Hogan Lovells

Real Estate Horizons

2019

The year ahead: are you ready?

2019 promises to be an eventful year but, despite ongoing political and economic uncertainty, real estate globally continues to attract record levels of international capital. Will that continue? Inevitably, attention will focus on the global effect of Brexit and whether and to what extent that triggers a shift in market appetite for investment in the UK and beyond.

Whilst the market strives to keep pace with changes within the macro and micro political climate, technological changes continue to change the way we work and the ways in which deals can be done. Blockchain, PropTech, tokenization and cyber security are all concepts that are becoming increasingly familiar.

Our strategy is to anticipate and monitor how clients can adapt to change and be ready for the year ahead. Not only does our international network mean that we are adept at dealing with a wide range of cross-border issues, but our offices throughout the world have the knowledge to offer both global and local solutions, ranging from effective deal structuring to PropTech and investment in student accommodation.

In this short guide, we highlight key legal and market trends which we see shaping the future of the real estate market. If you would like to explore any of the issues mentioned in this booklet further, please speak to one of the contacts listed, or to any partner from our global industry sector.

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The impact of Brexit on real estate

The original Treaty of Rome excluded land law from the ambit of EU legislation so many aspects of the UK land ownership system remain long-standing and stable, and operate on a UK specific basis. The industry can therefore take comfort that, unlike many other sectors, key day-to-day features of UK real estate investment and operation will remain unaffected, but....

All very frustrating?

A 2019 legal case considered whether Brexit could frustrate a lease. Frustration is the legal principle that a contract, including a lease, can be terminated if performance effectively becomes impossible. The landlord argued that the UK's withdrawal from the EU and/or the relocation of the tenant (the European Medicines Agency – "EMA") did not cause the lease between the parties to be frustrated. The court agreed and the EMA remains bound by the lease not withstanding Brexit. Ultimately, the arguments turned on the very bespoke characteristics of the EMA as a European institution. However, the EMA has been granted permission to appeal so residual concerns about the risk of commercial tenants arguing that Brexit is a legally frustrating event will remain pending the outcome of the appeal.

Development delays?

Lack of skilled construction workers is already a problem facing the development industry, which is only likely to be exacerbated by a reduction in access to overseas workers.

This could be compounded by changes to the rules for freedom of movement of goods and the resulting congestion at UK entry points whilst new systems are put into effect. That may include building materials with the consequent impact on construction programs and therefore cost.

Planning consent challenges?

Judicial reviews are already a favored tool for those seeking to prevent development, with grounds such as air quality frequently being relied on. With the EU control over these issues lost it seems even more likely that people will look to the courts to protect the environment, increasing the risk of challenges to planning permissions.

Brexit Hub

When law, policy and politics converge, you need advisors who do not see Brexit through a narrow lens. Our Brexit Hub contains all our thought leadership across practices, sectors and jurisdictions to help you navigate Brexit's impact on your business. We have developed tools and checklists to provide practical solutions and you can access our dedicated Brexit Taskforce for specific advice. Find out more at hoganlovells.com/brexit.

Brexit Toolkit

Brexit Hub

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Smart contracts

"Smart contracts", a term originally coined over 20 years ago, is nowadays used to describe computer codes and algorithms that allow contracts to self-perform. The term is highly related with blockchain, as the main trend is that these work on a blockchain-based platform. In a nutshell, a smart contract will "self-enforce" / "self-perform" a pre-determined outcome from a contractual provision once its objective criteria is met without the need of an intermediary.

At present, smart contracts are best suited to execute somewhat rudimentary legal tasks, which typically involve transferring funds or imposing financial penalties when certain conditions are satisfied. However, as the applications of blockchain and the assets controlled by it expand, the use of smart contracts is likely to become more complex and legally sophisticated.

Have you been at a hotel and found that once you've been billed and paid through your card, an app will open the room door? That's a smart contract. Other actions can be performed such as utilities in a flat which might continue to work as rent is paid through a credit card. Eventually, smart contracts might rule and perform transfer of real estate ownership. These contracts are expected to reduce transaction costs and time spent on real estate deals, while still benefiting from the security, transparency, immutability, decentralization and permanence that blockchain offers. Furthermore, smart contracts—coupled with other property record-keeping applications of blockchain—could be used to review leases, cash flows, and property history. This can greatly improve asset management and the auditing process of properties and leases, which would be especially useful in real estate portfolio transactions.

Notwithstanding its promising applications, smart contracts still have a long way to reach maturity and overcome traditional text-based contracts. There are concerns that need to be addressed before the wide-spread application of smart contracts. These include technological shortcomings and the incompatibility between the smart contract's objective and automated nature versus the desirable subjectivity sometimes needed in real-life business.

Like many other digital applications in traditional contracts, such as eSignatures or eDocs, smart contracts are likely to be more formally regulated and implemented in the near future. The application of smart contracts is not only an exciting new intersection between the law and technology, but it is also a transformational stage for the real estate industry if implemented as proponents believe.

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The year of the dedicated property stock exchange?

An intriguing prospect for 2019 is the possibility of the first UK stock market listings of individual real estate assets. The listing of a single office block, shopping centre or even a sports stadium could become a possibility.

IPSX Group announced at the beginning of the year that it has obtained UK Financial Conduct Authority authorization to launch a new regulated securities exchange solely focused on companies owning real estate assets. Other market participants are understood to be looking at similar proposals. The potential benefits to investors include the ability to make highly targeted decisions to obtain investment exposure to particular properties, businesses, and sectors.

But significant elements of the listing process and on-going obligations for the new exchanges will be similar to the requirements for existing stock exchange-listed property companies.

The securities traded on the new exchanges will be shares of closed-ended public limited companies that own the relevant properties.

In order to list, a company will have to prepare a prospectus which is reviewed and approved by the Financial Conduct Authority and which must include a RICS valuation and a description of the company's material contracts, which may include key debt finance and tenancy agreements.

The company might also constitute an "alternative investment fund", meaning that it, or an external manager appointed by the company, has to register or be authorized as an "alternative investment fund manager".

Most significantly, a company listed on a property exchange must comply with the on-going disclosure obligations applicable to public companies. This includes prompt public disclosure of any material changes in the company's circumstances, for instance regarding a key tenant or a rent review, irrespective of the impact that the disclosure may have on the company's share price.

An advantage of a listed company over a private company is the ability to become a REIT for tax purposes. But a REIT must own three or more single rental properties. What counts as a single property is fairly flexible, but not all single-asset listed property companies will necessarily meet that test.

Apart from listing single property companies, most of what the new exchanges are intended to facilitate could probably be achieved by a listing on one of the UK's existing regulated markets. Newcomers will need to differentiate themselves by providing investors with better exposure, pricing and liquidity than the current options.

The power of the brand

With property developments increasingly focusing on experience and becoming "destinations" or lifestyle brands in their own right, branding has become an essential element of the development process. Therefore, protecting your intellectual property rights ("IP") is important, helping to protect and even increase the value of your development.

There are four main reasons to protect your real estate brand:

a) to prevent copying;

b) to create a branded, experiential destination for customers, tenants and other users;

c) to increase revenue through licensing (for example through merchandise); and

d) to increase recognition of your brand and marketability of your development.

Conversely, if you are an investor/purchaser you should be looking to ensure that all the necessary IP rights are owned by the developer and transferred as part of the transaction.

Here are some key things to consider in protecting these rights

Trade Mark Rights

This covers amongst other things, names, nicknames and logos.

The name of the development, as well as any nicknames, can and should be protected by registration as well as any designs or logos used.

Registering trade marks will help to protect against damaging infringement and copycats.

There are many trade marks registered in retail and real estate services. It is a crowded market and that can make it difficult to register a trade mark which is sufficiently different to those already registered. Register the trade mark early. If the name of the development becomes synonymous with the area it's in it may be difficult to register the name as geographical locations are not generally registrable and must be kept free for all to use.

Copyright

Copyright arises automatically in certain original works and is ordinarily owned by the creator of the work. Copyright may arise in building plans, websites, photographs, virtual tours and in software code for example AR/VR used in apps.

Summary

Get ahead and stay ahead of your IP rights. IP rights are an important part of the development process and as the influence of tech and lifestyle branding continues to increase, the importance of IP rights and protecting your development brand continues to grow.

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The changing landscape of real estate taxation in the UK, Germany, France, and the U.S.

There are some significant changes coming to the way real estate is taxed which will affect investors acquiring, holding or selling real estate in the UK, Germany, France, and the U.S.

UK

From 6 April 2019, UK tax will be charged on gains made by non-UK resident investors on disposals of UK property and of interests in UK property-rich vehicles ("NRCGT").

Non-UK residents making disposals subject to NRCGT will generally have 30 days to file a UK tax return and pay the NRCGT so should take advice prior to making any such disposals.

Germany

In the German real estate market, the most important change to law aims at tightening the real estate transfer tax ("RETT") treatment of share deals.

Today, share deals are generally structured in a RETT neutral way. RETT does not arise if an independent co-investor acquires 5.1% of the shares in the target company or, in the case of joint ventures, if the seller retains a 5.1% interest in the target for five years.

It is proposed that the relevant threshold be reduced from 95% to 90% and the minimum holding period increased from five to ten years.

Additionally, a new provision may be introduced whereby RETT is attracted if, within any given time period of ten years, the shareholding in a company changes, directly or indirectly, by 90% or more. This latter provision would create immense tax risks and is severely criticized by the industry and tax practitioners.

France

The new double tax treaty signed between France and Luxembourg should finally come into force as of 1 January 2020 (instead of 2019 as initially contemplated). The new treaty includes the OECD/G20 BEPS standards aiming at preventing tax evasion and avoidance, and also contains specific provisions which may impact investors holding French real estate via one or more Luxembourg vehicle(s).

United States

The U.S. tax regulators have been working on providing guidance, mostly in the form of proposed regulations, on the U.S. Tax Reform known as the Tax Cuts and Jobs Act.

On 18 January 2019, the IRS issued final regulations on the Section 199A deduction for "pass-through" entities. Section 199A allows individuals and certain trusts to deduct 20% of their "qualifying business income," subject to certain limitations. Section 199A also allows individuals and certain trusts to deduct 20% of their ordinary REIT dividends.

The IRS also issued proposed regulations, which clarify that the Section 199A deduction applies to shareholders invested in REITs through a mutual fund. Taxpayers may rely on these proposed regulations until final regulations are issued.

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In the spotlight: student accommodation

Purpose built student accommodation can be an attractive investment. The UK has seen a significant increase in this asset class but the industry is mindful of its future. Here are some of the key threats and trends affecting the market at the moment.

Rights of residential tenants - Student accommodation is regarded as residential property and tenants of residential property have additional statutory protection. Investment into student accommodation must be structured carefully to avoid giving third parties a right to acquire the freehold of a building, require the grant of a lease extension of 90 years in return for the payment of a premium, or exercise rights to manage the building.

Upcoming law reforms – Both the right to manage and the right to acquire the freehold are under government scrutiny and reform is on the radar although the extent and exact timescale is currently not known.

The government has also introduced legislation which restricts landlords and letting agents from charging residential tenants and occupiers (including those in student accommodation) any fees other than those expressly permitted by the legislation. This will not prevent recovery of such fees through higher rents although no spikes in rent at the start of the letting are permitted. This law comes into effect on 1 June 2019.

Additionally, the government will make it mandatory for all private landlords of residential property, regardless of whether they employ a managing agent, to be a member of a scheme for remedying complaints. Notably, this includes all private providers of purpose built student accommodation.

The Brexit impact – The UK is particularly concerned about the Brexit impact and whether postgraduate numbers will be affected. This could have a knock on effect in terms of quality of provision, research and reputation if universities start to lose their postgraduate students. Competing institutions in other countries would be keen to pick up on lost numbers.

Long term vision - The industry needs to monitor emerging markets such as China and India, and the changing higher education culture (shorter degree courses and the rise in online courses) to future-proof the appeal of the UK higher education market.

The new Opportunity Zone program

The new Opportunity Zone program offers investors significant tax incentives to invest in economically distressed areas within the United States and its territories. Investors can defer federal income tax on their gains by rolling over capital gains into vehicles known as Qualified Opportunity Funds (QOFs), with the added benefit that a portion of such gains can be permanently excluded from tax, and future appreciation in the value of a QOF can potentially escape U.S. federal income tax altogether. This new investment regime is intended to tap into an estimated US$6 trillion in unrealized capital gains, and according to government officials is expected to generate US$100 billion in private capital targeting opportunities in these areas.

Investments eligible for preferential treatment under the OZ program are investments made in QOFs which must, through the activities they conduct or investments they make, have a substantial geographic and economic nexus with designated opportunity zones. Significantly, QOFs need not be structured as typical investment funds; indeed, a better way to think about QOFs may be as holding companies. Indeed, perhaps the most significant way in which QOFs differ from a traditional investment fund is the requirement that an investor dispose of QOF interests to secure the most meaningful of the available tax incentives—the permanent exclusion from tax of gain following a 10 year hold. Given this requirement, fund sponsors may seek to impose transfer restrictions and drag rights in order to facilitate a group sale of QOF interests.

Significantly, even non-U.S. investors that may enjoy some form of U.S. tax exemption may still benefit. Many such investors may be sitting on unrealized gains that, upon sale, would be treated as income effectively connected with a U.S. trade or business (ECI). Such gains are eligible for the deferral and income exclusion benefits of this regime. Moreover, future appreciation in the value of the QOF can be fully exempt from U.S. income tax upon a subsequent sale of QOF interests, even if such gains may otherwise be ECI. This is a surprising development, and provides an unusual (and unique) opportunity for non-U.S. investors to make ECI-generating investments and avoid U.S. federal income tax.

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Cyber security in real estate

It is acknowledged by most that cyber security is of paramount importance in any technological advancement and smart cities and buildings are no different. We are increasingly reliant on sophisticated building management systems (BMS) to control every moment we spend in our workspace and leisure space, from lights and lifts to CCTV and AV.

The prioritization of cyber security is increasing, particularly after the introduction of the EU General Data Protection Regulation (GDPR) and potentially eye-watering fines. It's easy to see why. Property managers should certainly consider the data they collect from tenants, employees and service providers and ensure that they comply with the GDPR. They should also give thought to the data that they may be less aware of, such as information collected for security purposes from CCTV cameras, ID cards, passes and security gates.

There may be an even weaker link; technological advancements mean that BMS are more integrated with occupier networks than ever before and the systems they control have become ever more connected. These cyber "bridges" linking the various services of the building not only offer a platform to launch a widespread data breach but also expose the property owner to physical disruption. It's not difficult to imagine the chaos that could result from a hacker gaining control of the lifts, heating and cooling systems or access controls to a property.

Property owners need to ensure that they have the appropriate level of security in place, both physically and virtually. Protecting property against potential cyber breaches starts with proper maintenance of the BMS. Regular upgrades and updates to security software should be carried out to ensure the BMS continues to outpace hackers. In light of the GDPR regime, owners and managers should review the data they hold and how they use it. Finally, they should have an eye to the future when entering new leases and insurance policies to make sure they cover the emerging risks as well as the existing.

No city or building is smart without cyber security.

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Tokenization of real estate

We look forward to considerable growth in the securitization of real estate assets via real estate security tokens on a blockchain. The tokenization of fractional real estate ownership interests, and of other interests related to real estate, will provide a new and diverse array of investment options for a much larger pool of real estate investors. Both security token issuers and accredited real estate investors are likely to reap significant benefits from the implementation of real estate security tokens.

The prospect of obtaining better financial terms can be expected to incentivize security token issuers to eschew traditional sources of real estate funding in favor of more diverse accredited real estate investors. The ability of a security token issuer to tap new sources of investment capital with minimal friction and expense has the potential to inspire the monetization of more aspects of real estate value, speed the real estate financing process, and spur further real estate development projects.

Where traditional real estate financing involves delays and unnecessary expense, the sale and trading of real estate security tokens on open, global regulated exchanges may provide welcome efficiency and liquidity. Certain financial intermediaries may be bypassed to yield some economic benefits while also increasing some risks. As well, the ability to diversify an investment portfolio with real estate security tokens may be a valuable opportunity for accredited investors otherwise unable to participate in such investments.

The array of potential benefits from implementing real estate security tokens, however, should not be expected to include any exemption from existing regulatory regimes. Most likely, real estate security tokens will be fully regulated as a type of security or other traditional investment vehicle by an array of regulators. Issuers will need to anticipate substantial, time-consuming, and expensive regulatory compliance efforts. Even where real estate security tokens are issued from a jurisdiction with relatively light regulations, the marketing of those tokens to investors outside that jurisdiction may be carefully scrutinized for regulatory compliance in the jurisdictions where the investors are located.

Real estate security tokens investments will also remain subject to tax. Whether tax is to be paid where the real estate exists, where the real estate security tokens are issued or traded, where the investor is located, or in all such jurisdictions, may present interesting new challenges for tax planning and optimization efforts. Moreover, the representation of real estate interests as tokens that can be flexibly exchanged for other tokens or used for payments will introduce additional tax complexity.

Energy efficiency in Italy - state of the art

Energy efficiency has been on the radar throughout Europe in recent years. In Italy, this has been driven by new technologies and a diversified incentive policy, which includes both mandatory measures provided to implement the European Directives and additional measures approved at national level.

These measures have proved especially effective for manufacturing sites, where energy efficiency can be realized simultaneously in buildings and production processes, and where energy savings can have a significant impact on competitiveness.

The most successful incentive has proven to be the "white certificates" scheme. Under this scheme, certain entities (mainly EsCos - energy saving companies) which implement energy efficient schemes into buildings can obtain the so-called white certificates from the State. These are then sold on a regulated market to companies which need to attain annual energy saving targets (such as suppliers of electricity/gas with more than 50,000 customers).

This scheme has allowed significant returns on investments in past years, although it recently slowed down due to stricter and more complex rules.

However, other sectors also benefit from energy efficiency incentives, such as the residential sector (where energy efficiency works are supported by tax deductions on the cost of the works) and the public sector, thanks to the continuation of the Programme for the Energy-related Renovation of Buildings of the Central Public Administration.

Building regulations also incentivize energy efficiency. If certain targets are met in reducing energy consumption, a "volume bonus" is granted. This allows an increase in buildable volumes and exempts certain rules on minimum distances and maximum height of buildings. Such incentives are provided both at a national and municipal level.

Finally, another regulatory measure which has pushed investment has been the "industry 4.0" scheme, which was launched in 2017. The objective of the scheme is to boost investment in new technology, research and development by providing various incentives including significant tax deductions for investment in innovation (which also includes investments on implementation of energy efficiency and Internet of Things).

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