Benelux Real Estate Insights

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Introduction

Following first signs of recovery in the second half of 2009, investment volumes continue to increase in 2010 in the Benelux region. Private investors and German funds have dominated the Benelux markets. Investment volumes are still far from the peak in 2007. This is caused by the scarcity of income producing prime assets which is the main focus of investors and their financers in today's market. Despite general economic recovery supported by positive first quarter results of many leading businesses, there is still significant concern on the occupier market. The gap between prime and non-prime is widening.

German Open-ended funds have billions of Euros to spend and allocations by institutional investors to non-listed real estate is increasing. The latter triggering new pan-European and single country fund initiatives of various fund managers. In this issue of Benelux Real Estate Insights we ask your attention for a number of developments relevant to the real estate industry in the Benelux region. Specifically on the regulatory side there are important developments to report on of which the following have been covered in this issue:

- The proposed **AIFM directive** has potential consequences to real estate funds. In this issue we cover the latest developments on the AIFMD and the potential consequences for Luxembourg real estate vehicles.
- Significant changes are expected in **lease accounting** for lessees following the publication of a discussion paper by the accounting bodies IASB and FASB. These changes may impact tenant behaviour.
- Based recently **changed IFRS accounting rules** development properties need to be valued at fair value as per 1 January 2009. In our article we describe various approaches on how to determine the fair value of these projects.
- Investors should be aware of the **revised VAT rules** as per 2010 that impose new reporting obligation. In this issue we have summarised the changes and provided points of attention for existing real estate investment structures.

How green is the tax environment for real estate in Belgium and the Netherlands? In this article we discuss the effectiveness of the Dutch and Belgian tax regimes in stimulating the reduction of the carbon footprint of buildings.

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Green Taxes

How green is the tax environment for the real estate sector in Belgium and the Netherlands?

Reducing carbon emissions has become a key priority for governments all over the world as a result of international commitments and widespread consensus on the harmful consequences of global warming. Buildings are considered to be responsible for not less than 40% of total carbon emissions and not surprisingly regulators have started imposing disclosure of a building's energy performance as well as minimum standards. Tax regulations may also contribute to stimulating sustainable and energy-efficient buildings. Which green tax regulations are currently of relevance for the commercial real estate sector in Belgium and the Netherlands?

Taxes on energy for heating or operating buildings (or exemption of such taxes on green energy) and taxes on waste water and water usage obviously stimulate efficient use of natural resources and should favour sustainable buildings. Such taxes exist in one or the other form both in Belgium and the Netherlands and qualify as indirect taxes.

Typical real estate taxes are local property taxes that are in principle due by the owner. In Belgium these taxes are levied at the regional level (Flemish, Walloon and Brussels Capital region). Interestingly, the Flemish Region currently offers a property tax reduction *(vermindering onroerende voorheffing / réduction précompte immobilier)* for energy-efficient buildings which are new or which have been built up again after complete demolition. A building's energy-efficiency (E-level) is measured by an independent expert appointed by the Flemish Region.

For buildings with an E-level of E70 or lower, the property tax reduction is currently 20% of the property tax due and applies for 10 consecutive years. The reduction is increased to 40% for buildings with an E-level of E40 or lower. The 10-year period starts in the tax year following the year in which the E-level has been granted. In case the labelled building is transferred, the reduction is also available in the hands of the new owner (until the end of the 10-year period). Contractually, these property taxes are typically at the charge of the lessee, but low property taxes should obviously contribute to higher rents (and represent an important element in the negotiation of so-called green leases). It is in our view rather likely that the other two Belgian regions will also start making their property taxes greener to stimulate green buildings. Please note that in the Netherlands there is also a yearly property tax (OZB-belasting) due at the communal level. Although each municipality is entitled to determine its own tariffs for property taxes from owners and users, currently these tariffs do not vary depending on energy performance levels.

There are also green incentives both in Belgium and the Netherlands for energy-saving investments in buildings. For Belgian corporate tax purposes, energy-saving investments (mentioned in a limitative list) such as insulation, solar cells and high efficiency boilers give entitlement to a so-called increased investment deduction (subject to a number of formalities such as a tax certificate). This deduction from the taxable basis comes on top of the deduction of the normal depreciation costs and thus represents a pure tax deduction. For investments in financial year 2010 (corresponding to assessment year 2011), the one-off investment deduction is 13.5% (for budgetary reasons the amount of the deduction has been reduced from 15.5% for the year 2009). In case the company is not tax-paying, the unused part of the deduction in a given year is carried forward in time and amount; the effective use of such carried-forward amount in a given year is however limited (for the year 2010 the amount is limited to €858,330 or to 25% of the investment, whichever is the higher). The investment deduction in practice can also be applied to real estate which is rented out and is therefore also of interest to the professional real estate investor.

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Green Taxes

In the Netherlands, there is a distinction to be made between the Energy Investment Allowance (EIA) and the Environmental Investment Allowance (MIA). The EIA *(energie-investeringsaftrek)* scheme offers a fiscal advantage for investing in sustainable energy and certain types of energy-saving assets, whereas the MIA applies to environmentally friendly assets and professional environmental advice. The fiscal benefit of EIA corresponds to a deduction from profit before tax (on top of normal depreciation allowances) equal to 44% of the total amount of qualifying energy investments in a calendar year. The deduction is available if a separate qualifying corporate asset costs at least €450 and the total amount of energy investment per calendar year exceeds €2,100. Maximum deduction is reached if the qualifying investments amount to a total of €115 million per calendar year. Only new corporate assets that enhance energy saving (used assets are excluded) and investments listed in the so-called Energy List or meeting certain energy performance criteria as set out in the Energy List qualify. Non-qualifying investments include, amongst others, land (except for improvement of land), dwelling houses, vessels, assets acquired from related parties or mainly used by non-resident companies or permanent establishments outside the Netherlands.

For the MIA, qualifying assets are divided into various categories, based on the extra costs for investing in environmentally-friendly assets, compared to a more conventional solution. The percentages are 60%, 50% and 35% depending on the category, and these rates may be increased later on approval of the European Commission.

The application of both schemes is subject to a number of further requirements such as timely reporting to the tax authorities (i.e. within three months from entering into obligations), a written request and a statement from the Minister of Economic Affairs that the investment qualifies for tax relief. The tax benefits are recaptured if the asset is disposed of within five years after the beginning of the calendar year in which the investment was made. A change in nature or use of the asset in a way that the asset no longer qualifies for the investment deduction is deemed to be a disposal, which may result in the recapture. In addition, the deduction is recaptured if the asset is not put into use within 12 months after the investment was made and less than 25% was paid, or if the asset is not put into use within three years of the investment.

In the Netherlands, certain investments that help to protect the environment (e.g. reduce or prevent waste, noise and pollution) may qualify for accelerated or even voluntary depreciation. Investors may thus generate for example greater deductions in the earlier years of the life of an asset, and this represents a cash flow and interest advantage. Used assets and assets exceeding EUR 25 million do not qualify. Also here, a number of formalities (reporting to the tax authorities) have to be observed. Free depreciation is recaptured if the asset is disposed within five years after the beginning of the calendar year in which the investment was made. It is important to note that buildings that are rented out do not qualify and therefore this benefit is only available to certain owner occupants (the professional real estate sector is thus excluded in practice). Please note that in Belgium there are no deviating tax depreciation rules for environmentally-friendly investments.

As mentioned above, land improvement costs that are capitalised may under certain conditions benefit from the above investment tax schemes (both in Belgium and the Netherlands). In addition, the Flemish Region currently applies (under certain conditions) a zero transfer tax rate (instead of the 10% normal registration duty rate) for transfers of developed or underdeveloped land qualifying as brownfields. In the Walloon Region, the legislator has stipulated that certain costs such as study costs or clean-up costs related to polluted land reduce the taxable basis for the 12.5% transfer tax.

The above examples show that both in Belgium and the Netherlands tax regulations exist to stimulate the efficient use of natural resources in buildings (and thus minimize carbon emissions), sustainable constructions and clean land. On the other hand, one can hardly speak today of a true green tax environment for the real estate sector in these countries. However, given the carbon footprint of today's buildings and their significant contribution to global warming, this may change in the near future.

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New EU VAT rules and reporting obligations

Modernisation of taxation rules leads to simplification of the payment of VAT but also imposes a new reporting obligation.

As of 1 January 2010, new rules governing taxation of services have been implemented in EU VAT legislation and local VAT legislation of EU Member States. The new changes should simplify the application of VAT rules but may also lead to new VAT costs and additional administrative burdens.

New rules in short

Under the new general place of taxation rule, most cross-border services between VAT taxable persons (business-to-business 'B2B' services) are taxable in the country where the customer (EU and non-EU) is established. Under the previous rule, this was only applicable to a limited list of services, for example consultancy or financial services.

In addition, EU countries are obliged to apply the so-called 'reverse charge mechanism' to B2B services that fall within the scope of the new general rule. Under this mechanism, the liability to pay VAT shifts from the service provider to the customer, who needs to self-account the VAT in his VAT return.

As was already the case under previous EU VAT legislation, there are still some exceptions to the general rule. For example, services connected with real estate continue to be taxable in the country where the real estate is located. Services that – for VAT purposes – qualify as connected with real estate are in any case the rental and maintenance of real estate and brokerage services. It depends on the local interpretation of EU Member States whether or not other services fall within the scope of this exception. Previous Belgian VAT legislation contained a list of 11 different types of services that, for VAT purposes, were deemed to be connected with real estate. As of 1 January 2010, this exhaustive list no longer exists.

Whether or not the reverse charge mechanism is applicable to services that fall within the scope of an exception rule depends on local VAT legislation too. As an example, Dutch VAT legislation provides for the reverse charge mechanism to apply to services connected with real estate located in the Netherlands, where the supplier is not established or does not have a fixed establishment for VAT in the Netherlands while the recipient of those services is established in that country. Luxembourg VAT legislation however does not provide for application of the reverse charge mechanism in such case (see overview 1).

The wider application of the reverse charge mechanism means that there are fewer cases where a business is charged with foreign VAT, which it needs to recover via a time-consuming procedure. But this simplification is somewhat offset by a new reporting obligation. As of 1 January 2010, EU service providers need to provide their tax authorities with a sales list of those services that fall under the new general place of taxation rule and that are subject to VAT under the reverse charge mechanism in the customer's country (where the customer is also established in the EU). The listing should include the value of the supplies and the country codes and VAT numbers of customers. Exceptions to the listing obligation are services that are VAT exempt in the country where the customer is established, or services to a customer who does not need to be registered for VAT purposes. Services connected to real estate do not need to be listed as these do not fall under the new general place of taxation rule.

VAT return forms contain some new entries, for example a box where taxpayers should now specify the value of VAT exempt services received from foreign EU service providers (in case the place of taxation of those services is in a taxpayer's country of establishment).

For foreign VAT incurred, a new electronic refund claim procedure should lead to shorter timeframes for processing and payments. As of 1 January 2010, claims

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New EU VAT rules and reporting obligations

should be filed with tax authorities in the country of establishment instead of with foreign tax authorities. Local tax authorities will forward claims to foreign VAT authorities, which must respond within four months.

Impact for the real estate industry

Barring the exceptions to the general rule, businesses have to self-account for VAT in the country where they are established for most services purchased from abroad. Relevant changes for the real estate industry can relate to the place of taxation of intermediary services, services by merchant and investment bankers, the recharge of bundled costs and management services. For example, a Benelux business is now liable to self-account VAT in its country of establishment for management services (sensu stricto) received from the US parent company, where no (Belgian, Dutch or Luxembourg) VAT was due before. The new rules could thus lead to an extra cost in case the subsidiary cannot fully recover this self-accounted VAT.

The changes do not impact the place of taxation of consultancy and financial services, the hiring out of personnel, business-to-consumer 'B2C' services (with some exceptions) and services relating to real estate, nor the application of the exemption on financial services (including services to investment funds) and the exemption for real estate transactions.

The new reporting obligations not only require adjustment of internal ERP systems but also knowledge about the status of the customer (VAT registered business or not) and the VAT treatment of services in the countries where the customers are established. Due to the different interpretations of EU legislation by Member States, the new sales listing could be a complex and tricky exercise. The mentioning of a customer by a service provider on the sales listing suggests that the customer is liable to 'reverse charge' VAT in his country. The customer, however, may well qualify the service as VAT exempt. Such divergence will lead to questions from tax authorities and may even result in a reassessment, as well as more difficult or even spoiled relationships with clients and/or service providers.

As tax authorities across the EU are committed (and legally obliged) to spontaneously exchange information included in listings, they can better identify if a local company receives services from a service provider in another EU country and, consequently, whether this company is liable to pay local reverse charge VAT on those services.

Local authorities in Benelux have introduced measures to ensure that VAT is properly paid, collected and reported in both a cross border and a local context. It can be expected that tax authorities will strongly monitor the correct filing of sales listings. If not yet done, it is, therefore, important to take action as soon as possible.

- review of existing structures, contracts and service flows
- identify transactions affected by the new rules
- identify VAT status of clients
- determine required systems and accounting changes
- identify efficiencies and planning opportunities
- reconsider VAT obligations in other EU Member States

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New EU VAT rules and reporting obligations

	Services connected with real estate					
	Belgium		Netherlands		Luxembourg	
	before 2010	as of 2010	before 2010	as of 2010	before 2010	as of 2010
Place of taxation	country of real estate	country of real estate	country of real estate	country of real estate	country of real estate	country of real estate
Reverse charge mechanism*	Yes*	Yes*	Yes**	Yes**	No	No
Conclusion	**Difference between countries regarding reverse charge mechanism, before and as of 2010**					
	No change in place of taxation and reverse charge mechanism as of 2010, for all countries					

	Management and administrative services ***					
	Belgium		Netherlands		Luxembourg	
	before 2010	as of 2010	before 2010	as of 2010	before 2010	as of 2010
Place of taxation	country of supplier	country of customer	country of supplier	country of customer	country of supplier	country of customer
Reverse charge mechanism	N/A	Yes	N/A	Yes	N/A	Yes
Conclusion	**No difference between countries regarding place of taxation and reverse charge mechanism, before and as of 2010**					
	Change in place of taxation and reverse charge mechanism as of 2010, in all countries					

	Advisory services					
	Belgium		Netherlands		Luxembourg	
	before 2010	as of 2010	before 2010	as of 2010	before 2010	as of 2010
Place of taxation	country of customer	country of customer	country of customer	country of customer	country of customer	country of customer
Reverse charge mechanism	Yes	Yes	Yes	Yes	Yes	Yes
Conclusion	**No difference between countries regarding place of taxation and reverse charge mechanism, before and as of 2010**					
	No change in place of taxation and reverse charge mechanism as of 2010, in all countries					

* Where the supplier is not established or does not have a fixed establishment for VAT in the country where the real estate is located, while the recipient of those services is registered for VAT and filing regular VAT returns in this country. In Belgium real estate is sometimes held by either a foreign entity directly or a real estate company (not filing regular VAT returns), reverse charge will not systematically apply.

** Where the supplier is not established or does not have a fixed establishment for VAT in the country where the real estate is located, while the recipient of those services is established in this country

*** Sensu stricto, not including:
- management of special investment funds
- property management

Impact of AIFMD on Luxembourg real estate vehicles

This article provides an update on the latest developments around the draft EU Alternative Investment Fund Managers Directive (AIFMD) and analyses its impact on real estate funds in Luxembourg. At this stage, it is difficult to assess the exact consequences of the Directive for managers of real estate funds and their business operations, due to multiple uncertainties in the way the draft text is evolving.

Latest developments and timeframe

The initial draft of the Directive produced by the European Commission on 29 April 2009 has become subject to extensive discussion at the European Commission, Parliament and Council of Ministers as the legislative process develops. The European Parliament's ECON (Committee on Economic and Monetary Affairs) issued a Rapporteur's draft report (the 'Parliamentary Draft') in November 2009. The Swedish Presidency has issued its final compromise position report on the Directive on 15 December 2009 (the 'Swedish Compromise'). Spain, which took over the rotating presidency from Sweden, issued in January 2010 its list of areas of contention, based on the Swedish report. These three current drafts of the Directive vary significantly regarding some of the core issues, although there are also areas of convergence. The European Parliament, the Council of Ministers and the European Commission will need to find a compromise acceptable to all.

European finance ministers have backed the AIFMD in May, bringing regulation for the hedge fund industry a step closer. Finance ministers will now engage in discussions with the European Parliament. This comes after the Parliament in May agreed on a common position on the AIFM Directive, meaning negotiations will now start in an effort to get the Directive adopted after the summer break.

The proposals agreed by ministers and parliamentarians, however, have significant differences.

The parliamentary view is less restrictive and limiting with regards to, e.g., third-country issues and depository liabilities, than the Council view. The next few months continue to be crucial to define the parameters of those discussions as the Council and the European Parliament try to lock down their respective positions to give themselves robust platforms for the negotiations. A second reading and the plenary vote may be delayed to late autumn in case of significant differences of view between the Presidency and the Parliament. Afterwards the Directive will need to be transcribed into national law during a two year period. The AIFMD is expected to become effective from summer 2012.

The key areas of the Directive, including the most controversial issues and their impact on real estate funds in Luxembourg, are summarised below.

Scope

All drafts seek to regulate the managers of alternative investment funds, and no distinctions or specific exclusions are made for real estate funds. Regardless of which draft is ultimately implemented, it is highly likely that real estate funds in Luxembourg, both regulated and unregulated, will be subject to a more comprehensive regulatory regime than currently. This means that any fund manager that manages or markets an FCP or SICAV already regulated under the 2007 SIF regime – or a SICAR under the 2004 regime – is within the scope of the draft Directive. Furthermore, even "Part II" retail-type funds – those not qualifying for the UCITS regime – are caught. The only escape would be for a fund manager that is already a management company or investment company of a UCITS FCP, SICAV or other fund with UCITS status. Currently these non-UCITS regulated fund vehicles are subject to regulation of a lighter type. Unregulated non-Luxembourg fund entities, which often have holding and financing vehicles located in Luxembourg, are expected to be heavily impacted by the Directive. At present, there is generally little or no regulation of these types of real estate vehicles.

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Impact of AIFMD on Luxembourg real estate vehicles

There are several controversial areas related to the scope of the Directive. The drafts, for instance, disagree on the exclusion of managers only involved with funds with aggregate assets below de minimis limits, and exclusion of banks and insurers that invest in alternatives, including real estate. None of the drafts yet give a clear definition of the manager in order to determine which entities are out of scope.

Impact of prior authorisation and notification procedure

All three drafts support an onshore passport for authorised alternative investment funds and their managers, so that funds can be distributed by means of a straightforward notification procedure. The question is whether this procedure will effectively simplify the process of creating new cross-border funds.

Impact of conduct of business operations

The drafts all impose extensive internal systems and control requirements. Real estate fund managers will have to implement documented internal systems for their processes concerning risk management / portfolio management separation, liquidity (stress testing), conflict of interest management, due diligence, etc. The implementation of

the Directive will in many cases hence result in additional costs related to the implementation and documentation of these controls, having an impact particularly on smaller operators.

Impact of reporting requirements

The drafts require that important information will need to be reported regularly to regulators, to allow member states to intervene if necessary. The drafts vary in the extent to which information about holding interests will need to be reported. These disclosures may result in substantial additional reporting for real estate funds. In addition, the Directive also imposes a tighter annual accounts preparation timetable. The four-month deadline after the year end is in line with the Part II UCI deadline but not with the six-month deadline for a SIF or SICAR. There is expected to be additional resourcing pressure in order to meet this shorter deadline.

Impact of capital requirements

The drafts introduce regulatory capital requirements for fund managers. There are no capital requirements for funds themselves. The requirement of the Directive for the fund manager is to have a minimum of €125,000 plus 0.02% of any excess of assets under management over €250 million. This should have a limited impact for managers of Luxembourg real estate funds. The Management Company of any FCP is already required to have a minimum capital of €125,000.

Issues related to limitations of leverage

The drafts introduce liquidity management obligations. Real estate funds systematically employing high leverage, with at least a 50% debt to equity ratio, should expect to be subject to significant additional disclosure requirements to regulators and investors. In addition, it is foreseen that the governmental bodies may, in crisis situations, set limits on leverage levels employed by the fund manager. It is not clear yet how leverage is calculated, as liabilities and equity may be defined differently depending on the GAAP used (IFRS or Lux GAAP). If limitations are set, there would be consequences for the structuring of real estate funds from a tax perspective, and returns and profitability of investment products based on real estate funds would also be affected.

"Valuator" issues

The initial draft of the Directive required each fund manager to involve an independent EU "valuator". In subsequent drafts, the independence and liability of the valuator have been debated. Independent valuators are already required by law for Part II UCIs but not for a SIF or SICAR. In practice,

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Impact of AIFMD on Luxembourg real estate vehicles

however, regulated funds involve independent valuators on a contractual basis. There might also be independence issues if the valuator is the same as the depository. The initial draft required the valuation of shares or units of a fund not only once a year but each time shares are issued or redeemed. This would impose heavier obligations on the managers of real estate funds. Common current practice in Luxembourg is to use independent valuators only for the annual valuations.

Depository issues

There is a consensus that depository duties and responsibilities will be increased. However, there is an ongoing, lively, and politically charged debate on the liability of the depositories, and on what type of entities may act as depositories. The impact of the Directive will probably be less for Luxembourg regulated funds, as they already have to appoint an EU regulated credit institution as a depository. For unregulated funds, this will be a major and entirely new organisational obligation. In the event that the Directive ends up providing that the depository will be responsible for all assets and any consequential losses to investors, a greatly increased cost burden due to extra responsibilities will materialise.

Issues related to delegation

This area is heavily discussed in the drafts. In accordance with the initial Commission draft, fund managers may delegate functions, such as administration or portfolio and risk management, only to EU authorised service providers. Delegation to non-EU service providers would only be possible if these are regulated and there is a cooperation agreement between the country of domicile and the EU. The Council draft allows the delegating of portfolio management functions to offshore entities provided certain less onerous conditions regarding supervision are met. The Parliamentary Draft is close to the Commission draft but adds bars against delegating risk and liquidity management to non-AIFMD firms. Depending on the outcome of the discussions, this may lead to a need for substantial reorganisation of the business model now in place.

Issues related to the non-EU dimension

The “third country” dimension is another controversial area. Initially, it had been proposed that the EU marketing activities of non-EU real estate fund managers would be shut down for a transition period of three years. Under the Commission draft such fund managers would only then be allowed to come back if their country meets the regulatory equivalence obligation and compliance with the tax exchange information regime of the EU. This may lead to the establishment of operations of some of these real estate fund managers in the EU. Non-EU funds could be marketed during a three-year transitional period, but afterwards would need to be domiciled in a jurisdiction with a tax regime allowing exchange of information with the EU.

In their turn, both the Council and Parliamentary drafts abandon the requirement to have an equivalent regulation of funds, their managers and service providers, although the Parliamentary draft is still envisaging some equivalence with respect to third country depositories. Both of these later drafts also appear to accept the marketing of off-shore funds in the EU under existing private placement regimes, although the Commission is thought to remain opposed to this.

One of the possible scenarios may be that non-EU funds increasingly look to be re-domiciled in the EU. The track record of Luxembourg as a country with pragmatic yet effective and efficient regulation may enhance its standing as a choice of location for real estate fund management and marketing activity. On the other hand, it may yet happen that it will be preferable to locate funds offshore and profit from “regulatory arbitrage” by using existing private placement regimes if these are not proscribed by the final Directive.

Remuneration

Although not foreseen in the original Commission draft, it is expected that the final regulation will include provisions dealing with remuneration. The exact form of the remuneration regime is still controversial, and yet to be determined.

Conclusion

PricewaterhouseCoopers believes that the AIFM Directive is potentially the single most important regulatory development to happen to those involved in the European alternatives sector. We urge our clients to follow these developments very carefully.

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The future of real estate financing in the Benelux

The European real estate market boomed during 2001-2008. Cheap and proliferate funding led to an historical number of transactions and a bubble in asset valuation. During these years a record amount of debt was issued while lenders were accepting ever lower margins and ever higher loan-to-values (LTV) at (often) lenient loan terms.

Real estate markets after the boom

Following the credit crisis, the number of real estate transactions has fallen dramatically. For the time being this number is likely to stay lower than during the boom years as investors are waiting as a result of uncertainty around valuations and there being less liquidity in the system as a whole. Rising yields have led to price deflation while both falling market rents and rising vacancy rates have put downward pressure on rental income.

Transactions that do take place are often in the "A" segment rather than the "B" or "C" segment. In these more risky segments the blow is yet to come, as owners and banks are still wary of taking their losses. Transactions are dominated by cash rich private investors and equity financed real estate funds, as equity is often a large slice of funding in current transactions. Recovery of the Benelux real estate market is not anticipated before the end of 2010. When it does come it will be in different phases for different types and segments.

Financing conditions

The dramatic fall in the amount of liquidity means that real estate companies are chasing less and in many cases more expensive credit. While banks are charging higher arrangement fees and risk premiums, there is also pressure on lending criteria with lower LTV ratios, a strong focus on covenants and a focus on the underlying collateral. Lastly, while a couple of years ago balloon payments were the norm, now increasingly lenders are seeking early amortisation. All these elements affect real estate returns, making early planning imperative in order to secure liquidity sources.
For the near future credit conditions will continue to be less benign than the last 10 years. The source of easy credit has dried up and risk premiums have increased. Increased Basel II capital requirements in conjunction with the uncertainty around the direction of securitisation leave banks hesitant to commit their balance sheets to real estate investments. Moreover banks are aiming to lower their overall exposure to real estate lending, especially in project finance.

Breaching of covenants and distress

To date we have seen a remarkable lack of visible distress in the Benelux. One reason is that there has been a marked difference in lending in Anglo-Saxon countries and mainland Europe. Not only was the total amount of transactions in the boom lower than in the UK and US, but these transactions were also financed more conservatively with lower loan to value (LTV) ratios. Also historically European lending has been dominated by on-balance-sheet debt (i.e. banks) rather than off balance sheet debt (i.e. CMBS's).

Other reasons for this lack of visible distress are that banks have been propped up with government funding and low interest rates. Moreover banks have been holding on to their distressed portfolios on the one hand to ride out the storm and support creditors in dire times, and on the other hand to avoid the negative publicity associated with bankruptcy procedures. Also they are eager to avoid writing off debt. Some time

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The future of real estate financing in the Benelux

in the future interest rates will go up. For some real estate sectors and segments the blow may then come. As we are now looking at the same amount of real estate assets but with significantly less value in addition to lower target LTV ratios, further deleveraging will be required.

In some cases investments will need restructuring. As collateral values fall and LTV covenants are breached, lenders will remain averse to foreclosing in response to these breaches. Provided that interest payments are made, banks are generally cooperative, but are also likely to amend loan terms.

However downward pressure on market rents and increasing vacancies may lead to more breaches in interest coverage ratio (ICR) and debt service cover ratio (DSCR). Also, while interest only (IO) loans and loans with a low amortisation have a lower probability of default on DCSR ratios during the life time of the loan, at maturity there is a significantly higher likelihood as the bullet repayment will depend on either a successful sale or a successful refinancing. Both of these are hard to achieve in the current market. Project developers are having particularly hard times as letting is currently difficult and/or investors have not materialised. Whatever the underlying reason, all in all when an investment's ability to generate enough cash to service the debt is at risk, lenders might take a different approach and stakeholders will seek to either restructure or liquidate that investment. With banks anxious to avoid plain vanilla debt for equity swaps, there are also other strategies in the "pretend-and-extend" to "file for bankruptcy" continuum that banks can pursue with respect to non-performing loans. A controlled wind down may be more optimal, as realised transaction prices may be higher than forced sales.

Banks will the also fully benefit from any potential rises in value through turnaround asset management and/or market recovery.

It is helpful to keep in mind that buyers of distressed debt may not have the same investment objectives as banks. The purpose of their investment may be to retrieve the collateral, effectively buying the underlying at a discount.

Refinancing in the Benelux

Real estate companies' ability to refinance real estate related investments will prove to be of particular importance to those who have made investments over the last five years with short-to-medium term acquisition finance. The record number of transactions during the boom years coupled with high leverage means that an historical but unknown amount of debt will be maturing in the coming years which will lead to a "refinancing bubble". These maturities are probably sufficient to lower the overall exposure of banks to real estate lending, however it is worrisome who is going to fill the shortfall in demand for and supply of debt. There are some new lenders currently entering the market such as the highly regulated German Pfandbriefe or covered bonds.

Refinancing will prove difficult and often the only option available (for both borrowers and lenders) will be the rolling over of existing facilities, be it at new (more stringent) conditions and higher margins. Renegotiation on these existing facilities will prove to be tough. Though only a fraction of the total debt outstanding in the Benelux, the refinancing of CMBS's could prove to be even more problematic, as a straightforward roll over with a multitude of creditors and lenders will be cumbersome.

New initiatives

The severe contraction in debt availability together with the refinancing of past short-to-medium term acquisition debt will limit the amount of cash available for new initiatives. With banks remaining more cautious in lending and keen to lower their overall exposure to real estate lending, real estate investors will need to get used to lower overall levels of debt. Also real estate investors may need to seek alternative sources of liquidity. The bottom line is that Investors will no longer be able to rely on financial engineering alone to boost their returns.

However there is activity in the debt market with banks now focussing on core geographies, on existing clients and on club deals. Lenders are looking at prime properties with stable income producing cash flows. In order to get credit, borrowers will need robust business plans that take into account the risks from the lenders point of view. For project developers it will remain a challenge to find sources of liquidity to finance new initiatives.

In the near future the balance of power will continue to tilt towards the sources of liquidity i.e. (new) equity participants, banks and alternative forms of credit. All in all, this means that the funding of new investment initiatives has more than ever become a strategic question.

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Model for valuation of investment properties under construction

Present practice

Common practice to determine the feasibility of a development project is the use of a static model. Such a model is used to determine the maximum investment regarding the development; this can be the maximum price for the plot of land or for property which is to be redeveloped. The maximum investment or so called residual value equals the estimated sales price minus the expected remaining costs of the development project. With respect to profit and risk it is common to use a predetermined percentage of revenue before deduction of development expenses. The residual then equals the maximum investment of the property under development in its current condition. The advantage of this approach is that it offers a quick insight into the feasibility of the project.

When a development project has already commenced and market conditions change, the static approach has the disadvantage that it doesn't give insight into the real time market value with respect to that particular development phase.

Continued

Model for valuation of investment properties under construction

Residual value: Expected Market Value minus development costs				
				market situation 1
Market value, after completion development				€ 40 million
Development costs, as January 1st, 2010:				
	Construction costs,			
	Advisors costs and fees,			
	Additional and selling costs,			
	Rent during construction period.	subtotal 1	- / -	€ 27 million
	Profit and risk premium developer.	subtotal 2	- / -	€ 4 million
Market value development project as 1-1-2010				**€ 9 million**

Figure 1: Example of static, nominal approach of a valuation development project

In stable or increasing markets this will most likely not provide a problem. Under current market conditions however, understanding of the market value and the remaining risks of the development project is crucial.

For instance, in figure 2 the market value of the project after completion drops by 10%. Subsequently the market value of the development project drops more than 40% to €5 million. The example in figure 2 fails to identify which risks influence the development process and which risks are subject to change during time. From a risk management point of view, the perception of risk regarding the development project is not only of concern to the owner/developer but also to the parties financing the project.

A more dynamic approach, with estimated cash flows and a discount for time and risk premium is shown in figure 3.

The challenge is to determine a discount rate that reflects the time value of money and the risk premium of the project cash flows. In addition to the time value of money, the discount rate must also reflect the risk of the estimated cash flows. A solution in absence of market evidence is the use of a calculation model in accordance with statistical theories (e.g. Monte Carlo simulation).
As an alternative, it is also possible to use a pragmatic approach. Such an approach is based on the following assumptions:

Valuation principles

Starting point is a fully let investment property after completion of the development. The profit of the development project equals the sales revenue of the completed project minus all the costs associated with realization of the project.
During the project the risks have to be identified. This means that certain risks, relevant in earlier phases of the development, could possibly have disappeared. The most important risk factors of property development are:

- Cost related risks: excess acquisition-, construction-, interest and marketing costs;
- Time related risks: delays from environmental and ecological planning procedures, objections, labour disputes;
- Market related risk: changing market conditions, interest rates, vacancy rates, incentives.

The valuation per phase is based on the relevant cash flows, an estimated time value of money and the remaining project

Residual value: Expected Market Value minus development costs						
				market situation 1	market situation 2 (-/- 10%)	difference
Market value, after completion development				€ 40 million	€ 36 million	10%
Development costs, as January 1st, 2010:						
	Construction costs,					
	Advisors costs and fees,					
	Additional and selling costs,					
	Rent during construction period.	subtotal 1	- / -	€ 27 million	€ 27 million	0%
	Profit and risk premium developer.	subtotal 2	- / -	€ 4 million	€ 4 million	0%
Market value development project as 1-1-2010				**€ 9 million**	**€ 5 million**	**44%**

Figure 2: Example of static, nominal approach of a valuation development project

Continued

Model for valuation of investment properties under construction

risks. Last but not least the valuation is based on the interpretation of the basic valuation principles and assumptions.

Alternative pragmatic model

This dynamic approach uses a discounted cash flow model. The projected cash flows are specified as:

- Estimated revenue (market value) of the finalized project at the end of the project period;
- Estimated costs as of the present situation (see also figure 3).

Discount rate (deducted from simular transactions of new standing investments)						7,00%
Additional risk premium development						
Risk premium in points	0	50	100	150	200	
Risk premium gradation	very low	low	average	high	very high	total
delay as a result of legal objections				x		1,50%
construction permit		x				0,50%
environmental permit					x	2,00%
incidental expenditures			x			1,00%
letting in advance			x			1,00%
fit in existing environment	x					0,00%
investment financing				x		1,50%
Additional risk premium specific development risks						7,50%
Discount rate for the development project, as of 1-1-2010						14,50%

Figure 4: Example of discount rate in a dynamic approach of a valuation of a development project

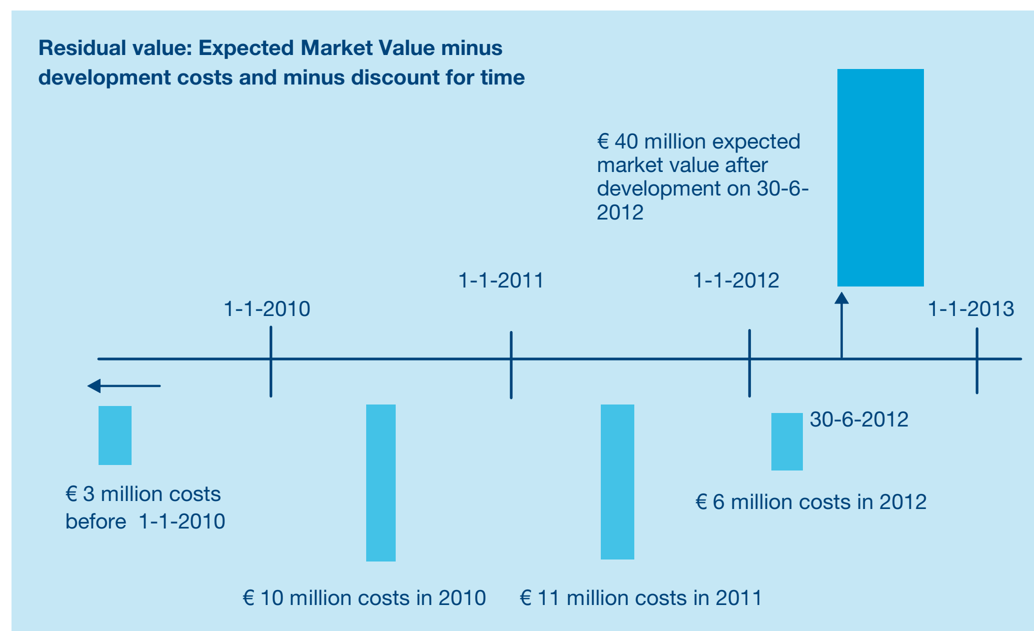

Figure 3: Example of cash flows in a dynamic approach

The discount rate is derived from transactions of similar new standing investments (when the development project is completed and totally let).
In the dynamic model this is also the minimum discount rate used during the development period of the project in case there are no additional risks.
The additional risk premium in the development period is estimated for specific project risks per development phase. The risk premium is expressed in time (delay) and money and eventually only in money.
During different phases of the development project, deviations can be determined by outlaying the risk factors. The sensitivity of the specific risk factor can be determined based on 'what if' questions related to particular circumstances. Deviations can be estimated for different scenarios: worst case (very high), best case (very low) and probable case (average).

In the case of zero risk with respect to the development project, the discount rate will be equal to the discount rate at project completion, which is 7% (see figure 4). In the dynamic approach, seven risks are specified and denoted in risk premiums ranging from 0 basis points (environmental fit) to 200 basis points (environmental licensing).
If the same cash flows are used in the dynamic model as in the static model, the

Continued

Dynamic approach			2010	2011	2012	30-6-2012
		nominal	-€ 10,0	-€ 11,0	-€ 6,0	€ 40,0
discount rate	14,5%	discounted	-€ 9,3	-€ 9,0	-€ 4,4	€ 28,5
1-1-2010						
Market value development project as is 1-1-2010						**€ 5,8**

Figure 5: Example of dynamic approach of a valuation development project

market value is assessed at €5.8 million based on a discount rate of 14.5% (see figure 5).

Static vs dynamic approach

In order to illustrate the difference between the static and the dynamic approach, the static example in figure 1 is used to determine which discount rate reflects the result of €9 million in the dynamic approach.
With the dynamic approach the discount rate turns out to be 7% (see figure 6). The static approach apparently assumes that the development project has the same risk as when the project is completed (fully let standing investment). In other words, the static, nominal valuation approach, assumes the additional risk premium appears to be a not very plausible zero percent.

The current economic conditions provide additional incentive to use a dynamic valuation model which accounts for the most commonly anticipated risks.

Dynamic approach			2010	2011	2012	30-6-2012
		nominal	-€ 10,0	-€ 11,0	-€ 6,0	€ 40,0
discount rate	14,5%	discounted	-€ 9,3	-€ 9,0	-€ 4,4	€ 28,5
1-1-2010						
Market value development project as is 1-1-2010						**€ 5,8**

Dynamic approach			2010	2011	2012	30-6-2012
		nominal	-€ 10,0	-€ 11,0	-€ 6,0	€ 40,0
discount rate	7,0%	discounted	-€ 9,7	-€ 9,9	-€ 5,2	€ 33,8
1-1-2010						
Market value development project as is 1-1-2010						**€ 9,0**

Figure 6: Difference in valuations as a result of identified additional risk premium

Practical use

As a consequence of a change of direction under IFRS for property accounting, development properties (subject to IAS 40R when completed and let as an investment) need to be determined at fair value as of 1 January 2009. As of this date, valuations based on construction costs or a completion percentage are no longer common practice.
With current economic conditions, insight into the value, in addition to insight into cost, is perhaps vital:

- As extra information in the annual report: comparison between investment amounts in the property market value;
- For owners or stakeholders of distressed real estate;
- For financing companies, developers, asset companies, real estate companies and housing associations.

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Will the proposed lease accounting rules affect your business?

In March 2009 the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) issued the Discussion Paper 'Leases Preliminary Views'. This Discussion Paper proposes a new model that would significantly change the current lease accounting for lessees. It is expected that an exposure draft to be issued in June 2010 and a final standard will be available in 2011, expected to be applicable for financial statements as of 2013. This article will examine the most important consequences for tenants (lessees) and the owner of investment property (lessors).

Lessee accounting: to a 'right-of-use' concept

The Discussion Paper introduces the 'right of use' concept which replaces the existing 'risk and reward' concept. The new concept will result in the recognition of all the rights and obligations arising from rental contracts on the balance sheet of the lessee as an asset and liability. As a result, the distinction between operating lease and finance lease will be eliminated. All rental contracts, including those that are now accounted for as off-balance obligations, will be accounted for as on-balance. Approximately half of the respondents to the discussion paper supported the overall principles and objectives set out in the discussion paper and approximately one-third of the respondents did not support the preliminary views made in the Discussion Paper.

Most rental contracts agreed between the owners and tenants contain an optional period. Optional periods under the existing standard, IAS 17, are considered part of the lease term if at the lease inception it is 'reasonably certain' that the right to renew the lease will be exercised. The Discussion Paper proposes a 'most likely lease term' approach. The tenant must consider all contractual and non-contractual financial factors and non-financial business factors in determining the most likely lease term. The lessee's intentions and past practice would not be considered in determining the lease term. It is expected that the 'most likely lease term' will lead to a longer lease term than the criteria 'reasonably certain'.

These factors must also be considered, in the initial measurement, when a rental contract contains an option to purchase the investment property on or after a specific date. The obligation may include the exercise price of the option if the most likely outcome is that the tenant will exercise the option to purchase the investment property.

The Discussion Paper proposes that the tenant would be required to reassess their estimates on the option periods and purchase options for each reporting period. However the IASB thinks that a detailed examination of every lease is not required unless there has been a change in facts of circumstances that would

Continued

Will the proposed lease accounting rules affect your business?

indicate that the lease term may need to be revised.

The initial measurement of the rental contract will be at cost, defined as the present value of the future lease payments discounted using the tenants' incremental borrowing rate. The asset will than be amortized using the straight-line method and the obligation will be accounted for using an effective interest rate method.

Lessee accounting: consequences for the tenant

The proposed changes in lease accounting for lessees will have a significant financial and business impact. The tenants must consider:

- That balance sheet totals will increase with the recognized asset and liability, increasing the companies leverage and decreasing its solvability;
- That whereas they previously accounted for rental costs in the income statement, they will now show depreciations and interest charges, therefore increasing the companies EBITDA.
- That the obligations' subsequent measurement is amortized cost using the effective interest rate, the costs in the beginning of the lease period will be relatively higher compared to the actual paid rent per year.

These changes might impact the companies' strategy towards the decision on renting or buying investment property, sale and lease back constructions, finance facilities and existing covenants such as loan to value ratio's and interest coverage ratios.

Lessor accounting: tentatively decided to scope out Investment Property

In the Discussion Paper, the IASB and FASB consider two approaches that could apply for lessors when using the 'right of use' concept. In the first approach ('derecognition approach') the asset is derecognized from the balance sheet and a receivable for the right to receive rental income and a residual value are recognized. In the second approach ('performance obligation approach') a lease contract represents a new right. The asset will stay on balance in the lessors financial statements and a separate asset is recorded for the right to receive rental income and a liability is recorded for the obligation to provide use of the asset to the tenant.

It is worthwhile to know that the IASB tentatively decided in January 2010 to remove lessors of Investment Property measured at fair value from the new lessor accounting proposals. The new lessor accounting requirements would only be required if the lessor measures its investment properties at cost. This will significantly reduce the impact of the new lease accounting rules for the financial statements of the property investors (measured at fair value) and will likely lead – if not already done so by most companies – to more fair value accounting of Investment Property.

Lessors must however not overlook the consequences of the lease accounting rules for their tenants and the way that this will affect their own business. It is unclear yet what the impact will be on the tenants' behavior. Will they look for shorter lease terms, more break clauses or different lease incentives? And if so, will this affect the lessors' stable cash flow and value of its property?

We will keep you informed on these important issues in next editions of our Benelux Real Estate Insight.

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Tax update: Belgium

Hereafter, we briefly outline some recent changes to the Belgian dividends received and notional interest deduction rules, new reporting rules for payments to tax havens and new VAT rules in respect of the supply of land together with a new building, which are of importance for the real estate industry.

Corporate tax

- **Dividends received deduction:** Belgian tax-resident companies (or Belgian branches) can deduct 95% of dividends received from qualifying holdings from their net taxable income (this is the so-called dividends received deduction, hereafter 'DRD'). The old conditions were that the company (or branch) had to have held or committed to maintaining a shareholding of at least 10% or having a minimum acquisition value of €1,200,000 in the subsidiary for at least one year.

  As of 1 January 2010, the minimum acquisition value has been raised from €1,200,000 to €2,500,000.

  In addition, under previous Belgian tax law, any 'excess' DRD in a given tax year (i.e. that could not be used in the year in which it arose due to a lack of net taxable income to offset it against) could in principle not be carried forward and was thus forfeited. The ECJ judged however that this rule was in breach of the EU Parent-Subsidiary Directive.

  Belgian tax law has now been changed so that any unused portion of the DRD from dividends received from an EU subsidiary as defined in the Parent-Subsidiary Directive can be carried forward to future tax years. The same should apply to Belgian and non-EU dividends in accordance with the October 2009 practice note.

- **Notional interest deduction ('NID'):** Belgian companies (and Belgian branches) can claim tax relief for their cost of capital by deducting notional (deemed) interest, which is calculated on their adjusted accounting net equity.

  For budgetary purposes, the NID rate for tax years 2011 and 2012 (i.e., financial years ending respectively as from 31 December 2010 and 2011) has been capped at 3.8% (4.3% for SMEs).

- **Payments made to tax havens:** Starting 1 January 2010, companies subject to Belgian corporate income tax or Belgian non-resident corporate income tax that make direct or indirect payments to recipients established in tax havens are obliged to declare them if they exceed €100,000 during the tax year. The reporting has to be made on a special form to be enclosed to the tax return.

  A tax haven is defined as: (i) a jurisdiction regarded by the OECD as not being cooperative concerning transparency and international exchange of information, or (ii) a jurisdiction where the nominal corporate tax rate is less than 10%. In the event of non-reporting, the payments will be disallowed for corporate income tax purposes.

VAT

- VAT on land: As from 1 January 2011, the supply of land that belongs to a new building or part of a new building will be submitted to VAT in so far as the supply of the building itself is subject to VAT. In this respect, the Belgian VAT Code has been aligned with EU VAT jurisprudence. This rule allows recovery of input VAT on costs incurred in relation to land (e.g. soil sanitation costs).

- **Concessions:** As of 16 August 2009, a new article has been implemented in the Belgian VAT Code according to which the putting at the disposal of goods immovable by nature in the framework of the operation of ports, navigable waterways and airports is subject to VAT.

Tax update – Luxembourg

Corporate Income Tax 2010

In July 2009, the Luxembourg government announced it would make no changes to the Luxembourg corporate tax rate for the year 2010. As part of its longer term plan, the government had reduced the effective corporate tax rate from 29.63% to 28.59% in the year 2009 and is still committed to gradually reduce it to 25.5% in the coming years.

Islamic Finance Circular

On 12 January 2010, the Luxembourg tax authorities issued their first circular on Islamic finance providing guidance on the Luxembourg direct tax treatment of some of the common Shariah-compliant financial instruments. The brief circular is of particular relevance to the real estate sector as it has also recognized the predominant Islamic finance instruments used by this sector.

The circular addresses the following points:

- Brief description of the main **Shariah** principles and Islamic Finance instruments (i.e., **Murabaha, Mudaraba, Musharaka, Ijara, Ijara wa Iqtina Sukuk** ,and **Istinah**), and
- Guidance on the Luxembourg direct tax treatment applicable to Murabaha and Sukuk instruments.

The circular explicitly excludes from its scope Luxembourg mutual funds making investments in Islamic assets.

Murabaha (forward sale)

From a Luxembourg tax perspective, the circular mentions that the profit earned on Murabaha instruments may be spread and taxed linearly (at the level of seller providing the financing) over the life of the contract, irrespective of the actual payments made, under certain conditions (and notably provided that the profit is also recorded linearly from an accounting point of view). This position underlines the emphasis on economic substance of a Murabaha transaction.

Sukuk (asset backed securities)

The circular confirms that payments made under a Sukuk agreement are, in principle, treated as tax deductible and are not subject to dividend withholding tax. The circular thereby puts Sukuk agreements and conventional debt instruments on an equal footing for Luxembourg direct tax purposes.

The issuance of this circular aims at confirming the compatibility of the Luxembourg tax framework with Islamic Finance requirements and thereby emphasising that Luxembourg has the potential to become the location of choice for such investments.

The following Luxembourg Double Tax Treaties (DTT) became effective as from 1 January 2010:

- India
- United Arab Emirates
- Moldova
- Georgia
- Azerbaijan

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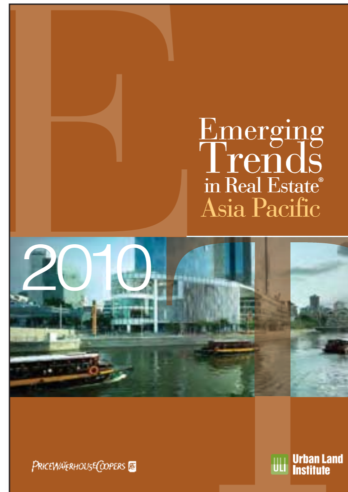

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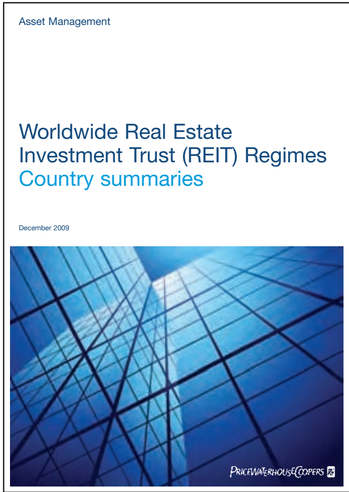

Worldwide REIT Regimes Country Summaries

European Real Estate Fund Regimes

Going Global 2010

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