European Real Estate Finance: Recent developments

June 2019

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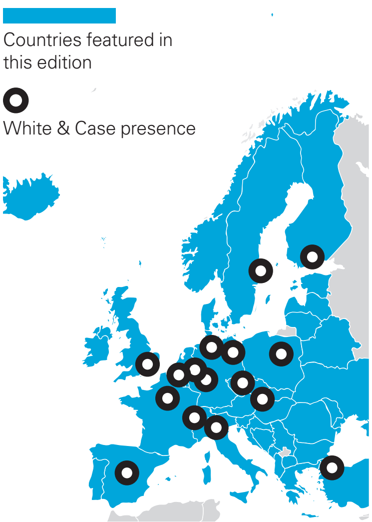
As part of our periodic updates, here is an overview of recent developments of relevance to participants in the real estate finance market across certain key jurisdictions in Europe.



Europe

INSTEX SAS to support trade with Iran

INSTEX SAS is a special-purpose vehicle with the aim of facilitating legitimate trade between European businesses wishing to continue trading with Iran.

Following the US decision to withdraw from the Joint Comprehensive Plan of Action (JCPOA), the EU Council has adopted conclusions in order to reaffirm the EU's support and to ensure that European companies give effect to JCPOA, despite the US withdrawal. To further assist with this, on 31 January 2019, France, Germany and the UK announced the registration of the Instrument for Supporting Trade Exchanges (INSTEX SAS), a special-purpose vehicle allowing for trade with Iran.

Although INSTEX SAS is available for use, the continued availability of INSTEX SAS requires Iran to implement its nuclear-related commitments as outlined in JCPOA, including cooperation with the International Atomic Energy Agency (IAEA) and the implementation of all aspects of its Financial Action Task Force (FATF), emphasising that INSTEX SAS will need to operate to extremely high standards regarding AML and combating terrorism financing. For more information, see here.

International Property Securities Exchange

The International Property Securities Exchange (IPSX), the first regulated securities exchange dedicated to trading companies owning single commercial real estate assets, has launched after receiving FCA approval. IPSX will enable investors to buy shares in companies that hold single commercial real estate assets in excess of £25 million, with a requirement for at least 25 per cent of the shares to be admitted to IPSX.

An IPSX flotation will provide an alternative and more flexible sale process for property owners and developers looking for investors for assets. It could also be a viable exit strategy for commercial real estate owners. IPSX will operate in two markets—IPSX Prime (which is now launched) and IPSX Wholesales (still under development), which will focus on trading joint venture single-asset Real Estate Investment Trusts (REITs).

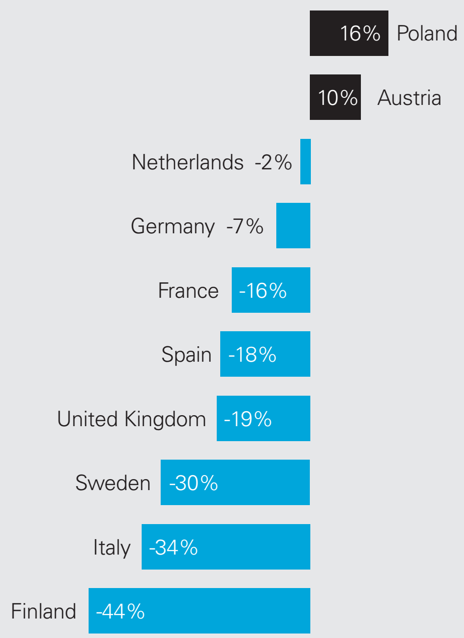
January 2019

A new regulated stock exchange, the International Property Securities Exchange was launched

Smaller European market growth in 2018

Year-over-year change in investment volume

Top 10 European commercial real estate markets; all property types, deals €5 million and greater



Source: Real Capital Analytics

IPSX Prime is an FCA-regulated exchange, operating as a 'Recognised Investment Exchange' and 'EU-Regulated Market' meaning that it will need to ensure the protection of its investors and establish transparent and non-discretionary rules and procedures. Any issuer will be expected to comply with the Market Abuse Regulation and the Disclosure Rules and Transparency Guidelines.

Sustainability-Linked Loan Principles extend Green Finance

The Loan Market Association, the Asia Pacific Loan Market Association, and the Loan Syndicated and Trading Association have released Sustainability-Linked Loan Principles (**the Principles**), providing a new standard for banks with the aim of presenting minimum standards for corporate engagement and incentivising borrowers to improve their sustainability performance.

Sustainability Performance Targets (**SPT**s) are pre-agreed and require negotiation over the lifetime of a loan. Under the Principles, for a loan to qualify as sustainability-linked, a borrower's performance is measured against those SPTs. A positive performance against the SPT could reduce the cost of the borrower's loan, whilst positively impacting the environment. The SPTs against which the loans are measured include energy efficiency, water consumption, affordable housing and sustainable farming.

For more information on Sustainability-Linked Loan Principles, please see here.

Belgium

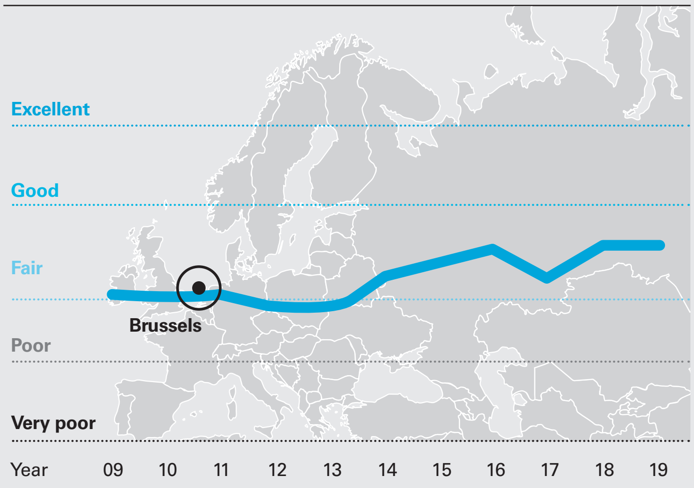
Draft law ratifying the MLI

In February 2019, the Belgian government released draft legislation ratifying the Multilateral Convention to Implement Tax Treaty-Related Measures to Prevent Base Erosion and Profit Shifting (the **Convention**), as well as its explanatory note. Whilst the Convention will only apply to those double-tax treaties that the contracting parties have agreed are within scope, the ultimate aim of the Convention is to allow jurisdictions to meet certain minimum standards when contracting with one another, ultimately ensuring the prevention of treaty abuse and improved dispute resolution.

February 2019

The Belgian government launches its draft legislation in respect of BEPs

Brussels: Investment prospects, 2009 – 2019



Source: *Emerging Trends Europe* survey 2019

In order to expedite the process, the Convention has sought to amend all bilateral tax treaties that are in force between two parties that have been agreed to be covered by the Convention. So far, Belgium has sought to notify all but two of its tax treaties, clearly showing the intention of the Belgian government to give effect to the Convention.

As the Convention may impact the tax regime of almost all international transactions, investors in cross-border real estate transactions, if they rely on exemptions provided for by double-taxation agreements, are advised to review structure to ensure they meet the requirements of the Convention (especially the new anti-abuse tests).

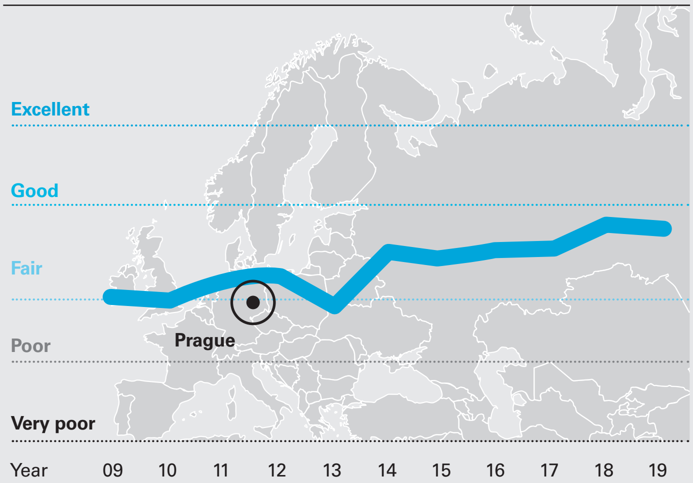
For more information on the scope of the Convention and particularly the proposed implementation into Belgian law, see here.

Czech Republic

Direct sale judgment

Direct sale as a permissible manner in which to realise security was introduced into Czech law in 2014.

Prague: Investment prospects, 2009 – 2019



Source: *Emerging Trends Europe* survey 2019

Czech Supreme Court Ruling

Czech courts give guidance on enforcement of security by direct sale

Until recently, it had not been tested before the higher Czech courts, but a recent decision of the Czech Supreme Court now gives guidance with respect to how the conditions for direct sale should be formulated in pledge agreements and mortgage agreements.

The Supreme Court ruled that a mortgagee may agree with the mortgagor that the mortgagee may sell the mortgaged real estate to a third party in a private transaction, either through a purchase agreement with a third party or a private auction, provided that the agreement on direct sale is in writing, and that the conditions of the sale rule out any arbitrariness on the part of the mortgagee. Further, the conditions of the sale must allow for the application of professional care in the process of selling the mortgaged property, so as to ensure that the customary price is obtained. The Supreme Court also confirmed that the mortgagee does not need to hold an enforcement title in the form of a final court decision in order to be able to proceed with the direct sale pursuant to the agreed conditions.

In the reviewed case, the Supreme Court examined the agreed conditions of a private auction sale. The Supreme Court said that if the direct sale clause (i) contains a specific agreement on the manner in which the purchase price will be determined; and (ii) is sufficiently detailed with respect to the procedure for selling the real estate, arbitrariness on the part of the mortgagee is ruled out and the requirement for the mortgagee to exercise professional care is fulfilled.

Germany

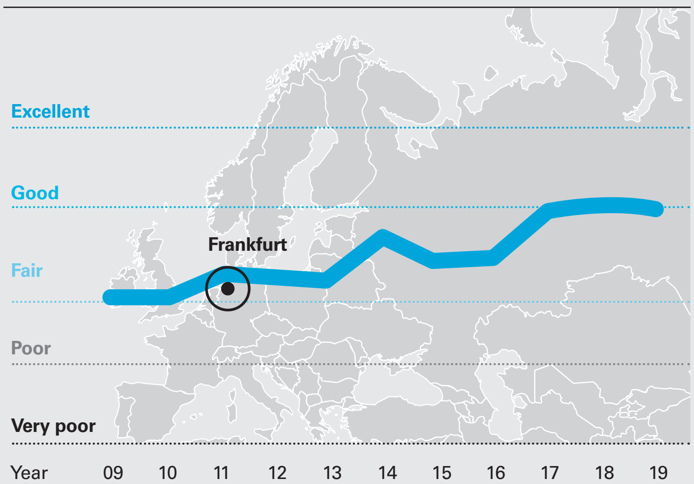
Pfandbrief and Brexit

In February, amendments were approved to the Pfandbrief Act in order to ensure the eligibility of applicable assets in the UK after its exit from the EU.

Currently, German Pfandbrief banks are able to fund themselves with low interest bearing loans from the Pfandbrief market, allowing them to provide cheaper onward loans to consumers. The ability to source this low interest rate results from the ability of the German bank to demonstrate that the onward loan is to be secured on real property situated in the European Union, the European Economic Area or other specific countries such as the US, Canada, Japan and Switzerland. With the UK intending to leave the European Union, without any amendments to the Pfandbrief Act, German banks would cease obtaining the benefit of lower interest rates based on real property situated in the UK. This would have been particularly difficult for the commercial real estate market in the UK, with German banks providing low-cost ways of financing and refinancing, allowing them to provide some of the lowest-priced debt in the market.

Accordingly, the German Federal Government reacted quickly to amend the Pfandbrief Act to preserve the eligibility of UK assets as collateral covered thereunder. The necessary change of the Pfandbrief Act came into force on 29 March 2019 (along with changes in other German laws, in particular tax law, triggered by the envisaged Brexit) and lists the UK as another country where real property may be situated.

Frankfurt: Investment prospects, 2009 – 2019



Source: *Emerging Trends Europe* survey 2019

Pfandbrief Act

Changes required to the German Pfandbrief Act as a result of Brexit

Italy

Deductibility of interest expenses on mortgage loans

In December 2018, the Italian government approved Legislative Decree n. 142/2018 transposing EU "anti-avoidance" Directive 2016/1164 (ATAD 1)—as amended by EU Directive 2017/952 (ATAD 2) into Italian law. The Legislative Decree seeks to replace Article 96 of the Italian Tax Code, pursuant to which interest expenses incurred on loans, which were secured by a mortgage on rented properties, were fully deductible for corporate income tax purposes. This exemption applied to real estate companies that obtained at least two-thirds of their revenues from rent received from their leased properties, where ordinarily the interest expense deductibility was capped at a maximum of 30 per cent of a company's EBITDA.

Effective from the 2019 financial year, the new regime will affect any expenses that may arise after this date, by effectively abolishing this exemption and making the ordinary 30 per cent EBITDA rule fully applicable to real estate companies. There is to be no grandfathering for existing loan documentation.

Given the controversies caused by this change (given its significant impact on Italian real estate companies), this extension has been put on hold by Article 1(7) of Law No. 145 of 30 December 2018 until the future reform of the tax regime applicable to real estate companies. However, it is still advisable for Italian companies to consider existing debt structures and consider any structures they are putting in place in the future to avoid incurring additional costs.

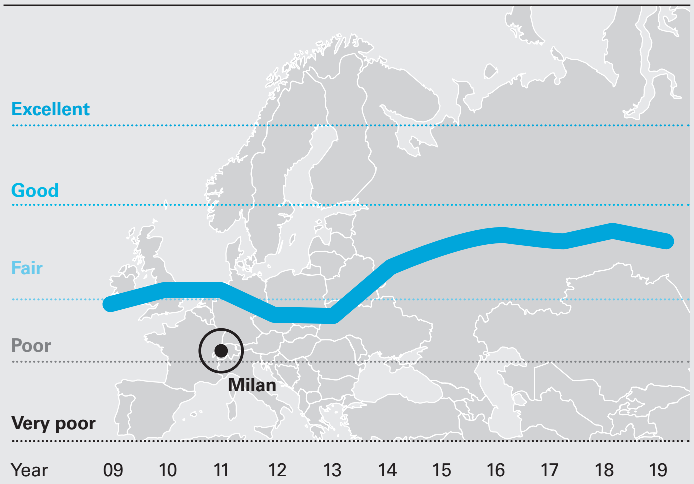
Italian fronting arrangements

certain fronting arrangements deemed illegal in Italy in March 2019

Illegal fronting structures

On 22 March 2019, the Fifth Criminal Section of Italy's Supreme Court of Cassation ruled that a fronting structure is illegal if an Italian bank provides a loan to an Italian entity in a

Milan: Investment prospects, 2009 – 2019



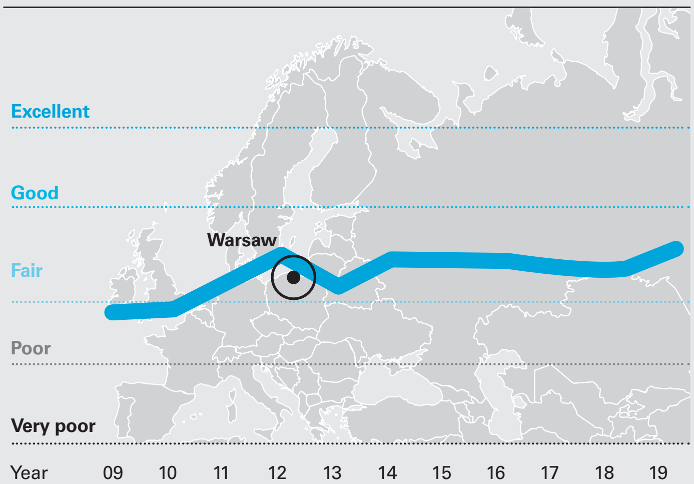
Source: *Emerging Trends Europe* survey 2019

fronting structure using the funds of a foreign bank.

The Italian Supreme Court deemed this to be a breach of banking licence requirements in Italy, as the Italian courts will look at substance rather than form, which effectively showed that the foreign bank was providing the loan given that the foreign bank shared in the insolvency risk of the Italian borrower, and that the Italian borrower was aware of the foreign bank's involvement in the transaction (as the Italian borrower was itself a party to the intercreditor arrangements), the foreign bank's credit exposure to the Italian borrower and its own credit analysis to determine whether to lend.

The Supreme Court ultimately held that whilst the loan had been made available by the Italian bank, the above arrangements meant that the Italian borrower was open to direct action by the foreign bank, and the arrangement was therefore illegal. Whilst therefore this structure is particularly fact-specific, parties using fronting arrangements are advised to check their structures to ensure they do not fall afoul of the Supreme Court's analysis.

Warsaw: Investment prospects, 2009 – 2019



Source: *Emerging Trends Europe* survey 2019

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Polish WHT

January 2019 saw a new regime for withholding tax in Poland

Poland

New Polish tax reforms

Effective from 1 January 2019, there is a new Polish withholding tax (WHT) regime that makes it more difficult for Polish tax residents to apply a WHT exemption or reduced WHT rates resulting from double tax treaties and EU directives. Previously, Polish remitters (generally, Polish tax residents) could, depending on other requirements, apply tax benefits such as a tax exemption or preferential WHT rates resulting from the double tax treaties concluded by Poland or EU directives if they had a certificate of tax residency (if payments were subject to beneficial treatment under a double tax treaty) and certain other documents. Under the new legislation, the application of the WHT rules to cross-border payments depends on the amount paid annually to the taxpayer.

If payments subject to WHT made by a particular remitter to a taxpayer are within the threshold of PLN 2 million (approximately, €470,000), WHT would be settled the same as under the pre-2019 legislation tax law with a few minor changes, such that the tax remitter is still obliged to pay WHT, but with the right to apply preferential tax rates or tax exemptions. The tax remitter may apply a WHT exemption or lower WHT rate if the requirements for tax benefits resulting from a double tax treaty or EU directives are met. For the application of a tax benefit (i.e., a different rate than from the CIT Act or a tax exemption), the tax remitter is obliged to exercise due diligence. In addition, in the case of tax benefits resulting from EU directives, the tax remitter will need to receive a written statement from the payment recipient confirming that it meets the conditions for applying tax benefits from EU directives (including the beneficial owner requirement, as defined in the Polish tax regulations). A certificate of tax residency will always be required to apply a lower WHT rate or exemption.

If the payments (subject to WHT as specified in Polish tax regulations) per year exceed PLN 2 million, the tax remitter will be obliged to calculate, collect and pay the WHT at the maximum Polish rates (i.e., 19 per cent or 20 per cent). In such a case, the tax remitter may apply for a withholding tax refund, upon written application to the tax authorities. Such refunds should be obtained within six months of the application date; however, an application may trigger further investigation proceedings leading to a delay. Tax remitters do, however, have the option to apply the existing regime to any payments exceeding PLN 2 million by filing additional statements to the tax authority, which, after exercising due diligence, requires the tax remitter to confirm, among others, the tax status of the taxpayer (including the beneficial owner requirement as defined in the Polish tax regulations).

In the case of EU directive benefits, another option is to apply to the tax authorities for an opinion on the application of an exemption for certain types of payments.

Please note that both a company (as tax remitter) and its management board members may be held liable for failing to comply with the above WHT procedures.

The new rules also affect bond issuances. Further information on that topic is available here.

Spain

Non-performing loans

The enforcement of non-performing loans in Spain has become easier, following the removal of a major obstacle to enforcement.

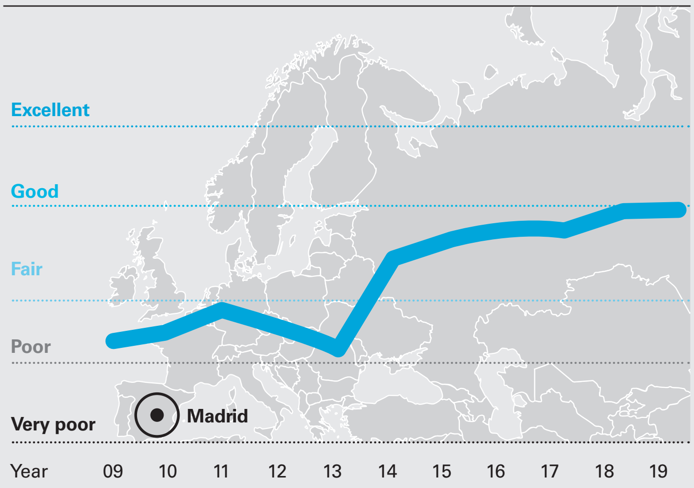
Under Spanish law, in order for a creditor to enforce a mortgage, the creditor is required to hold the original enforcement notarial deed or apply for a court order to obtain such a mortgage deed. Historically, this second option was only available to creditors that were party to the original documentation, making it difficult for any purchaser of non-performing loans to obtain a copy of the enforcement notarial deed. Given the impact on the ability of such purchaser to enforce that mortgage, purchases of non-performing loans were sometimes less attractive or the pricing was negatively impacted when taking this into account the additional costs and hurdles of enforcing such mortgage.

A resolution of the Spanish General Directorate of Registries and Notaries entitles purchasers of non-performing loans to obtain an enforcement deed *provided that* (i) it has not previously requested such enforcement deed in order to enforce a mortgage; and (ii) the purchaser can prove that it is the legal owner of the debt and security.

Spanish stamp duty liability

Supreme court ruling prompts Royal Decree 17/2018

Madrid: Investment prospects, 2009 – 2019



Source: *Emerging Trends Europe* survey 2019

Stamp duty

In our previous update (available here), we informed you of the Spanish Supreme Court ruling (and the resultant Royal Decree 17/2018), which established that lenders, not borrowers, would be liable for the payment of stamp duty if a mortgage was granted in favour of the lender.

The Royal Decree-law 17/2018 added a new section to the Corporate Income Tax Law specifying that, applying from the fiscal year after the Royal Decree came into effect, any such stamp duty paid by the mortgagee will not be tax deductible for the purposes of corporate income tax. This is an additional cost burden for lenders.

Practically speaking, there is nothing to stop the borrower and lender contractually agreeing that the borrower will bare these costs. However, this could effectively result in a form of double taxation, as should the lenders seek to pass the stamp duty costs on to the borrower through the indemnity provisions in loan agreements, the lender could also be liable for tax for any amounts received under that indemnity.

One should note, however, that a Spanish court may see any such pass-through arrangement as an unfair provision and declare it null and void. Lenders may, therefore want to proceed with caution. Another option is for lenders to take this cost into account when pricing the loan, whether this is through higher margins or an additional upfront fee. It will be interesting to see how market practice develops in this regard.

United Kingdom

Canary Wharf judgment

On 20 February 2019, the High Court determined, in the case of *Canary Wharf (BP4) T1 Limited and others European Medicines Agency* [2019] EWHC 335 (Ch), that Brexit was not an event that frustrated a lease.

In this case, the European Medicines Agency argued that Brexit would frustrate its lease on the basis of Regulation (EU) 2018/1718 of the European Parliament and of the Council of November 2018, requiring it to relocate its headquarters from London to Amsterdam. Should it have been successful in its suggestion, the European Medicines Agency would have been released from any further performance of its contractual obligations under the lease. In finding in favour of the landlord, the court held that the European Medicines Agency did not lack capacity to continue to perform its obligations and therefore continued to be liable to make the rental payments.

Whilst the decision was welcomed by commercial landlords, it is important to note that the judgment does not lay down any general principles that Brexit does not constitute a frustrating event, especially as the court did not reject the possibility that the claim may have been successful in different circumstances. Instead, it is clear that frustration will require a case-by-case analysis.

Interestingly however, the judge did note that the European Medicines Agency suffered a material adverse effect from Brexit. It will be interesting to see whether this will be an avenue open to lenders under loan agreements in the future, given the high threshold set by previous case-law on this topic.

For further information on the case and the arguments raised, see here.

IFRS 16

From 1 January 2019, lessees were required to recognise certain operating leases on their balance sheets. Under the pre-IFRS 16 position, finance leases and operating leases were treated separately, such that finance leases were treated as debt and operating leases remained off-balance sheet. Similarly, in the case of rent, the rental expense under operating leases was recognised in the profit and loss account as it fell due, with no liability arising on the balance sheet. Under IFRS 16, the distinction between operating leases and finance leases has been removed and all leases are expected to be recognised on the balance sheet.

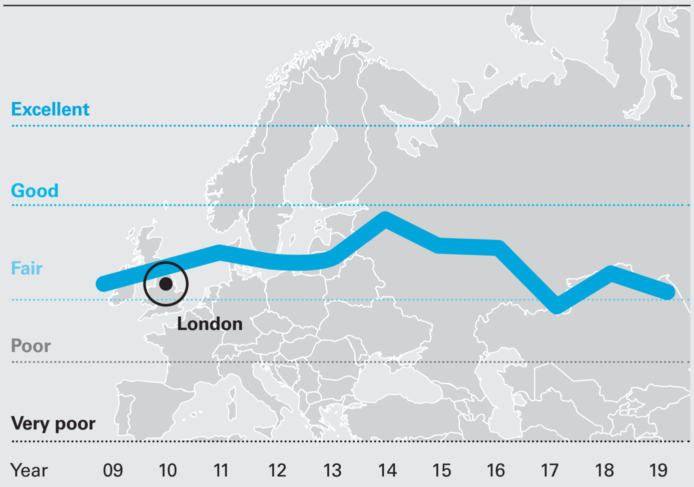
For the real estate finance market, particularly landlords and tenants, this is an important consideration to be taken into account. For rack rent leases, tenant and landlords may want to seek to take advantage of the short lease exceptions under IFRS 16 (applying to leases of less than 12 months), which effectively allows for the pre-IFRS 16 position to be applied. This may not be ideal for landlords, as it does not have the certainty of a longer lease, but it could be beneficial from an accounting perspective.

For borrowers under financing arrangements, additional thought must be given to financial covenant testing and debt undertakings, given that the amount payable under leasing arrangements will constitute debt, therefore increasing the "Financial Indebtedness" and "Borrowings" figures for the purpose of financial covenant testing, as well as rises in "Finance Charge" figures and "EBITDA" numbers in recognition of the interest component. Borrowers and lenders will therefore need to ensure that the relevant financial covenants are set at the correct level or with sufficient headroom.

IFRS 16

Took effect from January 2019, changing the accounting treatment of leases

London: Investment prospects, 2009 – 2019



Source: *Emerging Trends Europe* survey 2019

For more information on this topic, see here.

1 per cent SDLT surcharge

Last year it was announced that an additional stamp duty land tax levy was to be added to foreign investors into the UK property market. Earlier this year, HMRC detailed the proposed 1 per cent SDLT surcharge for non-UK residents purchasing residential property in England and Northern Ireland covering both freehold and leasehold interests, which is to apply on top of existing rates. The consultation closed earlier this month.

The test for non-resident for SDLT is different from that of the non-resident for income tax purposes. Under these rules, an individual will be a non-resident if they have spent less than 183 days in the UK in the 12 months prior to the purchase of the property. However, if said individual remains in the country for 183 days or more following their purchase, the SDLT will be refunded. This will make this new surcharge increasingly difficult to monitor and increase the overall complexity of the regime. As the regular tax residence rules still apply to corporate buyers, the 1 per cent surcharge will apply to companies established and managed outside the UK.

Furthermore, if there are multiple purchasers of a property, the surcharge will apply if any of the buyers is non-resident. This also applies if a UK company, which is controlled by a small number of non-UK private entities, is used to acquire a residential property.

The date for implementing the proposal (after taking into account the results of the consultation) is currently unknown, but is expected to take effect in a future Finance Bill.

SDLT filing reduced to 14 days

From 1 March 2019, the period for filing an SDLT return and paying the SDLT reduced from 30 days to 14 days. The government's rationale for this change is to increase efficiency and reduce the burden and costs for HMRC and its customers.

A £100 penalty is automatically incurred in the event of failure to file a return within the 14-day period, with this doubling to £200 if the delay extends to three months. Interest will also be payable in these circumstances.

The 14 days are calendar days and therefore include non-business days. The change will only apply to properties in England and Northern Ireland. The 30-day period will continue to apply in certain limited circumstances.

SDLT

Filings to be made within 14 days from 1 March 2019

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