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European REITs and Cross-border Investment

- A Discussion Paper

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Preface

The European Public Real Estate Association (EPRA) is the representative voice for the listed real estate sector in Europe. EPRA's members own and manage approximately EUR300 billion of real estate assets globally.

EPRA is delighted with the speed at which the REIT concept continues to spread within Europe and worldwide and has at all times been open for discussion and exchange with those wishing to promote the idea. In particular:

- EPRA has participated in discussions (with local industry representatives and/or respective government officials) with all those European countries that have successfully introduced a REIT regime or are in the process of introducing it
- EPRA has participated in the working-party mandated by the OECD Committee on Fiscal affairs on the application of tax treaties to REITs. This resulted in the recommendation of specific language covering REIT distributions for incorporation into the OECD Model Tax Convention
- EPRA will continue to document and publish the characteristics of existing REIT-like regimes in its annual EPRA Global REIT Survey, in order to encourage the spread of best practice, and to support national initiatives wherever possible
- EPRA plays a leading role in increasing the transparency of the listed real estate environment by improving the quality and consistency of the financial reporting and performance reporting framework within Europe. Each year, EPRA produces its Best Practice Recommendations which are a recognised benchmark for reporting listed real estate under international accounting standards
- EPRA plays an active role in the promotion of the REIT concept internationally through regular contact and interchange with European Member States and through its membership of REESA – a global alliance of real estate organisations.

In this positive context, EPRA has considered whether the REIT concept can be usefully widened to all countries within the European Community, and to what extent the 27 European Member States could benefit from a common framework for REITs.

At the current stage of development, EPRA considers that the benefits that a Community-wide statute (a uniform "EU REIT") might bring are outweighed by the inevitable complexity of its design and implementation. It would be a shame if such a project, embarked upon prematurely, resulted in a compromise structure, which, while accepted by Member States, proved unattractive to investors. For those reasons, EPRA's objective is to seek practical solutions to resolve the tax issues that make cross-border, intra-EU investment through REITs difficult.

This report starts from the presumption that each Member State will introduce, or continue to develop its own REIT regime, and makes preliminary recommendations by which Member States may resolve certain tax issues in order to facilitate cross border investments through REITs in Europe.

These recommendations have been developed by a working party of European REIT experts recruited by EPRA and under the guidance of a group of organisations representing real estate companies and REITs covering the major European economies.

A more detailed analysis of the recommendations is intended to be published in the first quarter of 2009, following broader input from interested parties and pending broader approval from the EPRA membership. All parties interested in this subject are kindly invited to bring their support and comments to EPRA by November 14, 2008. We look forward to our continued involvement in this important initiative.

Finally, EPRA would like to thank the authors for their contribution to this report - the preparation of which is a true example of European cross-border cooperation!



Serge Fautré

EPRA Chairman



Philip Charls

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1. Introduction

- 1.1. A key feature of the REIT concept is the tax-exempt status of earnings from its rental activities (the flow-through principle) and full taxation of those earnings, when distributed by the REIT as a dividend, in the hands of the shareholders. Thus, the investment in a REIT has, from a taxation standpoint, some comparability with a direct investment in real estate.
- 1.2. The legitimacy of REIT regimes in the long run depends on their capacity to generate overall tax revenue for governments that (i) is "sufficient" in comparison with the overall tax revenue generated by non-REIT companies owning a similar asset base in the same jurisdiction and (ii) is not dependent on the identity of the shareholders of the REIT.
- 1.3. Whilst the principle of tax flow-through is easy to understand and generally simple to operate in the context of investment by a REIT in property situated in its own jurisdiction, cross-border investment by REITs gives rise to certain difficulties. The position is particularly complicated in the context of cross-border investment in the EU by the need to respect the fundamental freedoms as laid down in the EC Treaty.
- 1.4. In EPRA's view, encouraging cross-border investment in property should be an important policy objective for a number of reasons:
 - At the broadest level, it conforms to the overall policy framework of the single market
 - At the narrower commercial level, facilitating cross-border geographical diversification enables investors to gain exposure to different property markets and facilitates the achievement of a lower overall cost of capital, by allowing access to a number of different capital markets
 - Finally, if it becomes easier for property investment activity to cross the EU's internal borders, it will become easier for Europe's REITs to grow larger, increasing competition, allowing greater economies of scale and thus enabling Europe to compete more effectively as a whole in the global markets.
- 1.5. Looking at the way in which different Member States have implemented REITs, it seems that they have taken a common approach on certain corporate law issues (such as the legal form of the REIT) but differing approaches on other issues (such as the level of minimum share capital, the debt to equity ratio, etc.). Many of the requirements for benefiting from a given REIT regime are motivated by governments' fear of abuse and their concerns about the loss of tax base in the international context.
- 1.6. Given the discussions at the level of the European Commission with the EU Member States regarding the introduction of a European REIT structure and considering the different viewpoints of the Member States on this issue, the conclusion can be drawn that there is no real appetite or drive among EU Member States to agree on a European-wide REIT. In fact, some Member

States would actively oppose such an initiative at this relatively early stage in the development of REIT regimes in Europe.

- 1.7. EPRA's view is that within the existing and emerging REIT regimes, there is both the need and the scope for facilitating cross-border investment through REITs, but that the better approach is to seek practical solutions to resolve the tax issues that make cross-border, intra-EU investment through REITs sub-optimal.
- 1.8. EPRA believes that a sensible system, preserving the right balance between having a competitive EU law compliant REIT regime and protection of the local tax base, should be a feasible objective for European Governments. This paper sets out EPRA's preliminary recommendations for practical solutions in this respect. Its main objective is to initiate discussions with interested parties in all Member States and to stimulate further research on how to address these issues.

2. Proposed solutions

2.1. This paper makes recommendations which:

- are EC Treaty compliant and therefore provide planning security for national European REIT regimes;
- assists in removing the need for Member States to introduce artificial cross border participation thresholds for investment in REITs to protect national tax revenues;
- provide a pragmatic approach towards removal of the existing “bottlenecks” in the growth of cross border investment in the European REIT market;
- complement existing improvements currently being developed through the OECD to achieve a framework for the consistent taxation treatment of global cross border REIT investment; and
- will play a role in encouraging convergence within Europe towards a uniform and transparent REIT structure for national REIT regimes.

2.2. EPRA’s recommendations consist of two key elements:

- The “Mutual Recognition” of REIT regimes in Europe so that a common flow-through approach to taxation can be applied.
- A system that provides for the collection of withholding tax by the REIT, and the fair allocation of that tax between the situs Member States where the property is located.

Mutual Recognition

2.3. EPRA’s principal recommendation is that EU Member States adopt an approach involving the mutual recognition of national REIT regimes in Europe. Under this approach, EU Member States can enter into reciprocal arrangements supported by the EC and bilateral tax treaty positions, to collect taxation revenues and allocate them between the situs countries. The concept of mutual recognition goes back to the early days of the European Union and is well known and accepted by and between Member States.

2.4. In the discussion of the “Mutual Recognition” criteria, a distinction is drawn between investment related requirements (such as the type of real estate allowed for an investment by a REIT, or the volume of debt financing) and other, non-investment related requirements (such as corporate and company related conditions).

2.5. Under the concept of Mutual Recognition, a REIT which has been formed under the laws of one Member State and which makes a real estate investment into another Member State (which also has a REIT regime), will be recognized by such other Member State as a tax-exempt REIT unless abuse

is apparent. However, the investee Member State may impose its own rules regarding the investments by the REIT in its jurisdiction that should be met in order to qualify for the exemption.

- 2.6. Under the Mutual Recognition principle, minimum criteria for REIT regimes in Europe should be established by the European Commission prior to entering into the Mutual Recognition process. As a basic definition of a REIT, it is suggested to take the recently published OECD definition of a REIT as a starting point. In a simplified format, this definition is as follows:

“A widely-held company that derives its income from long-term investment in real estate, distributes most of that income annually and does not pay income tax on the income that is so distributed. The fact that the REIT vehicle does not pay tax on that income is the result of tax rules that provide for a single-level of taxation in the hands of the investors in the REIT (distribution to investors being subject to withholding tax).”

- 2.7. EPRA takes the view that in principle, no further minimum criteria should be imposed on a Member State REIT, although the European Commission may find it helpful to establish its own broad, minimum criteria. However, as stated previously, each Member State is able to control its own rules regarding the investments in its jurisdiction, among which the permitted debt-to-equity ratio, the interest cover ratio and the permitted activities of the REIT in its jurisdiction.
- 2.8. Notwithstanding the above, it is likely that Member States will pay particular attention to the shareholder conditions that the other Member State will impose. Shareholders conditions are often used by governments as a means to prevent a loss of tax revenues where otherwise, foreign shareholders are able to apply a low or nil withholding tax on REIT distributions. In this context, any European solution adopted needs to take into account the non-EU aspects of the collection and allocation of tax between Member States and their non-EU shareholders.

How the principle of Mutual Recognition works

- 2.9. If two Member States (Country A and Country B) each have a REIT regime, they would recognise, under the principle of Mutual Recognition, the other's REIT regime, and if a REIT in Country A (A-REIT) makes an investment in Country B, Country B would treat A-REIT in the same way as it would treat one of its own REITs (B-REIT).
- 2.10. In particular, Country B would treat A-REIT as a tax-exempt REIT (in line with the treatment of a B-REIT) in relation to its investments in Country B if:
- A-REIT meets all non-investment related requirements imposed by Country A's REIT regime and
 - A-REIT meets, in relation to its investments in Country B, all investment related requirements imposed by Country B's REIT regime.

- 2.11. As regards an indirect investment by A-REIT in Country B, this should benefit from tax exemption if and to the extent that the rules of Country B for B-REITs confer tax exemption on corporate subsidiaries of B-REIT.
- 2.12. EPRA acknowledges that the Mutual Recognition procedure would encourage various countries to converge to the “European standard” for REITs that has already begun to emerge in the European market. That is, the Mutual Recognition procedure is likely to have a positive harmonising influence on the individual REIT regimes in Europe.

Collection and allocation of tax

- 2.13. As a condition for agreeing to the Mutual Recognition procedure, Member States must have the certainty that they will receive a fair share of the tax revenues generated by cross border operating REITs.
- 2.14. EPRA have considered various options for collecting and allocating tax under the Mutual Recognition process. It has identified a solution, which respects the basic principle of international taxation of income from real estate in the country of *situs* and, at the same time, achieves the dual objectives of REIT regimes - the tax exemption of the REIT and REIT dividend taxation in the hands of the shareholders.
- 2.15. Under this solution, Country B would (indirectly) obtain the tax on the income from A-REIT's direct or indirect real estate investment in Country B.
- 2.16. Country B would receive the share of the tax withheld by A-REIT from the dividend distribution to its shareholders which is attributable to the income received by A-REIT from its property investments in Country B. Where A-REIT derives income from a number of different countries, the share payable to each of those countries would be identified using an appropriate allocation mechanism applied to the net revenues of A-REIT which are subject to withholding tax in Country A.
- 2.17. The basis for the allocation of tax between the Member States should be the net revenues on a consolidated basis of A-REIT which are subject to Country A's withholding tax.
- 2.18. The withholding tax will have to be allocated between the respective situs countries following an appropriate allocation key. For this purpose, one could take the allocation keys that are currently under discussion in the EU project for a Common Consolidated Corporate Tax Basis (CCCTB). The CCCTB project is considering allocation keys by reference to sales, number of employees/payroll, and assets. EPRA's initial view is that sales (net rental income) and assets are probably the best keys for determining the withholding tax share allocable to the countries involved (Country A and Country B).
- 2.19. Income received by A-REIT from participations that are normally subject to tax (either in Country B or in a third country) and income from real estate located in third countries that do not apply the REIT regime, will, in principle, be left outside the scope of the allocation mechanism.

- 2.20. Certain other issues will need the consensus of the Member States involved, such as the situation where profits arise in one country and losses arise in the other country. Member States should also agree on an acceptable rate of withholding tax and this is an area which could be influenced by both the European Commission and the OECD.
- 2.21. Finally, Member States will need to decide what to do with investors that benefit from an exemption from withholding tax (at source or by way of refund) in connection with REIT distributions. It is EPRA's view that Member States should accept that certain foreign exempt investors, like pension funds, should be entitled to an exemption from withholding tax, if a domestic investor having similar features is also entitled to an exemption from withholding tax. Member States should come to an agreement on this when entering into a Mutual Recognition procedure for REITs.
- 2.22. Another category of investors that are entitled to an exemption or reduction of withholding tax, are investors resident in countries with which the REIT country (Country A) has concluded a tax treaty that foresees a reduction or exemption from withholding tax. Member States will need to consider how to preserve an appropriate level of withholding tax. One way of dealing with this subject is, of course, to preserve the current shareholders' conditions in situations where a REIT investor is not qualifying for the Mutual Recognition regime (i.e., a non-REIT shareholder). Another route would be to enter into negotiations with treaty partners regarding the introduction of a higher withholding tax treaty rate for REIT distributions.

Implementation of the recommendations

- 2.23. Since experience indicates that it would not be practical to initiate a proposal for a REIT related directive or regulation, a feasible way to bring the REIT related European tax issues to a resolution would be for the European Commission to put forward a Communication inviting the Member States to adopt the Mutual Recognition procedure.
- 2.24. This Communication would become effective between Member States, which have REIT legislation in their domestic legislation. The Communication might also invite Member States without a REIT regime to recognize the REIT regime of another Member State, thereby attracting real estate investment by European REITs from other Member States into their country.

3. Conclusions and next steps

- 3.1. The issues summarised in this paper and the suggested solutions are complex, both in terms of the wide range of stakeholders potentially affected and the difficulty of the issues involved.
- 3.2. These and other issues are considered in more detail in a separate research paper and it is EPRA's intention, subject to further input from interested parties and wider approval from its members, to initiate discussions with the European Commission and other interested stakeholders.
- 3.3. Our preliminary recommendations are based on a thorough analysis of the issues concerned by technical experts in this field from a range of different European jurisdictions. However, it is recognised that an appropriate way forward will only be established after detailed discussions with the European Commission and Member State governments.

4. Invitation to comment

- 4.1. EPRA would like to invite its members and interested parties to give their views and comments on the above analysis and preliminary recommendations by November 14, 2008.

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