The REIT answer for Europe

Executive summary

- Much of the discussion about extracting value from corporate property portfolios by hiving properties off into a UK real estate investment trust (REIT) has been purely in the domestic context, but are similar structures possible for pan-European portfolios?

The basic idea of a real estate investment trust (REIT) in a domestic context is a variation of a traditional sale and leaseback. An operating group (an operating company, or 'opco') transfers all or part of its existing property portfolio to a REIT but continues to occupy the properties under leases from the REIT. Going forward, the REIT will not pay corporation tax on the rental income and capital gains from the properties and (in theory at least) should be able to offer more attractive lease terms as a result (see *Diagram 1*).

As with any significant transaction, there are issues. The opco will need to be comfortable with ceding control of its property portfolio to a separately listed REIT, although the opco may be able to retain a significant shareholding in the REIT provided this does not result in the REIT becoming a 'close company' for tax purposes. The transition to the REIT structure will need to be structured carefully to ensure any latent capital gain on the property portfolio is not taxed, and this is likely to require clearances from HMRC. The opco and the REIT will also be keen to minimise stamp duty land tax on the transition.

THE EUROPEAN OPPORTUNITY The UK's rules for REITs work tolerably well with a domestic portfolio. But can European properties be included in a REIT and operate tax-efficiently? In short, can a UK REIT be used to create a pan-European REIT, a tax-efficient listed vehicle investing in many jurisdictions?

THE EUROPEAN CONUNDRUM A UK REIT is, like REITs in other successful jurisdictions, permitted to invest in overseas real estate. The investment may be direct, through a subsidiary, or in a joint venture with a non-REIT company (or another REIT). The non-UK property will count towards the balance of business test.

However, the REIT's tax-exempt status in the UK for income and gains from investment properties will not be reflected in the country where the property is situated if outside the UK. Normally, tax will be payable locally on rental income and often on capital gains on sale in accordance with local rules. This additional layer of tax leakage makes the REIT inefficient for investments outside the UK as investors will in general be unable to credit local tax against their own tax liabilities on distributions received from the REIT.

This tax leakage might be reduced by relying on internal debt. The REIT would incorporate a subsidiary, either in the country in which the real estate asset was situated or in a third jurisdiction such as Luxembourg or Denmark. This subsidiary would then acquire the real estate asset, funded with shareholder debt provided to it by the REIT in addition to sufficient equity to comply with local thin capitalisation rules and with external debt as illustrated in *Diagram 2*.

Local tax on rental income is reduced or eliminated by tax relief for interest payments, and the listed top company in the structure (the REIT topco in *Diagram 2*) receives income as interest and dividends from its subsidiary, rather than as rental income. This is 'bad' income for the purposes of the UK REIT rules and will be taxable in the hands of the REIT. Again, the result is substantial tax leakage affecting the return to investors.

A UK REIT is therefore unlikely to provide a suitable vehicle for cross-border property investment on any significant scale. The situation is scarcely better for the French REIT equivalent – *sociétés d'investissements immobiliers cotées* (SIICs) – as interest payable by a subsidiary to a SIIC is taxed at 34.4% in France.

A US REIT can invest in non-US real estate, and particular US REIT qualification issues in relation to local subsidiaries holding real estate assets can often be addressed by electing for the local subsidiaries to be disregarded for US tax purposes. However, a combination of US REIT qualification rules concerning the effect of foreign exchange gains and withholding tax on distributions to and certain sales by non-US investors means that a US REIT is unlikely to provide a suitable vehicle for a predominantly non-US shareholder base to invest in European property.

The German REIT (or G-REIT) provides perhaps the best tax rules for pan-European portfolios, but disposals of real estate assets by G-

BEN EATON EXAMINES THE CHANCES OF SUCCESS FOR CORPORATES LOOKING TO INCLUDE EUROPEAN PROPERTY IN A REIT.

Diagram 1: How a REIT works

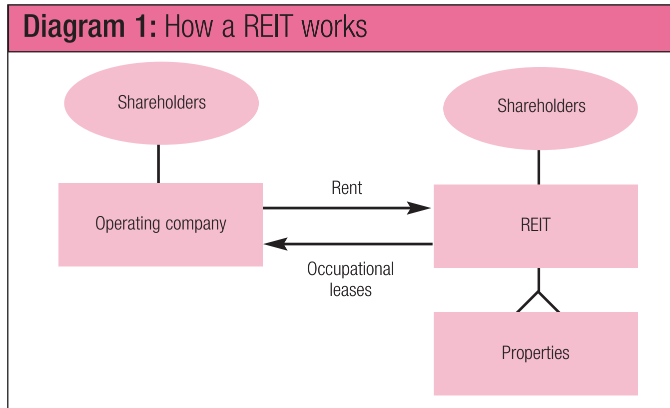
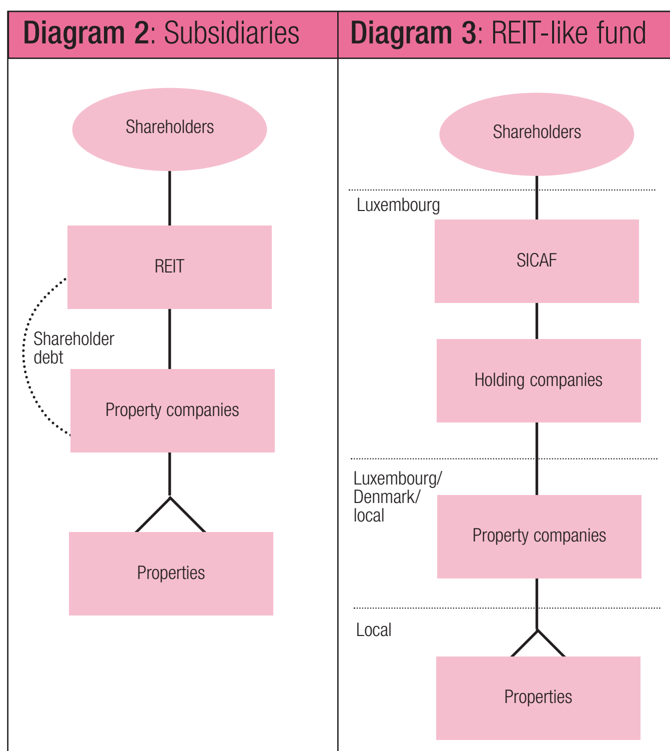


Diagram 2: Subsidiaries

Diagram 3: REIT-like fund



REIT subsidiaries would in effect be taxed twice as shareholders would not get credit for local capital gains tax borne by the local subsidiary.

Although the creation of a true European REIT regime is considered unlikely in the near future, it is possible to establish a tax-efficient listed property investment structure that, while not qualifying for any specific legal designation as a REIT, has similar characteristics.

THE EUROPEAN SOLUTION? Many major funds investing across Europe already use Luxembourg holding structures. The advantages include the ready availability in Luxembourg of the expertise for implementing and operating these structures and a local tax regime which is conducive to holding structures together with an extensive double-tax treaty network. By establishing the fund entity as a *société d'invetissement à capital fixe* (SICAF) regulated by the CSSF and whose shares are listed, a tax-efficient listed REIT-like fund can be set up in Luxembourg, as shown in *Diagram 3*.

The SICAF itself is a largely tax-exempt vehicle in Luxembourg and as such will not qualify for protection under most of Luxembourg's double-tax treaties (the treaty with Germany is an important exception). Typically, further Luxembourg holding companies, qualifying for the Soparfi tax regime, will need to be incorporated as subsidiaries of the SICAF. These subsidiaries would make real estate investments through further subsidiaries incorporated in the countries where the real estate is located or in another jurisdiction, with the subsidiaries funded by a mixture of debt and equity to allow rental flows from the opco to be sheltered from local taxes and cash paid to Luxembourg with minimal tax leakage.

It is crucial for tax efficiency that the Luxembourg holding companies' capital and funding are carefully structured, and that sufficient 'business substance' can be shown in Luxembourg. This requires the Luxembourg companies in the structure to have a real business presence in Luxembourg and are not 'brass plate companies' that merely pass cash to investors.

THE OFFSHORE ALTERNATIVE It is often possible to implement similar structures around companies domiciled in the Channel Islands or other offshore jurisdictions. But in assessing the robustness of any cross-border structure on a long-term basis, it is important to take account of developing trends in international tax law. There is inevitably a tension between the desire of most 'high tax' countries to tax income and gains from real estate assets within their borders and the use of tax-reducing cross-border structures as profits are paid to shareholders who may be resident in different countries. While there is a trend in international tax law against low-tax jurisdictions, there is an arguably more powerful trend in European tax law against penalising entities established in EU states such as Luxembourg.

None of the REIT regimes in the major jurisdictions most familiar to a European audience really facilitates a tax-efficient listed structure for holding a pan-European portfolio. But for the moment, a REIT-like structure can be established under existing Luxembourg rules.

Ben Eaton is a Counsel in the London office of Allen & Overy.
ben.eaton@allenovery.com
www.allenovery.com