

# Benelux real estate insights

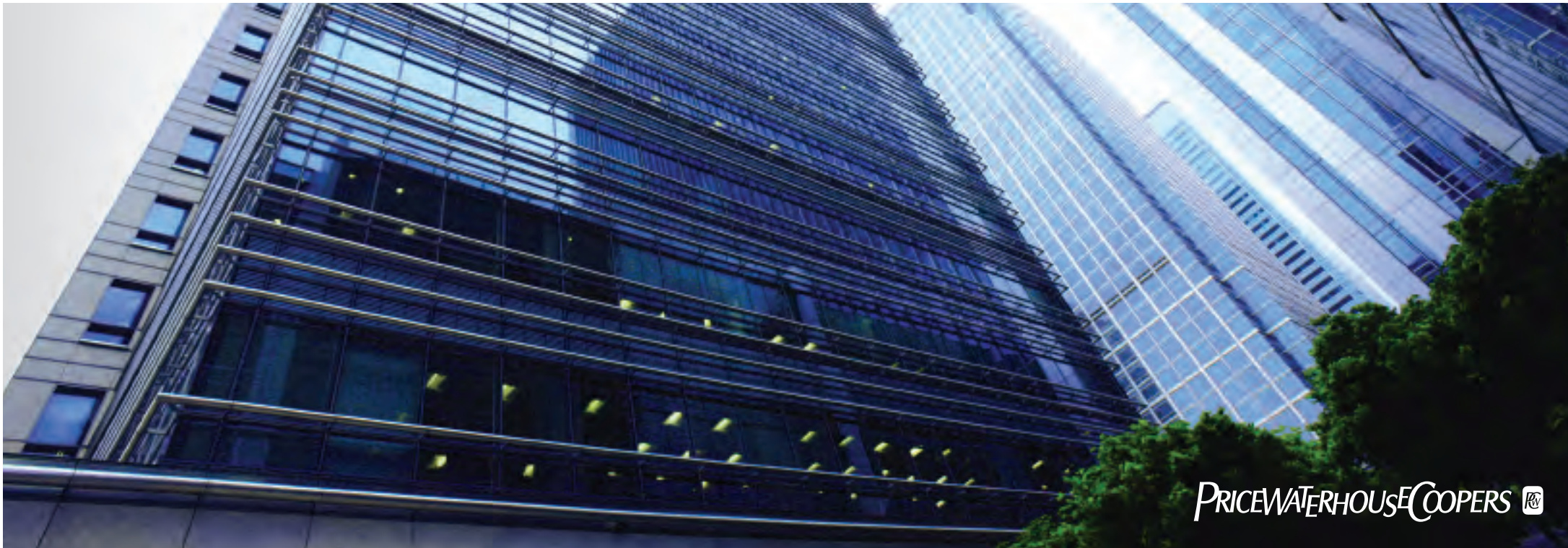
Issue 1 – November 2009

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## Introduction

**Welcome to the first issue of Benelux real estate insights, an e-publication co-produced by PricewaterhouseCoopers real estate teams in The Netherlands, Belgium and Luxembourg. Benelux real estate insights follows the successful launch of UK real estate insights last year.**

Through Benelux real estate Insights, our aim is to inform investors in the region on certain topics relevant to the real estate industry.

Following five consecutive quarters of contraction of the Euroland economy, commentators report on signals of stabilisation of economic output. Despite these recent positive signals there are still significant differences in economic performance of Euroland's member states. Following France and Germany reporting GDP growth again in the second quarter, the Belgian and the Netherlands are reporting GDP growth in the third quarter. Consumer and business confidence has clearly improved. While the economy is stabilising, the property sector is entering an occupier crisis partly caused by rising unemployment. Together with the limited liquidity and shortage of bank financing, this has caused many investors to stay out of the market. In the meantime yields have moved up significantly. The Dutch ROZ/IPD index reported a -3% annual return over the third quarter. At the same time brokers report an increase in investment volume compared to the first quarter and speculate about stabilising yields in the months to come.

In this issue of Benelux Real Estate Insights we present to you a number of subjects relevant to the real estate



industry in the Benelux region. Unfortunately, the market has been faced with serious fraud in large real estate organisations. How vulnerable is your organisation for fraud? From the regulatory field we will report on the draft AIFM directive published by the EU recently. When implemented this directive will have significant consequences for the real estate fund industry. Further we will report on recent

developments of the REIT regimes in Belgium and the Netherlands and a number of tax developments in the Benelux countries.

**Jeroen Elink Schuurman**  
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## Economic views – Euroland

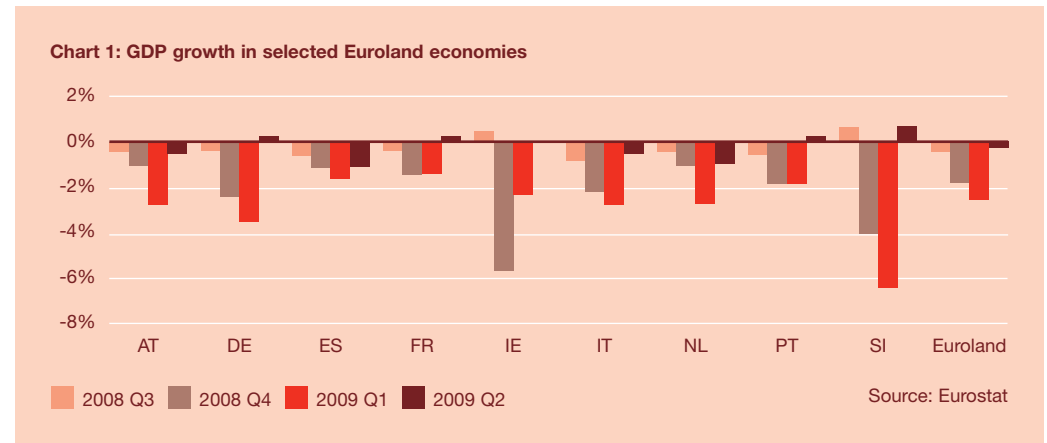
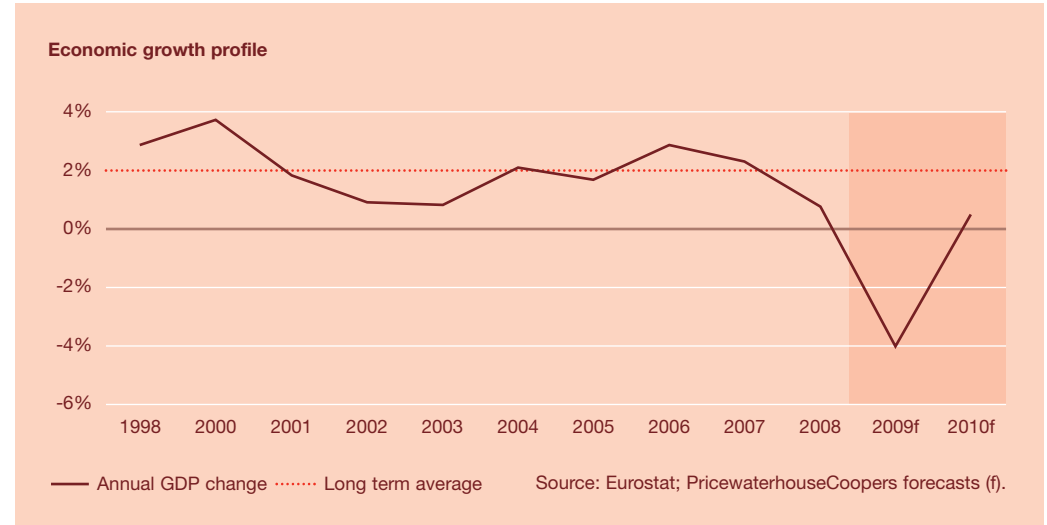
Economic output in Euroland appeared to stabilise in Q2 2009 but has now contracted for five consecutive quarters. Fiscal and monetary policy measures have boosted demand, but consumer spending and business investment remain weak.

### Euroland

The Euroland economy contracted for a fifth consecutive quarter in Q2 2009, with output 0.2% lower than in the previous quarter and 4.8% lower y-o-y. However, the pace of contraction has moderated considerably from the 2.4% q-o-q reduction in output recorded in Q1 (see Chart 1).

As might be expected within a regional economic bloc, the aggregate figures mask quite varied economic performance amongst Euroland’s sixteen member states. The economies of France, Germany, Portugal, and Slovenia all grew in the second quarter; economic output in Ireland was unchanged compared to the first quarter; and Spain, Italy, the Netherlands, and Finland all contracted further.

The near stabilisation in economic output has been accompanied by increasing consumer and business confidence, particularly in the services sector. The composite Euroland Economic Sentiment Indicator rose to 82.8 in September from 80.8 in August, and an historic low of 64.6 in March (see Chart 2 overleaf).



## Economic views – Euroland

Chart 2: Euroland composite economic sentiment index



However, consumers in Euroland still appear unwilling to spend. Retail sales volumes continue to decline – total retail trade in Euroland was 2.6% lower in August than a year earlier, compared to a 1.6% decline in the year to July. Sales of durable goods have contracted more rapidly than food sales.

The downward trend in spending was despite the current price deflation and evidence of positive wage growth – consumer prices across Euroland fell by 0.3% in the year to September whereas labour costs were 4% higher in Q2 2009 compared to a year earlier – which should boost consumer purchasing power, other things equal.

Weak consumer spending is likely to have been caused primarily by the high and rising unemployment rate, which will weigh heavily on household budgets and sentiment. The Euroland unemployment rate rose to 9.6% of the labour force in August, compared to 9.5% in July. Over 3.2 million jobs were lost in Euroland in the year to August. Spain, Ireland and Slovakia have the highest unemployment rates in Euroland at 18.9%, 12.5% and 11.6% of their labour forces respectively.

In addition, the published retail sales figures do not include vehicle auto sales, which have been boosted by car scrappage schemes in some Euroland economies. This may have resulted in some expenditure on durable goods



being diverted towards new car purchases. Overall consumer expenditure increased by a marginal 0.1% in Q2 2009 compared to the previous quarter, but was 4.8% lower year-on-year.

Weak consumer demand is at least partly responsible for continued investment restraint by businesses, with investment expenditure 11.4% lower in Q2 compared to a year earlier.

Industrial new orders increased for the second consecutive month in July, rising by 2.6% compared to June, suggesting that conditions in the sector have stabilised. However, forward looking surveys of business confidence in

Euroland suggest expectations of a continued mild contraction in the manufacturing sector, and expectations of an expansion in the services sector.

Export businesses continue to be affected by weak demand amongst some of Euroland's key trading partners. Demand is likely to be constrained further by the strength of the euro, which has appreciated against other major currencies in recent months. However, the pace of decline in export volumes slowed to 1.5% in Q2 2009 relative to the previous quarter, from 9.2% in Q1.

**Continued**

## Economic views – Euroland

### Outlook

Despite growth in the key Euroland economies of France and Germany in Q2, the outlook for the Euroland economy remains weak. We forecast a contraction of 4.1% in 2009 with only a modest recovery of 0.6% in 2010.

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### Euroland latest GDP forecasts

GDP (annual %change)	2008	2009f	2010f	Inflation (HICP %change, annual)	2008	2009f	2010f
Euroland	0.7	-4.1	0.6	Euroland	3.3	0.3	1.4
Austria	1.8	-3.8	0.0	Austria	3.2	0.3	1.1
Belgium	1.1	-3.4	0.1	Belgium	4.5	0.1	1.0
Finland	0.9	-5.7	0.5	Finland	3.9	1.6	1.3
France	0.4	-2.2	1.2	France	3.2	0.1	1.2
Germany	1.3	-5.0	1.3	Germany	2.8	0.3	1.0
Greece	2.9	-1.1	0.8	Greece	4.2	1.2	2.0
Ireland	-3.0	-7.9	-1.8	Ireland	3.1	-1.6	0.4
Italy	-1.0	-5.1	0.2	Italy	3.5	0.7	1.4
Netherlands	2.1	-4.2	0.3	Netherlands	2.2	0.9	0.9
Portugal	0.0	-3.4	0.1	Portugal	2.7	-0.7	0.9
Slovakia	6.4	-5.2	1.5	Slovakia	3.9	1.1	2.0
Slovenia	3.5	-6.2	0.5	Slovenia	5.6	0.7	1.9
Spain	1.2	-3.8	-0.7	Spain	4.1	-0.2	1.5

Source: Eurostat; PricewaterhouseCoopers forecasts (f)

### Euroland latest GDP forecasts

	2006	2007	2008	Share of 2008 world total
Population (millions)	322	324	325	4.94%
GDP, market rates (US\$ billions)	10,735	12,306	14,203	22.86%
GDP, PPP rates (US\$ billions)	9,976	10,524	10,873	15.67%
GDP per capita, market rates (US\$)	33,379	38,023	43,657	
GDP per capita, PPP rates (US\$)	31,018	32,516	33,423	

Source: International Monetary Fund

Key metrics updated regularly at [economics.pwc.com](http://economics.pwc.com)

## The day after tomorrow – a short perspective on the financial crisis

Whereas the unprecedented financial crisis of late 2008 revealed clear flaws in the banking system, the asset management sector showed itself to be considerably more robust. Assets under management did shrink, of course, and individual cases of malpractice arose, but the reputation of many firms did not suffer unduly. Nevertheless, the impact of the crisis on the sector is likely to be felt at a profound level and for a long time. Changes in regulations, investor preferences and changes within the industry itself will provide a range of opportunities as well as threats that no asset management firm can afford to ignore.



PricewaterhouseCoopers' point of view "The day after tomorrow" focuses on the nine key issues and imperatives for a new world in asset management, and provides a clear articulation of our view on what asset management businesses should consider given the unprecedented market conditions. In this article, we discuss three of those issues that are relevant for the real estate market.

### Business models are under stress

Real estate firms are accustomed to economic cycles. But rarely has a downturn hit so suddenly and with such force as in the second half of 2008. A combination of sharply falling markets and investor redemptions in the space of just a few months produced a reduction in assets managed.

Many businesses are still in survival mode and will examine ways of further reducing costs in the short-term to maintain profitability or contain losses. But they will also need to evaluate exactly what sustainable cost management means to them. Making indiscriminate cuts, cutting too deeply or not enough will be detrimental to the business model. Each firm will need to develop its own view and methods of implementing its view – unfortunately there is not a template for this in the current environment.

At the same time, those firms that are able to invest in key areas such as compliance, risk management and reporting infrastructure to cope with new, possibly draconian regulation, will derive a direct benefit. So investment, where possible, must be reallocated in a highly targeted way.

In some cases, real estate investors will postpone entry into new product areas and/or overseas markets. Although these markets may bring the possibility of the largest medium and long-term growth, survival will inevitably come before expansion.

A key variable cost – human resources – will remain a focus for some time to come and firms must decide which

**Continued**

## The day after tomorrow – a short perspective on the financial crisis

sections of their staff contribute directly to the bottom line and which do not. Where reduction of labour is challenging, reallocation of resources should, at the very least, be considered. Spending on marketing and sales, administration, advisers and consultants will be pared to the bare minimum and may only rise slowly over a period of several years.

The effect of lower revenues and pressure on profitability levels may lead some firms to look at the disposal of non-core funds or businesses, or change their focus from direct to indirect investments. As they have been less impacted by the crisis, independent fund managers and insurance companies could leverage these disposals to grow their asset base and enhance their skill sets.

### How will investors react in the post-crisis environment?

Institutional investors have great cause for grievance in the wake of the credit crisis, as many suffered sharp losses from banking products that were poorly understood by buyer and seller. Institutions are likely to seek safe havens in well-capitalised and well-run companies. Smaller investment managers, with insufficient infrastructure, are likely to struggle to attract significant assets from large institutions.

Institutional investors will increase their due diligence efforts and asset managers will need to better articulate risk and reward to investors. Larger real estate funds may be better equipped to meet demands on requests for information, transparency and risk management reporting than smaller competitors. All firms will need to bear in mind that less can be more. There is an inverse relationship between the quantum of data and its ability to be understood, and investors are increasingly aware of this.

There will be particular attention paid to counterparty and liquidity risk. Ensuring that assets are segregated on the balance sheet of the counterparty will be critical and asset managers should be aware of the sensitivities. At the same time, investors have suffered from limited liquidity in some of their investments. This will make them think twice about which asset classes and which asset managers to select.

Investors will also want to see more evidence of enhanced management of risk, in its broadest sense. The ability to explain how risk is managed and controlled is now as important to sceptical investors as information about specific risk measures relating to asset classes and portfolio construction. In the latter half of 2008, it became evident that scenario planning by some managers had failed; they either did not anticipate



or did not prepare for an extreme range of market conditions. Investors will now ask how well managers understand their own strategies, and asset management firms will need to be more persuasive than they have been in the past on this point if they are to attract and retain assets. Where investor scepticism remains – such as in illiquid or complex strategies where full transparency is difficult to provide – managers will

increasingly employ third-party assurance to introduce an independent view.

Allocations to equity investments are likely to increase as investors seek to rebalance their portfolios after a period of declining values in their equity allocations. However, the investment

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## The day after tomorrow – a short perspective on the financial crisis

strategies followed by many alternative products like real estate will be examined given their relatively poor performance during the crisis. Many alternative products were found to be correlated to other asset classes – particularly equities – bringing into question the rationale for investing in some of them.

### Deleveraging in the banking system will affect asset management

Banks have expanded their balance sheets rapidly in recent years without a simultaneous rise in core capital. They are now being compelled to redress this imbalance. As banks seek to rebuild their balance sheets they are likely to be ruthless in enforcing penalties on covenant breaches by companies they lend to.

This has a particular impact on asset managers. Although they are not highly leveraged at company level, they have a high natural gearing to markets, so in a downturn their earnings tend to be hit disproportionately. This leaves them exposed to potential breaches of covenant and other cash flow and balance sheet difficulties.

Asset Management

## The day after tomorrow

Continuing the PricewaterhouseCoopers perspective series on the global financial crisis



The biggest impact of deleveraging is on those funds which depend on debt to gain access to transactions and magnify successful investment strategies. Without access to affordable leverage with reasonable levels of collateral, their business models may struggle.

Since one of their unique selling points is access to plentiful debt and the extra levels of return this implies, their value to investors may decline. As a reflection, fee levels are already moderating and this trend may accelerate.

The weight of redemption requests has put pressure on some firms to raise the necessary cash to repay banks or investors. Investors may in the future only be willing to commit funds to vehicles with solid financial backing and access to ready cash. This could lead to a speeding up of the domination of the alternative investment funds sector – including private equity and real estate funds – by large, stable institutions.

For the complete report please visit [pwc.com/dayaftertomorrow](http://pwc.com/dayaftertomorrow)

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## Belgian and Dutch REIT going cross-border in the light of the European fundamental freedoms

Both the Dutch FBI (Fiscale Beleggingsinstelling) and the Belgian SICAFI (Société d'investissement Immobilière à Capital Fixe) are regulated real estate investment vehicles with special tax status. The FBI was introduced in 1969 and was the first REIT look-alike regime in Europe; the introduction of the Belgian REIT dates back from 1995. Over the years, each regime has experienced a number of changes.

REIT vehicles are typically subject to a number of restrictions in terms of permitted activities, gearing restrictions, shareholder and distribution requirements. In the enclosed table, you will find an overview of the main restrictions for the FBI and SICAFI respectively. You will see that these restrictions are comparable.

Restrictions	FBI	SICAFI
Permitted activities	Passive investments (no third party property development)	Real estate investments (no third party property development)
Risk diversification	No	Max 20% in same project (with exceptions)
Gearing restrictions	Loan to value of 60%	Loan to value of 65% (max 40% mortgaged loans) Interest cover ratio: 125%
Shareholder restrictions	Yes	No
Listing requirements	No	Yes (30% initial free float)
Distribution requirements	100% of its taxable profits (excluding capital gains to the extent that these are contributed to a reinvestment reserve)]	Minimum 80% of its net earnings (after net debt reduction) and excluding capital gains (provided reinvestment within 4 years)

The Belgian SICAFI regime is only available to listed vehicles and in principle also to unlisted subsidiaries of listed SICAFI, whereas in the Netherlands there are public and private FBI's, albeit subject to (different) shareholder restrictions.

Like most of the REIT regimes, taxes on the income generated via the FBI/SICAFI are levied at shareholder level and not at the level of the REIT vehicle itself. Whereas a Dutch FBI is subject to a corporate income tax rate of 0%, the Belgian SICAFI is subject to the standard corporate income tax rate of 33.99%,

albeit only on a notional tax basis (consisting of the disallowed expenses and the so-called abnormal or benevolent advantages received). As a consequence, there is virtually no income tax due on the rental income and dividend income received by the REIT vehicle. Due to the fiscal unity rules in the Netherlands, profits generated through subsidiaries of the FBI are in practice also exempt from tax. Belgium does not have tax grouping rules, but due to recent changes to the Belgian Income Tax Code, the special tax regime will become available to SICAFI

subsidiaries once some adjustments to the Royal Decree of 1995 providing for the regulatory framework will become effective.

The dividend distributions by the FBI/SICAFI to their shareholders trigger a withholding tax of 15%. Withholding taxes are reduced to zero in the event of distributions by a residential SICAFI and in case of distributions by the FBI to the extent of distributions out of its reinvestment reserve.

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## Belgian and Dutch REIT going cross-border in the light of the European fundamental freedoms



The Belgian SICAFI is not subject to any shareholder restrictions. In the Netherlands, different shareholder restrictions apply to public and private FBI's. FBI's whose shares are officially quoted on a stock exchange and FBI's holding a permit to issue shares to the public are considered to be a public FBI. No single entity who is subject to tax on

its profits may, together with related entities, own 45% or more of the shares in a public FBI and no individual may hold an interest of 25% or more. With respect to a private FBI, 75% or more of the total shares must be held by individuals, entities not subject to taxation on their profits and FBI's.

There are no specific restrictions applicable to foreign shareholders. In the event of foreign shareholders being resident in a treaty country and entitled to the treaty benefits, the 15% domestic withholding tax rate can possibly be further reduced. As the Belgian SICAFI is subject to Belgian corporate income tax, albeit on a limited taxable basis, it can be defended that the taxation condition in the Parent Subsidiary Directive is met and that subject to the company form and minimum shareholding requirements being met as well, the withholding tax in the hands of EU corporate investors can be reduced to zero.

There are no specific regulatory restrictions to the SICAFI/FBI to invest in foreign real estate assets. The question whether foreign REITS investing in Belgian/Dutch real estate are eligible for the special tax status is more problematic.

The Belgian SICAFI regime is subject to regulatory approval by the Belgian Banking, Finance and Assurance Commission and this regulatory approval is only available to public limited liability companies and partnerships limited by shares established under the laws of Belgium. Therefore, based on the current status of the legislation, a Dutch FBI

investing in Belgian real estate will not be eligible for the benefits of the Belgian SICAFI regime. The Belgian legal form requirement can certainly be challenged under EU law and a foreign REIT whose shares are offered on the Belgian market should not be refused to be recognised as a SICAFI, assuming all other regulatory conditions are met. So far, Dutch FBI's who have invested in Belgian real estate in the past have done so without applying for the SICAFI advantages or have set up a full scope Belgian SICAFI controlled by the REIT (and listed on Euronext Brussels).

The Dutch FBI regime has been modernised with effect from 1 August 2007. Since then, besides Dutch public companies, limited liability companies and mutual funds, the FBI regime is also open to certain non-Dutch entities including entities from EU Member States, provided that the entity has similar characteristics as a Dutch public company, limited liability company or mutual fund. Therefore, a SICAFI could in principle benefit from the zero corporate income tax on the real estate income generated in the Netherlands, provided that it can be considered as having similar characteristics.

**Continued**

## Belgian and Dutch REIT going cross-border in the light of the European fundamental freedoms

So far, the Dutch tax authorities have been very reluctant to grant the FBI status to foreign REIT companies, applying this comparability test indeed very restrictively. Based on the wording of the law Belgian SICAFI having direct real investments in the Netherlands should be able to apply the Dutch FBI regime provided that the SICAFI abides by the strictest regulatory restrictions applicable both in the Netherlands and Belgium. When comparing each of the criteria, one should take into account that the tax and accounting rules applicable to the FBI and SICAFI are not the same and therefore the calculation bases for these criteria differ (e.g. loan to value calculations). Furthermore and notwithstanding the above, it remains to be seen whether such a strict view adopted by the tax authorities can be upheld in the light of recent European jurisprudence, especially if it is clear that the investors of the SICAFI will be effectively taxed on the distribution of the Dutch real estate income.

A Belgian SICAFI can also invest in Dutch real estate indirectly through a Dutch vehicle qualifying as a FBI. In that case it is of great importance that SICAFI is a qualifying shareholder of FBI under the Dutch shareholder tests. This is the



case if SICAFI fulfils the conditions to qualify as an FBI. The dividends paid by the Dutch FBI to the Belgian SICAFI will however trigger 15% dividend withholding tax in the Netherlands (5% WHT in case of minimum 10% participation in accordance with the Belgian-Dutch double taxation treaty)

and such withholding tax is not creditable (refundable) in the hands of the Belgian SICAFI.

Considering the above it can be said that – based on tax laws and policies – there is still a fence around the existing REIT regimes forming a barrier for non-resident funds to invest in multiple

jurisdictions. The question is whether this situation can be upheld in the light of articles 43 and 56 of the EC Treaty. In any case, the Dutch FBI/Belgian SICAFI holding or considering real estate investments in Belgium/the Netherlands have every reason to call upon recent case law of the European Court of Justice to secure their tax status, where needed, through protective tax filings/claims. Surely, the recent Aberdeen case sheds light on the question whether the Dutch and Belgian regimes are in practise EU-proof. Also the complaints lodged by the European Commission against Italy for non compliance of its REIT-regime (SIIQ) and Estonia in respect of the real estate income received by the foreign funds are worth watching closely.

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## European Alternative Investment Fund Manager's (AIFM) Directive

The European Commission's draft Alternative Investment Funds Management Directive (Directive) that was released on 29 April 2009 has caused waves of consternation across the industry in Europe and further afield. Clearly, this autumn will determine the shape of the legislation that eventually comes into force. What this will be is, as yet, far from clear. But what is clear is that some form of legislation – impacting the alternative investment industry very broadly – will be introduced.



If enacted in its current form, the Directive will impose a comprehensive regulatory regime on the managers of all collective investment vehicles which are not qualifying UCITs, whether open or closed ended and whether or not listed, subject to a few minor exclusions. This could significantly increase the costs faced by real estate fund managers.

Below we give a quick introduction to some of the main aspects of the expected directive as well as our view on the potential impact for the real estate industry.

### Who falls under the scope of the Directive?

The Directive catches the managers of real estate funds as well as REITs, listed investment trusts and other forms of collective investment vehicle which have previously been outside the scope of financial services regulation. However, some Alternative Investment Fund Managers (AIFM) are excluded from the scope of the Directive because either they have limited assets under management or they are divisions of regulated institutions like banks, pension funds and insurance companies.

Fund managers established outside the EU will, after a transition period of three years, need to seek authorisation from a Member State in order to market shares or units in any alternative investment fund in the EU, subject to meeting certain stringent conditions which have been approved by the EU Commission. These conditions relate to prudential regulatory capital, systems and controls, risk management and reporting requirements.

# European Alternative Investment Fund Manager's (AIFM) Directive

## What are the core requirements of the expected Directive?

**Regulation:** AIFMs require authorisation from the home Member State regulator. AIFMs will be subject to operating conditions. They should amongst others display their operational activities, like arrangement for governance, risk management, liquidity management.

**Disclosure:** Report “regularly and periodically” to regulator and investors on various matters.

**Capital:** Minimal capital requirements will apply for AIFMs.

**Valuation:** (Independent) Regular valuation requirements for all AIFMs.

**Depository:** AIFM must ensure that each alternative investment fund appoints a depository for its assets. The exact restrictions and role of the depository are a major topic of discussion.

**Leverage:** Disclosure of systematic use of high degree of leverage.

## What might the impact be on the real estate industry?

Currently the real estate fund regulatory regime around Europe is broadly divided between relatively lightly regulated partnership regimes (e.g. the UK) and more heavily regulated regimes e.g. in Germany, Luxemburg and France. Investors have a choice as to what is most appropriate for them. The new regime will result in all AIFMs being heavily regulated with significant increased costs (authorisation, transparency, reporting requirements).

The Directive could accelerate a consolidation in the European fund management industry with the burden of regulation making the cost/benefits of managing smaller funds uneconomic.

EU registered banks, pension funds and insurance companies are potentially excluded from the Directive which could give them an advantage over private equity real estate fund managers.

A migration of Non EU AIFMs (offshore) to EU Jurisdictions (onshore) can be expected in the years following implementation. Jurisdictions which already have a good fund manager infrastructure in place, like Luxembourg, Ireland, the Netherlands or Switzerland, are expected to be most attractive.

As it is highly unlikely that the political approval of the Commission's proposals is reached before the end of 2009, the Directive will probably not come into force before 2012. However, if the draft Directive is implemented even substantially in the current form, then all funds and their managers that are affected by the Directive will need to recognise that the new regime will have a major effect on how they operate, and on their cost base.

From discussions with stakeholders, it is clear that there is a strong commitment by many in Brussels and elsewhere to ‘get this right’ and to ensure the European alternative investment industry is made safer but that the interests of European investors are not damaged in the process.

## Process

Recently, Sweden, which holds the EU Presidency until December 2009, released an issue note that focuses on key areas for further study and debate in the Council. Adhering to its facilitator role, the Swedish note puts forward various options for consideration without (often) stating its own preference. Although it is not clear what the outcome of the discussions in Council will be at this stage, it does appear that some of the more contentious issues will be considered fully. The Swedish

Presidency's transparent approach, in making this document public, demonstrates its desire to keep the wide group of stakeholders informed (as there can be no formal consultation with stakeholder groups at this stage in the legislative process).

## What is your contribution?

The co-decision makers – the Council and the European Parliament – are keen to engage with industry to develop workable solutions. As the first exchange of views in Parliament shows, there is a recognition that this legislation cannot be allowed to jeopardise European investors' access to global capital markets. It is still important for all parts of the industry to engage in the debate directly or through industry associations. And not just market participants themselves, the voice of institutional investors – such as the Association of British Insurers and a combination of Dutch pension funds and institutional investors which have spoken out recently – has a strong weight in the debate.

### **Serge de Lange**

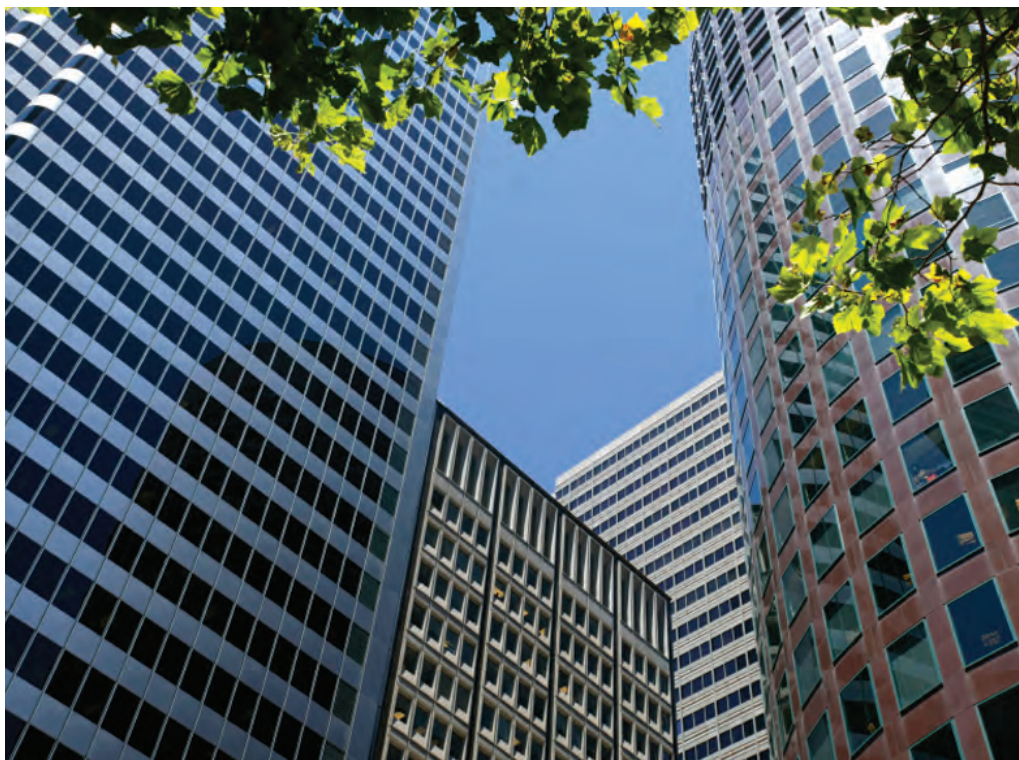
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## Fraud within Real Estate companies – lessons (to be) learned

The real estate sector in the Netherlands has been stirred up by several fraud cases over the last few years. Even though this is not something completely new within the real estate sector, it is notable that even large and well-known real estate companies have recently become subject to fraud.



Because of its specific characteristics, the real estate market is more sensitive to fraud. The real estate market is characterised as an inefficient and imperfect market making it non-transparent. real estate is heterogeneous and therefore comparing transaction prices is difficult. Combined with the fact that market evidence is not always available and individual properties have high unit prices, this makes the real

estate sector an attractive target for fraud.

**Have you ever considered the possibility that your own company may be subject to fraud?**

Motives for fraud, such as opportunity and pressure, together with a lack of internal control make companies extra vulnerable. Main causes of fraud lie in

(i) leadership (ii) people (iii) policies & strategy (iv) partnerships and resources and (v) processes<sup>1</sup>.

In this article, we will provide an insight into risks of fraud frequently seen and recommendations relating to internal control. Perhaps these guidelines may be of use for your company too.

**Have you implemented proper internal controls to cover the risks of fraud?**

### Leadership

Limited access to top management, procedures that are sometimes ignored by them and inappropriate use of power of attorney by (top) management encourage improper behaviour within all functional levels in an organisation. One of the most important preconditions to minimise fraud is the tone at the top of the company, including the company's culture on improper behaviour. Top management must show that integrity is of utmost importance and act accordingly. This can be supported by a code of conduct, corporate governance code and provisions for reporting alleged irregularities.

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# Fraud within Real Estate companies – lessons (to be) learned

## People

In the real estate sector, it regularly occurs that employees have their own (advisory) companies that provide real estate services, alongside their regular terms of employment. They can also hold a substantial interest in (e.g. shares) or have strong connections (e.g. relatives) with a company within the real estate sector. A risk for conflict of interests may occur when employees execute their duties for your company.

It is recommended to screen personnel on commencement of employment, when they switch within the organisation or get promoted to a next functional level. Screening should at least be performed through all publicly known sources and can additionally comprise obtaining references from third parties. As this research is complicated and confidential and often requires access to expensive databases, you may consider using a professional company to carry out this work for you. Furthermore, it is recommended to have employees register the interest they hold in companies and let them confirm their independence.

## Policies & strategy

**Have you ever checked what happened to the real estate in the period prior to your own purchase as well as a few months after you have sold it?**

When real estate you once owned has been sold again by the buyer to a third party within a short timeframe or even several times afterwards, the increase in price can be remarkable in this (limited) period of time. The company faces the risk that the transaction price was too low compared to the actual market value at that time.

It is recommended to track the transactions of the real estate sold during a certain period of time (e.g. one year) and investigate if the price has increased. If you notice that a transaction occurred for a substantially higher amount, you should investigate the reason for this and determine if there is a risk that your company perhaps sold the property for an amount below the actual market value on the date of the transaction.

## Partnerships and resources

When properties are bought or companies work on a development project they often contract several subcontractors, such as a real estate brokers, developers, architects and construction companies. Potential risks in this area are non-transparent (project) administrations, charge fees for unclear or non-performed work, and favouritism, which can result in damage to the company's reputation.

It is recommended to screen suppliers to determine the ultimate beneficial owner and the reputation of the counterparty. When using subcontractors it is recommended to agree with them to have the right to access their (project) administration.

**Do you know to whom and which payments your subcontractor makes?**

## Processes

Within project development, it often occurs that additional work is invoiced by the counterparty that was not foreseen and/or approved, or that work in progress is written off without proper investigation and reporting. The company faces the risk that it agreed on illegitimate deals that are beneficial to employees in the organisation or to a counterparty.

It is recommended to contractually only agree on additional work that has been approved on the basis of the four-eye principle and after checking the appropriateness of that additional work in the light of the contract. Overruns of the development projects must be analysed in detail by an independent employee within the organisation who also needs to focus on checking the appropriateness and completeness of the initial cost calculation (calculation, methodology, assumptions, etc.)

In this article, we have described some situations frequently seen in the real estate sector that might increase the risk of fraud within an organisation. The main conclusion is that proper internal controls with sufficient checks and balances are needed to minimise the risks on each of the five causes of fraud (i) leadership (ii) people (iii) policies & strategy (iv) partnerships and resources and (v) processes.

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## Tax update – Luxembourg



After two years of strong economic growth in 2006 and 2007, disturbance in the financial markets slowed Luxembourg's economy in 2008. However, the Luxembourg government has continued to take steps to retain and improve Luxembourg's attractiveness as a jurisdiction for international business, and this is likely to be beneficial both to investors owning real estate in Luxembourg and to investors using Luxembourg as a holding and financing location for real estate in other European or Asian territories.

A recent and positive development for Luxembourg has been the government's response to the discussions at the G20 summit in early April 2009, concerning tax havens and black lists. Luxembourg has reacted promptly to ensure that its standing in the international community is not damaged by incorrect and harmful perceptions. At the end of April 2009, the Luxembourg government announced that it had already completed renegotiation of the "exchange of information" clause in its tax treaty with the USA, in order to give (or be given) rights of access to information for tax authorities investigating fiscal irregularities which are fully consistent with OECD norms. This will mean that Luxembourg will no longer appear on the "black list" of territories referred to in draft US tax legislation targeting tax haven abuse. Luxembourg is also energetically working on other tax treaty renegotiations, in order to meet commitments to have sufficient tax treaties in force that meet the OECD norms in this area of "exchange of information", and hence to be removed from the OECD "grey list" published following the G20 summit.

Specific developments in the tax system that are likely to be of special significance for the Real Estate industry include:

- The abolition with effect from 1 January 2009 of the 0.5% capital duty (previously computed on any increase in the equity of a company) and its replacement by a fixed duty of EUR 75;
- For 2009, a reduction of the aggregate corporate income tax rate to 28.59% (it was 29.63% for the year 2008), assessed on the commercial (and worldwide) income of a Luxembourg company unless a specific exemption is applicable (e.g. participation exemption or by virtue of a tax treaty);
- The recent entry into force of the Luxembourg/ Hong Kong tax treaty (applicable retrospectively from 1 January 2008 in Luxembourg), and the signatures of both the Luxembourg/India tax treaty and the Luxembourg/ UAE tax treaty (date of pending ratification); and
- The removal with effect from 1 January 2009 of the withholding tax levied on dividends distributed to companies holding a significant participation (as defined under Luxembourg's broad-ranging participation exemption) in a Luxembourg company, and which are resident and fully taxable in any country with which Luxembourg has a double tax treaty.

An evolution in the fund structuring environment has been the growing use of the SICAR (Société d'Investissement à Capital Risque) form as a fund vehicle. In the past, questions have been raised as to whether the SICAR's tax attributes (which offer a broad exemption from income derived from risk investment, including debt) was at risk of being regarded as state aid under EU law. Whilst it is understood that the EU Commission may have carried out some form of review, there is now little indication that any unfavourable conclusions will ever emerge.

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## Tax update – Belgium



Over recent years, there have been no significant changes to Belgian tax law. The Belgian tax climate for real estate has remained stable which is of major importance to investors. Its attractiveness lies in low effective tax rates and an efficient ruling practice.

The main Belgian tax features of relevance for real estate investments can be outlined as follows:

- nominal corporate income tax rate of 33.99%, whilst the average effective tax rate in Belgium approximately amounts to 26% due to the so-called notional interest deduction. Indeed, as you may know, this tax incentive (also known as “NID”) provides that Belgian companies and Belgian permanent establishments (e.g. holding real estate) are allowed to deduct an amount of notional interest based on their adjusted net equity at a rate fixed by reference to the 10-year linear Belgian government bond. The rate for assessment year 2010 (financial years ending from 31 December 2009 to 30 December 2010) is 4.473% (compared to 4.307% for assessment year 2009) In the framework of the Belgian draft budget for 2010-2011, the Prime Minister and the Government proposed to cap the rate for the assessment years 2011 and 2012 at 3,8%;
- concurrent with the introduction of NID, Belgium abolished the 0.5% proportional capital duty on contributions to share capital;
- possibility to receive advance certainty (ruling) on tax treatment of a specific transaction. In this respect, note that

the ruling commission has currently revised slightly the conditions imposed on the so-called split sale structures. By transferring real estate through those structures, the effective mixed transfer tax can be reduced to approximately 1% (instead of 12.5% or 10% in case of sale of full ownership of the property);

- no withholding tax on dividends distributed to parent companies (i.e. 10% holding) located in EU and Treaty Countries;
- VAT is a cost on most real estate investments, as the letting and the transfer of real estate property are generally VAT-exempt with no input VAT deduction. However, several alternatives exist to mitigate this potential VAT cost, such as VAT leasing, VAT grouping scheme, business centre scheme, etc. VAT is therefore a key point of attention when investing in Belgium;
- no general thin capitalisation restrictions and generous tax depreciation rules.

The Belgian real estate tax environment has started turning green. Indeed, in the second half of 2008, the Flemish Government introduced a new tax measure for energy-efficient buildings located in the Flemish Region. Also, energy-saving investments made in 2009

(assessment year 2010) can, subject to certain formalities, result in a one-off investment deduction amounting to 15.5% of the invested amount.

Belgium has implemented the EU Merger Directive with effective date as of 12 January 2009. The new regulations will lower most of the tax obstacles standing in the way of cross-border reorganisations involving Belgian companies. In the current economic climate, this may constitute a basis for real estate groups that aim to optimise their real estate operations, for instance by taking advantage of the cross-border use of tax deductions or simplifying their organisational charts.

In order to assure the going-concern of distressed companies, in January 2009 Parliament adopted a law that provides for an exemption of profits stemming from a waiver of debt in the hands of the latter companies, provided an agreement is obtained between the distressed company and its creditor(s) that is approved by a Court of Justice.

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## Tax update – Netherlands



Below we have summarised the main developments in the Dutch tax system that are of importance for the real estate industry. The developments are mainly driven by the need to be competitive and to improve the Dutch tax climate.

### Relaxation of the participation exemption regime

As part of the 2010 tax bill, on 15 September 2009 a legislative proposal was published that relates to a relaxation of the Dutch participation exemption. It is expected that, if approved by Parliament, the new rules for the participation exemption enter into force as from 1 January 2010.

- It is proposed to partly return to the pre-2007 rules, meaning that the participation exemption is applicable as long as the participation (of at least 5%) is not held as a portfolio investment. The participation exemption is applicable if the active business activities of the Dutch parent are in line with the active business activities of the subsidiary company. This also applies to Dutch intermediary holding companies if the business activities of the direct or indirect shareholder are in line with the active business activities of the subsidiary. Dutch (top)holding companies can rely on the participation exemption if its management is involved in the active business strategies of the active subsidiary company.

- For participations of at least 5% in portfolio investment companies the participation exemption is applicable if the assets of the subsidiary consist for 50% or more of “good assets”. Real estate is considered a “good asset” for this test.
- Finally, the participation exemption is applicable to holdings of 5% or more in entities that are subject to a profit tax at an effective rate of at least 10%.

The proposed rules form a clear improvement for Dutch based property investment groups and Dutch (intermediary) holdings of real estate investment companies. Under the current rules these taxpayers had to rely on the 90% asset test for “real estate subsidiaries”, while under the proposed rules this threshold is effectively replaced by a 50% test.

### Overhaul of Dutch CIT Act 1969

The Dutch Ministry of Finance issued a Consultative Document on 15 June 2009 containing several proposals to change the Dutch Corporate Income Tax Act. The proposals may enter into force as from 1 January 2011.

### Introduction of compulsory group interest box

As part of the Consultative Document a compulsory group interest box will likely be introduced. This means that interest received from group companies will be taxed at an effective tax rate of 5% and group interest expenses would likewise be deductible at an effective tax rate of 5%. Whether this new regime is positive depends on the specific position of the tax payer. Dutch tax payers with net group-interest receivable may clearly benefit from this new regime. Net group-interest payers may be focussed with an increase of effective tax rate.

### Measures to limit the interest deductibility

Also measures to limit the deductibility of interest on both internal and external debt are proposed. The first alternative measure limits the deductibility of interest in relation to the financing of shares in subsidiaries. If an amount of cash invested by a Dutch parent company in its subsidiary companies as equity, exceeds its own average equity, then the excess will be deemed to be funded with debt on which the interest is not deductible. This irrespective of whether there is a direct relationship between the debt and the investment in shares of subsidiary companies.

## Tax update – Netherlands



The second alternative is an anti-earnings stripping measure limiting the amount of deductible interest to 30% of EBITDA. The amount of interest expenses that is disallowed in one year can be carried forward to a future year in which the interest expense incurred is less than 30% of EBITDA.

### Further relaxation of existing REIT regime

As of 1 January 2009, legislation was introduced to provide relief from gearing restrictions.

- Back-to-back finance is now explicitly allowed under the permitted activities of REITs. In back-to-back finance situations, where the REIT attracts third party borrowing that is then

loaned to subsidiary companies, the amount of borrowed funds loaned to the subsidiary, and the note receivable from the subsidiary are disregarded for the calculation of the leverage restrictions;

- The leverage restrictions on REIT investments in subsidiary companies were alleviated. REITs are now allowed to finance up to 60% of both the value of directly held real estate investments and indirectly held real estate (shares in subsidiary companies).
- REITs are explicitly allowed to provide guarantees to third parties – like financial institutions – to secure obligations of subsidiary companies.

The changes were inspired by the increasing trend that REITs tend to invest indirectly in real estate assets via separate subsidiary companies and become more and more holding companies rather than companies investing in real estate investments directly.

### Transfer of going concern without VAT

The Dutch VAT Act provides for the possibility of a VAT-free transfer of 'going concern' of a business or independent part of that business. Based on a Supreme Court ruling, the facility of a

VAT-free transfer going concern could also be applied to leased real estate. As a result of the transfer of going concern, the transfer is outside the scope for VAT purposes and the buyer takes over the VAT position of the property from the seller as of the date of transfer. In many cases, the transfer of leased real estate as "going concern" reduces the amount of non-deductible VAT on VAT-exempt leases.

### Tax treaties

The United Arab Emirates and the Netherlands have signed a first-time tax treaty. The tax treaty will enter into force when ratified by both countries. The UK and the Netherlands have signed a new tax treaty. Once in force, the new treaty will replace the UK-Netherlands tax treaty of 7 November 1980. The tax treaty and protocol are ratified by the UK and must still be ratified by the Netherlands. Also a new tax treaty between Mexico and the Netherlands will enter into force when ratified by both countries, replacing the current tax treaty.

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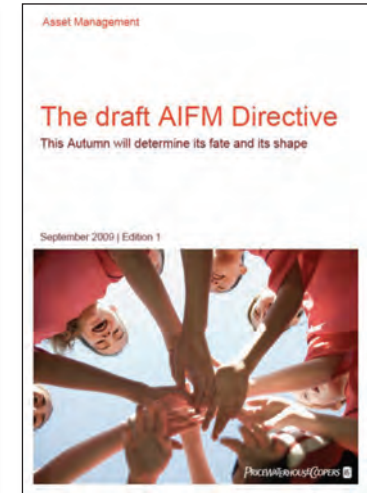
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