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Progress on REIT Regimes in Europe

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PROGRESS ON REIT REGIMES IN EUROPE

LOYENS & LOEFF

Contributing parties:

Simon Clark, Linklaters, London

Olivier Mesmin, Baker & McKenzie, Paris

Matthias Roche, Ernst & Young, Frankfurt

Ronald Wijs (editor), Loyens & Loeff, Amsterdam

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European Public Real Estate Association
Schiphol Boulevard 283
1118 BH Schiphol Airport
The Netherlands

T +31 (0)20 405 3830
F +31 (0)20 405 3840
W www.epra.com

Introduction

This paper will briefly set out recent major developments in existing REIT regimes in Europe and will discuss some of the developments that are expected to take place. It will not go into great technical detail, but rather will focus on crucial legal and regulatory issues and the latest news. A brief explanation of the impact of European law on the REIT regimes will be given in the last section.

The year 2006 has seen considerable activity in the field of REIT regimes in Europe:

- The UK has adopted a brand-new regime which will take the spotlight next year;
- In Germany a proposal has been published in the media, and the possibility still exists that the proposed regime will be adopted for introduction next year;
- France has made some interesting amendments and improvements to its SIIC regime and the Netherlands is bringing its BI regime more closely in line with EU law. Finally, Belgium is also making amendments to its SICAFI regime.

So, if all goes well, we may be looking at five full-fledged REIT regimes in Europe as of 2007: two brand-new ones and three older ones that have been spruced up. The flowering of REIT regimes in Europe is not the result of concerted action by European institutions or governments; it rather is the fruit of successful lobbying by industry groups and the competitive pressure that existing REIT regimes and proposed REIT regimes exercise on the political willingness of authorities in various European countries. Furthermore, EU law is starting to leave its mark on the legislation of European Member States.

Even though the general framework of the various REIT regimes is to a large extent identical, there are nevertheless many technical differences among the various regimes. 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.
Because many of these regimes are becoming more and more similar, the various REIT systems are slowly becoming harmonised. Perhaps a uniform EU REIT regime, as discussed in last year's EPRA report, may not be as far away as it seems...

EPRA believes that attractive REIT regimes, which are open to foreign investors, are important for the further development of the quoted property sector in Europe. It will, therefore, continue to study the various European regimes, exchange information between countries and strive for well-balanced REIT regimes and for the possibility of a uniform EU REIT regime in the future.

Simon Clark
Olivier Mesmin
Matthias Roche
Ronald Wijs

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1 Developments in France: SIIC 2/3 and the OPCI

1.1 The French SIIC

The French REIT/SIIC[1] regime was introduced in 2003, and certain amendments/improvements have been made since then. The main advantage of this tax regime is that it exempts quoted property companies from corporate income tax, provided these companies meet the obligation to distribute most of their income.

An SIIC is a non-transparent vehicle, with a corporate income tax exemption for qualifying activities. Qualifying activities are (i) the purchase or development of buildings with a view to leasing them and (ii) participation in corporate subsidiaries or partnerships having the same activity. Non-qualifying activities, such as trading activities, are fully subject to tax. When a company makes an election for the SIIC regime, an exit tax at a rate of 16.5% is triggered.

The conditions for application of the SIIC regime are fairly flexible and simple compared to similar European REIT regimes. An SIIC must be quoted and is subject to a distribution obligation. There is at present no required minimum floating percentage for an SIIC[2]. An SIIC has to distribute 85% of its rental income and 50% of realised capital gains. It is worth noting that an SIIC is not subject to any formal gearing limitations (debt-to-equity ratio or the like).

The French SIIC regime is relatively tax efficient for foreign investors who invest in French real property. Dividends distributed by an SIIC to a foreign shareholder are subject to withholding tax, whereby the rate of withholding tax (25%) is often reduced under tax treaties to 15%. Moreover, foreign EU-quoted property companies may also benefit from the SIIC status in respect of their French properties, provided the foreign company maintains a French permanent establishment to which the French assets (or the shares in the French property companies) are allocated. Based on treaty provisions, a repatriation of profits by the French branch to the foreign head office is possisbly not subject to tax. Various foreign quoted property companies have already opted for the SIIC regime.

The new provisions of the SIIC regime introduced in the past two years

- widen the scope of the regime to real estate properties financed through financial leases and adapt the existing favourable tax regime for mergers in order to allow SIICs to take part in restructuring operations; and
- provide for a temporary tax regime encouraging the outsourcing of real estate assets to SIICs (the "SIIC 2 and SIIC 3 regime").

1.2 SIIC 2 and SIIC 3 regimes

If an ordinarily taxed company switches to the SIIC regime, it is subject to an "exit tax" in respect of the unrealised capital gains on its properties. The exit tax is levied at a 16.5% rate rather than at the ordinary French corporate income tax rate (33 1/3%). In order to promote the use of the SIIC regime, France has introduced a very beneficial regime from 2005 under which third parties may contribute real estate to an SIIC[3]. Under the new rules, corporate income tax is levied at a rate of 16.5% plus additional social taxes (17.05% in total) on net capital gains resulting from the contribution by a corporate taxpayer of properties[4] to an SIIC. The SIIC that benefits from such a contribution must covenant to keep the building for five years. Non-compliance with this covenant entails a penalty corresponding to 25% of the contribution/sale value of the building. This penalty is payable by the SIIC that benefits from the contribution.

From 2006, the regime's scope has been extended to "selling operations", as "contribution operations" are complex and experience during the first year has shown that it can only apply to major transactions. The contribution of real estate assets to a publicly traded company requires the holding of an extraordinary shareholders meeting, the appointment of a special auditor to appraise the value of the real estate assets contributed, as well as prior clearances from the French stock exchange authorities, etc.

[1] "Sociétés d'investissements immobiliers cotées".

[2] It is, however, expected that specific minimum free-float requirements will be adopted in the near future.

[3] This regime will also apply to other publicly traded property vehicles. However, in practice, most companies that benefit from the regime are believed to be SIICs.

[4] Or of rights attached to a financial lease agreement.

A sale to an SIIC is a much simpler operation and may be implemented even for minor transactions. The downside is that when the real estate assets are sold, these fall within the scope of the transfer tax. This means that the sale triggers a 5.09% transfer tax liability to be paid by the buyer. Contribution operations are subject to a fixed transfer duty only.

The scope of the SIIC 2 and SIIC 3 regimes is very broad. In order to benefit from the reduced capital gains tax rate of 17.05%, the only requirement is that the vendor be subject to corporate income tax, whatever its activity or real purpose of business. Short-term gains realised by real estate brokers or property developers are, however, outside the scope of the regime. It is believed that the SIIC 2 and SIIC 3 regimes have contributed to the creation of a number of new SIICs during the past months.

Finally, it is important to note that both the SIIC 2 and SIIC 3 regimes are due to expire on 31 December 2007.

1.3 OPCI: "the non-listed SIIC"

The OPCI[5], a new type of non-listed real estate investment vehicle, has been introduced by order of 13 October 2005. Further regulations are awaited. It is expected that creation of an OPCI will be possible in the first month of 2007.

The OPCI may take the form of a tax-transparent fund (with no legal personality) or a limited liability company, which will be exempt from tax, subject to distribution obligations. Under both forms, the subscribers can request the repurchase of their units by the OPCI on the basis of the net asset value. An OPCI will need to be managed by an AMF-approved manager (i.e. a manager subject to French regulatory supervision). Unlike the SIIC, an OPCI is generally subject to specific rules such as dispersion of assets, liquidity requirements, gearing limitations. Such rules are, however, relaxed or even not applicable to the simplified form of the OPCI (OPCI RFA[6]), designed for certain qualified investors. The OPCI RFA is likely to become an interesting "club deal" investment vehicle.
The main difference between the OPCI and the SIIC is that SIIC shares may be traded above or below net asset value depending on stock market performance, while the value of an OPCI unit is solely linked to the assets' value.

[5] Organismes de Placement Collectif Immobilier.

[6] OPCI à Règles de Fonctionnement Allégées.

2 The German REIT

Unlike in France, where the REIT structure was introduced in 2003, and in the UK, where the REIT structure will be introduced from 1 January 2007, in Germany the tax authorities and legislator are still struggling to implement the Real Estate Investment Trust (G-REIT).

2.1 Key Conditions

According to a first draft of the G-REIT legislation that was very recently leaked to the German media, a German Real Estate Investment Trust will have the following parameters:

- The G-REIT must be a stock corporation with both its legal (statutory) seat and its management seat in Germany. A dual-resident corporation will not qualify for G-REIT status. A listing requirement will apply.

- The G-REIT must distribute at least 90% of its net income (this percentage could increase depending on the outcome of the further legislative discussions). Distribution must cover ordinary income and capital gains (the latter may qualify for placement in certain reinvestment reserves).

- The G-REIT may not have a single shareholder with a 10% or more direct shareholding.

  The feasibility of this requirement and, in particular, its control and monitoring, have been subject to very intense discussion on the German capital markets.

  The 10% rule is seen as one of the major, if not the most important, elements in the G-REIT structure with regard to protecting Germany's right to levy tax on dividends distributed to any non-resident investors in a G-REIT structure (for more details, see the section entitled "Taxation of Shareholders").

- The G-REIT must have a minimum of 15% of its share capital in free float, and an individual shareholder may not own 3% or more of the G-REIT's share capital (in order for it to count as free float).

- Private G-REITs will not be allowed.

- The G-REIT must have a debt-to-equity ratio of at least 60:40. This ratio is also found in the thin capitalisation rules pertaining to German shareholder loans. However, with regard to the G-REIT, it seems that not only shareholder loans will be captured but every other kind of loan as well; i.e. also regular third-party bank loans.

- The G-REIT must meet the 75% asset test; i.e. at least 75% of the assets on its balance sheet must comprise real estate that meets the qualifying criteria. The G-REIT must also meet the 75% income test; i.e. it must generate 75% of its gross income from letting its real estate assets. Furthermore, the G-REIT must not be a real estate dealer. It must hold its real estate long-term.

- Development activities for a G-REIT's own portfolio are likely to be permitted. Activities related to third-party real estate must be placed in a (fully taxable) subsidiary corporation. Activities not relating to real estate (such as ring-fenced versus non-ring-fenced activities in the UK) are prohibited.

2.2 Taxation of the G-REIT

If the G-REIT meets the above criteria, it will be fully exempt from corporate income tax, the solidarity surcharge and from trade tax.

2.3 Exit Taxation

With a view to supporting the introduction of G-REITs, the G-REIT legislation shall provide for a favourable tax treatment in connection with the establishment of a G-REIT.

An effective exit taxation of around 20% is expected.

2.4 Taxation of Shareholders

Because of the G-REIT's tax exemption, all its distributions will be subject to full taxation at the shareholder level. A distinction must be made between resident and non-resident shareholders.

G-REIT dividends are fully taxable at the resident shareholder level, regardless of whether they are sourced by ordinary income or by capital gains.

Any capital gains realised on the sale of shares in the G-REIT will also be subject to full taxation.
Any tax withheld by the G-REIT is creditable or refundable at the resident shareholder level, depending on individual circumstances such as tax rate, losses, etc. A reduced withholding tax rate may apply for tax-exempt resident taxpayers (such as non-profit organisations, public bodies, etc.).

Non-resident shareholders are subject to individual or corporate taxation on their global income in their country of residence; Germany, as the source of the dividend income from the G-REIT, has only a limited taxation right on such dividend income.

To ensure that Germany retains the right to levy a reasonable level of tax and to make sure that a foreign corporate investor does not generate income that is not taxable in Germany ("white income"), the 10% rule will be introduced with regard to the level of the shareholding so that Germany retains its right to levy a withholding tax of 15%.

2.5 Comments

First of all, it must be reiterated that the major parameters of the G-REIT structure and the tax implications outlined above are based on draft legislation that was leaked to the press. The draft legislation has not been officially released and will probably be subject to (significant?) changes.

One issue requiring clarification is how foreign withholding taxes will be treated at the G-REIT shareholder level. If the G-REIT transparency principle is taken seriously, foreign withholding taxes would at the very least have to be classified as a creditable tax at the German resident shareholder level.

On the basis of the rather limited information available at present, it can be concluded that the detailed provisions regarding the structure of a G-REIT, how it works, and its tax ramifications, look attractive and seem to be workable in practice.

There is still some way to go until the legislative draft has passed all the parliamentary barriers and becomes law. However, it is realistic to assume that the new G-REIT law will take effect from 1 January 2007 and the real estate industry should be prepared to enter the world of the G-REIT by then.

3 The UK REIT

Following the enactment of the Finance Act 2006, the development of the UK REIT is now in its final stages and ready for a launch date of 1 January 2007. From this date, existing listed companies can convert to REIT status and new REITs can be incorporated and listed, provided the various conditions set out below are satisfied. Regulations and informal guidance are being prepared which will flesh out the details of the code set out in the primary legislation. Potential REITs are therefore using the time to identify whether and how they can meet the various requirements.

3.1 Key Conditions

The key conditions to becoming a UK REIT can be broadly summarised as follows (for convenience, references will be made to a vehicle, although there can be REIT groups):

- the vehicle (or the principal company of the group) must be a UK tax resident, widely held and listed on a "recognised stock exchange", with a simple share and loan capital structure;
- the vehicle must be substantially a property investor with 75% "balance of business" tests (income and capital); at least three investment properties must be held although the definition of "property" includes separate rental units (in other words, a single shopping centre would qualify). Owner-occupied property does not qualify. Development for investment is permitted (subject to a tax charge in certain cases if a sale takes place within three years of practical completion); and
- 90% of the otherwise taxable income (but not capital) profits of the property investment business must be distributed within 12 months of the end of the relevant accounting period.

3.2 Taxation of the REIT

The proposed tax treatment for the UK REIT itself is that it will be exempt from UK tax on the income and capital gains produced by the property investments. The exemption is tightly defined so that it will not, for example, extend to the sale of group companies owning investment properties rather than the properties themselves. There is no obligation to distribute capital gains. Cash proceeds of sale held for up to 24 months after the sale are treated as the equivalent of the property for the purposes of the 75% (asset value) balance of business test.

The UK tax authorities have given themselves broad powers to counteract "tax avoidance" transactions carried out by UK REITs and in extreme cases to cancel UK REIT status.

The UK REIT may carry on non-exempt activities (up to the 25% limit from the balance of business tests). However, it will pay corporation tax on the profits from such activities at the usual rate of 30%. In addition, the UK REIT will suffer tax penalties but not immediate loss of REIT status if it

- pays a dividend to a shareholder holding (directly or indirectly) 10% or more; or
- has interest expense such that its gross income falls short of a 125% coverage ratio.

Both of these provisions come from a desire to protect the UK Treasury from tax leakage. The 10% threshold is at the point where treaties reduce UK withholding tax below 15%. Interest will usually, of course, be paid free of withholding tax. Neither provision is affected by the residence of the recipient of the payment, which is relevant from an EU law perspective.

3.3 The Entry Charge

In order to secure UK REIT status, an "entry charge" has to be paid amounting to 2% of the market value of the investment property assets, i.e. those which will obtain the benefit of the tax exemption. The charge does not, therefore, apply to assets held as trading stock. Acquisition by a UK REIT of a non-REIT will also lead to a requirement to pay the 2% charge on the investment property held by the non-REIT. The obtaining of UK REIT status produces a re-basing of the property for tax purposes so that historic contingent capital gains are extinguished, in addition to tax exemption being secured for the future.

3.4 Taxation of Shareholders

For shareholders, distributions will be divided between income from the exempt and the taxable parts of the business. Distributions from the exempt side will be treated for UK tax purposes as if they were a special class of property income and paid subject to a withholding tax of 22%. Regulations will permit certain shareholders to recover or avoid this withholding tax. Bilateral tax treaties may reduce the rate (by reference to the dividend article). Distributions from the taxable side of the business will be treated like normal UK dividends (no withholding tax will apply).

3.5 Comments

The new rules have been relatively well received and the expectation is that many of the major listed property investment companies will convert to UK REIT status on or after 1 January 2007. However, the details of the new code are still emerging and prospective REITs need to consider carefully and to monitor their ability to satisfy and continue to satisfy the tests.

Attention is being given to how in practice a UK REIT can monitor its share register and avoid paying dividends to 10% shareholders. Shareholders who already own more than 10% in a listed company are considering whether to sell down their holdings and/or carry out dividend strips to avoid causing penalties for the REITs.

Groups with non-qualifying activities are considering whether those activities can be accommodated within the 25% tolerance or whether they should be sold. Although there are no limitations on the types of asset that can qualify, there are questions whether certain types of business (self-storage, hotels) operate in a suitable manner to do so.

The feeling is that the entry charge has been set at a level which will not put off those willing to convert. It also provides an opportunity for a REIT to buy non-REITs with significant contingent tax charges on a preferential basis.

The new code works best for the conversion of existing listed companies rather than the IPO of new ones. Existing offshore property investment companies are likely to be better off remaining offshore for the time being, rather than to convert immediately. But this may change over time.

There is no prohibition on owning non-UK real estate, and investment property will count for the 75% balance of business test wherever it is located. However, cash flow from non-UK subsidiaries holding non-UK property will be part of the non-qualifying (i.e. taxable) income of a UK REIT group.

4 The Dutch REIT

4.1 Introduction

In 1969 the Netherlands introduced the BI regime (**fiscale beleggingsinstelling**) in the Corporate Income Tax Act. The BI is subject to a corporate income tax rate of 0%, and may, in principle, claim treaty benefits. The BI is widely used in the quoted domestic and international sector. It is also quite popular in the non-quoted sector.

4.2 Key Conditions

In order to apply the BI regime, certain conditions need to be met. We will not elaborate on these in great detail here, but will provide a general overview of the most important conditions.

The most important conditions are:
- Only a Dutch resident NV, BV or mutual fund may apply for the BI regime;
- Shareholder requirements (requirements are different for quoted and non-quoted BIs);
- Gearing limit of 60% of the total book value of the real estate;
- Profit distribution obligation within eight months after the book year; and
- Activity test (only passive investments are allowed).

The gearing limit can prove to be burdensome, since, in general, it is not permitted to revalue the real estate at fair market value for purposes of calculating the gearing limit. Therefore, it could be difficult to refinance property once the fair market value has increased. Leverage is allowed up to 20% of the book value of all other assets (besides real estate).

Under the BI regime, it is only allowed to invest passively (the BI may not run an enterprise). The Under-Minister of Finance has taken the position that real estate development is considered to be active investment. If a BI engages in real estate development, it could potentially lose its BI status and will become fully taxable. This makes the activity test a true bottleneck. However, a new legislative proposal allowing for limited development activities is expected to be published soon (see below).

4.3 Current Tax Regime

A BI is subject to a corporate income tax rate of 0%. Capital gains may be added to a tax-free reinvestment reserve. The net rental income is subject to an annual distribution obligation. As the BI is not a tax-transparent entity nor an exempt entity, it is, in principle, allowed to claim treaty benefits (e.g. to apply for a lower withholding tax rate).

Dutch withholding tax on dividend distributions received by a BI (e.g. from a Dutch subsidiary) is refundable. In respect of foreign withholding tax on income received by the BI, a partial refund (cash reimbursement) is granted by the Dutch tax authorities in lieu of the credit to which the Dutch resident shareholders of the BI would have been entitled, had they received the foreign income directly. The limitation of this cash reimbursement to the pro rata amount of the foreign withholding tax allocable to Dutch resident (taxable) shareholders may not be in line with EU law (see the EU law section). These refunds and/or credits create a lower tax leakage on foreign investments made by the BI.

Distributions by a BI are subject to Dutch domestic dividend withholding tax at a rate of 25% (the Ministry of Finance has issued draft legislation in which a rate of 15% is introduced). Bilateral tax treaties may provide for a lower rate. Distributions from the reinvestment reserve may be made free of dividend withholding tax. Capital duty has been abolished in the Netherlands from 1 January 2006.

4.4 New Developments – Less Stringent BI Requirements and Exempt Investment Funds

On 25 April 2006, the Ministry of Finance published a legislative proposal that includes, among other things, a relaxation of the requirements for application of the existing BI regime:

- Foreign legal entities comparable to a Dutch NV, BV or mutual fund may apply the BI regime;
- The BI may have its place of effective management outside the Netherlands;
- Making a distinction for purposes of the shareholder requirements on the basis of whether the BI is quoted or not will be replaced by a distinction based on whether the BI has a licence under the Investment Institutions (Supervision) Act or not; and
- The requirement that foreign resident entities may not hold an interest of 25% or more in the BI will be cancelled.

This legislative proposal also introduces a new regime for **exempt investment funds**. This regime includes an exemption from corporate income tax and an exemption from dividend withholding tax on distributions to its shareholders. Treaty protection will not apply. This regime will not be open to investments in real estate.

According to the legislative proposal, the bill will be enacted prior to 1 January 2007.

4.5 New Developments – Real Estate Development Activities

A second bill is expected to be made public soon. It is a legislative proposal regarding the scope of the permitted activities for BIs. Real estate development may possibly be allowed as a separate, taxable activity. The following would apply:

- The BI would be allowed to hold the shares in a subsidiary that conducts real estate development activities. This subsidiary will be taxed normally (current rate 29.6%, which is likely to become 25.5% from 1 January 2007) on its profits or losses. The BI is explicitly not allowed to develop real estate in the BI itself;
- If the BI wishes to develop real estate already held, the subsidiary may develop the real estate held by the BI in exchange for an arm's length fee. The result is a taxable development activity at the level of the subsidiary and exempt passive investment income at the level of the BI; and
- Renovation of property will be allowed at the level of the BI as long as the investment in respect of the renovation stays within a safe harbour of 30% of the fair market value of the real estate.

4.6 New Developments – Dividend Withholding Tax

Recently, the Netherlands Ministry of Finance announced the introduction of an exemption from Dutch dividend withholding tax for certain EU shareholders. The proposals are expected to become effective from 1 January 2007. Under current law, Dutch qualifying pension funds and other Dutch tax-exempt entities are entitled to a refund of Dutch dividend tax upon request. For foreign pension funds and other similar tax-exempt entities the dividend tax is a final levy and an exemption or refund is not available to them. In view of the potential conflict with EU law (some cases are currently pending before the Dutch courts and the European Court of Justice on this), the Netherlands government has now announced the introduction of what effectively amounts to an exemption for EU pension funds and other similar tax-exempt entities.

Finally, the proposed reduction of the rate of dividend withholding tax from 25% to 15% (from 1 January 2007) will most likely have a positive effect on the BI's attractiveness internationally.

5 EU Law and REITs: What Are the Issues?

5.1 Introduction

The basic principles of EU law are quite simple and only require common sense to be understood. The EC Treaty's aim is to create a true Common Market without "economic frontiers" to hinder cross-border business. This Common Market is to be achieved by means of the EC Treaty freedoms, of which the free movement of capital is the most important for REITs. A Common Market for REITs in the European Union entails the removal of cross-border tax barriers between the EU Member States. The basic idea is that whether an investor invests in his domestic market or in another EU Member State should not make a difference (from an economic point of view).

Where cross-border investments are treated less favourably than domestic investments, this difference in treatment enters the "danger" zone, meaning that the different treatment could form a prohibited restriction of the free movement of capital (or the freedom of establishment). As follows from the above, it should be simply a matter of common sense for the legislators in the EU to determine whether their REIT systems are in line with EU law. Until the issue of the EU-compatibility of REITs is resolved, the REIT or its investors should safeguard their rights under EU law by filing requests for equal treatment in a cross-border investment situation.

5.2 European REIT Regimes and Potential Infringements

Currently, the REIT regimes in the EU contain quite a few potential infringements. Many of these were analysed in the EPRA report of August 2005 entitled "European REIT regimes and the impact of the EC Treaty freedoms".[7]

[7] Available at: www.epra.com

To sum up, prohibited restrictions seem to exist in various European REIT regimes with respect to the following:

- Withholding tax burden;
- REIT requirements;
- Shareholder restrictions;
- Listing requirements; and
- Asset level/activity test.

We will briefly discuss a few examples of these restrictions below.

A difference in withholding tax treatment for domestic dividend distributions and cross-border dividend distributions occurs in various Member States: for instance, the application of an exemption in the domestic situation and an actual withholding in the cross-border situation[8]. In general, the cross-border situation should receive equal treatment. This means a lower or no withholding tax burden in the cross-border situation.

[8] The Dutch legislator has acknowledged this for distributions to foreign pension funds and has made public a proposal in which foreign EU pension funds are effectively granted an exemption from Dutch withholding tax, just like their Dutch counterparts.

In order to be eligible for REIT status, most Member States require a company to be incorporated under domestic law. Furthermore, the REIT often needs to be a tax resident according to the applicable domestic legislation. The fact that some Member States do not allow foreign legal entities or non-residents to opt for REIT status creates an economic disadvantage in a cross-border situation; in disallowing such an option, the Member States would seem to be protecting their domestic markets. Such a protectionist approach may constitute a prohibited infringement of the free movement of capital.

Certain REIT regimes impose different rules on resident and non-resident shareholders. If the rules for non-resident shareholders are less favourable than those for resident shareholders, we may be looking at a prohibited infringement.

We are currently experiencing that the EU Member States are starting to look at EU law compatibility of their (REIT) legislation, further to recent EU case law. Hence, we may conclude that EU case law has a greater harmonising effect, than the combined political efforts from the European Member States.

European Public Real Estate Association

Schiphol Boulevard 283 1118 BH Schiphol Airport The Netherlands

T +31 (0)20 405 3830 F +31 (0)20 405 3840 W www.epra.com