Berlin

REITs in Germany, the UK and the U.S.

A General Comparative Analysis

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MATTHIAS ROCHE, ERNST & YOUNG **REIT – an unknown beauty, a mystery or something else? Maybe a little bit of everything if one looks at what the abbreviation "REIT" stands for: Real Estate Investment Trust. This is because in the German legal environment, which is based on Roman law, the trust is not really known, whereas Anglo-Saxon legal systems (such as the UK and the U.S.) are familiar with this term and have integrated it into their legal system. The success story of the REIT started in the U.S. in 1960. The idea was (and still is) to combine the flexibility of a financial market instrument (share) with the stability of an investment product (real estate), and to allow smaller investors to participate in large-scale real estate investments. Since then, REITs have been introduced in many countries around the globe including many European countries, and listed real estate has firmly established itself as a separate asset class. In Germany, it was a particularly long journey before German REIT legislation finally passed all parliamentary hurdles in 2007. The German REIT law was enacted on May 28, 2007 with its publication in the Federal Law Gazette of June 1, 2007, and it came into effect retroactively as of January 1, 2007. Compared to the U.S. REIT system, both the UK and the German REIT structure are really "youngsters", and it is interesting to see the different approaches the three legislative branches took when structuring their REIT systems, and also what the common features are and where there are major differences.**

In very broad terms: In Germany and in the UK, the REIT must have a corporate structure (a stock corporation in Germany and a close-ended company in the UK), and in the U.S. it must have the legal form of a US entity which is taxable as a domestic corporation (stock corporation, limited liability company, including – because of the check the box election with the U.S. tax authorities – also partnership or business trust structures). Thus the critical important common feature is: The REIT must have a corporate structure or it must at least be taxed as a corporation. Regarding the residency of a REIT, the clear message from all three countries is: The REIT must be tax resident in its country of formation, and the German and the UK-REIT must both have their statutory seat in their respective home country. No dual residence is permitted for a G-REIT or UK-REIT, respectively. For both, the G-REIT and

the UK-REIT, the shares must be listed on a recognized stock exchange; i.e., only public REITs are allowed in Germany and the UK. This is different to the U.S., where private REITs are also accepted. However, the shares of a US-REIT must be transferable in any case.

Capital Requirements

The share capital requirements are completely different and reflect the highly diverse approaches of the three countries vis-à-vis REITs. In Germany, the minimum registered share capital is EUR 15 m. In the UK, the minimum share capital is set at GBP 50,000 (which is around EUR 75,000) and in the U.S., no minimum share capital is needed at all. In the German legislative process, it was made very clear that a high minimum share capital shall be entered into the law to ensure the substance of the REIT, and demonstrate the financial commitment of the REIT's founders and shareholders. Obviously, this aspect is seen very differently in the two other countries. Not really common and "harmonized" is the view regarding the class of shares a REIT can issue. In Germany and the UK, only one class of ordinary shares is allowed. In the UK, a REIT may issue additional non-voting fixed rate preference shares. Total flexibility exists in the U.S.: A US-REIT can have various stock classifications (common stock, preferred stock). However, all shareholders within the same class of stock must be treated equally.

Qualification as Real Estate Assets

To qualify as a REIT, all three countries apply and require the same "magic" three numbers: 75/75/90. The first number stands for the assets which a REIT must own. In Germany, a REIT must have 75% of qualifying real estate as its asset. Real estate assets do not qualify if they have predominantly (more than 50%) residential space, which was built prior to January 1, 2007. In the UK, a REIT must hold at least 75% of its assets in the property rental business. A UK-REIT must hold at least three separate assets and no single asset may exceed 40% of the market value of the total portfolio. Residential property is allowed. Interestingly, only the UK allows its REITs to include non-real estate assets in the remaining 25% with which other activities could be performed (so-called non-ring-fenced assets). In the U.S., 75% of a REIT's assets must consist of real estate (including mortgages), government securities or cash items.

Requirements for REIT´s Income

The second number stands for the income which a REIT must generate. In Germany, a REIT must derive at least 75% of its gross earnings from rental, leasing and letting, and the disposal of immovable property. A G-REIT is not allowed under any circumstances to generate non-real estate related income (such as from the production of bicycles), and may only carry out real estate development and management work for its own portfolio. For third parties, such work can only be carried out via a wholly-owned service subsidiary. The related income falls into the 25% basket and must not exceed 20% of the total income. Trading in real estate is very limited: only 50% of the fair market value of the property can be sold within a five-year period. In the UK, a REIT must generate at least 75% of its income from property rental business. The other 25% can be generated from non-real-estate-related activities (such as from the production of bicycles). This maximum 25% portion of the income is subject to ordinary taxation (so-called non-ring-fenced income). In the U.S., a REIT must derive at least 75% of its gross income from real estate property rental or from interest on mortgages on real estate property. In addition, U.S. law provides for a 95% requirement: 95% of the gross income must come from a combination of real estate-related sources and passive sources such as dividends and interest. No more than 5% of a US-REIT's income may come from non-qualifying sources.

Dividend Distribution

And the third number stands for the dividend distribution. In all three jurisdictions a REIT must distribute 90% of its profit in the year following the year of income generation (Germany and the UK) or in the current year in which the income is generated (the U.S.); in the U.S. the 90% test is measured by taxable income, which can be different from the financial standards or corporate law definitions of profit. As far as capital gains are concerned, a G-REIT must distribute only 50% and can put the other 50% into a reinvestment reserve for no more than two years. If the reserve is not used for reinvestment, it falls under the distribution obligation after two years. The UK-REIT is not required to distribute capital gains but can use them for reinvestment within the following two years. If no reinvestment is made the amount is counted as bad assets for the 75% asset test. A US-REIT is not required to distribute capital gains, but undistributed amounts become subject to corporate income tax. Also, a US-REIT, like other entities doing business in the U.S., can swap real estate for "like kind" real estate on a tax-deferred basis.

London

Allowed Leverage

Another important question is: How much leverage is a REIT allowed to have? The rule for the G-REIT is very clear: only 55% of the qualifying assets (75% rule) can be financed by outside debt (including shareholder debt) and the remaining 25% of assets can be fully debt-financed. In the UK, borrowing is limited by the "interest cover" ratio. Interest cover is defined as earnings before interest and taxes (EBIT) over financing costs. If the result of this formula falls below 1.25 for an accounting period, the excess finance cost will be subject to a 30% tax charge. The U.S. again has the most

generous view on the issue of leverage. There are no statutory or regulatory limits for US-REITs.

Shareholding in subsidiaries

In Germany, when creating the REIT law, there was a very heated discussion about whether a G-REIT can be a shareholder in a corporate structure or not. The answer is: The G-REIT can only be a 100% shareholder in a foreign property subsidiary, a service subsidiary, or in a General Partner subsidiary in which it may also hold a share of less than 100% (all three entities are not tax exempt). A REIT-to-REIT shareholding is not allowed. The G-REIT can, however, own any amount of interest as a limited partner in a real estate partnership (which must meet the same asset requirements as the G-REIT).

In the UK, a shareholding of more than 75% in a subsidiary is allowed, and a partnership interest can be held. If it is less than 20% it does not qualify for the ring fence.

New York

In the U.S., a REIT may not have securities of taxable subsidiaries that represent more than 20% of the REIT's total asset value at the end of a given quarter. Further restrictions apply. The ownership interest of a US-REIT in a partnership is ignored and the partnership assets are allocated directly to the REIT. Also, shares in another REIT are treated as real estate for the 75% asset tests and dividends from another REIT are treated as qualifying income under the 75% and 95% gross income tests. If the US-REIT is a shareholder in a corporation other than another REIT or a corporation that elects to be treated as a "taxable REIT subsidiary", it can not own more than 10% of the shares, and the US-REIT may not have more than 5% of its total assets represented by securities of any one issuer other than in another REIT or a taxable REIT subsidiary.

If the REIT – and this applies in all three countries – meets the various requirements, it is not subject to tax under its domestic jurisdiction (in the case of the US, with respect to amounts it distributes to its shareholders).

There are two approaches to achieve this. In Germany and the UK, a REIT structure is simply tax exempt – in Germany with all its income including dividends from subsidiaries and partnership income, and in the UK only with its ring-fenced income. The U.S. applies a different technique. Its REITs can deduct their distributed dividends when calculating their taxable income (dividend deduction approach), and any retained income is subject to ordinary corporate income tax. If the US-REIT acts as a dealer and does not comply with certain multiple objective tests, it is subject to a 100% excise tax on dealer sales.

If a REIT in Germany, the UK or the U.S. fails to meet either the 75% asset test, the 75% income test or the 90% distribution test (or a combination of them) in one single year or in several consecutive years, each domestic legal framework provides for monetary sanctions or even the loss of REIT status.

Absence of Shareholders

A big issue for the G-REIT and also for the UK-REIT is not having any domestic or foreign individual or corporate direct shareholder (for the G-REIT) or any direct or indirect corporate shareholder (for the UK-REIT) holding 10% or more of the shares in the REIT. This issue is driven by the need for the REIT country to safeguard a certain level of tax revenues from the real estate income of a REIT resident in its territory. Under most of the tax treaties, domestic withholding tax is reduced to 5% (in some cases even to 0%) if a dividend goes to a foreign corporate shareholder with a 10% or greater shareholding in the REIT corporation.

Since REITs are rather young in Germany and the UK, the re-negotiations and adjustments of a large number of tax treaties was not seen as an appropriate way to resolve the 10% issue so that it became part of domestic legislation. However, and as an additional point, this 10% issue has an EU dimension under the freedom of the EC Treaty.

Since the U.S. has had REITs much longer, they have had time to adjust their treaty network to the 10% issue. Thus, in most US treaties, the withholding tax rate is set at 30% for a foreign shareholder who owns more than 10% of a REIT. Obviously, the US does not have to worry about any EU discrimination concerns.

All three REIT countries allow the ownership of foreign real estate and their REIT shareholders can be domestic and/or foreign individuals or corporations, or can have any other legal structure, such as pension funds or government entities. If one or more pension plans own certain levels of a US-REIT, then the pension plan(s) are deemed to own the REIT's assets directly for purposes of the unrelated business income tax rules.

Conclusion:

Looking at the REIT laws in Germany, in the UK and in the U.S., it can be summarized that despite the many technical differences of how many aspects are dealt with by the national legislator, the three REIT regimes do have the main guiding principles of the 75/75/90 requirements in common. This allows investors to generate dividend income from their REIT investments free of tax at the corporate REIT level, and to share in the development of the value of the real estate owned and operated by the REIT. The legal, tax and administrative details are sorted out by the legal and tax experts, and the differences allow room for planning opportunities. Experience shows that REITs are an attractive instrument for retail and institutional investors to invest globally in high value state-of-the-art real estate.