

## The Status of European REITs

Fraser Hughes, Research Director, European Public Real Estate Association (EPRA)

In order to set the scope of the REIT landscape, the EPRA Tax Transparency Committee (TTC) published its first EPRA Global REIT survey in 2003. The first survey covered Europe and the United States. Driven by strong demand for a broader publication, the TTC published the updated version of the EPRA Global REIT survey in September 2004. The updated survey covers all of the major existing REIT regimes around the world<sup>1</sup>. Drawing from the detailed analysis contained within the survey, Table 1 highlights the main features of existing REIT structures in Europe. The EPRA Global REIT survey compares these structures within a regional setting for Europe, Asia/Pacific and North America.

### And, what is coming?

The aim of this article is not to examine existing REIT legislation. The EPRA

Global REIT survey comprehensively covers those existing REIT structures. Moreover, in Europe there are a number of significant developments taking place with the existing Dutch structure, and there is a very real possibility that Europe's two largest economies—Germany and the United Kingdom will introduce REIT legislation in the next 24 months. These current discussions in Europe will have huge implications for the future of the listed real estate market.

### Netherlands

The “Fiscale Beleggingsinstelling” (FBI) was introduced into the Dutch Corporate Income Tax Act of 1969. Currently discussions are taking place to relax restrictions for FBIs in terms of their development actives, capital taxes, foreign shareholders restrictions,

Table 1

Existing European REIT Structures Overview					
Country	Established	Payout	Development	Gearing	Foreign Ownership
Netherlands	1969	100% taxable profit	No	< 60%	Max 25% by single non-national
Italy	1994	No obligation	Limited	< 60%	No restrictions
Belgium	1995	80% of net profit	Limited	< 50%	No restrictions
France	2003	85% of profit from leasing	Limited	Unlimited	No restrictions

Source: EPRA Global REIT Survey, 2004

withholding taxes and the abolition of the minimum required payout. The Institutionele Vastgoed Beleggers Nederland (IVBN), the Dutch Fund Association (DUFAS) and EPRA, are contributing to the debate with the Dutch Finance Ministry.

The purpose of the update, or the “luxury version” as it has been named, is to make the FBI easier to market to foreign investors, effectively equivalent to the Luxembourg SICAV regime. The “luxury version” would incorporate the following changes<sup>2</sup>:

- No shareholder restrictions;
- No minimum required distribution of dividends;
- No withholding taxes on distributed dividends;
- Reclaiming of paid withholding taxes would no longer be possible (no possibility to use treaty protection, which is possible under the current FBI structure).

Under the current trend towards REIT introductions in Europe, the current FBI structure has become outdated. The Netherlands is losing many investment funds to Luxembourg. Moreover, the French and Belgium REIT structures, and the proposed structures in the UK and Germany are a lot more flexible and less restrictive than the current FBI. Quite simply, changes are required for the FBI to become competitive again.

Ronald Wijs, tax partner at Loyens & Loeff Amsterdam, and chief editor of the EPRA Global REIT Survey, comments “I think the ‘luxury version’ is not going to take-off for Dutch REITS. As the new regime is likely to

be fully exempt, with distributions not subject to withholding tax, including property in the regime would mean that rental income could flow directly to foreign shareholders free of taxation for the Dutch Government. It is more likely that the Dutch Government will try to strip out the main bottle necks, firstly the very restrictive interpretation of the permitted activities (no project development - even in the organization’s own portfolio) and secondly the very complicated ownership/shareholders’ requirements.”

### **United Kingdom**

The UK REIT issue has been debated for many years. However, following the introduction of the SIIC, or French REIT, the progress in the UK has moved on, albeit more slowly than first expected.

Alongside the March 2005 budget statement, HM Treasury and the Inland Revenue published a paper entitled “UK Real Estate Investment Trusts: a discussion paper.” The document confirmed that, “The Government is committed in principle to reforming the taxation of property investment. The consultation has enabled the Government to better define the key features of a potential UK-REIT model that allows for market flexibility. The paper also raised some challenging issues in designing the tax treatment for a model that meets both the needs of the UK property investment market and the Government’s objectives for a UK-REIT. The Government will therefore engage in further dialogue with industry representatives. Subject to finding a workable solution that meets the stated objectives, including reform at no

overall cost to the Exchequer, the Government aims to legislate for a UK-REIT in Finance Bill 2006.”<sup>3</sup>

There are three key areas where the government wishes to conduct further consultation before the drafting of the legislation can commence<sup>4</sup>:

- How can the Government ensure gearing is not used to manipulate returns and avoid tax?
- There appears to be a concern that REITs may be exploited by certain sophisticated investors, who may gear up the vehicle and channel interest payments to lenders with tax capacity while allowing capital growth to flow to equity holders.
- How can the Government introduce a REIT regime that works within the UK’s EU commitments and double tax treaty obligations without a loss of UK tax revenue? The issue of the taxation of distributions from the REIT in the hands of non-resident investors is likely to be the greatest hurdle in the delivery of a UK REIT. It is difficult to understand how the UK could achieve its aim of introducing an entirely tax-exempt structure without losing tax revenue from offshore investors—who have the ability to utilize double tax agreements, or EU law.
- How can group structures be accommodated within the proposed regime? The government will need to clarify how any conversion charge will apply on transfers from group companies to a REIT.

Richard White, tax partner at Ernst & Young in London and chairman of the EPRA Tax Transparency Committee comments, “whilst there is almost unanimous agreement that a tax transparent vehicle for real estate investment is required to enable the UK to compete with other developed economies, the practical difficulties in satisfying the UK Revenue’s insistence on tax neutrality are likely to result in, at best, a delay in the introduction of UK REITs or, at worst, the introduction of a model which is not sufficiently attractive to investors to be workable.”

Meanwhile, as the REIT discussion continues in the UK, offshore growth in private vehicles has rocketed. Since 1998, the size of the offshore market has grown from next to nothing, to in excess of \$40 billion. HM Treasury is fully aware of this development. However, if we see REIT legislation enacted in 2006, and in a workable and attractive format, we expect to experience a positive impact on the market. UBS<sup>5</sup> estimates that market capitalization in the UK market could reach \$90 billion (currently \$50 billion) by 2011.

### **Germany**

Germany is the largest country in Europe in GDP terms. However, Germany has one of the smallest listed real estate markets in the region. In fact, there are only three German real estate companies which are constituents of the FTSE EPRA/NAREIT Global Real Estate Index. Germany has a total estimated real estate stock of \$8,500 billion, by far the largest real estate stock in Europe, however, only a small fraction is held by institutional real

estate investors (approximately \$470 billion). Therefore, the opportunity to repackage, or mobilize, a portion of this real estate is significant.<sup>6</sup>

In a 196-page document prepared by Germany's Centre for European Economic Research (ZEW), the European Business School (EBS) and input from Germany largest property players, estimates indicate that \$140 billion of corporate and \$130 billion of unleveraged residential assets could be spun off into REITs. The Initiative Finanzplatz Deutschland (IFD, a key lobby group for the creation of German REITs) expects that \$150 billion of real estate can be floated in the next five years (see Table 2 below).

medium term. However, the report stresses that market volumes and extra income tax for the government cannot be precisely quantified because the success of a REIT strongly depends on the cyclical development of the real estate sector as well as the details of the financial incentives.

On 22 May, the Social Democrats (SPD) lost the state elections in North Rhine-Westphalia. Consequently, Chancellor Gerhard Schroeder announced that he would seek a national election, probably in September 2005. There is a common belief in Germany that there will be a shift in power from Schroeder's SPD to the Christian Democrat Union (CDU). However,

**Table 2**

<b>Sources</b>	<b>Property Portfolio (\$ billion)</b>
<b><i>Contributions from:</i></b>	
Tax paying companies	70
Former tax-free residential companies	35
<b><i>Conversions:</i></b>	
Closed-end funds	25
Open-ended publikum funds	12
Open-ended special funds	8
<b>Total</b>	<b>150</b>

*Source: IFD, June 2005*

The authors of the report state that for REITs to be effective in the German market, they need to be introduced soon to help lift the German real estate market out of crisis. It should be made clear that a German REIT market will not occur overnight. It is estimated that the potential of the German REIT structure may only be realised over the

Michael Meiser, vice chairman of the CDU/CSU faction in the German Parliament, has stated that he believes the introduction of a German REIT structure would provide a platform to generate employment in the financial and real estate sector, without significant costs. Given the developments around Europe, Mr Meiser stressed urgency for the

German REIT to be launched quickly and certainly before the UK-REIT.

Max Berkelder, research director at Kempen & Co in the Netherlands, sums up the position, “The process of the German REIT introduction seems to be on the right track although some tax leakage issues still have to be solved. A German REIT introduction combined with the announced abolition in June 2005 of penalty tax for German investors that hold foreign property stocks will lead to a revolution in the German property sector in the coming five to ten years. The size of the German listed property sector plus the appetite from German investors for

REIT stocks will structurally improve.”

UBS<sup>7</sup> estimates that the German REIT will be launched in the second or third quarter of 2006, to be enacted respectively from 1 January 2006. The impact on the European sector could be significant. The IFD estimates that \$70 billion of equity from tax paying companies is 60 percent free float weighted, and then Germany would leap from its current weighting of 3 percent in the FTSE EPRA/NAREIT Europe Index to approximately 30 percent. The effect on a global basis would be that Europe increases to approximately 25 percent<sup>8</sup> of the global real estate market. ★

*Fraser Hughes is research director at the European Public Real Estate Association (EPRA) in Amsterdam, The Netherlands. He is a regular contributor to a broad range of publications and a frequent speaker at real estate conferences. He holds a BA (Hons) in Finance and an MSc in Investment Management from City University, London.*

*The European Public Real Estate Association (EPRA) is a not-for-profit association primarily focused on promoting the European quoted real estate sector. Members are real estate companies, investment banks, pension funds, lawyers, accountants and business schools.*



<sup>1</sup> EPRA Global REIT survey is available from [www.epra.com](http://www.epra.com).

<sup>2</sup> Taken from: “Dutch REIT system”—Kempen & Co, 7 July 2005.

<sup>3</sup> UK Real Estate Investment Trusts: discussion paper, March 2005. HM Treasury & Inland Revenue.

<sup>4</sup> Three key points taken from “The Tax Journal” from an article “UK REITs—The Road Ahead” by Peter Beckett and Steve Kirby, Ernst & Young.

<sup>5</sup> UBS Investment Research—Q-Series®: German Real Estate, 13 July 2005.

<sup>6</sup> Introduction of REITs in Germany—A briefing paper, February 2005, issued by Deutsche Bank.

<sup>7</sup> UBS Investment Research—Q-Series®: German Real Estate, 13 July 2005.

<sup>8</sup> Estimate does not include UK market growth highlighted earlier in the article.