

The EU REIT and the Internal Market for Real Estate

A research report for the European Landowners' Organization, the European Property Federation, the Royal Institution of Chartered Surveyors, The European Group of Valuers' Associations, and the Urban Land Institute Europe



Preface Executive Summary

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Preface

The property industry is like the European Union: It has transformed itself in less than a generation and become much better equipped to meet the needs of European citizens. Yet at the same time, the job is not yet done, the transformation far from complete. More effort is needed for things to work really well and be seen to work well.

The property industry is one of the bedrocks of Europe's wellbeing and competitiveness, providing the affordable housing and sophisticated infrastructure needed by citizens, services and industry. The European knowledge-based economy needs a property industry that competes in providing this investment everywhere in Europe and not just in the prime market segments, and property companies need European scale to develop their increasingly specialised products.

A specific regime has played a key role in the modernisation and enhancement of property investment: the Real Estate Investment Trust, or REIT, an investment vehicle that puts shareholders in property companies on a level playing field with investors who own property portfolios outright.

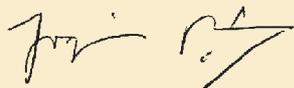
Governments and markets favour REITs because they enable industrial and service companies to sell off their corporate real estate, leaving it in the hands of property professionals and freeing up capital for core business, and because they enable small investors to safely invest in property, enjoying the diversification benefits this asset class has to offer and its qualities as a protection against inflation.

And yet there is no EU Internal Market for REITs. Investors have long been conscious of the problems raised by the lack of an EU REIT structure, but the Maastricht University report for the first time sheds light on the scale of the challenge:

- the need to address increasing distortions of competition as national REITs multiply
- the opportunity to buttress market safety and security. Simply by ensuring a properly functioning Internal Market for real estate investment, the EU can make a major contribution to the control and stabilisation of property markets
- the need to correct a situation where savers in small member states cannot access good quality property investment in other member states or even the prime property investments in their own countries
- the opportunity to reverse the current trend of initiators of property companies to resort to tax havens
- the chance to boost specialisation in cutting edge real estate and investment in social property that both require development on a European scale

The report goes farther, outlining a preferred structure for an EU REIT with no need for invasive tax harmonisation as no approximation of tax rates on shareholder dividends is required.

Some readers may feel that it doesn't address all aspects; others may disagree with this or that option, but that would be missing the point, which is to kick-start a debate on REITs in the Internal Market and inspire the European authorities – national parliaments and governments, the European Parliament and the Commission – to focus on finding a solution so that we can all work to create, in Prof. Eichholtz's excellent words, the largest and most efficient property capital market in the world.

A handwritten signature in black ink, appearing to read 'Joaquim Ribeiro', with a stylized flourish at the end.

Joaquim Ribeiro
Chairman of the EU REIT Coalition

Executive Summary

For pension funds and other investors, property is an important part of the portfolio, and many investors choose to build up their property exposure through publicly listed property companies. This market has grown substantially in the last two decades: from € 28 billion in the early eighties to approximately € 1.2 trillion in 2007.

To facilitate private savers and institutional investors, numerous countries have created special tax regimes for property companies, commonly called Real Estate Investment Trusts or REITs, so as to avoid double taxation, and to create a level playing field between different forms of real estate ownership. The goal of these regimes is to avoid taxing a rental income stream at the corporate level and again at the shareholder level. Thus, exemption from corporate tax for a property company puts the shareholder in such a property company in a comparable position with an investor who owns a property portfolio outright, since the rental stream for such an investor will only be taxed as income. In other words, corporate tax exemption creates a level playing field between the direct segment and the indirect segment of the property market. In this sense, such tax treatment of property companies is analogous to the corporate tax-exemption of mutual funds, for which a corporate tax levy would also entail double taxation.

Legislation regarding tax exemption of property companies is in flux: 13 out of the 27 EU member states now have some kind of tax-transparent regime for property companies, of which most have been introduced in the last five years. Once introduced, these regimes tend to be reformed quite frequently. Moreover, the exact form of these regimes varies widely – and seemingly arbitrarily – across countries, as Exhibit A shows. This holds especially with respect to operational restrictions, leverage restrictions, and the question whether stock market listing is mandatory. There seems to be no standard towards which the tax-transparent regimes evolve.

The strongly varying nature of property share regimes across the EU keeps the market for indirect property investments fragmented. This fragmentation hinders competition among property companies from different EU member states, and even more so between property companies and direct property investors, who face no double taxation to begin with, and are far less restricted in their operations and financing.

The fragmented market situation in the EU contrasts markedly with the situation in the United States, which has one and the same property share regime from coast to coast, enabling the development of a property share market that is now bigger than all of the EU's national property share markets combined. The market size created by this one legal regime enables property companies in the United States to harvest economies of scale and scope that are out of reach for their European counterparts. For example, U.S. property companies tend to be specialized in rather narrow product niches in the property market. The academic literature and empirical evidence presented in this report show that this focus generally improves the creation of shareholder value.

This market scale also facilitates access to the capital market for fast-evolving semi-government sectors like senior housing, healthcare, and correctional property. Besides that, the efficient tax regime for U.S. REITs provides fertile ground to spin off corporate real estate

assets to institutional and private investors. It is very likely that specialized property investors add more value to their properties than do corporations and the government. Furthermore, these 'new' investment property categories will bring additional diversification benefits for investors.

Contrary to the developments in the United States, European property companies are mostly active in one member state only, and usually invest in a diversity of different property types, with office and retail property being the dominant investments. This precludes them from deep specialization and does not foster an innovative property capital market.

An additional disadvantage of the current institutional situation is that it makes international property diversification less efficient, especially for investors from member states who do not have a tax-transparent property company regime in place, and for those from smaller member states. This obstacle to diversification also hinders efficient allocation of capital across EU member states, especially to the new member states in Central Europe.

For private and institutional investors in the European Union to harvest the full potential of investments in the real estate market, it is important to have one uniform institutional setting for property companies, covering the European Union in its totality. To accomplish this uniform institutional setting, pan-EU regulation is of the utmost importance. Without such regulation, the EU's property share market will remain fragmented. This report shows that such a fragmented market leads to inefficient allocation of capital, which is particularly detrimental to small member states.

Introducing a pan-EU property company regime is not likely to produce significant tax losses for member states. Quite the contrary, the strongly increasing use of tax havens by listed property companies suggests that the market has already found ways to avoid double taxation. In the absence of a REIT regime, this development is likely to continue, and even expand. From a regulatory and supervisory point of view, however, the trend towards incorporation in tax havens is sub-optimal.

A pan-EU property company regime will support market safety and security. First, the introduction of a pan-EU property company regime would likely diminish the use of tax havens, which is beneficial for transparency. Second, although market integration has weakened the risk-spreading benefits of international diversification, the evidence in this report shows that the performances of different geographical property markets in Europe are still very dissimilar. This reduces risk, which is especially relevant in case of financial crises. Third, REITs frequently have to turn to the capital market, due to the obligatory distribution of earnings. Therefore, they are subject to regular scrutiny by external agents, which reduces the conflict of interest between managers and investors. Fourth, the evidence in this report shows that the introduction of a REIT-like structure lowers the use of debt in property companies. Especially in the light of the current crisis on the debt market, it is clear that lower debt levels increase financial security for investors.

The academic literature and additional empirical evidence presented in this report provide strong and fundamental arguments for the creation of an EU REIT. To offer guidance in creating such a structure, the report also presents the key components of a blueprint for a pan-EU regime for property companies, addressing governance issues, operational and financial requirements, and other structural issues. There is abundant academic literature

regarding property companies, their operations, performance, and governance. This literature, combined with best practice experience that can be observed in the U.S. and European listed property markets, can lead the way towards an optimal regime for an EU REIT. Exhibit B provides the key characteristics of a blueprint for such a regime. The EU REIT regime should leave maximum freedom for the management of property companies to engage in value creation for their shareholders. This would mean, among others, that restrictions on leverage and share ownership should be avoided, and that would also hold for mandatory listing of property company shares, and for portfolio diversification rules. Property development by EU REITs should be allowed, but taxed in such a way that a level playing field with pure property developers is maintained. Lastly, the EU REIT should have a closed-end structure and we strongly advise that internal management be allowed.

Creating an EU REIT along these lines would turn the current fragmented EU market for property companies into the largest and likely most efficient property share market in the world. Investors, small and large, private and institutional, would greatly benefit from that.

Exhibit A. The Dispersion of REIT-like Structures in EU Member States

Country	Tax exempt	Distribution requirements	Operational Restrictions	Leverage Restrictions	Shareholder Requirements	Withholding Tax
Austria	++	+	++	++	++	++
Belgium	++	++	++	++	++	++
Bulgaria	++	++	+	N/A	++	+
France	+	++	++	0	++	++
Germany	++	++	++	++	++	++
Greece	++	0	++	++	++	++
Italy	++	0	++	++	0	++
Luxembourg	++	0	+	+	0	0
Malta	+	0	0	++	+	++
Netherlands	++	++	+	++	0	++
Poland	++	0	++	++	0	++
Spain	+	0	++	++	+	++
UK	+	++	++	0	++	++

Note: This exhibit shows the characteristics of REIT-like structures in EU member states. A '++' indicates that the requirement or restriction is strong, a '+' indicates that it is moderate, whereas a '0' indicates that there are no or (almost) no requirements or restrictions.

Exhibit B. Blueprint of the EU REIT

Restrictions and Requirements	Motivation
Tax exempt	Avoids double taxation of rental income and creates level playing field with direct real estate ownership.
Payout requirement: 80% - 100%	Guarantees ultimate tax payment and is effective government mechanism, mitigating agency problems.
Internally managed	Better governance and alignment of interests of managers and shareholders; better performance, more shareholder value.
Operational restrictions - development allowed, but taxed - no diversification requirements - no asset restrictions	Development can create shareholder value, but maintain level playing field with pure - taxed - developers. Investors can diversify themselves and do not need extra protection. Government should not interfere with investment strategy.
No leverage restrictions	Restrictions put REITs at disadvantage to other property investors. Management should decide on optimal financing
No mandatory listing	Listing not always beneficial. Management should decide on optimal financing
No ownership requirements	Better for governance.
Withholding tax equal for domestic investors and those from other EU member states	Creates level playing field for all EU investors.
Closed-ended structure	Open-ended structure fundamentally unstable. Closed-ended structure creates more shareholder value.

Note: this exhibit provides a blueprint of the EU REIT. Restrictions and requirements are based on the existing academic literature and empirical evidence presented in this report.

Full report downloadable from all websites below



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