European Public Real Estate Association (EPRA)
Position paper on upcoming administrative guidance for the implementation of OECD Pillar 2

March 2024

<u>Introduction</u>

The European Public Real Estate Association (EPRA) is the European association representing the publicly traded European real estate sector and over EUR 840 billion of real estate assets. With more than 290 members covering the whole spectrum of the listed real estate industry, EPRA's mission is to promote, develop and represent the European public real estate sector.

EPRA welcomes the agreement and expected implementation of OECD Pillar 2 which constitutes a strong step in the right direction in ensuring harmonised and fair taxation of multinational enterprises globally and within the European Union. We have been actively engaged with OECD stakeholders throughout the development of the Pillar 2 rules and were encouraged by the recognition of Real Estate Investment Vehicles (REIVs) as one of the six defined Excluded Entities within Pillar 2.

As EPRA, we produce an annual Global REIT Survey, assessing national Real Estate Investment Trust (REIT) regimes in an effort to support further investment and growth in the real estate market. The International Cooperation and Tax Administration Division at the OECD Centre for Tax Policy and Administration is intending to publish in spring 2024 additional guidelines concerning the real estate industry that will notably address such regimes. Following our call in December 2023, we therefore would like to take this opportunity to share our expertise to help support in the harmonised and level application of the Pillar 2 REIV exclusion across all jurisdictions of the Inclusive Framework (IF).

<u>Overall assessment:</u>

OECD Model Rules provide for the exclusion of REIVs which are Ultimate Parent Entities (UPEs) of MNE Groups (Article 1.5.1 of the OECD Model Rules). A REIV is defined as "*an Entity the taxation of which achieves a single level of taxation either in its hands or the hands of its interest holders (with at most one year of deferral), provided that person holds predominantly immovable property and is itself widely held*" (Article 10 of the OECD Model Rules).

The same exclusion applies to Entities which have at least 95% of their value owned (directly or through a chain of Excluded Entities) by one or more Excluded Entities which meet the activity tests as detailed in Article 1.5.2. (a) I or II of the OECD Model Rules. The OECD Model rules trigger some difficulties that would create a Top-up tax on the profits of REIV subsidiaries where the REIV owns less than 95%. This results in situations where subsidiaries are within the Pillar 2 rules only by virtue of being part of a large REIV group (the vast majority of which is excluded) but are unable to benefit from the REIV exclusion. This is an unfair and inequitable result for such subsidiaries on a standalone basis.

In addition, REIVs intend to apply the Pillar 2 exclusion at their level but also at the level of their subsidiaries that are in a REIT exempt environment. However, the OECD Model rules trigger some difficulties that would create Top-up tax on the profits of some REIVs subsidiaries while said profits are already taxed in the hands of the ultimate investors of the REIV UPE which at the end would substantially increase the tax burden on these investments.

The Top-up tax would thus be diverted from its intended purpose and the economic and fiscal equilibrium of the REIV regime, which is based on an established single taxation in the hands of the investors, would be durably affected.

Furthermore, we fear that, since all REIT regimes are not fully similar and the REIV definition may not capture all the specificities of every REIT regime, not all jurisdictions of the IF may equally or mutually recognize, as a REIV for Pillar 2, entities defined as a REIT in another jurisdiction.

Finally, whilst not a REIT only issue and one which impacts real estate investment groups generally, there is a high degree of uncertainty and inconsistency about whether unrealised gains on annual investment property valuation movements should be included within revenue for the purpose of the €750m test.

Recommendations:

To further improve the existing framework, achieve the OECD's aim of consistent application across all member jurisdictions and avoid detrimental situations of double taxation, we would recommend the below guidance at the OECD or European Union levels:

1. **Allow for subsidiaries, in the REIT environment, that are less than 95% owned by a REIV UPE (but consolidated on a line-by-line basis in the Consolidated Financial Statements of the REIV UPE) to benefit as well from the Pillar 2 exclusion;**

2. **Allow for Tax Transparent Entities a proper allocation of its income or loss to all owners even if the owner of the ownership interest is an Excluded Entity; and**

3. **Facilitate a mutual recognition of entities defined as REITs and within the scope of the REIV exclusion under Pillar 2 across all OECD member jurisdictions; and**

4. **Explicitly exclude unrealised gains on annual investment property valuation movements from revenue.**

We remain at your disposal to further discuss this if needed and to participate to your next discussions and work sessions in the frame of the preparation of the upcoming guidance. We detail below our recommendations.

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1. Exclusion of <95% owned subsidiaries

REIVs generally invest in real estate properties, directly or indirectly, through dedicated subsidiaries (which can be Tax Transparent Entities or opaque Entities having elected for the REIT regime) as well as through other listed REIVs. These underlying Entities in a REIT environment can be held, directly or indirectly, by the REIV UPE at less than 95%.

To preserve the general coherence of the REIV regime and avoid double taxation, such subsidiaries in the REIT landscape that are not owned at a 95% level or higher by a REIV UPE, should still benefit from the Pillar 2 exclusion.

This also has the merit of consistency in the application of the Pillar 2 rules. If consolidated companies are within the Pillar 2 rules by virtue of being part of a large group (>€750m revenue), then they should be afforded the same exclusion rights as the parent REIV. Otherwise, those same companies would be unfairly treated simply by being less than 95% owned by a REIV. This seems arbitrary, and potentially results in tax treatment driving commercial behaviour, which could ultimately damage investment in the built environment and infrastructure.

Indeed, we understand that the 95% ownership requirement was only designed for Investment Funds which are externally managed by a management company owning a residual interest (less than 5%) in the fund vehicle as an incentive. EPRA members have called for this to be clarified within the OECD's upcoming administrative guidance.

Recommendations:

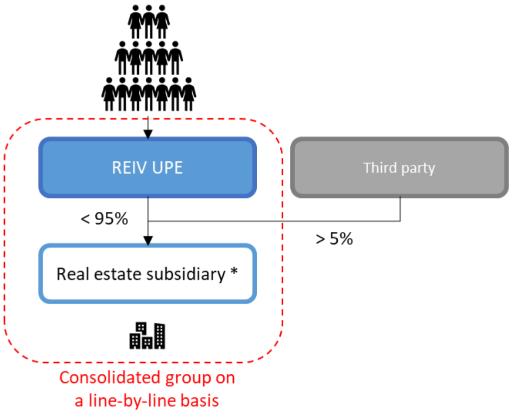
To achieve the above objective, EPRA recommends for upcoming guidance by the OECD or the European Commission to include wording confirming the application of the Pillar 2 exclusion in the following cases:

A. *An Entity included in the Consolidated Financial Statements on a line-by-line basis of a REIV UPE and that satisfies the activity test mentioned in Article 1.5.2. (a) I or II of the OECD Model Rules should always qualify as an Excluded Entity, even though it is not 95% owned by a REIV UPE; and*

B. *Joint Ventures that satisfy the activity test mentioned in Article 1.5.2. (a) I or II of the OECD Model Rules should always qualify as an Excluded Entity whether they are owned directly or indirectly by a REIV UPE.*

Issues:

A. **Entity held at less than 95% by a REIV UPE**



** Listed REIV, tax Transparent Entity or Entity having elected for a REIV regime.*

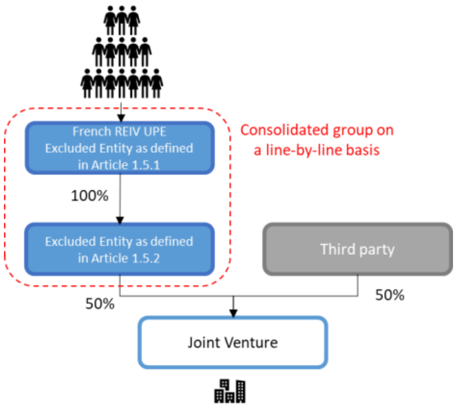
In the above situation, a REIV UPE holds an Ownership Interest of less than 95% in a subsidiary that is in the REIT environment. Such subsidiary can be:

- a Tax Transparent Entity (Flow-through Entity), which profits are tax exempt in the hands of the REIV UPE pro rata its Ownership Interest;
- an Entity, in principle subject to corporate income tax but having elected for a REIT regime; or
- a listed REIV which is not a REIV UPE.

Being in a REIT environment, such subsidiaries benefit of a tax exemption subject to distribution obligations: their income is not liable to tax but subject to compulsory distribution obligations in favour (notably) of the REIV UPE or, with Tax Transparent Entities, directly subject to distribution obligations at the level of the REIV UPE. Such subsidiaries are included in the Consolidated Financial Statements on a line-by-line basis of the REIV UPE and meet the activity test of Article 1.5.2. (a) i of the OECD Model Rules. They can be held directly by the REIV UPE or indirectly through a chain of Excluded Entities.

<u>Thus, we expect the upcoming guidance by the OECD to confirm the application of the Pillar 2 exclusion to such subsidiaries.</u>

B. **Joint Ventures held directly or indirectly by a REIV UPE**



In principle, entities whose financial results are reported under the equity method should not qualify as Constituent Entities. Nevertheless, such subsidiaries could potentially be subject to the OECD Model Rules if they satisfy the requirements to be considered as Joint Ventures according to Article 10.1.1.:

"Joint Venture (JV) means an Entity whose financial results are reported under the equity method in the Consolidated Financial Statements of the Ultimate Parent Entity provided that the Ultimate Parent Entity holds directly or indirectly at least 50% of its Ownership Interests".

According to Article 6.4.1 of the Model Rules, the Top-up tax of a Joint Venture must be computed as if it was a Constituent Entity of a separate MNE Group and as if the Joint Venture was the UPE of that Group. This mechanism does not apply to a Joint Venture which meets the criteria of an Excluded Entity in accordance Article 1.5. Indeed, the definition of Joint Venture points out that:

"A Joint Venture does not include: (…)
(b) an Excluded Entity as defined by Article 1.5.1;
(c) an Entity whose Ownership Interest held by the MNE Group are held directly through an Excluded Entity referred in Article 1.5.1 and the Entity:
(i) operates exclusively or almost exclusively to hold assets or invest funds for the benefit of its investors;
(ii) carries out activities that are ancillary to those carried out by the Excluded Entity; or
(iii) substantially all of its income is excluded from the computation of GloBE Income or Loss in accordance with Articles 3.2.1(b) and (c)."

We understand from the above provisions that a Joint Venture which is held directly by an Excluded Entity referred in Article 1.5.1 and which meets an activity test similar to that provided for by Article 1.5.2, does not qualify as Constituent Entity and as such is not subject to the OECD Model Rules.

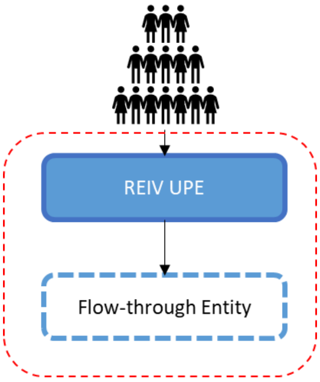
But this wording creates ambiguity as it seems to limit the Exclusion to Joint Ventures held "*directly*" (only) through an Excluded Entity referred in Article 1.5.1 of the Model Rules (e.g. a REIV UPE). Such a limitation contrasts with:

- the Commentary on paragraph (b) to (d) on the Joint Venture Definition which indicates that paragraph (c) is the "*same requirement included in Article 1.5.2(a) and 1.5.2(b). The only difference is that those provisions include a 95% ownership test and a wholly or mainly owned test*". But Article 1.5.2 of the Model Rules admits extending the Exclusion to an Entity which is owned "*directly or through a chain of Excluded Entities by one or more Excluded Entities*" referred to in Article 1.5.1.
- The wording of the EU Directive which states in Article 36, 1(a)(ii) that a Joint Venture does not include an entity whose ownership interests are held directly through a chain of excluded entities referred to in Article 2(3) which comprises a REIV-UPE or any entity where at least 95% of the value is owned by a REIV-UPE.

Restricting the exclusion to the sole Joint Ventures directly held by Excluded Entities in Article 1.5.1 and not 1.5.2 does not make sense. We do not see why Joint Ventures directly held by Excluded Entities referred in Article 1.5.1 should be treated differently from Joint Ventures indirectly held by Excluded Entities referred in Article 1.5.1 and directly held by Excluded Entities referred in Article 1.5.2. From an economic and domestic tax perspectives, both situations are similar. There is no reason to penalise one Joint Venture holding structure over another.

<u>Thus, we expect the upcoming guidance by the OECD to confirm the application of the Pillar 2 exclusion to Joint Ventures held by a REIV UPE directly or indirectly through a chain of Excluded Entities.</u>

2. Allocation of Income or Loss of Tax Transparent Entities held by an Excluded Entity



Tax Transparent Entities are widely used by REIV UPE in their holding structures. Such Tax Transparent Entities may satisfy the activity tests mentioned in Article 1.5.2. (a) i or ii of the OECD Model Rules but some may not for various reasons: indeed, some subsidiaries of REIV may perform other non-qualifying real estate activities (such as real estate development activities for example) or have management activities that for example are not ancillary according to Article 1.5.2. (a) ii of the OECD Model Rules because of the nature of the services rendered or because the services are rendered for an important part to entities outside of the MNE Group. In these cases, they cannot be considered as Excluded Entities.

Such activities are in principle subject to standard taxation at the level of the REIV UPE because of the tax transparency. The REIV UPE will have in this case a taxable sector subject to standard taxation rules (standard tax basis computation rules, standard CIT rate and standard CIT payment rules). Indeed, REITs can have in some jurisdictions, under their domestic rules, an ancillary taxable sector which does not jeopardize its REIT exempt status provided that the taxable activity remains limited.

Nevertheless, the rules of allocation of Income or Loss from a Flow-through Entity described in Article 3.5 of the OECD Model Rules work only with owners which are Constituent Entities and not with owners which are Excluded Entities. This creates a discrimination between:

i. Owners that are Excluded Entities for which the Income or Loss upstream mechanism of Article 3.5 of the OECD Model Rules does not work and may create harmful situation of double taxation where a Top-up tax would be automatically triggered at the level of the Tax Transparent Entity vehicle while its profits are ultimately taxed at the level of the REIV UPE;
ii. Owners that are Constituent Entities for which the Income or Loss upstream mechanism of Article 3.5 of the OECD Model Rules works and allow to compute properly the Effective Tax Rate at the level of the Constituent Entity owner.

Recommendations:

EPRA recommends for upcoming guidance by the OECD to:

- *Include wording confirming that Flow-through Entities qualify as Tax Transparent Entities and benefit of the rules of allocation of Income or Loss provided under Article 3.5.1 of the OECD Model Rules for all owners of Ownership Interest, i.e. Constituent Entity owners and Excluded Entity owners.*

Issue:

According to the Article 10.2.1 of the OECD Model Rules, a Flow-through Entity is: *(a) "A Tax Transparent Entity with respect to its income, expenditure, profit or loss to the extent that it is fiscally transparent in the jurisdiction in which its owner is located;"*

Article 10.2.2 provides that *"An Entity is treated as fiscally transparent under the laws of a jurisdiction, if that jurisdiction treats the income, expenditure, profit or loss of that Entity as if it were derived or incurred by the direct owner of that Entity in proportion to its interest in that Entity."*

Where a Constituent Entity is a Flow-through Entity, Financial Accounting Net Income or Loss is allocated according to a specific sequencing. In the case of a Tax Transparent Entity that is not a UPE, any Financial Accounting Net Income or Loss must be:

- Firstly, reduced by the amount allocable to its owners that are not Group Entities and that hold their Ownership Interest in the Flow-Through Entity directly or through a Tax Transparent Structure (Article 3.5.3 of the Model Rules);
- Then allocated to its Constituent Entity-owners in accordance with their Ownership Interests (Article 3.5.1(b) of the Model Rules).

As a result of the combination of these above provisions, the profits generated by a Tax Transparent Entity are deemed to constitute profits of its Constituent-Entity owners in proportion to their stake in the Tax Transparent Entity.

A Constituent Entity means, within the meaning of Article 1.3.1 of the OECD Model Rules:

"*(a) Any Entity that is included in a Group; and*

(b) Any Permanent Establishment of a Main Entity that is within paragraph (a)".

However, according to Article 1.3.3. of the OECD Model Rules "*A Constituent Entity does not include an Entity that is an Excluded Entity*".

If we transpose these principles to Entities benefiting from a tax transparency regime and owned by a REIV UPE, such Entities should not be able to allocate their profits in proportion to the stake held by the REIV UPE since – as an Excluded Entity – it cannot qualify as a Constituent Entity.

Accordingly, there is a risk that the Top-up tax may be due on profits deriving from these Entities while their profits are effectively taxed in the hands of the REIV UPE itself (in its taxable sector). Indeed, in this case, the Effective Tax Rate would have to be computed at the level of the Tax Transparent Entity which would have an Income but without Covered Tax in front, automatically triggering a Top-up tax. Such a risk is nonsensical.

In addition, the EU Directive transposing the OECD Model Rules does not suffer from the same flaw. The definition of Constituent Entities as referred to in Article 3(2) of the EU Directive does not provide that Excluded Entities cannot qualify as Constituent Entities. In consequence, under the EU Directive, profits of a Flow-through Entity which is tax transparent are allocated to their owners regardless of their status under Pillar 2 rules.

Thus, we expect the upcoming guidance by the OECD to confirm that Flow-through Entities that qualify as Tax Transparent Entities and benefit of the rules of allocation of Income or Loss provided under Article 3.5.1 of the OECD Model Rules, even though the owner of the Ownership Interest is an Excluded Entity.

3. Mutual recognition of REITs

Entities that benefit from treatment as REITs and are within scope of the REIV exclusion within a particular OECD member jurisdiction be considered a REIT in other member jurisdictions with REIT regimes.

Recommendations:

In order to achieve mutual recognition, EPRA calls on the OECD to:

- *Ensure wording be included within the expected 2024 administrative guidance on Pillar 2 to allow for a REIT that qualifies under the REIT regime of its home jurisdiction qualifies as a REIV for Pillar Two purposes, and a REIT that qualifies as a REIV for Pillar 2 purposes qualifies as a REIV in any Pillar 2 member jurisdiction.*

Issue:

While all functioning along the same principle, certain national REIT regimes vary to some degree from jurisdiction to jurisdiction. Moreover, while the requirements of the REIV definition are broadly aligned with requirements for REIT status in jurisdictions' domestic regimes, most domestic regimes include more detailed and specific rules with respect to such requirements. For example, many domestic REIT regimes include detailed rules regarding the requirement to hold predominantly immovable property.

Given the generality of the requirements set forth in the REIV definition, more guidance is needed on how the determination is to be made as to whether an entity that is a REIT in its home jurisdiction qualifies as a REIV for purposes of Pillar 2, in order to ensure consistent treatment by all jurisdictions that could seek to impose Top-up tax under Pillar 2 on such entity if it were not an excluded entity. Without certainty regarding the consistent treatment of an entity as a REIV for Pillar 2 purposes, the policy objectives of providing excluded entity status for REIVs that are Ultimate Parent Entities under Pillar 2 would not be achieved, and the tax-neutral treatment provided by domestic REIT regimes would be undermined.

Without a mutual recognition regime in place, implementation of Pillar 2 cannot be expected to be harmonised across all member jurisdictions. In essence, entities may still be facing differing tax obligation across OECD member jurisdictions due to the potential lack of recognition of their REIT status even though they should all benefit from the same treatment under Pillar 2.

If successful, this will not only allow for common application of Pillar 2, but significantly increase the amount of cross-border investments between Pillar 2 jurisdictions. EPRA would therefore call for guidance to be published by the OECD.

4. Unrealised valuation gains included in revenue?

For real estate investment groups, there is a high degree of uncertainty and inconsistency over the inclusion of unrealised gains on annual investment property valuation movements within revenue for the purpose of the OECD Article 1.1 €750m revenue threshold test. If unrealised gains are included in revenue, then the cyclical nature of the real estate market will result in some groups being included in Pillar 2 for some accounting periods and not others.

Recommendations:

To address the issue above, EPRA calls on the OECD to:

- *Publish guidance on the need to exclude valuation gains from investment properties from turnover.*

Issue:

To simply illustrate the issue, if unrealised gains are included, e.g. one of our members with a recurring annual revenue of less than €300m, would be included in the rules for only one accounting period as a result of exceptional property valuation gains during the pandemic. They do not expect to fall within the rules again in the future but this would add a significant compliance burden and administration cost to a group that is not a target of the Pillar 2 rules given their much lower recurring revenue.

Our understanding is that the underlying principle of the OECD is to follow basic accounting rules to determine revenue. From a pure accounting perspective, investment property valuation gains are not included within revenue under IAS. Including such gains in revenue for the purposes of Pillar 2 would therefore be against the underlying principle.

The December 2023 OECD Administrative Guidance (see 10.2 to 10.4 in section 3.1.3) adds a great deal of uncertainty to the basic accounting position. It states, "For the purposes of Article 1.1 of the GloBE Rules, revenue includes the inflow of economic benefits arising from delivering or producing goods, rendering services or other activities that constitute the MNE Group's ordinary activities", and goes on to say "revenue for the purpose of Article 1.1 shall include net gains from investments (whether realised or unrealised) reflected in the profit and loss statement of the consolidated financial statements and income or gains separately presented as extraordinary or non-recurring items."

The initial part of this wording makes it clear what should be included in revenue. However, the second part in relation to "net gains from investment results" is not clearly defined and could be interpreted in different ways. As a starting point, it is not entirely clear whether "investments" include investment properties (which are dealt with under their own IAS accounting standard and are reported separately from revenue).

This uncertainty is further exacerbated by an example given in the OECD Administrative Guidelines issued in December 2023, under paragraph 10.6 section 3.1.3:

"Example 1: MNE Group A is a manufacturing company, and it has generated ancillary interest income outside its ordinary activities. The interest income is recorded in MNE Group A's profit and loss statement as Interest Income, below Cost of Goods Sold and Selling, General and Administrative Expenses. Therefore, interest income shall not be included in MNE Group A's revenue for the purpose of Article 1.1."

This example goes against the general wording of Article 1.1 that revenue should include net gains from investments reported separately from revenue in the profit and loss statement. This highlights that the OECD model rules do not require all gains on investment to be included within revenues, leaving this point open to interpretation.

EPRA would therefore call for guidance to be published by the OECD on the need to exclude valuation gains from investment properties from turnover.

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