

German Real Estate Investment Trusts (G-REITs) and Proposed Tax Relief for Real Estate Divestments

By Thomas Busching

In line with its voiced intentions, the German Federal Ministry of Finance (BMF) recently circulated its draft legislation for German real estate investment trusts (G-REITs). It sees all corporate, regulatory and tax issues previously under scrutiny resolved and, indeed, the draft does not contain any insurmountable unpleasant surprises compared to the industry's "wish list". Despite a few skeptic voices in Germany's grand coalition, G-REITs are expected to become effective as planned on 1 January 2007– and, if need be, retroactively. In addition to traditional real estate players, domestic and foreign companies owning real property in Germany are monitoring the developments with considerable interest: the BMF is contemplating relieving Germany's principally 40 percent capital gains taxation on transfer of real estate to G-REITs. This provides ample reason to take a closer look at things to come.

What Will the General Concept of a G-REIT Be?

In line with international standards, G-REITs shall be structured as tax-transparent, nonregulated, listed stock corporations with mandatory real property investments as well as mandatory annual profit distributions. REITs have spread to many countries in Europe, the most recent being France (2003) and Belgium (1995). The French and, to a certain extent, the UK model appear to be serving as the main blueprint for G-REITs.

What Are the General Effects of Tax Transparency?

The main effect of tax transparency is that a G-REIT's profits shall be taxed only at the shareholder level. The G-REIT itself shall be exempt from any profit taxes. These so-called transparent structures are not unknown in Germany. Partnerships, investment funds and investment stock corporations are other examples.

The tax transparency of G-REITs is the major distinguishing factor setting them apart from Germany's real estate holding companies of today. Like any other corporate body, these companies are subject to corporation tax (in total 26.375 percent) and, in principle, also to trade tax (up to 15 percent), although specific exemptions for real estate companies may apply.

According to the draft legislation, G-REITs shall only be profit tax exempt if they:

- are listed on a regulated stock exchange in the European Union or the European Economic Area, i.e., the EU plus Norway, Liechtenstein and Iceland;
- comply with prescribed free float requirements, e.g., long-term at least 15 percent;
- hold 75 percent of their assets in the form of domestic or foreign real property;
- derive 75 percent of their revenues from rental, leasing and sale of real property;
- distribute at least 90 percent of their distributable income;
- do not engage in real estate trading; and
- do not exceed a debt ratio of 60 percent of the G-REITs assets.

Should these criteria not be met, the draft entitles the authorities to impose penalties and, in the worst case, to withdraw the tax exempt status of the REIT.

Nonlisted REITs shall not be able to benefit from a tax exemption. The reasoning, according to the draft, is that institutional investors are free to set up a Special Investment Fund on the basis of the German Investment Act that also provides for tax exemption. Thus, the government does not see the need for an additional nonlisted investment vehicle such as private REITs in the United States.

Apparently, the tax exempt status shall not be granted to nonresident REITs investing in German real estate. One of the further requirements is that the REIT is registered and has its actual place of management in Germany.

How Does Tax Transparency Affect G-REITs?

As outlined above, a G-REIT's real estate income shall be subject to neither corporate nor trade tax. However, tax exemption at the G-REIT level shall be reversed at the level of the investor. To avoid tax leakage due to excessive dividend deferrals, retained earnings need to be restricted and mandatory profit distributions need to be made. Thus, the draft legislation prescribes a mandatory annual dividend of 90 percent of distributable profit. In this context, the definition of *distributable profit* is obviously critical.

In contrast to previous expectations, the distributable profit shall be determined on the basis of German GAAP, enabling G-REITs to provide, for example, for sufficient deferred maintenance expenses and the like. In terms of depreciation of buildings, however, German GAAP is slightly modified, limiting the accepted depreciation to a straight-line 2 to 4 percent, depending on the age of the building.

Notwithstanding, the amount of depreciation may be distributed to investors if the articles of association do not contain a contradictory provision.

Half of the capital gain on disposal of property may be credited to a reinvestment reserve reducing the distributable profit for that specific fiscal year. This reserve is to be reversed at the latest at the end of the second fiscal year following the disposal. Upon reversal, the appropriate reserve must either be deducted from property acquired, or built up within the year of reversal or allocated to the amount of distributable profit.

In order to enhance transparency regarding the fair market value of the REIT's assets, IFRS group accounts shall be drawn up in accordance with section 315a of Germany's Commercial Code, albeit predominately for information purposes of the investors – thus preventing the distribution of unrealized profits. However, the IFRS accounts shall be the basis for determining compliance with the 75 percent thresholds in respect of real property assets and revenues mentioned above and the leverage limit outlined in the following.

To balance the effects of substantial liquidity drains caused by the mandatory distributions, the industry had suggested that G-REITs should not be subject to any leverage limitations. However, the draft prescribes a leverage limit of 60 percent of the assets, provided the articles of association allow funding by loans.

Are G-REIT Activities Restricted?

G-REITs are tax-privileged entities and therefore have a substantial competitive edge over fully taxable companies that could add up to 40 percent of profits in tax savings. Thus the privileged activities of G-REITs must be defined carefully and limited to prevent distortion in relation to unprivileged market players. As mentioned above, G-REITs must derive at least 75 percent of their revenue from privileged activities, i.e., acquiring, holding, rental and leasing (including not specifically defined "required supporting activities"), management and sale of its own real property.

In this context it is important to note that not only unrestricted ownership in real estate qualifies but also other property rights, e.g., leasehold or usufruct. This provides for considerable structuring flexibility, increasing the attractiveness of G-REITs.

In contrast to the industry's wish list, facility management and brokerage services as well as project development and control for third parties are not privileged activities. In these areas, G-REITs would be competing with unprivileged market players. Therefore, these activities need to be limited and provided by "service subsidiaries" wholly owned by the G-REIT. Service subsidiaries are not tax exempt and may not exceed 20 percent of the assets and revenues of the G-REIT.

It was also expected that G-REITs would be entitled to hold interests in other G-REITs. This would facilitate the establishment of umbrella REITs to hold focused subsidiaries that specialised in certain real

estate sectors, such as shopping centres or hotels. Whilst this may still be possible, the draft prescribes the legal form of a partnership and does not allow subsidiaries, the exception being the incorporation of wholly owned foreign subsidiaries holding foreign real estate. As in the case of the service subsidiaries, the foreign subsidiaries are taxable entities.

To separate exempt G-REITs from taxable real estate traders, a certain holding period for the property is prescribed. According to the draft, G-REITs shall be entitled to tax exemption only if their property sales within a period of five years are restricted to 50 percent of the average value of real estate investments at market rates within this period.

What Are the Effects of the Listing Requirement?

It is proposed that G-REITs must be incorporated as stock companies in accordance with all regulations of the German Stock Corporation Act (AktG). Therefore, the decision to raise capital and invest funds lies in the hands of the shareholders and management, which provides for greater flexibility in responding to market conditions.

In contrast, German real estate unit trusts are often exposed to a high influx of investor funds and corresponding investment pressure, e.g., as in 2003. The opposite case of unexpectedly high unit redemptions and liquidity drains, as some German property funds have experienced the recent past, is certainly even more unpleasant. G-REITs in the form of stock corporations are protected from these radical swings, and this should ultimately translate into higher returns for the investor.

Notification and publication requirements of listed companies will provide more transparency for investors and have, therefore, been widely welcomed. The success of Japanese J-REITs is seen as evidence. Several authorities on the subject view the high transparency of J-REITs – which disclose not only property valuations but also vacancies, rental indexing and the like – as the main contributing factor. A high level of transparency may be the key to a positive market response to this new asset class in Germany. In any case, there is considerable room for improvement in the transparency of the current indirect German real estate market.

G-REITs may be formed by conversion according to Germany's Conversion and Conversion Tax Act or by incorporation of a new entity. Tax exemption will be granted only from the beginning of the fiscal year in which the G-REIT is listed. The listing needs to be applied within three years of formation, as described above.

Non-listed predecessor REITs (pre-REITs) will be available. Pre-REITs shall have the same structure as REITs in their preparation for listing. Pre-REITs shall be taxable, but property sales to pre-REITs shall benefit from capital gains tax relief just as sales to with a REIT, provided the pre-REIT will be listed within four years of the property purchase.

Are There Any Other Regulatory Requirements?

Just like any listed company, G-REITs shall be subject to stock exchange and capital market supervision. However, the draft clearly determines that G-REITs shall not be product regulated as open-ended investment funds or unit trusts. Consequently, G-REITs shall not come under the purview of Germany's Investment Act or its Investment Tax Act and thus shall not be treated as unit trusts.

How Does Tax Transparency Affect the Investor?

As mentioned above, the G-REIT's real estate income shall be taxed only in the hands of its shareholders. According to the draft, the distributions shall constitute dividend income fully taxable in the hands of the shareholder – whether this is a domestic corporation or individual.

With regard to nonresident investors, the draft prescribes a direct shareholding limit of under 10 percent, enabling the German tax authorities to impose a withholding tax of effectively 10 to 15 percent, depending on the relevant tax treaty. Please note that higher indirect shareholdings are not restricted. The implications of a direct holding of 10 percent is not the loss of tax exemption for the REIT or the right of dividend or voting right for the shareholder. However, the shareholding would not qualify for participation exemption under a tax treaty reducing the withholding tax rate.

Restrictions in accordance with the EU Parent-Subsidiary Directive, on the other hand, should not be applicable, as it applies only to taxable entities.

What Would the Investor's Exit Look Like?

In most cases unit trust investors exit by returning their shares to the fund. Not so for G-REIT shareholders; as with any other shares, G-REIT holders will sell their shares on a stock exchange. Consequently, G-REIT shareholders could be exposed to general stock exchange cycles and movements. However, analyses have shown that there is limited correlation between the general market and REITs. In addition, REITs generally trade at a premium to net asset value. In contrast, German listed real estate companies generally trade at a discount.

Compared with German real estate unit trusts, REITs are considered more acceptable to foreign investors. The absence of an up-front fee, as in the case of unit trusts, is certainly an additional advantage. Due to their high fungibility, G-REITs are expected to generate demand as they reduce the risks of disinvestments, which should lead to a higher return.

What Are the Tax Consequences of Selling G-REIT Shares?

The industry's suggestion was to exempt the capital gain from the sale of G-REITs. It sees this proposal as reasonable, as the profits of a REIT have already been taxed at shareholder level due to the high distribution quota. The draft remains unclear on this point, but the supporting documentation to the draft

seems to suggest that normal tax implications apply; i.e., 95 percent of any capital gain should be exempt in the hands of a corporate shareholder and fully exempt for an individual after a holding period of one year. The final wording of the G-REITs Act will, hopefully, clarify this issue.

Why Are G-REITs a Beneficial Exit Scenario for German Real Estate?

G-REITs were introduced not only to create a new asset class; the tax authorities also want to encourage domestic and non-German companies to realise capital gains in German real property. As an incentive, the authorities are prepared to grant tax relief. Thus, capital gains shall be realised and taxed as explained below.

Real property shall be transferred to the G-REIT as a contribution in kind; i.e., in exchange for new shares in the REIT. The transfer shall take place at fair market values, realizing the hidden reserves in the property and generating a capital gain for the new shareholder.

According to the draft, only half of this capital gain shall be brought to tax, thus effectively reducing the current roughly 40 percent capital gains taxation to 20 percent. Various conditions apply, e.g., the tax benefit shall only be available:

- within the period between 1 January 2006 and 1 January 2010;
- for properties held by businesses for at least 10 years

and not:

- for businesses terminating or converting their business; or
- if the property is sold by the purchaser within four years of acquisition.

Unfortunately, the deferral of the capital gains tax payment the industry had hoped for did not materialize in the current draft. This may be the most crucial default of the draft, as the seller of the property may be forced to dispose of REIT shares in order to pay the tax bill.

On the bright side, the draft clarifies that sale and leaseback structures shall be recognized and that no holding period for the REITs shares shall be prescribed. In addition, tax relief shall be applicable not only to property disposals tofor REITs but also to pre-REITs and to real property investment funds.

From a property seller's perspective, linking the tax payment to an actual cash flow to facilitate disposals and create a sizable market would be even more beneficial. The capital gain derived from the contribution in kind could first, therefore, be allocated to a profit reserve that should be taxable only as and when the investor sells new shares in the G-REIT, thus generating cash to pay taxes. Appropriate recommendations will have been made to the BMF and the further developments in this respect need to be monitored closely.

It should be noted that there are no plans to relieve the 3.5-percent real estate transfer tax levied on property sales or contributions in kind. In addition, VAT implications need to be considered – as always in the case of exempt sales of property with corresponding input VAT restrictions.

Outlook

German market players seem to be quite enthusiastic about G-REITs, and we share that enthusiasm. Relieving the tax burden on the disposal of real property could help companies develop more attractive balance sheets and improve their liquidity in the times of Basel II. Legal and tax issues appear to be resolved, and the skeptical voices in Germany's grand coalition seem to be in the minority. Unfortunately, the latest word has it that residential property shall be excluded from G-REITs in order to appease these voices. It remains to be seen what the final wording will look like and whether only exclusive residential REITs shall be discouraged and mixed REITs allowed. The potential market for G-REITs is seen to be quite substantial, given the fact that roughly 75 percent of German companies own real property, in contrast to about 25 percent in the United States. Apparently, the 65 largest listed companies could generate capital gains of 80 billion. It is seldom that both tax authorities and businesses expect added value from new corporate structures any legal entity, but such appears to be the case with G-REITs. And, since win-win situations are important to success, there seems to be reason for optimism.

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