EUROPEAN REITS AND CROSS-BORDER INVESTMENTS

SUMMARY PAPER

September 2009
1. Introduction

1.1. The introduction of REIT legislation by national governments has been seen as an opportunity to attract new sources of capital into the local real estate market and to increase the accessibility of real estate investment to a wider range of retail and institutional investors. Our most recent estimate of the size of the global REIT market is approximately $386bn¹. The difficulties now being experienced by the capital intensive property industry in accessing capital funding, has seen an acceleration in the introduction of REITs in a number of European countries, the announcement of impending REIT legislation in China, Pakistan and India as well as a raft of measures by various governments aimed at making REITs more attractive to overseas investors.

1.2. The tax treatment of REITs gives rise to particular issues and inefficiencies in a cross-border context because of the unique tax-exempt corporate status of the REIT. From an EU law perspective, the tax-exempt status raises a number of questions when a REIT of one EU Member State makes a direct or indirect investment in another Member State, which may or may not have a REIT regime of its own.

1.3. EPRA’s view is that there is a need to facilitate cross-border investment into and through European REITs and this need is heightened in the current financial environment where access to new capital is severely restrained. EPRA believe that the approach should be to seek practical solutions to resolve the tax issues that make cross-border, intra-EU investment through REITs difficult.

1.4. This note summarises the recommendations of a more detailed EPRA paper entitled “European REITs and Cross Border Investments” (June 2009) and makes further suggestions on how the European Commission could take this initiative forward. The recommendations are based on a fundamental principle which is that the Member State in which the real estate is located, obtains a fair allocation of taxation relating to the income from that real estate. This principle is consistent with the OECD’s view on the taxation of immovable property and its recent recommendations with respect to REIT distributions².

2. Principal features of a REIT

2.1. The principal common feature found in REIT regimes worldwide is the tax exemption of the REIT and the full taxation of REIT distributions in the hands of the receiving shareholders. Thus, the REIT structure resembles a direct investment in real estate by the shareholders in the REIT – where all net income is taxed in the hands of the property owner.

2.2. The exemption is only available if certain conditions are met, of which the most important one is that the activities are restricted to investment type of activity. However, because of the (typically) corporate structure of the REIT, the income received by REIT shareholders retains the character of a dividend for both legal and tax purposes and is not reclassified as rental income.

2.3. A comprehensive definition of a REIT can be found in the OECD 2008 Update to the Model Tax Convention (MTC) approved on 18th July 2008 by the OECD Committee on Fiscal Affairs as follows:

“A widely-held company trust or contractual or fiduciary arrangement that derives its income from long-term investment in immovable property (real estate), distributes most of that income annually and does not pay income tax on income related to immovable property 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 (with corresponding withholding tax obligations imposed on the REIT with respect to its distributions to foreign investors).”

¹ Reuters Market Data – Industry Report – 11 August 2009
² See http://www.oecd.org/document/15/0,3343,en_2649_33747_41032207_1_1_1_1,00.html
3. Taxation hurdle for cross border REIT investments

3.1. There are no particular issues regarding the investments in real properties by a REIT in its country of residence, hereinafter referred to as A-REIT. The profit is not taxable or is subject to a zero percent tax rate if certain conditions are met. One of the conditions is that (almost) all of its annual profits will be distributed to its investors. The distribution is subject to dividend withholding tax, if applicable. The dividends are taxable in the hands of the domestic investors. With respect to foreign investors, the dividend withholding tax is the final taxation for the country of residence of the A-REIT. Such withholding tax may be restricted under applicable tax treaties.

3.2. Issues do arise if the A-REIT invests cross border in another country, hereinafter referred to as Country B. More often than not the A-REIT is not recognized as a REIT in Country B, even if Country B has provided for REIT legislation. Therefore, usually the profit made by the A-REIT in Country B is subject to taxation according to the ordinary taxation rules of Country B. If the A-REIT has invested through a legal entity in Country B, a distribution of profits is normally subject to dividend withholding tax in Country B. Depending on the applicable legislation, the A-REIT could nevertheless be obliged to distribute the dividends received from Country B to meet the obligations under the REIT regime in its country of residence. Moreover, usually there is no possibility to offset the dividend withholding tax levied by Country B. Taxation is therefore a barrier to cross border investment.

3.3. In EPRA’s view, it is not entirely clear how, as things currently stand, the ECJ would decide a case involving cross-border investment by a REIT where the REIT claims – but the investee Member State refuses to grant it - the local REIT tax regime (i.e., tax-exempt status). It is uncertain how the ECJ would resolve the apparent conflict between the fundamental freedoms of the EC Treaty and the lack of EU harmonisation in the field of direct taxation, which stays under the sovereignty of the 27 individual Member States. There is, however, a risk that Member States will be obliged to grant REIT status also to foreign entities whose characteristics are similar to those of local REITs.

3.4. Below we will describe how Member States having a local REIT regime could remove the above described tax hurdle in cross border situations and, at the same time, protect themselves against a potential loss of revenue as a result of the application of EU law. The EPRA recommendations in this paper will be based on a system of ‘mutual recognition’ of respective Member States REIT regimes and a simple but fair system for the allocation of profits realised on properties located in their countries.

4. Proposed solution

4.1. The principal recommendation of EPRA is that Member States adopt the approach of ‘Mutual Recognition’ of each other’s REIT regimes.

4.2. Under this approach, Member States should accept the tax-exempt status of an investing REIT from another Member State. Furthermore, they should enter into reciprocal arrangements supported by the EU and bi-lateral tax treaty provisions, to ensure that the net earnings of a REIT from one Member State arising from direct and/or an indirect real estate investments are allocated fairly among the different situs countries. That way, each country’s taxing rights in respect of property situated in its territory would be respected.

4.3. As discussed further in Section 6, it is proposed that this process of Mutual Recognition of REIT structures by Member States would form the basis of a Communication issued by the European Commission.

4.4. Under the concept of Mutual Recognition, a REIT which has been established under the laws of one Member State and which makes a direct or indirect real estate investment into another Member State, which also has a REIT regime, will be recognized by that other Member State as a tax-exempt REIT.

4.5. In this context, EPRA suggests that it would be helpful for minimum criteria to be established for REIT regimes in the different Member States qualifying for Mutual Recognition, either prior to
implementation, or as part of the Mutual Recognition process. Such criteria should aim to be broad.

4.6. It is proposed that the definition of a REIT for the purposes of the Mutual Recognition process should be the OECD definition stated in paragraph 2.3 with the following additional (minimum) criteria:

<table>
<thead>
<tr>
<th>REIT characteristic</th>
<th>Minimum requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal form</td>
<td>Corporate</td>
</tr>
<tr>
<td>Listing requirements</td>
<td>Listed</td>
</tr>
<tr>
<td>Mandatory distribution of income</td>
<td>&gt;80% net tax-exempt income</td>
</tr>
</tbody>
</table>

4.7. The combination of the OECD definition with the above additional criteria should give strong protection to the Member States against unwanted “REIT-shopping” and that the concept of Mutual Recognition does not lead to abuse. Only a REIT which meets the defined minimum criteria would qualify for Mutual Recognition as described further below.

4.8. Since there are differences in the REIT regimes in the various Member States, both in terms of corporate law requirements and investment related conditions, EPRA considers it reasonable and helpful to distinguish, in the discussion of Mutual Recognition criteria, between ‘non-investment’ and ‘investment’ related criteria.

4.9. The reason that a distinction should be useful is that it may be simpler to determine (1) whether a particular vehicle qualifies to be recognized under the concept of Mutual Recognition as a REIT by looking at the non-investment related REIT rules of its country of origin, and (2) whether a particular investment by that vehicle into property located in the investee country, should attract tax-exempt status by looking at the investment related rules of the investee country.

4.10. Thus, each Member State retains sovereignty in terms of the operation of its REIT regime:

- Country A has control over its non-investment related REIT rules under which a corporate vehicle is recognized as a REIT – and which Country B agrees (under the Mutual Recognition concept) to accept.
- Country B has control over its own investment related REIT rules, which A-REIT must observe in relation to its investment in Country B if it is to attract tax exempt property income in Country B.

4.11. The specific investment and non-investment related conditions should become part of the EU Commission’s Communication. Alternatively, those conditions might be left as an ultima ratio at the discretion of national governments to be resolved between the two REIT countries concerned (i.e. the investor and the investee country) on a bilateral basis.

4.12. Thus, EPRA’s view is that:

- non-investment related requirements should be assessed in relation to the REIT by applying the rules of Country A; i.e., the country of residence of the investing REIT; and
- investment related requirements should be assessed in relation to the investments made by the REIT in Country B, i.e. the country in which the investment property is situated, by applying the rules of Country B.

4.13. The table below shows how this approach could be applied in practice to certain of the requirements typically encountered in REIT regimes. The list of conditions is not intended to be exhaustive.
<table>
<thead>
<tr>
<th>Requirement</th>
<th>Type</th>
<th>Applicable rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum equity capitalisation</td>
<td>Non-investment</td>
<td>Country A</td>
</tr>
<tr>
<td>Restrictions as to permitted classes of shares</td>
<td>Non-investment</td>
<td>Country A</td>
</tr>
<tr>
<td>Listing requirement</td>
<td>Non-investment</td>
<td>Country A</td>
</tr>
<tr>
<td>Minimum distribution requirement (both in regard of the percentage of profit to be distributed and the type of income to be included in the distribution)</td>
<td>Non-investment</td>
<td>Country A</td>
</tr>
<tr>
<td>Permitted debt to equity ratio</td>
<td>Investment</td>
<td>Country B</td>
</tr>
<tr>
<td>Permitted interest cover ratio</td>
<td>Investment</td>
<td>Country B</td>
</tr>
<tr>
<td>Restrictions on permitted investment types/activities</td>
<td>Investment</td>
<td>Country B</td>
</tr>
</tbody>
</table>

5. **Fair allocation of taxation between the EU member states**

5.1. As a consequence of agreeing to the Mutual Recognition between Country A and Country B, a fair allocation of the revenues in connection with the profit on properties located in Country A and Country B must be implemented.

5.2. This could be achieved in two ways:

- Country A, either directly from A-REIT or indirectly through an allocation process handled by the tax authorities of Country A, transfers part of the withholding tax collected which is attributable to the investments in Country B to the authorities of Country B. This approach is hereinafter referred to as: **Single Country** taxation.

- Country B is entitled to levy a withholding tax on the profits of A-REIT regarding its investments in Country B. In case of a direct investment in real properties this could be achieved by a quasi withholding tax. In case of an investment through a local legal entity (REIT subsidiary) in Country B, a withholding tax could be levied on the distributions by the REIT subsidiary to A-REIT. This approach is hereinafter referred to as: **Situs Country** taxation.

5.3. In both situations the investors in A-REIT should be able to offset the full withholding tax levied by Country A against the tax due on their income without regard to the either the payment to Country B or the deduction of the tax due by A-REIT because of the tax levied by Country B.

5.4. In the Single Country taxation approach the tax on the distributions of A-REIT will be divided between the various countries in which A-REIT has made its investments on the basis of an allocation mechanism. There will first have to be consensus between the Member States concerned how to achieve that. EPRA would be in favour of an approach whereby Member States would agree that, regardless of their own country’s contribution (be it a profit or a loss) to the overall result of A-REIT, the consolidated profits and losses of A-REIT are the starting point for the allocation of tax revenues to the investee Member States. The Member States could, however, choose to agree on a different way of allocating the tax.

5.5. In the Situs Country taxation approach, A-REIT is entitled to offset the tax withheld by Country B against the tax to be withheld on its distributions to the investors. An issue could arise in the case where Country B levies a withholding tax at a higher rate than Country A. The Member States should agree on that issue bilaterally. The better solution, however, would be that one uniform EU-wide REIT withholding tax rate is introduced. A reasonable uniform rate could, in the...
view of EPRA, be set in the range between 10% and 15% in the light of the fact that almost all income will be distributed regularly.

5.6. Another issue is how to deal with situations in which the distribution by A-REIT is reduced by losses either in Country A or in another country in which A-REIT has invested. It may even occur that A-REIT has no obligation to distribute at all, because its losses exceed the result derived from the investments in Country B. A tax burden that corresponds to A-REIT’s consolidated result can only be achieved if Country B in such situation would be willing to reduce it’s withholding tax.

5.7. Comparing the two solutions discussed it seems that the Single Country approach is the more favourable one to the REITs themselves because their tax burden will correspond to their consolidated profit (to the extent it relates to their EU investments at least). The Situs Country taxation approach is for obvious reasons likely to be more acceptable to tax authorities and therefore a more realistic one to achieve within a shorter period of time.

6. Due process for developing the proposals

6.1. There is a general acceptance of the basic REIT model as described in this paper and we expect that over time, market forces will encourage convergence to an increasingly uniform REIT model. Nevertheless, the development of REIT regimes are at different stages around the globe and within Europe. At this time, many differences exist in the detailed legislation of REIT regimes and this will continue for the foreseeable future as individual governments impose their own specific requirements and policy objectives for investment vehicles residing in and investing in their own jurisdiction.

6.2. Accordingly, our recommendation is that the solution proposed in this paper will be developed and implemented most efficiently by working towards the development of a Communication by the European Commission - inviting the Member States to adopt the Mutual Recognition procedure. This Communication would become effective between those Member States which have REIT legislation in their domestic system and would allow those countries with established REIT markets to "lead the way" by adopting the Mutual Recognition process with other willing Member States, without interfering with the continued development of the less established REIT markets.

6.3. Perhaps the main objective for the introduction of REITs by national governments in Europe is to enable retail investors access to a high quality, transparent and liquid form of real estate investment. Confidence in this form of investment, which is well established worldwide but relatively immature in Europe, is therefore crucial. The approach recommended above would not only promote the position of European real estate investment as a whole by facilitating the growth of confidence in the European REIT market but it would also enable those countries best placed to tackle the issues to ease the way for other countries as the network of Mutual Recognition countries expands.

6.4. We suggest that the initiative should be led by DG MARKT with input from DG TAXUD. The proposed solution is not intended to, nor requires, individual Member States to comply with the recommendations. We therefore believe that the solution could be developed relatively quickly and at a low cost, initially through the establishment of an EU Industry working group comprising experts drawn from representative organisations, DG Markt and DG TAXUD. Using this approach, resource and expertise from within the industry could be used to efficiently develop the solution having agreed certain parameters and requirements with the European Commission.

6.5. EPRA would be very happy to assist the Commission in developing its agenda by undertaking a more detailed assessment of the costs/benefits of the initiative, evidence to support the need for EC action and the due process.