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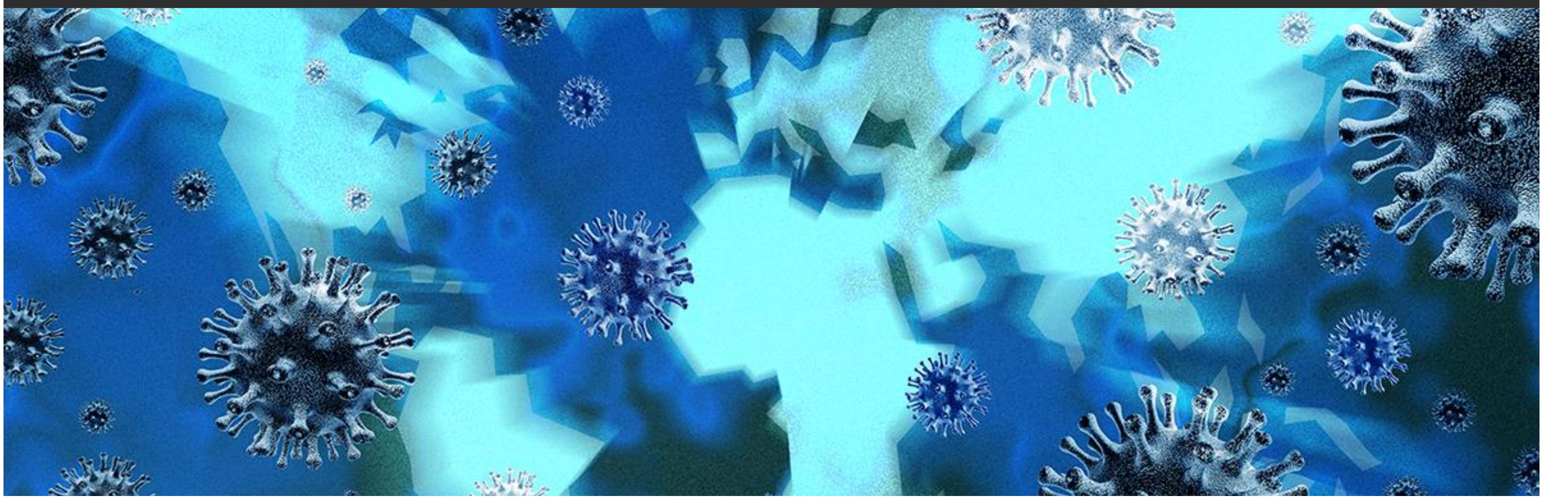
Alert | Health Emergency Preparedness Task Force: Coronavirus Disease 2019



23 March 2020

Real Estate Private Equity: COVID-19 and Corporate Tax Residence

THE ISSUE

Funds and joint ventures for real estate, as for other asset classes, are structured on the basis that each entity involved will be tax resident in a particular jurisdiction. If an entity in a fund or joint venture is tax resident in a jurisdiction other than that in which it was intended to be tax resident, a number of adverse consequences may ensue.

- Returns to investors may be adversely impacted as tax paid within the structure reduces cash available for distribution.
- As the managers' entitlement to carry or promote will typically key off distributions, with entitlement to it being contingent on a minimum level of distributions to investors (or hurdle) having been achieved, the effect may be particularly acute for managers as carried interest may be both delayed and reduced.
- Loan documents, for instance for external debt used to finance an acquisition, may require that the borrower and other entities involved in the financing are and continue to be tax resident only where they are intended to be tax resident for the duration of the loan, and any departure from this may result in a default.

- Where a general partner has contractually committed to investors to maintain the tax residence of entities in the structure, either in the limited partnership agreement or a side letter, a change of tax residence may result in a breach of that commitment.

- Entities may need to register for and file tax returns in any jurisdiction in which they are treated as tax resident.

- Constitutional documents, such as articles of association of a company, may prescribe that decisions must be made in a certain way, e.g. that the directors must meet in a certain location, or that no director may join a meeting by telephone or video conference whilst he or she is in a different jurisdiction. A decision taken in breach of these restrictions may render that decision invalid.

However, there are steps that funds and their managers can take to reduce the likelihood of these occurring, or to reduce their impact where their occurrence is unavoidable. Further, for UK real estate assets, recent and impending changes to the UK tax rules may mean that the tax impact is less significant than might have been the case in the past.

WHY IS COVID-19 RELEVANT TO THIS?

Ensuring that a company is tax resident where it is intended to be tax resident normally involves ensuring that key decisions are taken in that jurisdiction by the company's directors in board meetings. This normally requires that directors who are not resident in that jurisdiction travel there for board meetings, or that they at least ensure that they do not participate in board meetings by telephone or video conference whilst they are in a jurisdiction, such as the UK, whose tax authorities might claim that the company is tax resident there because a director happens to be there when he or she participates in a board meeting. Best practice is also to ensure that a majority of directors are themselves resident in the jurisdiction where a company is intended to be tax resident.

COVID-19 may impact these governance principles in the following ways.

- Directors who would need to travel internationally to attend a board meeting may be unable to do so due to ''lock-downs'', ''self-isolation'', or disruption to normal airline services and schedules.

- Even where such a director is permitted and able to travel, he or she may consider that international travel is inadvisable. For instance, the UK government has advised its citizens against all ''non-essential'' travel outside the UK, although it is unclear what ''non-essential'' means.

- Directors' abilities to participate in a board meeting, even by remote means, may be impaired by illness.

Any of these scenarios could result in the directors being unable to meet in the location where they would typically meet to ensure that decisions are taken there. For instance, consider the example of a company formed to hold a real estate asset (a "**PropCo**") that is incorporated in Luxembourg and is intended to be tax resident there. Its directors comprise two individuals who are resident in Luxembourg and a third individual who is resident in the UK but travels to Luxembourg for board meetings. Someone in the UK director's household has shown symptoms of COVID-19, so the director, along with the rest of her household, are self-isolating and not leaving their home. The PropCo urgently needs to make a decision as to whether to buy an asset.

Should the board convene solely with the two Luxembourg directors? Or should it convene a full board meeting with the UK director participating by telephone from her home in the UK? Is a decision taken under either approach valid and will the PropCo's tax residence be compromised? What if one of the Luxembourg directors becomes ill to the point where he isn't capable of participating in a meeting?

WILL TAX AUTHORITIES ADOPT A LENIENT APPROACH?

This remains to be seen. Unfortunately, both the UK concept of place of "central management and control" and the concept of place of "effective management" as used in many double tax treaties are objective tests based on the location where decisions are made or management takes place. As a matter of law, the reasons, even if exceptional, that decisions were taken in one location or another aren't relevant.

Whilst tax authorities do have some scope for flexibility as there is a degree of uncertainty in the law on certain points, the extent to which they will be lenient in selecting cases to challenge remains to be seen. There is also the point that on an exit by way of share sale, a buyer (or, most often nowadays, a warranty and indemnity insurer) will need to be comfortable that the PropCo's tax residence has not been compromised.

It is however relevant to consider the company's history. A company which has an established history of holding board meetings in the jurisdiction where it is intended to be tax resident with all directors physically present there and which resumes that pattern after the COVID-19 pandemic has passed but conducts an isolated board meeting with a single director participating telephonically from the UK presents a lower risk of challenge than it would if the company already had a history of holding meetings with directors participating from the UK.

SO, WHAT DO WE DO?

There are two parts to the strategy here. The first is to establish any constraints on the manner in which the directors of each entity in a structure can make decisions and whether these can or should be amended. The second is to establish what can be done within these constraints to mitigate the possibility of a company being treated as tax resident in a jurisdiction it is not intended to be tax resident in.

RESTRICTIONS ON THE MANNER IN WHICH DECISIONS CAN BE TAKEN

These would normally be contained in the constitutional documents of the entities concerned but can also be contained in shareholders agreements or side letters with investors. Debt documents should also be reviewed, in particular to establish whether a change of tax residence might trigger a default. The following constraints may be relevant:

- A requirement for board meetings to be held at regular intervals, e.g. quarterly.
- A requirement that directors should meet in a particular location, or that a director should not participate while he or she is in a particular location (often the UK).
- Quorum requirements as to the directors who must participate in order for a decision to be validly taken.
- The ability to appoint alternate directors, and any constraints on their tax residences.

- Side letters with investors requiring "substance" to be maintained in particular jurisdictions or that entities should only be tax resident where intended.

- Covenants in external debt documents that would be breached if the tax residence of an entity were to be changed.

Where restrictions are identified, consideration should be given to whether it is necessary to amend them to allow greater flexibility. In this context, the approach taken with respect to "internal" documents to which only entities within the fund or joint venture structure are party may be different to documents with external parties such as lenders and investors. Restrictions in the latter category of document are more often concerned with outcomes (e.g. Company A must not be tax resident anywhere other than Luxembourg) and may be less prescriptive as to the manner in which those outcomes are achieved (e.g. the directors of Company A must all physically attend board meetings in Luxembourg) than documents in the former category. On the other hand, it is likely to be easier to amend "internal" documents to allow flexibility around otherwise prescriptive requirements (e.g. to allow flexibility as to the manner in which directors participate in board meetings) than it is to convince a lender or investor that they should accept the possibility of a less attractive tax outcome.

MITIGATION OF TAX RESIDENCE RISKS

As noted above, rules for determining tax residence based on decision making tend to focus on the fact of where decisions are made with the reasons why a decision is made in a particular place being irrelevant. Mitigation strategies therefore need to revolve around ensuring that the fact pattern is as benign as possible, recognising that constraints on travel that arise as a result of COVID-19 may necessarily mean that fact pattern cannot be as robust as would normally be the case.

Managers and boards of directors should consider the following approaches.

- Can a meeting be postponed until the directors can meet in the intended location? This approach will obviously not work for urgent matters, but for non-urgent matters where a decision can be deferred it is likely to be the best approach.

- If the meeting cannot be postponed, can a suitable alternate be found who can attend in place of the director who is unable to? Care needs to be taken here. If the alternate is to stand in for a director who is resident in the UK then the alternate needs to be able to form an independent view on the matters to be decided: he or she should not act as a puppet for the director who cannot attend.

- Can a decision be taken by a sub-group of directors who are able to meet where intended? In our example above involving a Luxembourg PropCo, could the two Luxembourg directors make a decision alone without the UK director needing to participate? A balance needs to be drawn here between the desirability of not having a director participate telephonically while in the UK and whether, without that director's participation, the board has sufficient "substance" to properly consider the matter on which a decision is to be reached – as to which, see the next bullet point.

- If there are concerns over the "substance" of local directors, by which we mean whether they could credibly be regarded as having the experience and qualifications necessary to consider not only the technical (legal, tax, accounting) implications of a decision but also its commercial merits, now is the time to address this. This may mean the appointment of additional local directors with greater commercial experience.

- If it is impossible to properly consider a decision without the participation of a director whose participation as a director might prejudice the company's tax residence, can that director, or better still someone else from his or her organisation, participate in an advisory, non-decision making capacity to answer questions from the other directors to assist their decision making? Care needs to be taken here to ensure that it is clear that participation is only in an advisory capacity.

- Failing all of the above, in circumstances where it is necessary for a director to participate in a meeting as a director while he or she is in the UK or some other problematic jurisdiction, ensure that the meeting is convened and chaired by a local director in the jurisdiction where the company is intended to be tax resident and that a majority of directors participating are in that jurisdiction. Whilst HM Revenue & Customs has expressed the view that they may still regard the meeting to have taken place in the UK where a director participates from the UK, the approach outlined may provide a counterargument based on the place of effective management where the majority of directors are in the jurisdiction where the company is intended to be tax resident and the UK has a double tax treaty with that jurisdiction that utilises the place of effective management in determining tax residence.

IS THIS STILL AN ISSUE FOR UK REAL ESTATE?

Where UK real estate is concerned, many holding companies are already being migrated to the UK because of the recent changes to the way that the UK taxes capital gains from UK real estate assets. The imminent changes to the way in which UK rental income is taxed on non-UK resident companies will further erode the traditional advantages of holding UK real estate through non-UK holding structures. A full discussion of this topic is beyond the scope of this alert and specific advice will be needed to assess the effect of migrating the tax residence of a holding structure to the UK, but in many cases it may well be that the tax consequences of such a migration are not significantly adverse. Even so, it may be better to arrange a deliberate migration to the UK than suffer an accidental migration.

* *This GT Alert is limited to non-U.S. matters and law.*

For more information and updates on the developing COVID-19 situation, visit GT's Health Emergency Preparedness Task Force: Coronavirus Disease 2019.

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