Structuring property investments: the lender's perspective

Property acquisitions in Belgium are subject to a fairly high property transfer tax (from 10% to 12,5% depending on the location). This tax is usually borne by the transferee. Share transfers on the other hand are exempted from any such tax.

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In addition, where capital gains realized on the disposal of a real asset are taxed at the standard corporate income tax rate (33,99%), those realized on the sale of shares are totally exempted. For this reason many developments are lodged in a single purpose company, the shares of which, not the property, are sold to the investor. The price of the shares will typically be equal to the adjusted net asset value of the company, the adjustment reflecting the market value of the property and including a discount for the fiscal latency deriving from the difference between the book value and the market value of the property. Any investor willing to finance the acquisition of shares in such a single purpose company with borrowed money will be faced with a number of constraints. Despite the transaction bearing on shares, any lender will look at it as a property transaction and will structure the security package accordingly. Typically, he will require a mortgage on the property and a pledge over the rental income.

Structured mortgage system

The taking of a mortgage triggers taxes, fees and costs exceeding 1,3% of the secured debt. For this reason, certain lenders accept to only partially secure their debt by a 1st ranking mortgage subject to the borrower issuing a so-called mortgage mandate whereby the bank is given discretionary power to register a 2nd ranking mortgage for the balance of the debt if it deems this necessary in the future. This mandate is not a security as such and the bank will be exposed to the risk that, upon registering the 2nd ranking mortgage, another creditor has already registered a mortgage on the property. Although this would clearly be a breach of covenant by the borrower, the bank would have no possibility to challenge the other creditor's mortgage. For this reason, banks tend to use this method only with clients they know well.
Unless the mortgage has been carefully structured from the outset, the investor should not forget that any refinancing of the debt will normally trigger the same mortgage-related taxes, costs and fees.
Another constraint upon a property acquisition structured as a share deal derives from the Belgian rules on financial assistance. Such rules prevent a company whose shares are being acquired from making loans or giving securities for the purpose of helping the buyer in the acquisition. It is generally accepted that the prohibition does not apply the schemes where the securities are provided for the acquisition of shares of the main parent company. Also, in a share deal, the single purpose company very often has an existing indebtedness (either towards banks or towards its shareholders) so that the securities provided to the bank will in reality also be securing a refinancing. Financial assistance rules do not apply to refinancing.

Cross-collateralization

Nevertheless, the law is fairly far-reaching and any post-acquisition restructuring of the debt planned by the investor and the bank at the outset of the transaction would fall within the scope of the prohibition. This means that for the acquisition financing part of the deal, the bank will only be able to look at the shares of the company to secure its position. Eventually, the position of the bank could be improved by using corporate reorganization techniques aimed at consolidating the debt at the level of the single purpose company. Also, provided the investor is acquiring several properties simultaneously, the bank could use cross-collateralization techniques. The debt could be segmented and each property could be used to secure those segments of the debt that relate to the other properties. This would, of course, require each single purpose company be able to demonstrate sufficient corporate interest in doing so.
In the future, the financial assistance constraints will probably become less stringent. Indeed, a new European Directive of

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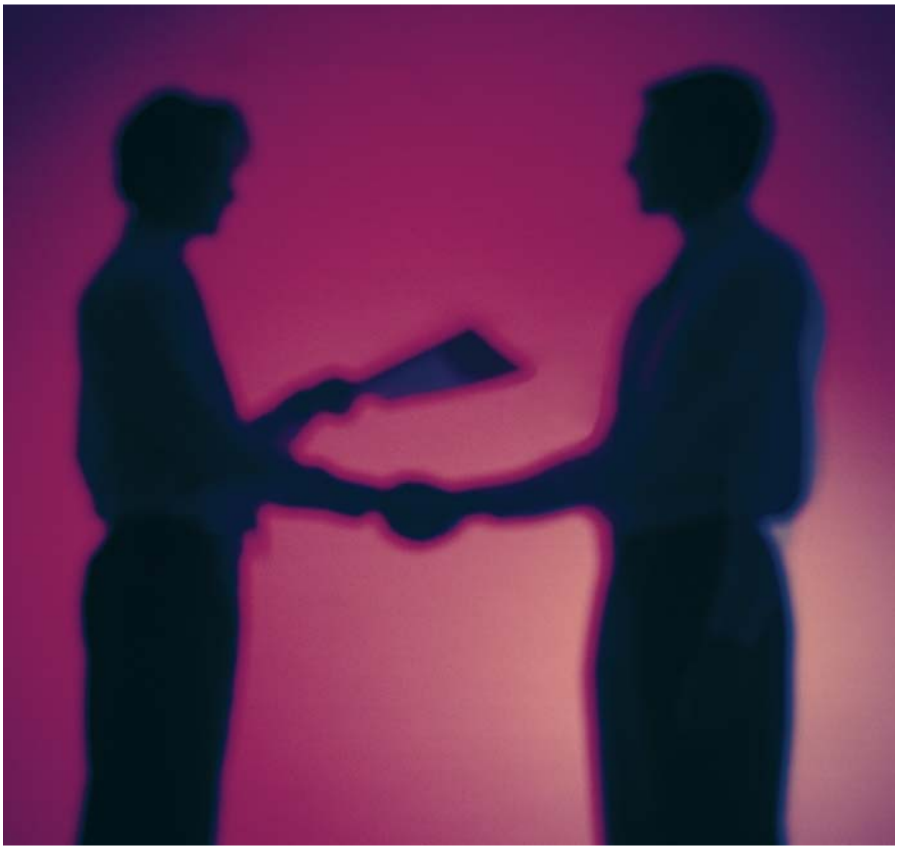
6 September 2006[1] provides that the Member States may permit financial assistance to take place under the responsibility of the board of directors of the company, subject to compliance with certain requirements. This directive should be implemented in the various Member States by 15 April 2008.

Another issue that may arise derives from the type of property title which certain investors are seeking to finance. Often, investors will be looking at the split sale structure to minimize the burden of the property transfer tax. Under this type of structure, one legal entity will be granted an emphyteotic lease by the owner for a period of up to 99 years, whereas another legal entity will be purchasing the residual ownership rights from that same owner. The "high value" emphyteotic lease (typically 95% of the total value) will be taxed at the low rate of 0,2% whereas the "low value" residual rights (typically 5%) will be taxed at the normal rate applicable to property sales. The tax administration has released guidelines aimed at clarifying its position on split sales. A key requirement set by the administration is the prohibition to recreate a full right of ownership during the lifetime of the emphyteotic lease. An emphyteotic lease may be mortgaged under the same conditions as a right of ownership. Yet the bank will generally regard the mortgage on the emphyteotic lease as insufficient to cover the risk adequately and for this reason will normally require a mortgage on the residual ownership rights as well. In granting a mortgage, the directors of the company holding such rights will obviously need to ensure that in doing so they are acting in the interest of the company.



Acquiring from public bodies

Other types of issues may arise when the investor is exclusively acquiring an emphyteotic lease. This situation typically occurs in the context of developments where the owner of the land is a public body. The developer is then given an emphyteotic lease allowing the public body to maintain some control over the development. In these types of instances, the public body will not grant a mortgage over the residual ownership rights and the lender will need to use alternative techniques to secure its position. These will aim at preventing the emphyteotic lease from being terminated while the financing is still in place. The public body is often asked to undertake to give notice to the bank when the lessee is in breach under the emphyteotic lease and the bank is then given a period of time to remedy the default situation. In most instances, the only obligation that survives the completion of the development is the payment of a yearly fee. In other instances, continuing obligations may have been imposed upon the developer and the bank will then also seek to put in place appropriate covenants with a view to preventing the occurrence of a default situation of this nature.

Similar issues arise when the property being financed is acquired from a public body on the condition that certain target be achieved by the buyer (e.g. regarding employment). If the targets are not met, the public body may rescind the sale at a low price. The bank is then exposed to receiving substantially less that the property value against which the loan was made.

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(1) Directive 2006/68/EC of September 6th 2006, OECJ September 25th 2006, L 264/32.