CADWALADER

Introducing REF News and Views

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Welcome and Introduction from the Global Head of Real Estate

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By **William P. McInerney**
Partner | Real Estate

We are proud to introduce the first issue of Cadwalader's *REF News and Views*.

The newsletter, to be published on a monthly basis, will comprise news and commentary around legal matters concerning mortgage finance, mezzanine finance, loan sales and construction finance -- critically important areas for participants in real estate and real estate finance and the cornerstones of Cadwalader's global Real Estate Group practice.

A special mention in our first issue goes to my fellow partner, Duncan Hubbard, and his team in London. Duncan's practice focuses on advising financial institutions, investment funds and alternative lenders on real estate and structured finance transactions throughout the capital stack, as well as loan and portfolio purchase and sale transactions. He advises clients throughout the UK, Continental Europe and the United States and has consistently acted as lead counsel on some of the largest loan portfolio trades between UK clearing banks and insurance companies.

Over the coming months, we hope that, with our exceptional thought leaders in the U.S. and London, we will be able to provide you with timely and important insight into new developments in real estate finance. And as *REF News and Views* evolves in the months to come, we plan to be as interactive as possible with our readership, seeking out your feedback as we make this new monthly newsletter a valuable addition to your review of the industry.

Current Trends and Issues Arising in U.S. Real Estate Transactions

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This section of REF News and Views will be an ongoing component of this publication and will highlight (as its title indicates) current trends and issues in U.S. real estate finance transactions. Generally, we will endeavor to identify issues of negotiation between lenders and borrowers that have become commonplace and trends we are seeing in the structure and documentation of U.S. real estate finance transactions.

In this issue, we would like to highlight the ever-increasing focus of parties on the eventual phase-out of LIBOR as the benchmark index in finance transactions. As you are likely aware, LIBOR is scheduled to be phased out at the end of 2021. Cadwalader is especially positioned to provide guidance and insight into this seismic shift in the finance landscape as we are the firm that has been tapped by the Federal Reserve Board and the New York Fed to sit on the Alternative Reference Rates Committee or ARRC. ARRC is a group of private-market participants convened by the Federal Reserve Board and the New York Fed to ensure a successful transaction from U.S. dollar LIBOR to a more robust reference rate, the Secured Overnight Financing Rate (SOFR).

Recently, ARRC published recommended fallback language for syndicated loans that proposes industry-wide language for inclusion in loan documentation which addresses the transition from LIBOR to SOFR and the multitude of "unknowns" which may accompany such transition. Again, as Cadwalader drafted this language, we are uniquely suited to counsel clients on its intricacies.

While the implementation of the transition from LIBOR to SOFR is a work-in-progress, we continue to see a heightened focus by borrowers and their counsel on the manner in which loan documentation addresses this eventuality. Many institutions continue to resist extensive negotiation of those provisions. This factor is mainly due to the fact that many institutions are working internally to determine how they want to address this matter across their institution.

While we continue to see heavy negotiation of these provisions, as ARRC and the Fed refine the landscape of what the transition will look like, we anticipate further clarity and uniform implementation across institutions.

Over the course of future issues of *REF News and Views*, we will indubitably revisit this issue as it will continue to be in the forefront of loan negotiation and documentation.

Market Views: Are U.S. Deal Terms Filtering into the European Real Estate Market?

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By **Duncan Hubbard**
Partner | Real Estate

Senior finance documentation is increasingly reflecting the demand from international private equity funds for softening of covenants in return for more corporatised lending terms. This trend is resulting in the following:

- the emergence of increasingly looser financial covenants/cov-loose on the basis of "bad-boy" guarantees being provided by Sponsors (essentially guarantees from the Sponsor against certain bad behaviours such as fraud/misconduct);
- covenant levels are set with ample headroom – most likely due to the fact that current deals are on slightly lower leverage ratios;
- alternatives to cash trap or cash sweep (*e.g.*, rather than having a cash trap, sponsors are seeking this to be replaced with a distribution blocker instead, the reason being they will need to use the cash on the property); and
- portability clauses with respect to change of control – certain sponsors in particular are demanding this so that any subsequent sale, provided the buyer and asset manager meets certain pre-agreed criteria, would not trigger change of control.

These deal terms are traditionally more common in the leveraged finance market. Real estate financing transactions are traditionally slow to adopt the trends developed in the leveraged finance space due to the fact that the lender's primary route to recourse (*i.e.*, the property) very heavily relies on the underlying value of the property, whereas leveraged finance places very different emphasis on many other factors, such as cash flows, quality of management, the business as a going concern, and its outlook, etc. However, we have seen the emergence of lighter covenants and more sponsor-friendly deal terms of late, which may be driven in part by the presence of U.S. debt funds that are active in the European market and therefore increasingly questioning the entrenched European market positions, and in part relating to the large supply of capital. The resurgence of CMBS in Europe has also assisted this trend, as sponsors ask lenders to give up certain maintenance covenants for transactions that are to be included in CMBS portfolios.

Changes to the UK's Regime for Taxing Gains on Real Estate: Does This Affect Your Real Estate Fund?

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By **Adam Blakemore**
Partner | Tax

By **Catherine Richardson**
Partner | Tax

With effect from 6 April 2019, non-UK residents will become subject to tax on chargeable gains arising from the disposal of all UK land, including commercial and residential real estate (the "NRCGT Regime").

Prior to the introduction of the NRCGT Regime, gains on UK real estate by non-UK residents were generally not liable to UK taxation, although this position was being gradually eroded by various pieces of legislation targeted at specific circumstances. The NRCGT Regime will go a long way to achieving the government's stated intention of levelling the playing field between domestic and overseas investors in UK real estate, as well as between gains in respect of both commercial and residential property, with the resulting tax considerations becoming a new reality for many non-UK investors.

The new regime taxes both direct and indirect disposals by non-UK residents of UK real estate, whether residential or commercial. Under the NRCGT Regime, non-UK residents will be subject to tax on all gains realised on their UK real estate assets, subject to various exemptions and reliefs. In addition, certain aspects of the NRCGT are intended to minimise the impact of the potential changes at the investor level, including the option for collective investment vehicles ("CIVs") to elect to be treated as transparent or exempt. Particular consideration should be given to whether the CIV is eligible to make these elections and the timing for doing so.

Given the complexity of the legislation and the fact that the NRCGT Regime introduces a significant change to the scope of the taxation of UK real estate, it is important to examine current investment and holding structures so as to understand the impact of the NRCGT Regime and the consequences of any restructuring.

Previous Regime

Owing to the territorial limits of the taxation of UK real estate, non-UK residents have generally been outside the scope of UK taxation in respect of income and gains derived from UK real estate. This regime had helped establish UK real estate as an attractive asset class and facilitated the establishment of tax-neutral structures for inward investment, especially when compared with the position of other jurisdictions.

However, in recent years, legislation targeted at specific holders of UK real estate has been introduced to remove some of the distinctions between the taxation of residents and non-residents and distinctions between the taxation of residential and commercial real estate. For example, a non-resident company carrying on a trade in the UK through a UK permanent establishment is chargeable to UK corporation tax on profits attributable to that permanent establishment, wherever such profits arise. In addition, changes were introduced in 2016 to bring gains realised by non-UK residents on the disposal of UK land or property that derives at least 50% of its value from UK land within the charge to UK taxation.

NRCGT Regime

With effect from 6 April 2019 non-UK residents will be subject to tax on gains realised on their UK real estate assets. The NRCGT Regime taxes direct disposals as well as indirect disposals of UK real estate and includes disposals in the course of an investment activity. Set out below is a high-level overview of some of the key features of the NRCGT Regime.

What are "Indirect Disposals"?

For the purposes of the NRCGT Regime, indirect disposals are the sale of interests in "property-rich" vehicles by a person who has a substantial indirect interest in the UK land. A vehicle is "property rich" for these purposes if it derives at least 75% of its value from UK real estate. Broadly, a person will have a “substantial indirect interest” where they have held a 25% investment in that property-rich vehicle. These provisions are subject to a two-year holding period, and interests can be aggregated with interests held by related parties. The application of this 25% threshold to investors in CIVs is considered further below.

Exemptions and Reliefs

Non-residents should consider the availability of existing exemptions and reliefs that are available to resident investors for the purposes of determining chargeable gains. Broadly, investors that are exempt from chargeable gains (such as overseas pension schemes and sovereign wealth funds) should continue to be exempt under the NRCGT Regime.

The NRCGT Regime includes a “trading” exemption which applies to indirect disposals (including disposals by non-corporate shareholders) of interests in companies with real estate-heavy trades. This exemption applies if it would be reasonable to conclude that (so far as the market value of the company’s assets derives, directly or indirectly from UK real estate) all of the interests in UK land are used for a trading activity, or all of the interest in the UK land would be used for that trading activity if any UK land assets used for non-trading (investment) purposes is no greater than 10% of the market value of the UK land held by the Company for trading purposes.

The current “substantial shareholdings exemption” (“SSE”) for trading companies also continues to be available in the context of indirect disposals. The SSE exemption may be preferred to the “trading” exemption on the basis that the non-trading activities test in the SSE uses a 20% threshold to determine whether or not the trading requirement is met. However, the “trading” exemption should prove to be available to a wider class of investors, including non-corporate shareholders such as individuals and unit trusts.

Further, where a property-rich company is owned by an appropriate proportion (80%) of “qualifying institutional investors” (including pension funds, charities and sovereign wealth funds) for SSE purposes the trading requirement is dropped altogether.

Double tax treaties

The UK-Luxembourg double tax treaty currently prevents the UK from taxing gains on disposals by Luxembourg residents of interests in UK “property-rich” vehicles. This position will continue to preserve the current taxation treatment for these vehicles under the NRCGT Regime. However, the UK is in the process of renegotiating the real estate-related provisions in the Luxembourg treaty, so the protection may not be available in the future. The NRCGT Regime also contains anti-forestalling provisions to prevent new structures being established in Luxembourg in order to take advantage of this protection.

Rebasing

The NRCGT Regime provides for the rebasing of assets held on 5 April 2019 that have not come into charge before April 2019. Alternatively, an election can be made for calculating a chargeable gain in accordance with the usual rules, where this produces a beneficial result, although there are limitations around this producing a loss.

Collective Investment Vehicles (“CIVs”)

Non-UK investors in CIVs that are not partnerships would otherwise be treated as if they owned shares in a company and could therefore be within the charge to UK tax on any gains realised on a disposal of their CIV interests. Non-UK investors in CIVs that are partnerships may be within the charge to tax on gains realised on disposals of underlying UK land.

The NRCGT Regime provides CIVs with the option to make certain elections so as to reduce the potential for double taxation of the fund and investors. Owing to the importance of “tax neutrality” for investors (such as pension funds and other exempt institutional investors) in these structures, this is an important feature of the NRCGT Regime and a welcome concession from the UK Government.

The 25% ownership requirement for the purposes of the application of the NRCGT Regime to indirect disposals will not apply to investors in CIVs (whether that CIV is a partnership or not), investors in companies that derive more than 50% of their value from one or more CIVs, or disposals by CIVs themselves or by companies in their ownership. However, the 25% ownership requirement will apply to investors in CIVs that were marketed on the basis that no more than 40% of the CIV’s market value will be derived from interests in UK land or UK property-rich companies.

A CIV can elect to be regarded as either “transparent” or “exempt”.

A CIV which is transparent for tax purposes (for example, a Jersey property unit trust ("JPUT")) can elect to be transparent for the purposes of the NRCGT Regime. By making a transparency election, the CIV will be treated as a partnership for the purposes of chargeable gains calculations. In particular, the CIV will not itself be subject to tax but UK and non-UK resident investors will be subject to tax on any gains realised on a disposal of the underlying assets.

The availability of this election is expected to result in JPUTs continuing to be an integral part of real estate structures in respect of UK land. From a compliance perspective, transparency elections are irrevocable and must be made within one year of the vehicle acquiring UK property. Existing CIVs have until April 2020 to make a transparency election, subject to the consent of all unitholders.

Alternatively, in certain circumstances, a CIV can make an exemption election. A CIV will be eligible to make an exemption election where it is a property-rich entity and meets one of a number of ownership conditions (by reference to being widely marketed, or for non-close entities, the ordinary share capital is traded on a recognised stock exchange or 75% of the CIV's value would be returned to investors on a winding up).

The effect of making an exemption election is that while the CIV (and any other elected entities) remain persons notionally chargeable to tax on gains, they will be exempt from tax on direct and indirect disposals of UK land. UK resident and non-UK resident investors will instead be subject to tax on any gains realised on a disposal of their interest in the CIV. Unlike the transparency election, the exemption election can be revoked. In addition, CIVs making an exemption election will have certain reporting obligations to HMRC (such as providing details of the CIV's investors and their tax status together with the value of any disposals the investors made in the relevant period). However, HMRC acknowledges that some funds may either not hold this information or be permitted under the terms of the CIV's constitution to disclose these details.

Non-UK investors should be aware that they may have UK tax filing obligations as a result of such elections being made. The practical impact of this position may be softened in the future, as HMRC is considering new rules that would allow funds to file returns and pay tax on behalf of their investors.

The New CGT Regime: What Is the Impact for Lenders and Borrower/Sponsors?

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By **Livia Li**
Associate | Real Estate

The new CGT regime seeks to level the playing field between domestic and overseas investors in UK real estate, with CGT being applicable to non-resident investors going forward, unless they fit within specific exemption/election categories.

Impact on investors

With respect to existing investors, there are certain transparency and exemption options available for certain qualifying co-investment vehicles. Provided that the investment vehicles are eligible to make these elections or apply for these exemptions in time, these investors can ensure the CGT application remains substantially the same as before. Therefore, it is important to be prepared for these changes and it may be worth examining your current investment/holding structure to ensure you're ready for these new changes.

Where the investment vehicle does not qualify for any elections and/or exemptions, any capital gains assessed on disposal will be made with reference to the value of the property as at 31 March 2019, meaning that all capital gains accrued prior to that date are effectively grandfathered. In determining the rebase value, HMRC allows investors to rely on the value on the investor's balance sheet, but investors may nevertheless want to conduct a full valuation which adheres to the Royal Institution of Chartered Surveyor's Valuation Professional Standards (also known as a "red book" valuation).

Investors who hold real estate for trading purposes (*e.g.*, those investing in hotels, the restaurant business) may continue to rely on the trading exemption that was previously available. This trading exemption has many rules and complexities and so care should be taken in making the assessment and professional advice should be obtained.

Impact on lenders

As a result of the changes to this regime, you may find that many of your clients are looking to make elections, or perhaps even adjust their holding structure (whether existing structures or new structures going forward) with respect to their UK real estate holdings. Depending on the security structure of your loans, amendments may be required to accommodate these changes. For example, with the UK Government intending to renegotiate the double tax treaty with Luxembourg and also the introduction of anti-forestalling rules, one consequence may be that the Luxembourg holding entity may fall out of favour in the future, and sponsors may prefer setting up new holding entities in other jurisdictions. The NRCGT anti-avoidance provisions will also need to be considered in relation to any proposed restructuring.

In addition, where investors are not able to benefit from exemptions and a CGT liability arises on the sale of the UK real estate, consideration may need to be given to how such a CGT liability will be accounted for in current structures or would be accounted for in new structures. This will be particularly important in enforcement scenarios. Where HMRC ranks as an unsecured creditor, consideration should be given to the contractual protections afforded to investors.

Real Estate Events

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Main Events

Sept. 4-6, 2019	**CMBA Western States CREF 2019** *Location:* Las Vegas *Organizer:* CMBA
Jan. 13-15, 2020	**CREFC January Conference 2020** *Location:* Miami *Organizer:* CREFC
Feb. 9-12, 2020	**CREF/Multifamily Housing Convention & Expo** *Location:* San Diego *Organizer:* MBA
June 8-10, 2020	**CREFC Annual Conference 2020** *Location:* New York *Organizer:* CREFC

Events in the U.S.

June 25, 2019	**Argus Enterprise Overview** *Location:* Boston *Organizer:* CREFC
Sept. 5-6, 2019	**Real Estate CFO & COO Forum East** *Location:* New York *Organizer:* IMN
Sept. 9-10, 2019	**Middle-Market Multifamily Forum Mid-Atlantic** *Location:* Washington *Organizer:* IMN
Sept. 12-13, 2019	**Bank Special Assets & Credit Officer's Forum** *Location:* Chicago *Organizer:* IMN
Sept. 23-24, 2019	**Real Estate Private Equity Forum on Land & Homebldg.** *Location:* Las Vegas *Organizer:* IMN
Oct. 10, 2019	**CRE CLO 2019** *Location:* New York *Organizer:* CREFC
Oct. 15, 2019	**CMF: Overview of CMF Insurance Compliance 2019** *Location:* webinar *Organizer:* MBA

Oct. 16-17, 2019	**Middle-Market Multifamily Forum Midwest** *Location:* Chicago *Organizer:* IMN
Oct. 23-25, 2019	**Fall Conference** *Location:* San Diego *Organizer:* Trigild
Nov. 7, 2019	**Real Estate Mezzanine & High-Yield Debt Forum** *Location:* New York *Organizer:* IMN
Nov. 18-19, 2019	**Middle-Market Multifamily Forum Southeast** *Location:* Atlanta *Organizer:* IMN
Dec. 4-6, 2019	**Single Family Rental Forum West** *Location:* Scottsdale, Ariz. *Organizer:* IMN
Jan. 21-23, 2020	**NMHC Annual Meeting** *Location:* San Diego *Organizer:* NMHC

Events in Europe

July 1-3, 2019	**Executive Education Program** *Location:* London *Organizer:* CREFC Europe
Nov. 20-21, 2019	**Autumn Conference 2019** *Location:* London *Organizer:* CREFC Europe