Highlighting some recent developments concerning the financing of real estate through mezzanine loans

The impact of transfer pricing on real estate funding – Mezzanine financing

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Introduction

In this article, we highlight some recent developments concerning the financing of real estate through mezzanine loans. With those developments in mind, we then describe the relevant transfer pricing landscape in three representative jurisdictions: Japan, the UK and the US. We conclude with some suggestions on how to increase the robustness of transfer pricing policies for real estate financing.

Current environment changing traditional lending dynamics

The weak economic climate, the sluggish tenant market and increasing regulatory requirements have changed the dynamics of traditional lending facilities within the real estate sector. The terms and conditions that third party providers of credit are willing to accept are, in many cases, substantially more conservative than those which were prevalent in prior years. As such, making optimal use of the funds already available within real estate groups is becoming ever more important.

This higher degree of self-funding, together with budget pressures experienced by governments, has resulted in an increased focus by tax authorities across the world on the transfer pricing of debt. For example, as of the writing of this article, two high profile audits involving intercompany debt have been taking place in the US.[1] As a result, the correct application of transfer pricing legislation has become a higher priority as the potential for incurring double taxation through adjustments and penalty payments, as well as the negative publicity linked to tax disputes and litigation, has increased. Ensuring that a robust transfer pricing policy is in place is becoming a key management focus.

> ***Rising threat of double taxation makes correct transfer pricing of debt funding a higher priority***

Recent developments

Real estate investment financing trends

Foreign investors, from high net worth individuals to sovereign wealth funds, are faced with certain challenges should they wish to fund their acquisitions with debt. European real estate investors are faced not only with the paralysing effect of the European sovereign debt crisis, but also the impact of unprecedented regulatory changes, resulting in banks facing a stark choice of raising new capital or disposing of

[1] At stake for Tyco is $883.3 million in additional taxes plus penalties of $154 million related to an IRS challenge of intercompany financing with certain international subsidiaries related to acquisitions and restructurings in the late 1990s. At stake for Ingersoll-Rand is a potential levy of $400 million and $700 million of additional withholding and income taxes with respect to a portion of the interest payments on intercompany debt to a Bermudan affiliate.

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assets. The US and Japanese real estate markets face similar issues as lending institutions exercise extreme caution as they slowly recover from the recent financial crisis and learn to deal with new regulatory restrictions.

European sovereign debt crisis, unprecedented regulatory change force stark choices on lenders

The widespread view within the real estate sector is that commercial real estate lending will shoulder a disproportionate share of the burden and, as such, debt has been the main story for the real estate sector. Although this development is a huge challenge for many, it also creates opportunities for others, in particular equity investors less reliant on debt; those who are able to take advantage of the opportunities from bank deleveraging and new debt providers entering the market, such as insurance companies and specialist debt funds.

It is not only the availability of new debt that is a challenge; underwriting standards are becoming more rigorous; loan-to-value (LTV) ratios are falling and the cost of borrowing is rising, reflecting the higher margins and higher capital charges faced by senior lenders. However, these LTVs vary on a case by case base: the PwC Real Estate Investment Survey states that "there is adequate money out there for deals involving core assets and core geographies, but debt is thinner for properties in secondary markets and weaker tenancies. Underwriting is still very strict for tertiary locations and unstable assets in core markets."[2]

Importance of mezzanine debt funds on the rise

According to the Property Week report, Property Finance 2013, there is a long-term shift in real estate financing. Many senior lenders have shut down their real estate lending businesses because they don't feel they can be profitable at their long-term cost of capital. However, new entrants are coming into the market, such as insurance companies and debt funds. The Property Week report also highlights the increasing importance of mezzanine debt

[2] The PwC Real Estate Investor Survey is widely recognised as an authoritative source for capitalisation and discount rates, cash flow assumptions, and actual criteria of active investors, as well as property market information. http://www.pwc.com/us/en/asset-management/real-estate/publications/pwc-real-estate-investor-survey.jhtml

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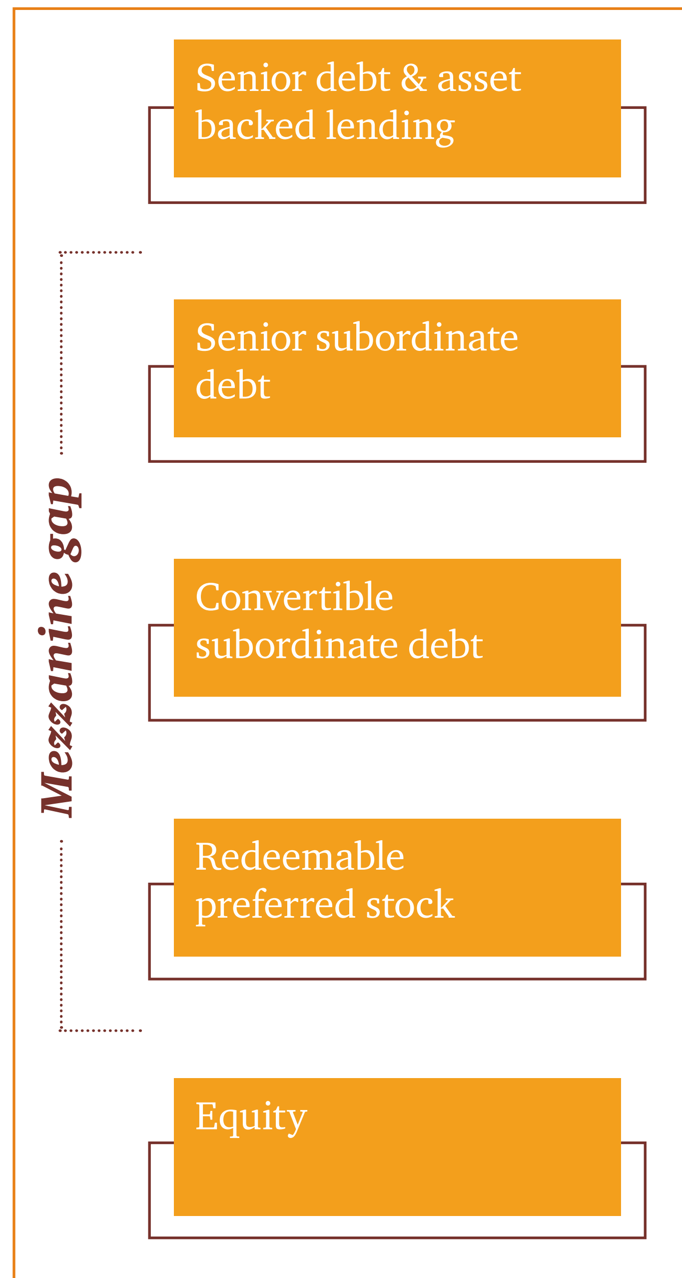
>60%

Risk aversion and regulation are pushing senior lenders down to LTVs of 60% or lower, which creates an opening for mezzanine debt providers.



funds that have managed to raise capital and are now starting to lend.

The mezzanine gap

The most immediate opportunity in real estate investment appears to be the provision of mezzanine debt since the retreat of senior lenders is opening a gap in the capital structure. When senior lenders, generally banks, were providing debt at 80% or even higher LTV ratios, few borrowers needed mezzanine debt. Risk aversion and regulation are pushing senior lenders down to LTVs of 60% or lower, which creates an opening for mezzanine debt providers.

However, two major concerns have been identified in Emerging Trends in Real Estate in Europe 2012[3]. First, mezzanine lenders need active senior lenders behind whom to provide the mezzanine product; i.e. the retreat of the banks could leave mezzanine lenders in an exposed position rather than tucked into a well protected gap in the capital structure. The other concern is pricing.

If return expectations for equity are falling, then the population of potential mezzanine borrowers will also decline unless mezzanine expectations are reduced correspondingly. If not, the main role of mezzanine and preferred equity will be in restructuring situations where the borrower has little alternative.

Real estate financing structures

Overview

There are various options to structure the financing of real estate: debt, equity or a combination of both. In terms of

[3] The 2012 report is the 9th edition of the report published by PwC and the Urban Land Institute. It is a survey of sentiment based on 310 face-to-face interviews and 386 online survey responses of representatives of the Real Estate sector consisting of senior executives from across Europe from a broad cross-section of the industry, including institutional investors, fund managers, listed and unlisted property companies, lenders and service providers. http://www.pwc.com/gx/en/asset-management/emerging-trends-real-estate/emerging-trends-in-real-estate-europe-2012.jhtml

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debt, various types of financing are available with a broad range of criteria including different priority levels of repayment in case of liquidation; i.e. ranging from senior debt which must be repaid first to junior and mezzanine debt, the latter being structured either as debt (typically an unsecured and subordinated note) or preferred stock.

As the main focus of this article is the transfer pricing of mezzanine debt in real estate financing structures, the following sections first define mezzanine financing from both a tax and a commercial perspective before going into more detail on the tax aspects associated with mezzanine financing.

Mezzanine financing

Moody's[4] defines mezzanine financing as: "lending to a borrowing entity or group of entities that directly or indirectly own a property-owning entity, which debt is secured by a first security interest in the borrower's pledged ownership interests in the property owner". Mezzanine finance is typically used by companies that are already highly leveraged but still have positive cash flow to support additional debt payments. Mezzanine finance is often used to support growth through expansion projects; acquisitions; recapitalisations, and leveraged buyouts.

Tax authorities may use a broader definition than Moody's. For example, Her Majesty's Revenue and Customs (HMRC), describes mezzanine debt in their International Tax Manual (INTM) as follows: "Mezzanine debt sits between senior debt and equity in the capital structure of a business. Often a high-risk form of finance, it is subordinated to the senior debt, so that if the borrower gets into financial difficulties, the mezzanine debt is unlikely to be recovered. It has the characteristics of debt but it may carry a right to shares as a way of providing some form of recompense to the holder in the event of default. The term originally referred to debt financing which gave the lender an equity stake, or had the possibility of conversion into equity. It has more recently been used to describe any middle layer of debt in leveraged buyouts, "below" the senior debt and "above" the equity, whether or not any equity rights are attached to the debt. Such debt may be fixed rate or floating, secured or unsecured and it is common that the loan is bullet repayment rather than amortising".

In contrast, the tax authorities of other countries, such as Japan and the US, may refrain from formally defining mezzanine financing in legislation.

[4] In its paper "US CMBS and CRE CDO: Moody's Approach to Rating Commercial Real Estate Mezzanine Loans", March 2007.

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Mezzanine financing may be short term or long term, amortising or interest only, floating or fixed rate, though the current market sees most mezzanine loans as relatively short-term, interest-only, floating rate transactions. In contrast to some preferred equity deals that have debt characteristics, few, if any, mezzanine loans destined for the capital markets have cumulative returns or equity "kickers"; they are straight debt notes, for the most part, albeit at higher spreads to reflect the risk of being in the transition zone between debt and equity.

Most mezzanine loans are targeted to be at the bottom of the debt stack and are expected to receive below investment-grade shadow ratings. Isolated mezzanine transactions, however, may reach low-to-mid investment-grade levels, often when the real estate is located in jurisdictions with hefty mortgage recording taxes. The common features of all mezzanine instruments are that they offer a risk/return profile that lies between debt and equity.

Intercompany mezzanine financing

As a result of the recent financial and economic turmoil, the utilisation and incidence of intercompany mezzanine financing in the real estate sector has become more prevalent. It is increasingly difficult for companies to obtain external third party financing and higher current market credit spreads have made external financing less attractive. Therefore, considering using funds available within the company, rather than attracting funds externally, has become even more important for many companies.

There are some important tax aspects to consider when choosing to use mezzanine financing. For example, returns on equity and returns on debt capital are treated differently for tax purposes and so thin capitalisation poses an issue for tax authorities as further elaborated below. The returns to shareholders on equity investment are not tax deductible for the paying company, being distributions of profit rather than expenses of earning profits. Alternatively, the returns to lenders of debt (typically in the form of interest) are normally deductible in arriving at profits assessable to corporation tax. Therefore, there is an incentive to present what is in substance an equity investment in the form of debt to obtain the favourable tax treatment.

Having said that, many countries, such as the UK, the US and Japan, place other restrictions on the use of debt funding, such as thin capitalisation rules or earnings stripping rules (which limit the deductibility of interest

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expenses on related party debt). Nevertheless, debt funding for real estate investment may still provide a more attractive alternative than equity funding for many real estate groups.

Transfer pricing of debt

Governments have imposed various regulations to curb the misuse of intercompany finance arrangements. Perhaps the most common regulations across various taxing jurisdictions would be the imposition of the arm's length standard, which states that the price of a related party debt arrangement should be consistent with the price of comparable third party debt arrangement. Below, we first set out the tax regulations on interest deduction in Japan, the UK and US relevant for the purpose of this article before describing the basic principles of transfer pricing of debt.

Relevant Japanese regulations

Broadly, Japan limits the use of related party debt through its thin capitalisation and earnings stripping rules.

In general, the thin capitalisation rules provide a 3:1 debt-to-equity safe harbour. Article 66-5 (1) of the Act on Special Measures Concerning Taxation (ASMT) sets out that if the annual average balance of interest-bearing debt owed to a foreign controlling shareholder exceeds the capital contributed by that foreign controlling shareholder by a ratio in excess of a 3:1 safe harbour, the excess interest expense paid or payable to the foreign controlling shareholder is not tax deductible. In addition, interest paid to a third party may also be subject to Japanese thin capitalisation rules if the loans are guaranteed or bonds are provided as collateral by the foreign controlling shareholder.

CUP method preferred for pricing of intercompany debt in Japan

In addition to the above, from the tax years beginning on or after April 1, 2013, an earnings stripping rule has been introduced. Under this rule, the deductible portion of a corporation's net interest expense to a related party will be restricted to 50% of adjusted income.[5] Where interest expense is not deductible, it may be carried forward for seven years and deducted in a fiscal year up to the 50% threshold in that fiscal year.

Given these domestic law limitations on deductibility of related party interest expense, the volume of debt has not been a major issue in Japan.

[5] Net interest is calculated as interest expense to related parties less corresponding interest income. Adjusted income is defined as taxable income, adding back interest expense, depreciation expense and exempted dividend income, but excluding extraordinary income or loss.

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Finally, in terms of the arm's length nature of intercompany debt pricing, the comparable uncontrolled price method (CUP method) is the preferred methodology. According to ASMT Directives 66-4, (7)-4, and 68-88, (7)-4, where the same method as the CUP method is to be applied, the following factors should be taken into account: The currency of the loan; the timing and term of the loan; the manner of setting the interest rate (i.e. setting of fixed or variable rate, or simple or compound rate); the method of interest payment (i.e. method of advanced or deferred payment and so on); the credibility of the debtor; and the conditions of collaterals and guarantees as well as other factors affecting the arm's length rate.

Relevant UK regulations

The UK transfer pricing legislation is contained in Part 4 of the Taxation (International and Other Provisions) Act 2010 (TIOPA 2010). S147 sets out the basic pre-conditions for transfer pricing legislation to apply: When a provision is made or imposed between any two persons by means of a controlled transaction that differs from the provision which would have been made in an uncontrolled transaction (the arm's length provisio") and, as a result, a UK tax advantage is conferred on one or both persons, then the profits or losses of the advantaged person are to be calculated for tax purposes as if the arm's length provision had been made or imposed instead.

For intercompany financing, specific rules around thin capitalisation are included in Part 4 TIOPA 2010. Following S152, a person is said to be thinly capitalised when it has excessive debt in relation to its arm's length borrowing capacity, which then leads to the possibility of excessive interest deductions. In addition to considering the level of debt, it is also important to consider whether the rate of interest applied is consistent with arm's length prices.

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HMRC takes a broader view than just the amount of debt and the interest rate when looking at thin capitalisation. One of the key considerations is whether indeed the borrower would have chosen to take on a loan, even if the lending were available. HMRC describes this approach as looking at the "could" and "would" arguments:

- The "could" argument – what a lender would have lent and therefore what a borrower could have borrowed; and
- The "would" argument – what a borrower acting in the best interest of their own business would have borrowed.

For mezzanine financing with a very high interest rate, it may be the case that it could be made available to a company; however, whether the company in reality would choose to take on that additional debt from a third party given the interest rate and terms of the available finance is a different question. In looking at the transaction from both sides (which is consistent with the OECD Guidelines and from a UK thin capitalisation perspective) it is necessary to apply basic transfer pricing of debt principles; on what terms a third party would be willing to lend, and on what terms would a third party be willing to borrow.

Relevant US regulations

In general, Treas. Reg. §1.482-2(a), describes the transfer pricing rules applicable to intercompany loans in the US. These regulations provide three general approaches to establishing an intercompany interest rate: i) safe harbour approach under Treas. Reg. §1.482-2(a)(2)(iii); ii) situs of the borrower approach under Treas. Reg. §1.482-2(a)(2)(ii); or iii) an approach that is based on comparable uncontrolled transactions under Treas. Reg. §1.482-2(a)(2)(i). However, it should be noted that the ability of a taxpayer to deduct interest on debt from a related party is contingent on whether the indebtedness is considered bona fide.[6] The issue of whether an intercompany debt obligation is bona fide debt is not described in Treas. Reg. §1.482-2(a) but rather, is described in Section 385 of the Internal Revenue Code. As part of US tax law, the generality of IRC §385 serves as guidance for defining bona fide debt for tax purposes, but the resolution of whether an intercompany debt obligation is bona fide debt has generally been considered in the context of US Tax Court decisions as a result of the lack of statutory or regulatory guidance. The approach taken by the US Tax Court can be best described as a facts and circumstances

[6] Treas. Reg. §1.482-2(a)(1)

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approach that considers the nature of the financial contribution to the recipient of the funds and the circumstances under which the contribution has been made. Ultimately, the economic substance of the transaction governs the tax treatment of the transaction.[7]

Other tax rules should also be considered in establishing an intercompany debt arrangement in the US. Section 163(j) of the US Internal Revenue Code limits interest deductions where the corporations debt to equity ratio exceeds 1.5 to 1 or when the corporation has excess interest expense for the tax year. Additionally, Real Estate Investment Trusts are subject to a 100 percent excise tax to re-determined interest deductions for their Taxable REIT Subsidiaries under Section 857(d)(7)(A) of the US Internal Revenue Code.

Basic principles for transfer pricing of debt

There are three key factors that determine interest expenses in third party scenarios. The first is the likelihood of borrower default; e.g. how creditworthy is the borrower and how able is it to meet its liabilities? Another factor is the expected loss in the case of default; e.g. how senior is the debt relative to the borrower's assets; is there any collateral pledged to protect the creditor from realizing a loss? Finally, what is the opportunity cost of making the loan for the lender; e.g. what is the lender's cost of capital and/or next best investment alternative?

Taking the above into account, in an attempt to comply with the various transfer pricing regulations, taxpayers have tried to replicate what unrelated parties do when entering into debt transactions in an attempt to establish debt on an arm's length basis in an intercompany situation by analysing:

- the terms and conditions of the debt (e.g. the loan tenure, its seniority and collateral);
- the volume of the debt (i.e. by analysing borrowing capacity through free cash flow analyses and comparing to financial ratios of comparable independent companies);
- the credit or default risk of the borrower (measured through a credit rating process); and
- the interest rates offered by other lenders in comparable circumstances.

[7] Treas. Reg. §1.482-1(f)(2)(ii)(A)

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Transfer pricing of debt – mezzanine financing

As previously mentioned, mezzanine financing is typically the most junior debt with equity-type characteristics. Furthermore, the interest rates on mezzanine financing are typically high given this junior character. As such, there is an increased likelihood of scrutiny on the levels of and interest rates on mezzanine financing; in particular in the real estate sector where mezzanine debt is more prevalent. To mitigate the risk of a challenge from tax authorities, it is important that the arm's length nature of any mezzanine financing has been assessed and documented by following the four basic principles of transfer pricing of debt.

Terms and conditions of the mezzanine debt

Accounting for the features of mezzanine financing and how they compare with those of external transactions is one of the most important aspects of any transfer pricing analysis. To address this point, and while it does not constitute a comparable for transfer pricing purposes because it does not represent actual transacted data, having a bankability letter typically represents good corroborative evidence. However, as a result of

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banks reducing their lending to the real estate sector, it may prove difficult to obtain such a letter for mezzanine financing to fund the acquisition of real estate.

As such, other sources of data to support related party transactions become even more important, including referring to third party loans (preferably third party mezzanine loans) with similar characteristics at the time of the intercompany transaction.

Arm's length borrowing capacity should be determined based on independent comparables

Volume of the debt

As described above in the case of Japan, some jurisdictions use safeguards other than transfer pricing rules to indirectly limit the volume of debt that may be borrowed from related parties.

In contrast, the volume of related party debt will be a critical issue in countries where there are less restrictive requirements outside of transfer pricing.

The arm's length volume of any mezzanine financing is a determinant of the total borrowing capacity of the debtor. The arm's length borrowing capacity should ideally be determined based on independent comparables; key financial ratios should be used to assess the arm's length nature of the transaction (e.g. interest cover and gearing/leverage ratios/LTV).

Several factors relevant to the real estate industry may impact the borrowing capacity of an entity, for example, in relation to property backed lending: third party lenders are more prepared to grant a loan if land or buildings are available to put forward as security. They will still, however, look closely at the borrower's capacity to service debt, and are likely to want financial conditions in the loan agreement (such as the ratios described above) to ensure that this capability continues.

In terms of quantifying the borrowing capacity of the debtor, market practice is to look at LTV ratios; which consist of the debt expressed as a proportion of the value of a property that a lender is prepared to lend (most often expressed as a percentage). However, it should be noted that mezzanine debt is often issued in situations where bank debt is not available. As such, careful thought should be made with respect to the use of LTV ratios in a mezzanine debt capacity analysis, particularly when such LTV ratios are derived purely from bank loans. Because publically available information on non-bank LTVs is scarce, it is recommended to substantiate the arm's length volume of the debt by additional analyses such as free

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cash flow analyses (i.e. will the property generate sufficient cash for the debtor to repay the debt and make the required interest payments).

Credit risk in relation to the mezzanine debt

In a transfer pricing context, typically one of the most important steps in analysing debt transactions is estimating the credit rating of the borrower adjusted for the transaction under review.

Under normal market conditions, the higher the credit rating of the debt issue, the lower the associated interest expenses (and vice versa). As such, in a transfer pricing context, the estimate of the credit rating of a borrower is of great interest to tax authorities since this is one of the clearest signals that the intercompany debt transaction has been structured at arm's length.

In terms of estimating a (shadow) credit rating of the debtor in relation to the mezzanine financing issued, a potential approach could be to use a credit scoring tool or to map the borrowing entity's financial ratios against S&P/Moody's financial ratios (e.g. Moody's Approach for REITs and Other Commercial Property Firms, 30 July 2010) to estimate the corporate credit rating of the debtor.

Subsequently, the corporate credit rating of the debtor may be adjusted to take into account the specific characteristics of the mezzanine financing (e.g. its junior characteristics).

Interest rates offered by other lenders in comparable circumstances

When looking for third party comparables, tax authorities typically focus their attention on executed transactions and evidence of actual market activity, and tend to be less willing to accept notional offers of finance, which have neither had to be issued or accepted in reality, without any additional supporting market evidence.

Higher values of ratios such as DEBT / EBITDA (Earnings Before Interest Tax, Depreciation and Amortization) and debt: equity are tolerated by lenders for a period of time following an acquisition, as long as the projections clearly show that the debt payments can be met and that the level of gearing is going to be reduced over time.[8] Typically, this means that the focus is on the intercompany financing arrangements that are in place at a point in the future that can be considered to represent a steady state (usually three to five years).

[8] http://www.hmrc.gov.uk/manuals/intmanual/INTM578090.htm
[9] http://www.hmrc.gov.uk/manuals/intmanual/INTM579030.htm

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Publically available information for companies with similar size and character in a particular industry is typically preferred for suitable comparables. For example, the De Montfort report which is published annually, along with a half yearly update, can be applied.[9] The report includes information covering major lenders within the UK, US, Germany and outside, as well as the majority of the smaller lenders. The information published includes a range of statistics, charts, and analyses covering comparisons of loan terms, interest rates, types and locations of lenders relating to the commercial property market.

Other sources of potentially comparable data include publically available databases such as Reuter's LoanConnector DealScan and Bloomberg Professional Database that contain information on debt issued (such as loans and bonds) by companies active in the real estate industry and can be searched based on a wide range of debt terms such as mezzanine financing. Furthermore, information contained in publications such as Property Finance 2013 can be used as corroborative evidence of the information obtained from the De Montfort report and the databases mentioned above.[10]

Conclusion

There is general pessimism regarding the availability of senior debt funding in the market. As the retreat of the traditional senior lenders is opening a gap in the capital structure, the most immediate opportunity in real estate investment appears to be the provision of mezzanine debt, which is typically the most junior debt with equity-type characteristics and interest rates that are commensurate with such risks. As a result of the high interest rates, and given that mezzanine debt is most prevalent in the real estate sector, many tax authorities have increased their scrutiny on the levels of and interest rates on mezzanine debt.

As the potential for incurring double taxation through adjustments and penalty payments, as well as the negative publicity linked to tax disputes and litigation, has increased, it is critical for real estate investors that a robust transfer pricing policy is in place which assesses and documents (i) the terms and conditions of the mezzanine debt, (ii) the volume of the mezzanine debt, (iii) the credit risk in relation to the mezzanine debt and (iv) the interest rates offered by other lenders in comparable circumstances.

[10] For example, PwC UK has prepared their own in-house database of real estate financing deals based on publically information for the purpose of corroborating information from the De Montfort report. In the U.S., the PwC Real Estate Survey provides detailed information on the real estate market in the U.S. which can be used to inform and anecdotally corroborate the debt capacity analysis described above.

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