

# Germany Enters the REIT Universe with a Big Bang

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This year, German real property players' New Year celebrations were postponed until March 30, the day the long awaited German real estate investment trusts ("G-REITs") finally crossed the finishing line. G-REITs are largely in line with international REIT standards with two main exceptions. The bad news first: holding residential property built before January 1, 2007, is disallowed. But luckily the good news prevails: Germany's capital gains tax of currently 40% is cut in half for real property sales to G-REITs — making these very attractive buyers. Consequently, Steve Wechsler, President and CEO of NAREIT, in a recent interview on the subject gave a thumbs up and sees G-REITs to be on the right track. Ample reason to take a closer look at what's happening in Germany.

## **What Will the Market Look Like?**

The potential market for G-REITs is seen to be quite substantial given the fact that 73% of German companies own real property — in contrast to 25% in the US. As an indicator, the 65 largest German stock corporations hold real estate of almost €200 billion. Thus, market capitalization projections for G-REITs range from €10 billion within 2007 up to €140 billion in the next three years.

A recent survey by DEGI shows that around 50% of Germany's listed companies are interested in selling property to G-REITs. Sale and lease back as well as leasehold structures are explicitly allowed and the G-REITs Act ("Act") does not contain any specific restrictions regarding re-purchase agreements. This provides for an encouraging amount of flexibility in using real estate to generate funds for companies in a very tax efficient manner whilst retaining the use of the property if necessary.

## **What Is the General Concept of a G-REIT?**

In accordance with international standards, G-REITs are structured as tax-transparent, non-regulated, listed stock corporations with mandatory real property investments as well as compulsory annual profit distributions. REITs have spread to many countries in Europe, the most recent being the UK (2007) and France (2003).

## **What Are the General Effects of Tax Transparency?**

The main effect is that profits of G-REITs shall be taxed only at the shareholder level. The G-REIT itself shall be exempt from any profit taxes.

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

According to the Act, 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., EU plus Norway, Liechtenstein and Iceland;
- Comply with prescribed free float requirements, e.g., long term at least 15%;



- Hold 75% of their assets in the form of domestic or foreign real property. Please note that the holding of German residential property built before January 1, 2007, is disallowed;
- Derive 75% of their revenues from rental, leasing and sale of real property;
- Distribute at least 90% of their distributable income;
- Do not engage in real estate trading; and
- Meet an equity ratio of at least 45% of the G-REITs immovable assets.

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

Non-listed REITs shall not be able to benefit from a tax exemption. The reasoning according to supporting documentation is that institutional investors are free to set up a Special Investment Fund on the basis of the German Investment Act which also provides for tax exemption. Thus, the government does not see the need for an additional non-listed investment vehicle such as private REITs in the US.

Apparently, the tax exempt status shall not be granted to non-resident REITs investing in German real estate. One of the additional 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 neither be subject to 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 deferrals, retained earnings need to be restricted and mandatory profit distributions need to be made. Thus, the Act prescribes a mandatory annual dividend of 90% of distributable profit. In this context, the definition of distributable profit is obviously critical.

The distributable profit shall be determined

on the basis of German GAAP enabling G-REITs to provide, e.g., for sufficient deferred maintenance expenses and the like. Standard depreciation of buildings is restricted to the straight line method on the basis of their expected useful life. Notwithstanding, an extraordinary write-down to the fair market value is allowed in case of an expected permanent devaluation of the building.

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 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 within the first or second year, or allocated to the amount of distributable profit.

In order to enhance transparency regarding the fair value of the G-REIT's assets, IFRS accounts shall be drawn up whereby IAS 40 is to be applied to immovable assets. The IFRS accounts shall also be the basis for determining compliance with the 75% thresholds in respect of real property assets and revenues mentioned above, as well as the leverage and property trading limits outlined below.

To balance the effects of substantial liquidity drains caused by the mandatory distributions and in order to take advantage of low interest periods, the industry had suggested that G-REITs shall not be subject to any leverage limitations. Unfortunately, the Act prescribes a equity ratio of at least 45% of the G-REITs immovable assets.

### **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% 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% of their revenues from privileged activities, i.e.,

acquiring, holding, rental and leasing, management and sale of its real property — whereby activities related to the management and development of its properties are seen as privileged, e.g., facility management, agent services, project management and development.

In this context, it is important to note that not only acquiring 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, property related services provided to 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 fully taxable and its assets and revenues may not exceed 20% 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 specialized in certain real estate sectors such as shopping centers or hotels. Unfortunately, the Act prescribes the legal form of a partnership and does not allow subsidiaries, the exception being the holding of wholly owned subsidiaries owning foreign real estate and the aforementioned Service Subsidiaries. As in the case of the Service Subsidiaries, the subsidiaries holding foreign property are taxable entities.

In order to separate exempt G-REITs from taxable real estate traders, a certain holding period for the real property is prescribed. According to the Act, G-REITs shall be entitled to tax exemption only if their

property sales within a period of five years are restricted to 50% of the average fair value of real estate investments 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.

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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 and professionalizing the industry may be the key to a positive market response to this new asset class in Germany, but 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 only be granted from the beginning of the fiscal year in which the G-REIT is listed.

Non-listed predecessor REITs ("Pre-REITs") will be available. In these cases, the listing needs to be applied within three years of the Pre-REIT registration. Pre-REITs shall have the same structure as REITs in their preparation for listing. Pre-REITs shall be taxable entities but property sales to Pre-REITs shall benefit from the same capital gains tax relief as sales to G-REITs, provided the Pre-REIT will be registered as G-REIT 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 supporting documentation to the Act clearly determines that G-REITs shall not be product regulated as open-ended investment funds or unit trusts are. 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 on its shareholder level. According to the Act, 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 non-resident investors, the Act prescribes a direct shareholding limit of under 10%, enabling the German tax authorities to impose a withholding tax of effectively 10 to 15% depending on the relevant tax treaty. Please note that higher indirect shareholdings are not restricted. The implications of a direct holding of 10% 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.

**G-REITs were introduced not only to create a new asset class; the tax authorities also want to encourage domestic and foreign companies to realize capital gains in German real property.**

#### **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, the currently listed German real estate companies generally trade at a discount.

Compared with German real estate unit trusts, REITs are considered more acceptable to non-German 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 shares are expected to generate demand as they reduce the risks of disinvestment, 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 gains from the sale of G-REIT shares. It saw this proposal to be reasonable, as the profits of a REIT have already been taxed at shareholder level due to the high distribution quota. The Act prescribes that any capital gains shall be exempt in the hands of an individual shareholder after a holding period of one year, provided the shareholding is below 1%. For corporate shareholders, the capital gains shall be fully taxable whereby holding periods are irrelevant.

## 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 foreign companies to realize capital gains in German real property. As an incentive, the authorities are prepared to grant tax relief for capital gains generated by the sale of real property to G-REITs or Pre-REITs as explained below:

According to the Act, only half of this capital gains shall be brought to tax thus effectively reducing the current roughly 40% corporate capital gains taxation to 20%. Should the current Corporate Tax Reform 2008 materialize, the tax burden would even be reduced to 15%. Various conditions apply, e.g., the tax benefit shall only be available:

- Within the period between January 1, 2007, and January 1, 2010;

- For properties held by businesses for five years;
- And not for businesses terminating or converting their business below fair market value;
- If the property is sold by the REIT within four years of acquisition.

The respective purchaser is liable if the tax benefit lapses retrospectively. On a bright side, the Act clarifies that sale and lease back structures shall be fully permissible. In addition, the tax relief shall not only be applicable for property disposals to G-REITs but also to Pre-REITs.

It should be noted that there are no plans to relieve the 3.5% (4.5% in Berlin) real estate transfer tax levied on property sales. In addition, VAT implications need to be considered and structured with care — as always in the case of exempt sales with corresponding input VAT restrictions.

## Outlook

German market players seem to be quite enthusiastic about G-REITs. 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. Seldom enough, both tax authorities and businesses expect added value from G-REITs. And since win-win situations are important to success, there seems to be reason for optimism: the G-REITs legislation is effective retrospectively as of January 1, 2007. ★



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