Why investors utilize Single Purpose Entities in real estate transactions

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summary In official real estate price statistics it is common to consider only actual asset deals as real estate transactions. In the real estate trading market however, there is another way to transfer property. Real estate can be accommodated into a separate company, also known as a Single Purpose Entity (SPE). In this case the real estate may be transferred by transacting the shares of the SPE instead. In this research the motives of investors choosing an asset or share deal are elucidated, which will help us to understand the trade-off between asset and share deals and what circumstances determine the popularity of either one. Furthermore several stylized SPE constructions are described, which will help us understand to what extent we should consider share deals as part of a CPPI. Finally the magnitude of SPE transactions in the Netherlands will be estimated. This will help us to determine whether SPE constructions should be considered in constructing commercial property statistics, which commonly exclude these transaction structures.

keywords Single Purpose Entity (SPE); Commercial Property Price Index (CPPI); share deal; asset deal

1. Introduction

In official real estate price statistics it is common to consider only actual asset deals as real estate transactions. These are, for instance, transfers of real estate ownership as recorded by Land Registry Offices or documented real estate sales in purchase agreements by real estate agents. In these cases the transfer refers to the reallocation of legal ownership of a real estate object. In the real estate trading market however, there is another way to transfer property from one to another. Real estate can be accommodated into a separate company that is specifically established to legally own the real estate. These separate companies are referred to as Single Purpose Entities (SPEs). If these circumstances are set and company A intends to transfer real estate to company B they may transfer the legal ownership as a share deal of the SPE instead. In this scenario there is no shift of legal ownership of the property. The SPE still legally owns the property, but the economic ownership is transferred from A to B.

Lynn (1962: 73) once stated that “it would only seem logical that entities engaging in essentially the same activities should be taxed essentially the same – that the choice of business form should not affect taxation and, in reverse, taxation should not affect the choice of business form”. In this statement the emphasis is placed on tax treatment, but there is a strong similarity in compiling real estate statistics. Should we not treat SPE transactions as real estate transactions? Neglecting this kind of transactions would be ignoring that there is a trade-off in the market between the two transfer constructions. Investors in real estate deliberately choose to engage in an asset deal or a share deal, while their intentions are exactly the same. Therefore favourable circumstances for one of the types will affect the other. For real estate statistics, based on just asset deals, this implies the following: when we see a decrease in transaction numbers, does it reflect a fall in demand or supply in the real estate market? Or could it be that the popularity of share deals is increasing and therefore compensating the alleged drop in the market? And if the share deals are included in the calculation of price developments, will it change our view on real estate price trends?

In addition to the conceptual treatment of share deals, the practical treatment is another aspect to take into account. Is the magnitude of share deals large enough to warrant the inclusion of asset deals in real estate statistics or are they negligible? As transferring company’s shares is assumed primarily to occur between investors (with no intention to be vested in the property itself), share deals are in particular applicable when it comes to commercial real estate. And especially since it is very complex to construct Commercial Property Price Indicators (CPPIs), knowledge on the size of SPE-like constructions should prove to be very useful. When the magnitude of share deals is relatively small, this may support a pragmatic choice to exclude them from a CPPI. On the other hand, should the data on share deals prove the be useful, this may increase the feasibility to compile CPPIs. More specifically, the low transaction numbers of commercial real estate are the most common disruptive factor of CPPIs and therefore an added number of share deals may just be what CPPIs need. Either way knowledge on the size of SPEs will prove to be useful.

The research, described in this paper, will focus on both the conceptual and the practical question. First, a definition is provided for what we consider an SPE. Second, the motives of investors choosing an asset or share deal are elucidated. Knowledge of their reasoning will help us understand the trade-off between asset and share deals and what circumstances determine the popularity of either one. Third, several stylized SPE constructions are described. This will help us understand to what extent we should consider share deals as part of a CPPI. The research we have conducted to clarify the motives and describe the structures consisted of expert interviews. In this regard investment firms, the tax authority and real estate law firms were consulted. Fourth, the magnitude of SPE transactions in the Netherlands will be estimated. The description of the estimation method may serve as an example for statisticians in other countries to determine the share deal size. To conclude, some of the lessons learned are summarized and a few open discussion topics on SPEs are presented.

2. Defining SPEs

Before diving in to the various possible SPE constructions and the motives for choosing such a construction we should first define what an SPE is. In the literature, various definitions of an SPE can be found. All of these definitions share the essence that an SPE refers to a legal entity that is specifically created to satisfy a specific purpose. In our case the purpose is owning real estate (Seligman & Stein, 2004; Rixon, 2012; Arden, Keller & Lewis, 2017). The terms that accompany the definition above come in a variety. Commonly used terms are 'Single Purpose Entity', 'Special Purpose Entity', 'Single Asset Entity' and 'Special Purpose Vehicle'. These terms are interchangeable in the context of the definition above. Terms that are also used to describe similar constructions are 'Straw corporations' and 'Nominee corporations'. Both these terms refer to entities that legally own property and by itself are beneficially owned by a parent company (Bertane, 1974). Straw or nominee corporations could therefore be SPEs, but they do not necessarily have to be. As straw corporations are typically used in the context of a way to circumvent property transfer tax, it is likely that straw corporations may also hold a second purpose, since an SPE transaction is a more obvious economic transfer of property. Terms that are also common are 'Bankruptcy Remote Entity (BRE)' or the more extreme 'Bankruptcy Proof Entity (BPE)'. These both refer to specific forms of an SPE. BREs or BPEs are always SPEs, but added legal characteristics make them more resistant to bankruptcy than common SPEs. In this research we define an SPE (Single Purpose Entity) as a legal entity that is specifically created to own real estate.

3. Why investors utilize SPEs

There are many arguments for an investor that could be decisive in choosing an asset deal or a share deal to transfer the economic ownership of real estate. The choice of a suitable construction depends on the specific circumstances like the applicable regulations, the value of the real estate (portfolio), the number of buyers/sellers and the current organization structure. The most decisive reasons in choosing a transfer construction are most likely legally and tax driven.

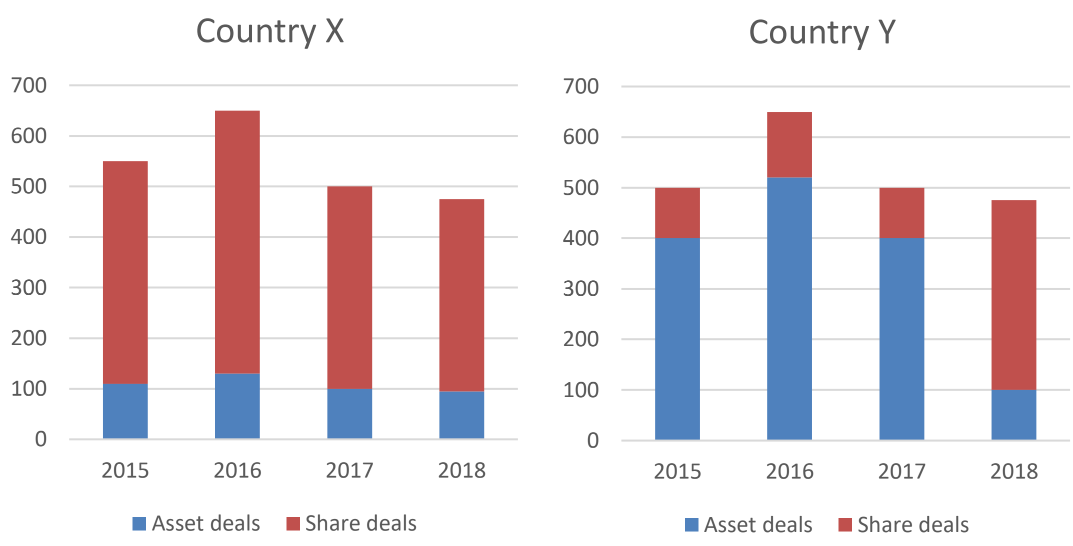
Legal perspective

There are clear advantages for companies to put the legal ownership of real estate at distance in a separate entity. In the management of real estate (not in transferring) SPEs are formed to reallocate liabilities (Bridson and Flammier, 2013). The aim is that declining performances of one of the organization entities does not harm the other and therefore SPE structures create obstacles in the path towards bankruptcy. This also causes real estate investments to be more attractive to commercial lenders (Sewell, 2006). Accommodating real estate in an SPE is a very common structure to manage real estate. In transacting real estate however, selling shares instead of assets does have some negative aspects. Purchasing an SPE also implies purchasing a company's statutory. The statutory could contain arrangements an investor is not willing to adopt. Buying an SPE therefore requires some research on the existing statutory and there is always a risk that there are (undesirable) regulations the researchers have missed. From a legal point of view an asset deal is mostly preferred over a share deal.

Financial perspective

From a financial perspective on the other hand, buying an SPE could be very beneficial. This however depends on the specific tax regulations and other legislation regarding real estate investment activities. A transfer of legal ownership of real estate is typically accompanied with property transfer tax. When the ownership of a company changes (share deal) instead of the asset itself (asset deal), other rules regarding the application of property transfer tax may apply. In case of share deals it is not always clear if the intention of both parties was to economically transfer real estate. Whether transfer tax applies in situations depends on the applicable legislation and the specifics of the deal. In the Netherlands for instance, transfer tax does apply to SPE transactions once a couple of conditions are met[1]. One of the conditions is a minimum percentage of the value of the SPE that should relate to real estate. Given the strong dependence on applicable legislation, and differences in legislation between countries, this is likely to cause incoherence between the frequency of share based deals among countries. The absence of tax regulations on share deals will cause investors to choose an SPE transaction more frequently. As a consequence, a decline in transaction numbers of asset deals does not necessarily reflect market developments as it could be compensated by an increase in share deals. This effect is illustrated in figure 1. In the first three years commercial property transaction numbers based on just asset deals are much lower in country X than in country Y. Based on this figures policy makers, for example, may conclude that the commercial real estate market is less pronounced in country X than in country Y. Yet, including share deals in the transaction numbers shows that market activity is actually very similar. Taking a closer look at country Y shows that the number of asset deals has declined in 2018. The increasing number of share deals in this example shows that the activity of trading real estate has not reduced, but that there has been a shift in the popularity between share and asset deals. Although this example is purely hypothetical, it shows how differences might occur in statistics due to differences in legislation.

Figure 1 – Exemplary transaction numbers in two countries



[1] Article 4, Law on the taxation of legal transactions. In Dutch: Wet op Belastingen van Rechtsverkeer (*Wet op belastingen van rechtsverkeer,* 2019, January 27).

Tax considerations in combination with legal considerations probably lead to the most decisive arguments for an investor to choose for an SPE transaction or not. If the tax circumstances are not in favor of the SPE, the legal risks will probably make an investor to prefer an asset deal.

Privacy perspective

Besides legally and financially driven motives, there are other arguments for choosing an SPE transaction. In general these are less decisive, but depending on the specific case they may still be important. Privacy related issues are exemplary in this regard. Transacting shares rather than assets has the (side) effect for investors of staying out of the books as legal owners. Should an investor have a strong preference to remain anonymous, a share deal seems more obvious than an asset deal. Considering that including privacy related issues into the decision-making are usually emotionally driven, these image considerations – and therefore share deals – probably suit private investors more than large institutional investors. Deductive reasoning implies that this could cause a sample selection bias in the selection of CPPI-input. Because private investors with privacy preferences are more likely to engage in share deals rather than asset deals, CPPIs solely based on asset deals may underestimate the share of deals made by private investors.

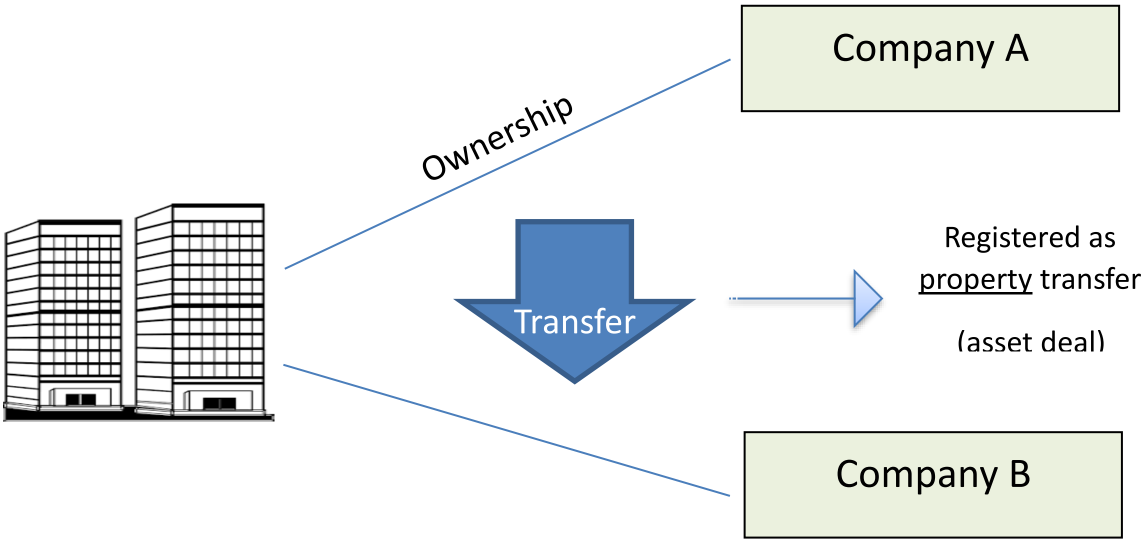
4. How investors utilize SPEs

In this section, several stylized SPE constructions are described. Beginning with 'simple' asset deals and continuing with more complex share deals will reveal the problems we face in considering share deals as part of the scope of CPPIs.

Asset deals

Before sketching various SPE constructions it may be useful to establish a starting point. The base in this case would be the construction of a so called 'asset deal'. As stated, in an asset deal ownership of a property is not only economically transferred, but also legally. These transactions are usually legally processed by a notary and subsequently processed by a Land Registry Office. This type of transaction, where A is transferring the legal ownership of property to B, is visualized in figure 2. This kind of transactions are typically input in the construction of CPPIs.

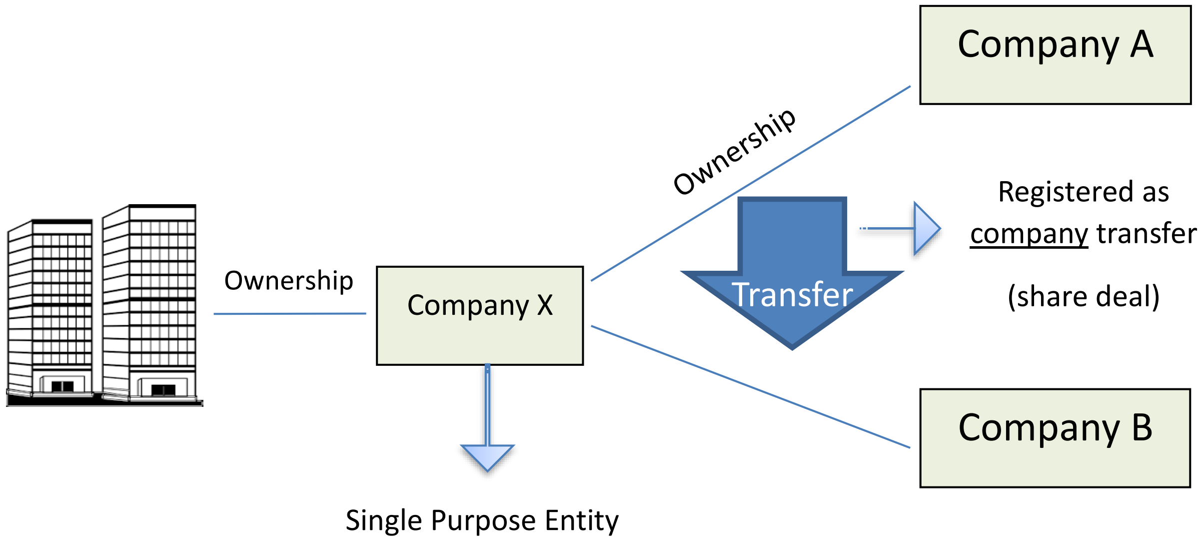
Figure 2 - Asset deal



Simple SPE construction

An SPE construction in its simplest form is one where company X is the legal owner of (a portfolio of) real estate, see figure 3. In this scenario company X has the role of a child of company A. Company A is, as a parent company, the legal owner of company X and therefore the beneficial owner of the property. In this scenario, where A has the intention of selling real estate to B, it will not (and is legally not able to) sell the legal ownership of the property, but it will transfer the legal ownership of company X to company B. Since this concerns a company transfer, the actual things that are transferred are the stocks or shares of company X. Therefore this type of deal is referred to as a 'share deal'.

Figure 3 – Simple share deal

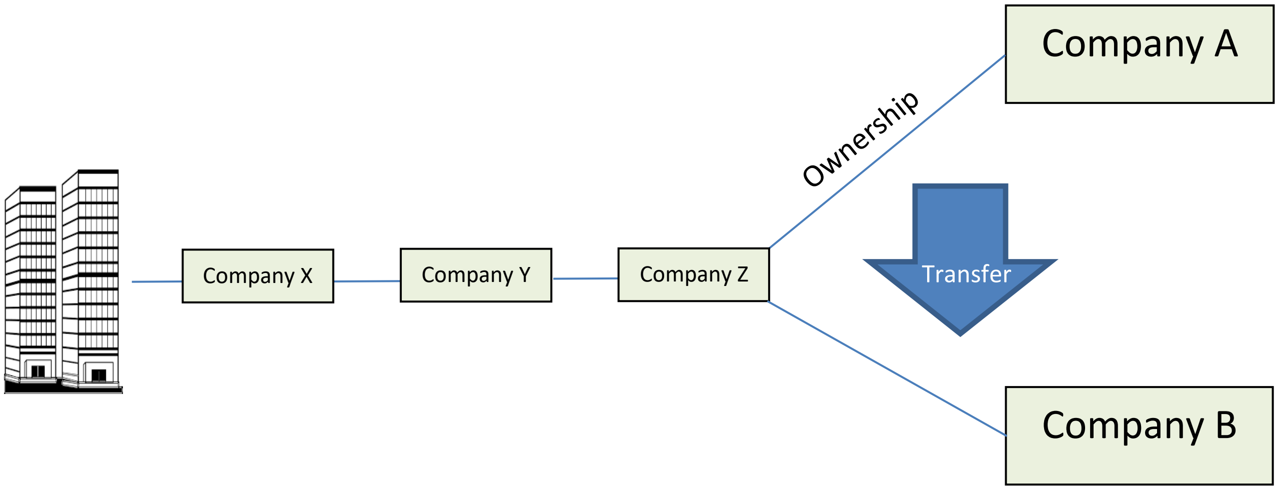


Complex SPE constructions

There will probably not be a lot of discussion whether a simple SPE construction should be included in a CPPI. There is a clear intention of selling real estate and to repeat our earlier statement: it would seem logical that entities engaging in the same activities, should be treated essentially the same. Highlighting a few more complex SPE constructions will show that we're entering a somewhat grey area. The problem remains the same: to what extent should share deals be considered in scope for a CPPI?

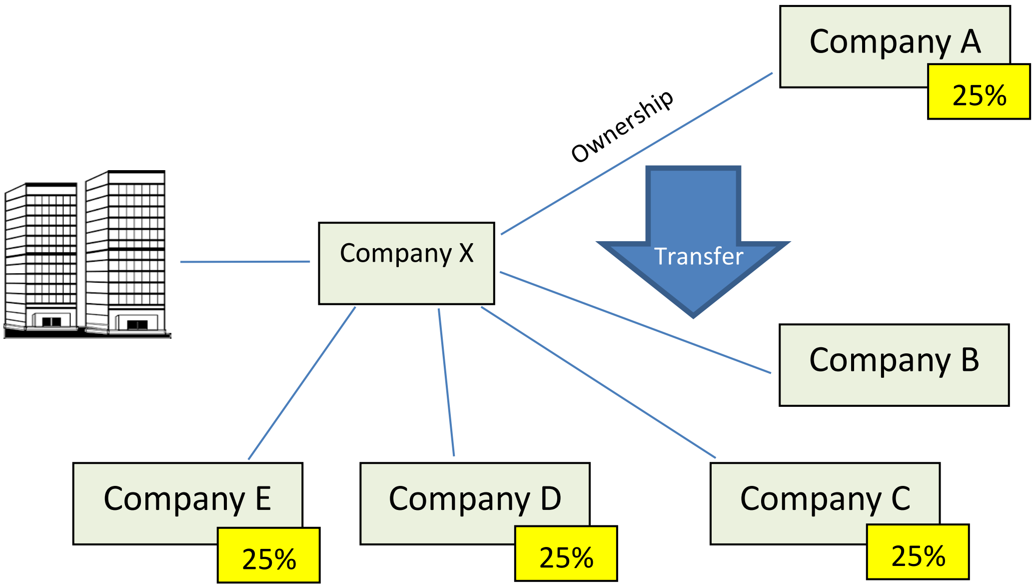
The first example is a construction where there are multiple layers of entities between parent company A and child company X, the entity that legally owns the property. In the illustrated example in figure 4 company A has the intention to economically transfer the property to company B. This is realized by transferring the shares of company Z, which is still three layers away of legally owning the property itself. Even though the provided example is hypothetical, in practice the transfer of property by a parent company that is multiple layers away, does occur. The question is whether we still need to consider an SPE transfer that is multiple layers away from the economic beneficial, as a real estate transaction? And would it be appropriate, in terms of practical feasibility, to set a threshold for the number of layers?

Figure 4 – Multiple layer SPE



Another example of more complex SPE transactions are so called Real Estate Investment Trusts (REITs). A REIT is a company that owns, operates or finances income-producing real estate. It's "a pass through entity that distributes most of its earnings and capital gains" (Geltner e.a., 2007; 586). The REIT allows multiple investors to buy and sell shares in the company and earn from profits due to value increases of the owned real estate. A simplified construction is illustrated in figure 5.[2] This example no longer shows a clean image where there are only two beneficial companies. In fact, there could be dozens. The point is that A is no longer the owner of 100% of the shares in the SPE. Company A only owns a part of the shares and is therefore only able to sell a part of the SPE - and indirectly some of the property.

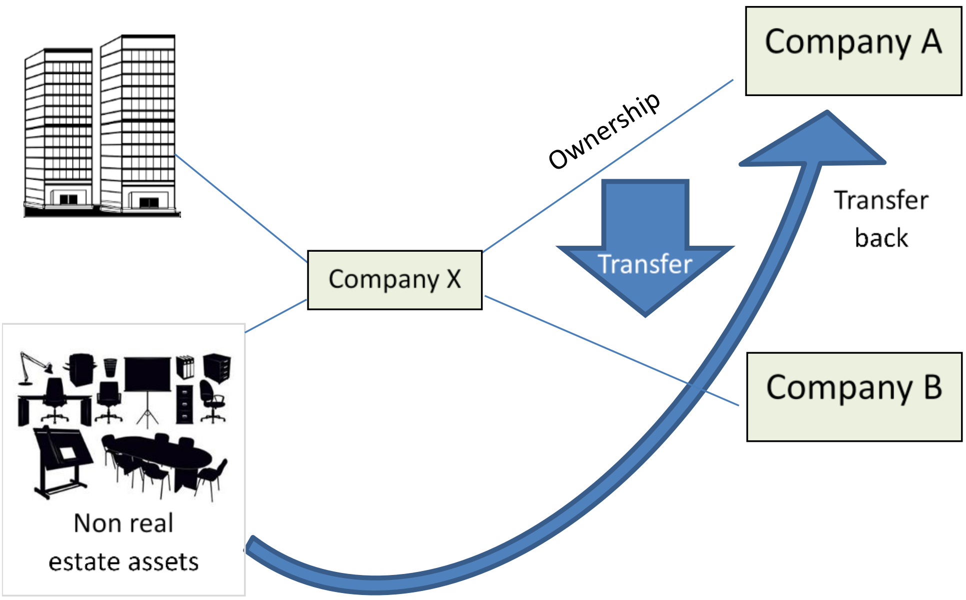
Figure 5 – SPE construction with multiple beneficial companies



[2] In reality, REIT-structures are more complex. The illustration is simplified to emphasize the presence of multiple shareholders.

In the next example the company owning the property serves other purposes as well. This company is therefore strictly speaking no longer an SPE as the 'SP' in SPE stands for 'Single Purpose'. A straightforward answer to include multipurpose entities into CPPIs is clearly 'no'. There are however two reasons why this is debatable. First of all, entities with a primary purpose to hold real estate could in practice serve other small purposes as well. An SPE that in its purest form serves a 100% purpose of owning real estate, may be hard to find. Let's say for example that a few desks in an office building are accompanied with the transaction of the building itself. Should this not be considered as an SPE, even if the value of the desk consumes less than, say, 0,1% of the entire transaction value? Another argument for including multipurpose entities might be that other purposes could be added to the company just to conceal the single purpose. In these cases the initial transfer from A to B would contain real estate and other assets. After a while, the other assets are transferred back from B to A. After this event the residual is an economic transfer of just the property. This routine, illustrated in figure 6, may be performed to avoid transfer tax (as discussed in the previous section).

Figure 6 – Share deal of a multipurpose entity



5. The magnitude of SPE transactions

-- Data analyses are still in progress. To determine the magnitude of SPE transactions in the Netherlands data from the Land Registry Office, the Tax Authorities, the Chamber of Commerce and a real estate consultancy will be used. This chapter will be written once the analyses are finished. --

6. Conclusions and discussions

In this paper we study why investors utilize SPEs in real estate transactions, how they do it and how often it occurs. Answering these questions will help us optimizing the selection of data sources for the compilation of CPPIs. The quality of CPPIs are heavily dependent on the selection of real estate transactions that enter the data. The selection of real estate transaction depends in its turn on the in- or exclusion of share deals. The trade-off between share deals and commonly used asset deals could complicate the selection of data further, but may be necessary to construct reliable CPPIs. In price statistics the aim is usually to capture market developments and not the popularity of certain transaction strategies.

Being aware of the arguments investors have for choosing a transaction construction creates insight in data incoherencies that may arise. As financial arguments are one of the most decisive arguments, differences in tax regulations among countries influence investors' strategies. Simplified: a country without tax restrictions regarding SPE transactions will probably show a larger segment of share deals than a country with tax restrictions. Comparing transaction numbers of commercial real estate between countries may therefore be distorted depending on the exact differences in tax regulations. Changing tax regulations may also affect the use of SPEs (compared to asset deals) within a country. In the Netherlands for example, share deals are only taxed since the year 1995 by the adoption of new legislation. A CPPI time series that would cover the years before and after 1995 is thus likely to suffer from a structural break. The observed change is not due to market changes, as desired, but due to a shift in transaction constructions.

An outline of the various share deal constructions in section 4 raised another issue in the SPE-matter. It showed that the question of including SPEs into CPPIs cannot be answered with a simple 'yes' or 'no'. In line with other aspects of constructing CPPIs, the answer to this question is rather complex. A simple SPE transaction in its purest form is most likely a welcome addition to CPPIs. In this situation it's quite clear that the main event is still a real estate transaction. The only difference is that the activity is moulded into another form. The more complex the construction gets however, the less clear the pureness of the real estate transaction becomes.

The key in solving all of the above is to come up with clear and practically feasible thresholds for considering an event as a commercial property transaction. The function of such thresholds is to draw a line between the two extreme cases: 'transacting legal ownership' and 'transacting economic ownership'. Transacting legal ownership excludes SPEs by definition and transacting economic ownership could include very complex forms of share deals. The optimal choice for CPPI input selection lies most likely somewhere in the middle. Furthermore, as far as harmonization is desired, these thresholds should be aligned between countries to increase comparability.

Prior to deciding on the preferred threshold, however, we suggest taking two actions. First, a number of countries could conduct research on SPEs, in particular on tax regulations, existing SPE constructions and the way they appear in the data. Second, it would be desirable to discuss the pros and cons of suggested thresholds. This would certainly be beneficial in determining and harmonizing the scope of commercial real estate transactions.

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