK which will fall outside this exemption (for example, debt secured on property held in a partnership, debt with parent company guarantees and related party debt) which will still be affected.



Moreover, the different interpretation of the OECD proposals at a country level potentially mean some markets will be much more adversely affected than others. Germany, for example, already limits interest deductibility but only if the aggregate interest per SPV reaches or exceeds €3m; companies above that tend to use separate corporate entities to avoid falling into the tax net; Spain has similar rules, with a lower limit of €1m. France, too, has an interest restriction regime in place to which it is unlikely to make substantial changes.

Nor is interest deductibility the only issue worrying investors. The "principal purpose test" proposed under BEPS to be included in double tax treaties also has ramifications for real estate investors in many European jurisdictions. Where a tax authority can show that a transaction or investment vehicle has been structured in order to take advantage of a cross-border tax treaty – even where there may be other motives for operating this way – it may be able to deny any relief granted by that treaty.

> We expect the transfer pricing, anti-treaty abuse and the interest restriction rules to be particularly relevant to UK and European real estate holding and financing structures.

Similarly, the OECD has sought to neutralise the effect of the hybrid financing instruments routinely employed in real estate structures, with rules that will raise the cost of routing investments in a particular way and negate several established tax planning strategies.

Martin Meanley, Head of Direct Tax – Real Estate at M&G Real Estate notes similar themes. "*The implementation of BEPS minimum standards and recommendations as promoted in Europe by the EU Anti-Tax Avoidance Directive is starting to gain traction in some countries,*" he says. "*However, as an international real estate investor, there remains some way to go before we understand how implementation will look across the impacted jurisdictions and in the meantime we continue to live with inevitable uncertainty in the context of long term investment. We expect the transfer pricing, anti-treaty abuse and the interest restriction rules to be particularly relevant to UK and European real estate holding and financing structures.*"

In addition to the OECD tax initiative, many countries across Europe have launched their own programmes of reform, with new regulation already introduced, or on the way. It's possible that reforms in some countries may prompt investors to refocus their efforts in other jurisdictions they regard as less onerous.

> It's possible that reforms in some countries may prompt investors to refocus their efforts in other jurisdictions they regard as less onerous.

UK targets non-resident investors

Non-residents trading in UK land were brought under the corporation tax regime last year under a reform that applies whether or not the investor has a taxable presence. The UK Government has also said it intends to extend corporation tax to the taxable income of non-UK resident investors. The likely effect of this change in law would be to subject non-UK resident landlords investing in UK property to the UK interest restriction rules. Although not currently envisaged, it also seems possible that the UK Government will consider extending the scope of UK corporation tax to include gains realised by non-UK resident investors from UK property, with the intention of treating equally non-UK residents and UK residents investing in UK property.

"*The changes to UK corporation tax are going to have a significant effect on non-UK resident investors,*" says Elliot Weston, a partner in Hogan Lovells London office. "*Historically, UK tax policy has been designed to encourage non-resident investment into real estate, and I think we're going to see a rebalancing of international property portfolios between the UK and other jurisdictions if the UK continues seeking to raise further taxes on non-UK resident investors.*"

Germany mulls transfer tax reform

Reforms to the taxation of investment funds in Germany, including real estate funds subject to German tax or with German investors, will come into effect in January 2018. While the reforms will reduce tax planning opportunities for some investors, they have been broadly welcomed as more transparent and simpler, since funds will no longer be required to calculate "deemed distributions".

By contrast, ongoing discussions about how to ensure more real estate investors pay German transfer taxes on real estate transactions – at up to 6.5% - are potentially more concerning. The current rules on share deal transactions enable most investors to circumvent transfer tax if they have a co-investor buying at least 5.1% of the shares; that threshold may be raised to 25%.

"*The cost of investment could rise significantly under these proposals,*" says Michael Dettmeier, a partner in Hogan Lovells Dusseldorf office. "*The German tax administration is on a learning curve, but it has discovered that real estate represents an opportunity to collect substantially more.*"

France renegotiates Luxembourg treaty

France's reforms of its tax treaty with Luxembourg has forced many real estate investors to rethink the structure of their investments over the past two years. The new treaty, which came into force on 1 January, effectively challenges the favourable capital gains tax treatment previously applied to Luxembourg entities with French real estate assets.

"*This one event very specific to France has triggered a great deal of work,*" says Bruno Knadjian, a partner in Hogan Lovells Paris office. "*For many investors, this has been the prompt to sell assets or to refinance, as they've been forced to reorganise their French real estate holdings.*"

Italy seeks to support loss-making companies

Italy has made relatively few changes to real estate taxation in recent times, but did seek to improve the lot of small, loss-making real estate businesses last year by allowing them to assign property to individual owners in certain circumstances.

"*The law effectively enables owners of properties that have often sat empty to rent them out at a lower amount and still turn a profit after taking into account their lower tax burden,*" says Fulvia Astolfi, a partner in Hogan Lovells Rome office.

Spain pursues multiple reforms

Spain's government has introduced a series of tax reforms in recent years including a reduction in corporate income tax rates from 35% to 25%, implementing the OECD's interest deductibility and anti-hybrids recommendations, limiting the carry forward of tax losses provisions, seeking to increase its capital gains tax revenues and providing further support for SOCIMIS, the country's equivalent of real estate investment trusts (REITS). Further reforms are possible, with speculation that the country's advantageous tax treaty with the Netherlands, which has resulted in many Spanish assets being acquired through special purpose vehicles ultimately owned by a Dutch company, may be reformed.

"*Some of the changes have been positive while others are negative,*" says Javier Gazulla, a partner in Hogan Lovells Madrid office. "*Investors are ready to pay taxes, but do not like changes in the middle of the match without grandfathering provisions. The bigger concern is that the uncertainty introduced into Spain's real estate tax structures may imply that investors prefer opportunities in countries with a more stable tax environment, such as the UK or Germany.*"

Poland tackles avoidance

Poland has sought to tackle tax avoidance through the adoption of updated General Anti Avoidance Rule (GAAR) regulation in July 2016, with implications for real estate investors that include a crackdown on the previously common practice of inter-company transfers of assets designed to reduce the tax bill on a sale.

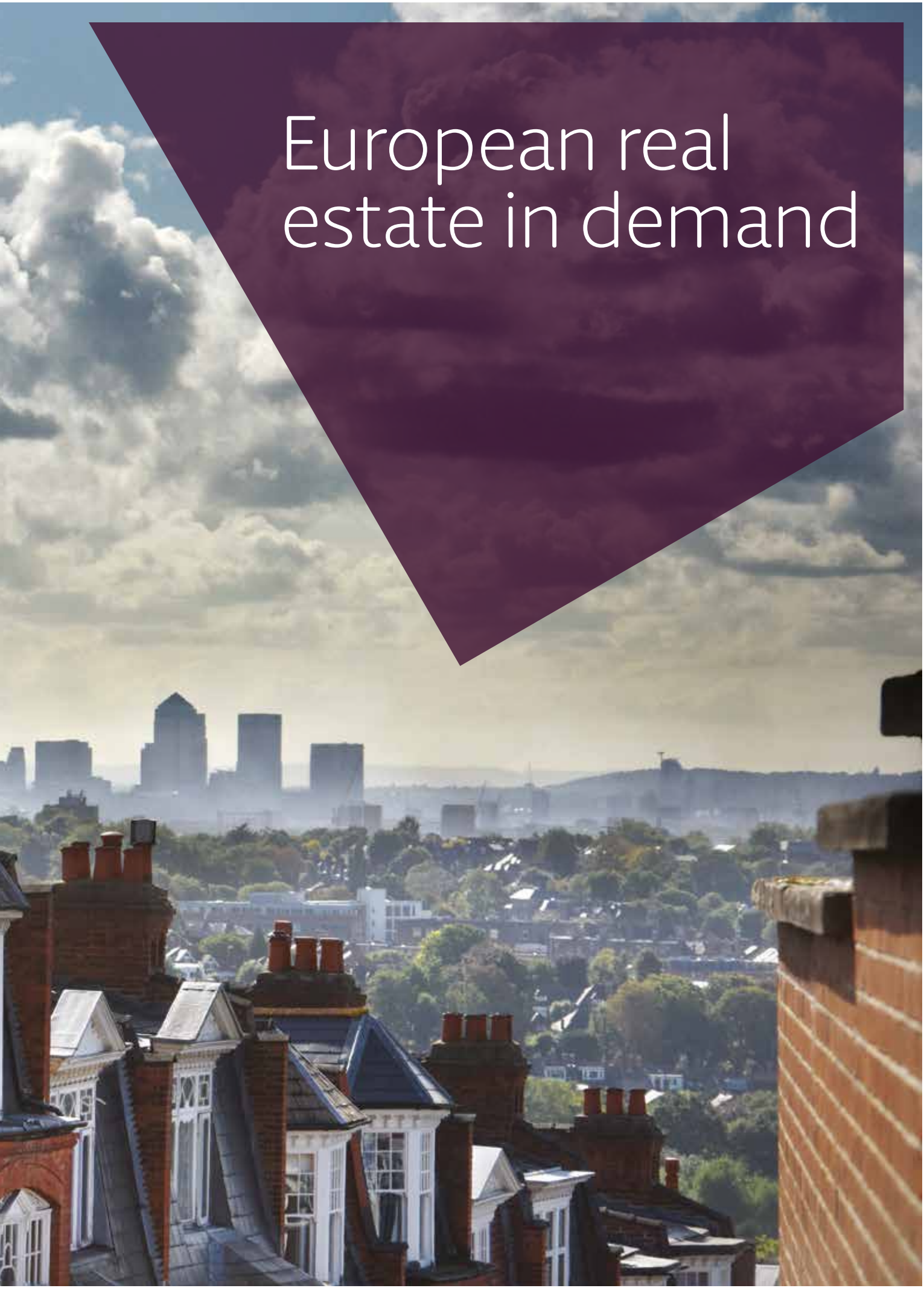
In 2016, the tax authorities changed their view on the VAT treatment of various real estate transactions stating that they should not be treated as simple asset deals (subject to VAT) but as disposals of an enterprise or part thereof (outside the scope of VAT). For these reasons, structuring Polish real estate transactions now requires very detailed analysis as to whether the object of the deal constitutes a simple asset or an enterprise. Increasing numbers of transactions are done as share deals as they do not involve such VAT issues.

In addition, at the beginning of 2015 Poland adopted Controlled Foreign Corporation (CFC) rules aimed at limiting artificial tax structures that use foreign jurisdictions with more tax efficient regimes.

More recently, as of 1 January 2017, changes to the tax exemption rules for Polish and other EU/EEA investment funds were implemented. Open-ended investment funds (meeting certain conditions specified in the law) will still benefit from the tax exemption on their overall incomes generated in Poland. The limitation will apply solely to closed-ended funds, as they will not benefit from the tax exemption on the profits derived from partnerships, as well as some other types of income obtained from partnerships (such as interest on financing).

"*Poland's regions and cities are very keen to encourage foreign investment in infrastructure and real estate, which limits the scope for further tax reforms,*" says Andrzej Dębiec, a partner in Hogan Lovells Warsaw office. "*However, some new taxes, such as the bulk assets tax introduced on banks and insurance companies last year, have already raised the cost of financing*."

European real estate in demand



European real estate in demand

Competition for European real estate assets remains fierce, with institutional investors from around the globe increasingly keen to acquire good-quality properties in Europe. While real estate has long provided investors with diversification benefits, equity market volatility and low yields in the fixed-income markets have accelerated institutions' moves into alternative asset classes. And despite the turmoil of Brexit – and the ongoing uncertainties in a major election year across much of the continent – Europe is regarded as politically stable.

Sovereign wealth funds, in particular, have become a dominant force in Europe's real estate market, accounting for increasing deal volumes and at the front of the queue in the largest transactions. Research published by the Sovereign Wealth Fund Institute last year suggested sovereign wealth funds had increased their allocations to real estate by 29% over the previous 12 months[6]. This looks set to continue: Prequin research suggests that Europe is the favoured region for real estate investment for 56% of sovereign wealth funds[7].

The demand from sovereign wealth funds is a global phenomenon. Norway's $830bn oil fund, the largest sovereign wealth fund in the world, has become a major investor in London's commercial property sector. In the Middle East, funds such as the Qatar Investment Authority, have made a string of high-profile purchases, while Asian vehicles are also increasingly prominent.

Nor is it only sovereign wealth funds that are asserting their power. Chinese overseas real estate investment rose by 53% in 2016[8], with the country's insurers and asset managers amongst the biggest investors and Europe taking a large slice of the money. Indeed, demand from investors across Asia has soared, as governments throughout the region have eased overseas investment restrictions on institutions including insurers and pension funds. North American pension funds, in both the US and Canada, have also raised their allocations to European property.

Then there is the private equity sector, where an increasing appetite for real estate investment, as evidenced by accelerated fund-raising from 2013 to 2015, appears to have continued last year; while full-year data is not yet available, European real estate-focused private equity funds raised $9bn in the first half of the year according to Preqin[9], ahead of 2015.

Other investors eyeing real estate include family offices, argues Hogan Lovells Michael Dettmeier. "*High-net-worth investors and families that have traditionally focused on the most secure fixed-income investments have not been able to earn the returns they require from those assets,*" he says. "*They are now looking more and more actively at real estate.*"

Moreover, while most investors taking their first steps into European real estate have begun with core assets, the search for yield has often prompted them to look further afield. Poland, for example, has begun seeing interest from Arab investors in its real estate infrastructure. Almost everywhere you look, traditional real estate investors have been joined by relative newcomers to the sector.

The result of so much competition for a limited number of assets has been price inflation, argues Hogan Lovells Bruno Knadjian. "*It's possible to raise funds at such low rates that cash is widely available and the number of potential buyers keeps increasing,*" Knadjian says. "*In France, that has increased prices to a certain extent*." Similar effects are recounted by real estate professionals across Europe.

The influx of large institutional investors has had another effect too. In Germany, Michael Dettmeier says developers have understood the need to professionalise their operations. "*Developers are aware that the highest prices are going to come from the foreign and the domestic institutional investors, but to attract that interest they've felt it necessary to make significant investments in their data rooms and presentation,*" he says. "*This is now a far more professional sector*."

"They will be a substantial part of the European property market going forward," Weston argues. "We're seeing the launch of more specialised and sector-focused REITs, and these vehicles offer a direct way for investors to put their money into particular classes of real estate ."

The rise of the REIT

The temporary closure of several open-ended property funds in the UK following the post-Brexit turmoil last year underlined a key attraction of real estate investment trusts (REITs) – the liquidity of publicly-traded securities in a closed-ended fund structure is an obvious advantage.

In fact, REITs are a relatively new concept for European real estate investment, having really taken off in the UK following regulatory reforms in 2012, and even more recently in markets such as France, Germany and Spain. Nevertheless, argues Hogan Lovells Elliot Weston, REITs have the potential to become significant players across Europe.

"*They will be a substantial part of the European property market going forward,*" Weston argues. "*We're seeing the launch of more specialised and sector-focused REITs, and these vehicles offer a direct way for investors to put their money into particular classes of real estate*."

New asset classes emerge

New asset classes emerge

There was a time when the real estate sector broke down neatly into three distinct segments, with investors taking their pick from retail, office and industrial assets. No longer – this is now a marketplace with a strong alternatives sector in which investors large and small are considering playing; many of those niches weren't on the radar of most investors until relatively recently.

In 2017, by contrast, 44% of real estate investors are considering investing in alternative sectors according to research conducted by PwC[10], 16 percentage points higher than in 2015. These sectors range from student housing to care homes and from hotels to data centres.

A variety of factors explain this trend. One crucial driver is change in social patterns, with investors recognising the implications of themes such as the ageing population and the extended education years of many younger European citizens. PwC cites student accommodation and retirement property as two of the three alternative real estate sectors where investors were most active last year, with investors signalling this will be true again in 2017.

It's important, too, that many of these alternative real estate assets offer stable income streams; in areas such as education and retirement, that income may even be underwritten by local authorities or institutional providers on some projects. Such an income profile offers obvious attractions to pension funds looking to match assets to their liabilities.

More broadly, the increasing allocation to real estate as a whole by many investors is driving a desire to diversify beyond conventional property assets. Equally, the huge demand for core real estate assets has resulted in yield compression in many areas of the market; investors looking for yield have therefore been forced to venture further afield.

The opportunities vary from country to country. In France, Hogan Lovells Bruno Knadjian says: "*We're seeing significant appetite for hotels, particularly in Paris, but we've also seen a great deal of demand for shopping centres, with a number of new developments, notably in the surroundings of Paris, capturing investors' imagination.*"

In Italy, meanwhile, Hogan Lovells partner Fulvia Astolfi says it is the emergence of the assisted living and retirement sector that is causing a stir. "*We know that this kind of real estate has been very profitable in other jurisdictions but we're only just beginning to see it exploited here,*" she says. "*The structure of the Italian family is changing, so where once older people would have lived with their families, this is becoming less common.*"

In the UK, by contrast, Hogan Lovells Elliot Weston points to the popularity of the country's universities with overseas students as a huge plus for the student accommodation sector. "*Student returns have been the most attractive of any asset class within real estate over the past five years,*" he says. "*Investment is continuing and some of the accommodation now has some similarities with operating businesses like a boutique hotel or retirement home.*"

The UK's private rental sector is also an increasing draw, says Weston, amid unprecedented demand for rental accommodation amongst Britons priced out of property ownership by inflation-beating house price appreciation and tough conditions in the mortgage market. "*You are going to see the UK increasingly become a residential lettings market and build-to-rent, rather than build-to-sell, will be an important part of the proposition for investors.*"

The UK and other countries are also seeing the changing shape of the economy drive real estate investment. The vast data storage facilities now required by many businesses represent a sub-sector

of the market that simply didn't exist a decade ago; similarly, the move to online retail has seen the emergence of warehousing and distribution infrastructure as an area of interest.

"*Do retailers really know what range of shed sizes they need to operate from with the ever increasing demand for internet retailing?,*" asks Andrew Creighton, Head of Direct Property , Europe at Aberdeen Asset Management. "*You only have to look at a company like Amazon who let more than 25% of vacant logistics space in 30 separate lettings in the UK in 2016. This was something like one in every seven sheds available to let.*"

In other cases, opportunistic investors are emerging. In Spain, for example, Hogan Lovells partner Javier Gazulla says: "*Residential has been very quiet in recent years since the bubble burst, but investors are now realising there is growing demand for good residential assets, particularly as residential yields have been increasing.*"

Tax headache for residential investors

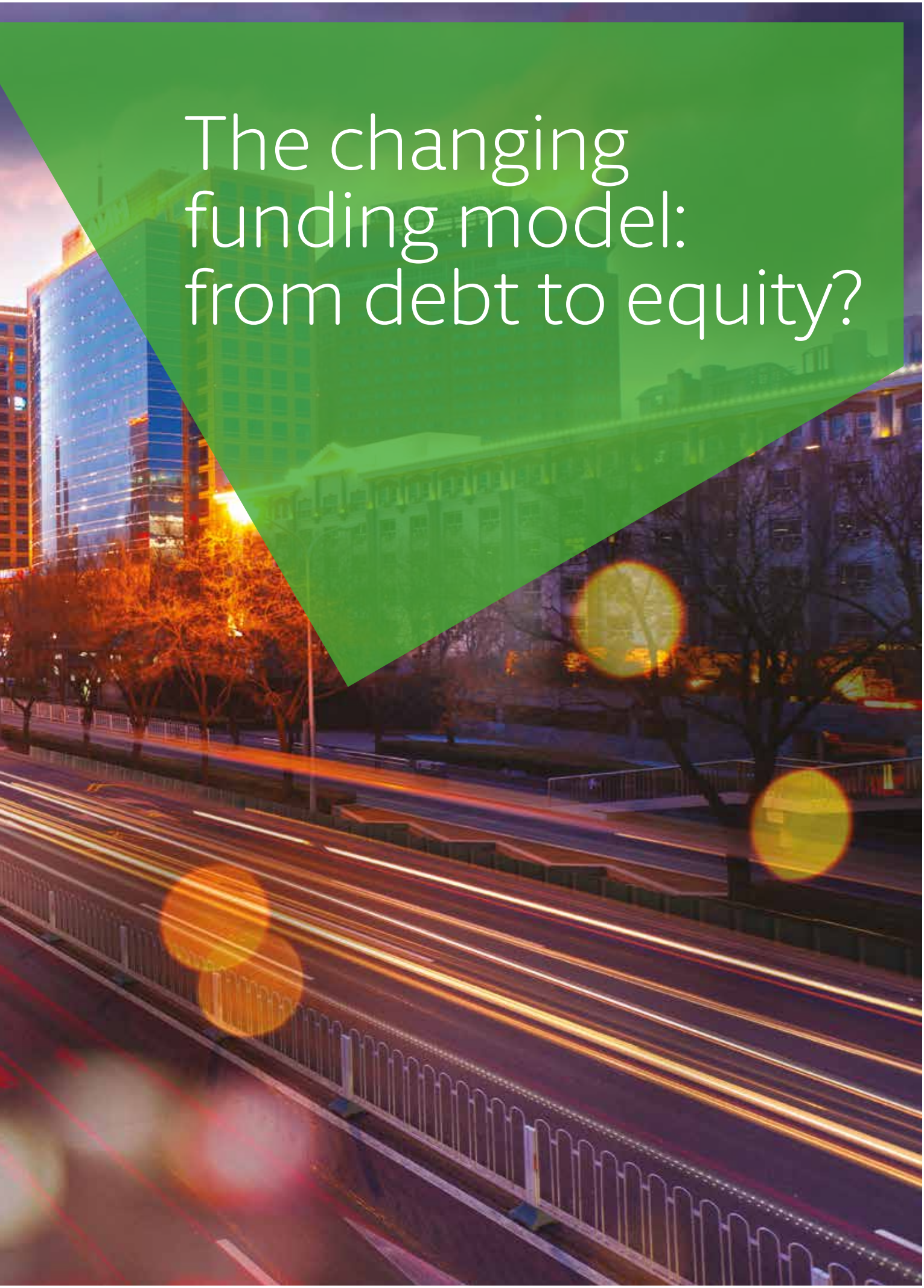
The move by institutional investors into residential property assets is a Europe-wide theme spanning student accommodation, retirement homes and the broader private rental sector in countries across the continent. But investors sometimes face significant headwinds in the form of tax compared to commercial property where the regime tends to be more benign.

Transfer taxes are one example, with a number of countries applying significantly higher duties on residential property purchases. In the UK, for example, the Government last year introduced a 3 percentage point stamp duty land tax surcharge on residential property acquired as an investment.

In the UK, the lack of capital allowances for residential property and the inability to recover VAT on repairs and letting costs also places residential property investment at a disadvantage as compared with commercial property investment.

By contrast, Spain has introduced several tax incentives for the acquisition of residential property by institutional investors, either to be re-sold or leased. For example, regions including Madrid, Catalonia and Andalusia have introduced reduced rates for transfer tax when the purchaser intends to re-sell the acquired residential properties to individuals within three to five years. Also, SOCIMIs can apply a 95% tax relief on transfer tax or stamp duty due on the acquisition of residential properties, provided the properties are leased during a minimum period of three years.

The changing funding model: from debt to equity?



The changing funding model: from debt to equity?

The availability of commercial real estate debt has long underpinned the sector's growth – and supported the broader European economy. The Commercial Real Estate Finance Council for Europe estimates[11] debt accounts for 47% of total invested commercial real estate capital in Europe today.

Since the financial crisis, however, the nature and structure of the real estate debt market has changed. Prior to the crisis, bank lending accounted for as much as 95% of European commercial real estate lending; that lending then collapsed during the credit crunch, and while it has recovered steadily since then, banks' share of the new lending market has reduced in favour of insurance companies and other institutional investors, as well as new entrants.

"*The question now is whether we are going to go back to a market where real estate finance increases again, year after year,*" says Elliot Weston of Hogan Lovells. "*I wonder if we're not – whether the way in which investment is made into real estate is going to be less debt-led and more equity focused.*"

Many real estate professionals share that view. PwC's research[12] reveals that 48% of investors and fund managers expect the supply of equity for refinancing or new investment in the real estate sector to increase during 2017, against only 40% who say the same of debt capital.

There are a variety of explanations for this shift. One factor is the inability of the banking sector to return to pre-crisis levels of financing given regulatory reforms that now require lenders to set more capital against the loans they make. So while lending increased rapidly in the immediate aftermath of the credit crunch, loan-to-value ratios and interest cover have been stable since 2014 or so. And while new entrants to the credit market, including insurers and private equity groups, have filled some of the gap with longer-term debt and products such as mezzanine finance, this has only partially closed the gap.

The loose monetary policy pursued in recent years by both the Bank of England and the European Central Bank might have been expected to boost bank lending in the real estate sector. But while lower-for-longer interest rates have kept the cost of debt finance down, liquidity from policies such as quantitative easing appears to have gone elsewhere.

In fact, the bigger impact of the low interest rate environment has been on the supply of equity capital to the real estate sector, as investors frustrated by low returns on conventional assets have looked elsewhere. The result has been a surge in the volume of equity flowing into European real estate investments.

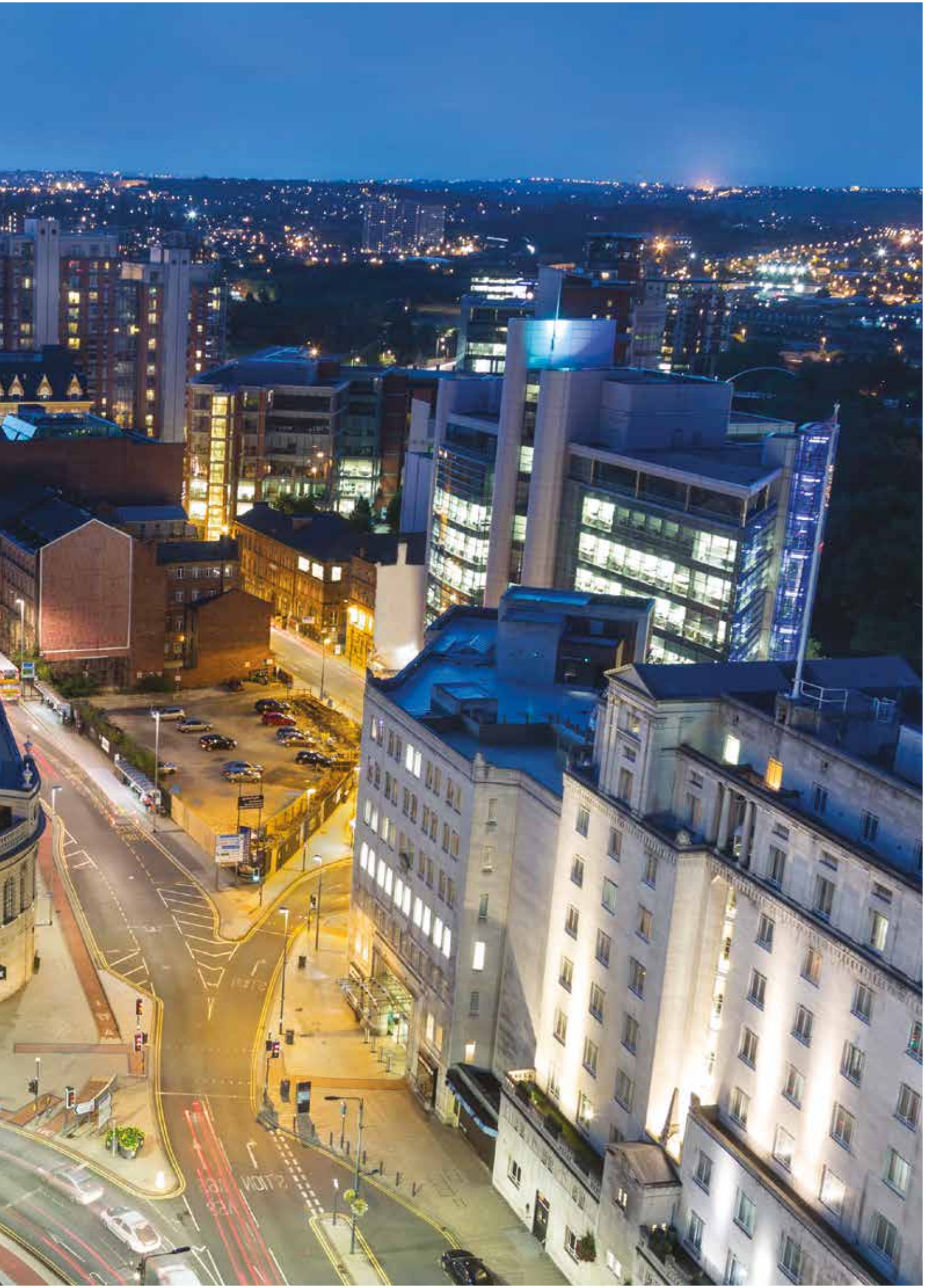
One other driver for this trend looms large on the horizon too. The OECD move to severely limit deductibility of interest will reduce the attractiveness of debt as a means of financing real estate investment. If post-tax returns on dividends and interest payments are broadly equivalent, that may see a shift to preference share structures – or simply to equity full-stop.

New types of arrangement may come to the fore against this backdrop. The Norwegian sovereign wealth fund's long-standing partnership with the Crown Estates in London's Regent Street is just one example of how equity investors might work together in new forms of collaboration.

Equally, however, not all investors require external financing. Gerald Neiens, a partner in Hogan Lovells Luxembourg office, says: "*Many of the major groups have the cash they need and aren't in the market for finance; they're capable of making the acquisitions they want to do without it.*"

Nor is there any prospect of the debt market withering on the vine. "*A potential increase in interest rates would impact loan-to-value ratios, and investors will need to fill this gap with more debt structuring; in which case we're going to see providers issuing loans to the market once more,*" forecasts Hogan Lovells Javier Gazulla. He points to Blackstone Group's recent purchase of the non-performing loan book of Catalunya Bank, which it has begun to offload via a securitisation fund.

The current year



The current year

What does 2017 have in store for European real estate? After the ups and downs of 2016, forecasting is fraught with danger, but many of the trends seen during 2016, from the search for yield to the appeal of alternative real estate assets look set to continue.

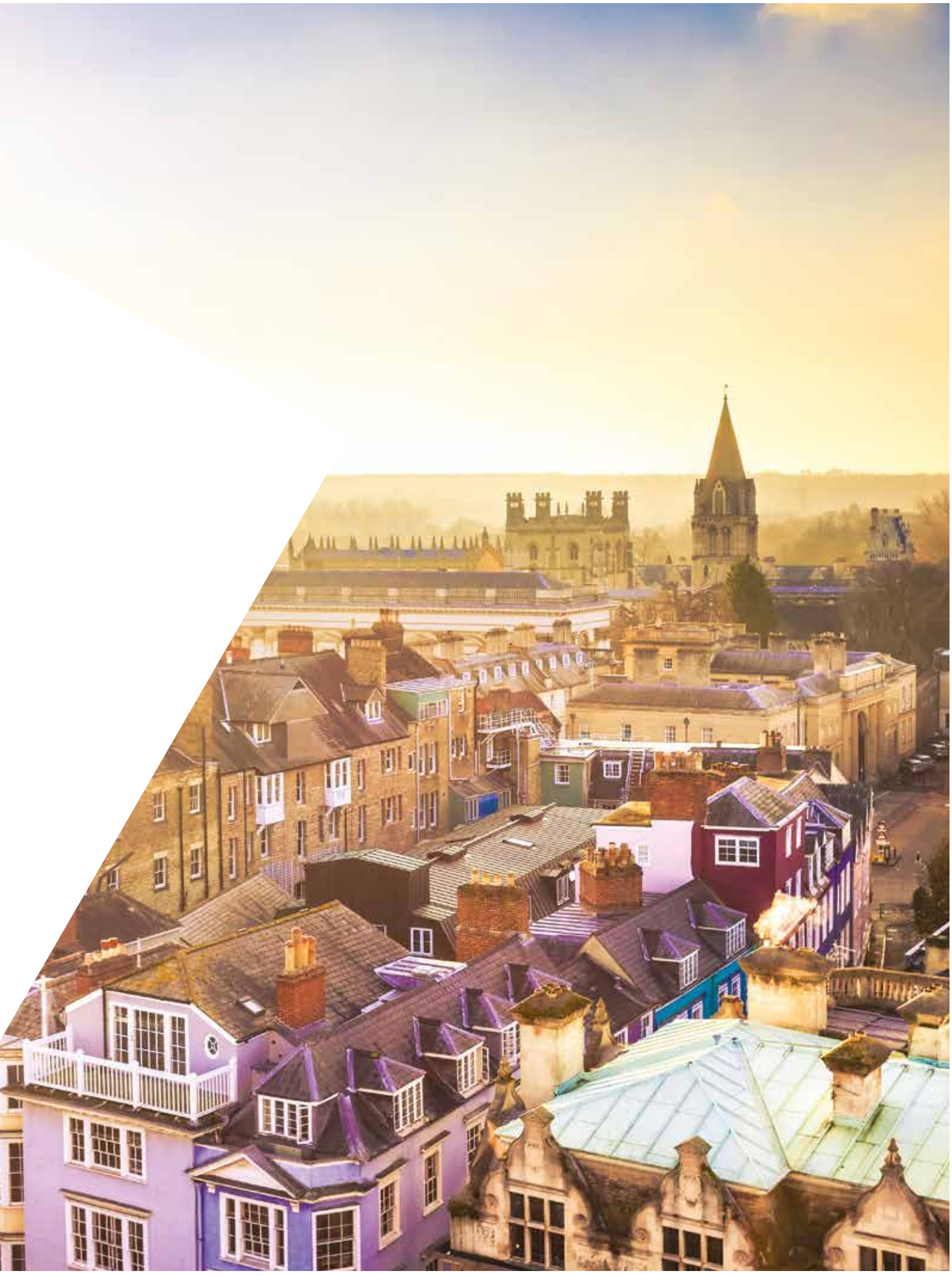
The economic backdrop is expected to be more of the same – growth, but at historically low rates. The International Monetary Fund forecasts GDP growth of 1.5% in 2017 in the eurozone and 1.1% in the UK[13]. And while some analysts, including the Bank of England, are more positive, a decisive move away from the loose monetary policy seen across Europe in recent times seems unlikely. In that context, with traditional asset classes continuing to offer meagre returns, there is little prospect of real estate falling from favour from investors seeking more rewarding performance.

Andreas Schultz, of Warburg-HIH Invest, believes this is the stand-out argument for the asset class over the year to come. "*The two factors that have driven investment into European real estate, even at high prices, have been the availability of very cheap financing and the absence of alternative compelling assets,*" he argues. "*Those factors aren't changing in the short run and investors are going to need to stick with real estate.*"

The economic outlook also suggests there is some scope for rental appreciation in leading markets. Indeed, CBRE Research predicts growth of 0.9% from the office sector across Europe as a whole during 2017, rising to 2.7% for both retail and industrial assets. Equally, the mismatch between supply and demand in many sectors and markets, with buyers outstripping sellers, particularly of higher-quality assets, should spell capital appreciation. Further yield compression looks likely.

"*I do believe that the pressure of capital pushing itself into real estate due to the yield gap with fixed income will continue to drive strong demand,*" agrees Philip La Pierre, Head of Investment Management Europe at Union Investment Real Estate. "*The question is whether we will be able to achieve the same level of transaction volumes in 2017 given the stock made available to the market? I doubt it.*"

The bigger question marks centre on the political uncertainties of 2017. The UK is beginning its two-year period of negotiations over how to leave the European Union, but Brexit is just one potentially destabiliser. Elections in Germany and, particularly in France provide further opportunities for unexpected outcomes, while Italy must resolve its constitutional difficulties. In Greece, meanwhile, concern is mounting that another fall-out between the Government and its creditors could see the eurozone's sovereign debt crisis move centre-stage once again.



The potential for political upheaval on so many different fronts will eventually begin to worry international investors in European real estate, warns Hogan Lovells Gerard Neiens. "*We have been a safe haven for US investors, for Asian investors and for Middle Eastern investors,*" he says. "*We could reach a stage where those investors no longer feel so comfortable with the political stability of Europe.*"

There's also the Trump effect to consider. Financial markets greeted the new President's election in November with a shift in interest rate expectations: Mr Trump's instincts for fiscal stimulus, including corporate tax cuts and infrastructure investment, potentially give the US Federal Reserve more room to raise interest rates at a faster pace than previously expected. That could suck in investment from Europe and elsewhere. It's also possible that the President's uncompromising views, particularly on global trade, could lead to political volatility and economic headwinds that damage investor sentiment across a multitude of asset classes.

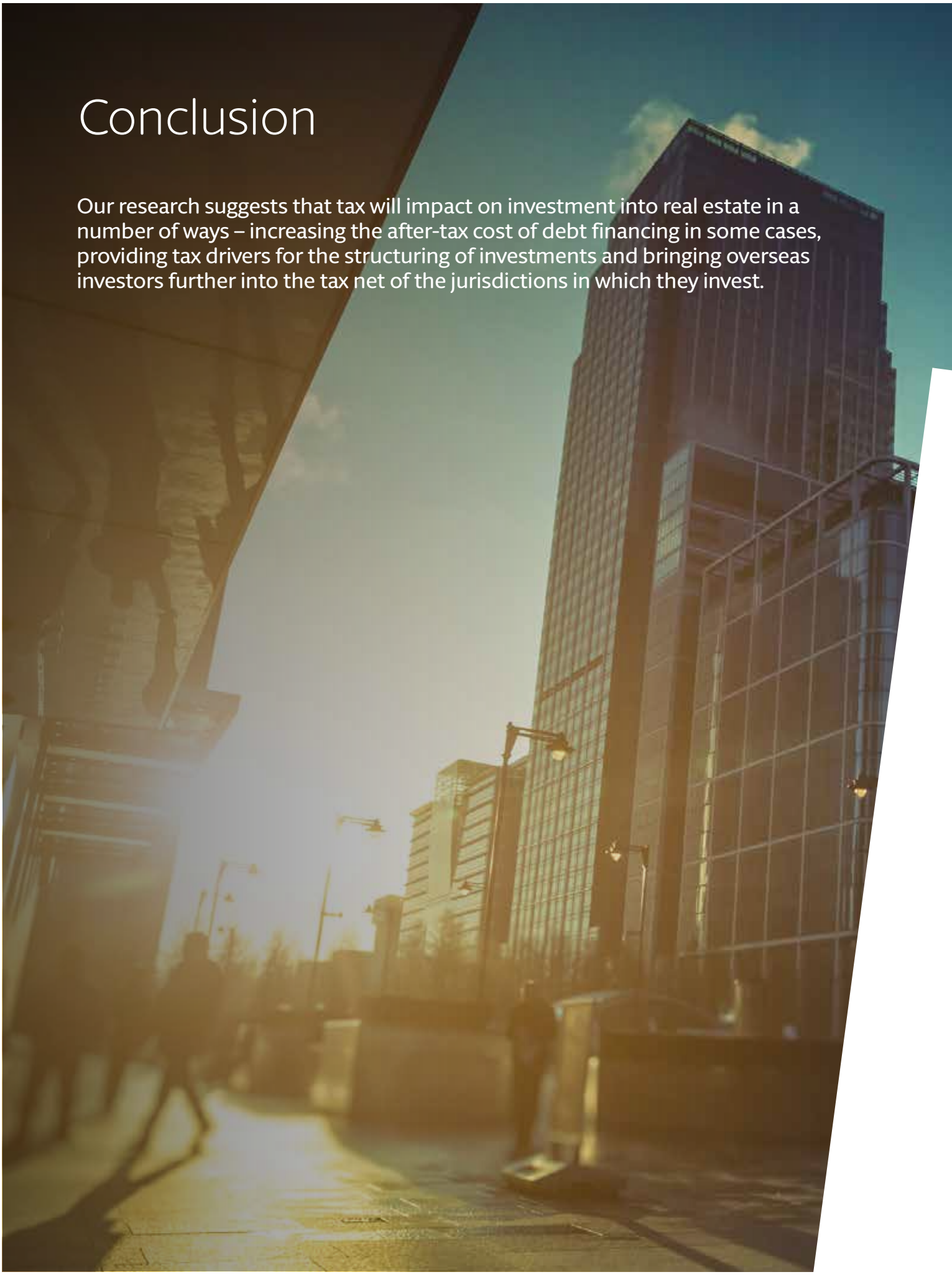
At a more micro-level, Europe's appetite for tax and regulatory reforms has yet to be sated; negotiations over the implementation of the BEPS regime in some countries continues, while others are pressing ahead with further tax reforms. For example, the UK government is consulting on extending corporation tax to the income of non-resident investors in UK property and could decide to charge corporation tax on capital gains for such investors as well; Germany is continuing to debate which mechanism it will use to ensnare more commercial real estate transactions in its transfer tax net; and Spain is widely expected to roll back its tax treaty with the Netherlands.

Tax reform in any one country will make a material difference to its attractiveness to real estate investors, particularly over time. Despite all the uncertainties, however, Union Investment's La Pierre doesn't expect investors to go anywhere fast. "*I think people will talk a lot, but that ultimately they'll swallow the risks,*" he says. "*It's a 10-to-one ratio out there right now for many deals, and there would have to be huge shifts in sentiment to drive all of those buyers away.*"

At Aberdeen Asset Management, Andrew Creighton is also sanguine. "*My own feeling is the political situation will calm down and that will help,*" he says. "*More generally, investors are increasingly focussed on income in this low interest environment and with the dominant element of the total return from property coming from income, it's going to remain in the spotlight.*"

Conclusion

Our research suggests that tax will impact on investment into real estate in a number of ways – increasing the after-tax cost of debt financing in some cases, providing tax drivers for the structuring of investments and bringing overseas investors further into the tax net of the jurisdictions in which they invest.



Tax systems are becoming more complex and the pace of change looks set to continue. Familiar acquisition and financing structures for cross-border real estate investment are being affected by these tax changes.

We expect that tax reform will be driven by both international initiatives, such as the OECD's BEPS reforms, and national governments looking to attract investment and protect tax revenues in both the U.S and Europe.

Under the early blueprints for U.S. reform, restrictions on interest deductions could negatively impact the after-tax returns of real estate investors, but the real estate industry would be likely to receive a significant boost from moves towards full expensing of the acquisition costs of U.S. real estate, further clarification on FIRPTA changes and incentives to repatriate profits held overseas.

While political uncertainty is elevated in both the U.S and Europe and has the potential to drag down appetite for investment, a basketful of market factors — solid fundamentals, robust international capital flows, cheap access to capital, declining unemployment combined with ample labor slack and a supply-demand imbalance supporting higher prices — should combine to buoy real estate markets in both the U.S. and Europe.

We expect some trends in real estate investment to continue:

– competition for high quality real estate assets will be global, with sovereign wealth funds and investors from Asia and the Middle East particularly prominent;
– investors will continue to diversify, with alternatives such as data and logistics centres, hotels and residential property forming a common part of investment portfolios; and
– equity investment into real estate, both on the public REIT markets and private joint ventures, will be an increasing feature of transactions.

Overall, the real estate sector should see plenty of activity and staying up to date and obtaining early advice on tax changes will be an important part of structuring cross-border real estate investment. If you would like to discuss any of these issues, please don't hesitate to get in touch.

References

1. http://news.cbre.eu/investment-in-european-commercial-property-reaches-a-868bn-record-in-q4-2016/
2. http://www.jll.com/gmp/market-perspective/residential
3. http://www.savills.co.uk/_news/article/110559/200105-0/3/2016/investment-in-alternative-real-estate-assets-becomes-the-norm-in-europe
4. http://www.costar.co.uk/en/assets/news/2016/December/Fidelity-European-cycle-still-has-legs/
5. Property groups say BEPS will cost UK sector £660m, Financial Times, January 2016 (https://www.ft.com/content/16f4008a-bac3-11e5-bf7e-8a339b6f2164).
6. Sovereign wealth funds pile into property, Financial Times, June 2016 (https://www.ft.com/content/9792d5f8-2f09-11e6-bf8d-26294ad519fc)
7. Sovereign wealth funds investing in real estate, Preqin, May 2016 (https://www.preqin.com/docs/newsletters/re/Preqin-RESL-May-16-Sovereign-Wealth-Funds.pdf)
8. China investment in foreign real estate hits a record $33bn, Financial Times, January 2017 (https://www.ft.com/content/d8d80b6e-e381-11e6-8405-9e5580d6e5fb)
9. Private Equity Real Estate Debt Funds Multiply in 2016, Preqin, August 2016 (https://www.preqin.com/docs/press/RE-Debt-16.pdf)
10. Emerging trends in real estate, PwC, 2016
11. Commercial Real Estate Debt in the European Economy 2016, CREFC Europe
12. Emerging trends in real estate, PwC, 2016
13. World Economic Outlook, IMF, October 2017

Tax team

Key contacts

Fulvia Astolfi
Partner, Rome
T +39 06 6758 2322
fulvia.astolfi@hoganlovells.com

Cameron Cosby
Partner, Washington D.C.
T +1 202 637 3681
cameron.cosby@hoganlovells.com

Andrzej Debiec
Partner, Warsaw
T +48 22 5292 930
andrzej.debiec@hoganlovells.com

Michael Dettmeier
Partner, Düsseldorf
T +49 211 1368 505
michael.dettmeier@hoganlovells.com

Javier Gazulla
Partner, Madrid
T +34 91 3498 271
javier.gazulla@hoganlovells.com

Karen Hughes
Co-Head of the Global Tax Practice, London
T +44 20 7296 5438
karen.hughes@hoganlovells.com

Bruno Knadjian
Partner, Paris
T +33 1 5367 1865
bruno.knadjian@hoganlovells.com

Anton Louwinger
Partner, Amsterdam
T +31 20 5533 785
anton.louwinger@hoganlovells.com

Gerard Neiens
Partner, Luxembourg
T +352 26 4 26301
gerard.neiens@hoganlovells.com

Elliot Weston
Partner, London
T +44 20 7296 2658
elliot.weston@hoganlovells.com

Notes

Alicante
Amsterdam
Baltimore
Beijing
Birmingham
Brussels
Budapest
Caracas
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta
Johannesburg
London
Los Angeles
Louisville
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Moscow
Munich
New York
Northern Virginia
Paris
Perth
Philadelphia
Rio de Janeiro
Rome
San Francisco
São Paulo
Shanghai
Shanghai FTZ
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar
Warsaw
Washington, D.C.
Zagreb

Our offices
Associated offices

www.hoganlovells.com