

A Reit map

The regional idiosyncrasies of real estate investment trusts

Taking inspiration from the US, real estate investment trusts (Reits) are emerging as a new asset class in Europe. Reits were introduced in the UK on January 1 2007, are expected to be introduced in Germany retroactively as of January 1 2007, and France has had Reits for some time.

United Kingdom

In the UK, companies can now elect for Reit status. A Reit must be a corporation that is tax-resident in the UK and whose shares are listed on a recognized stock exchange. Reits do not pay UK tax in respect of their property rental business (PRB) but dividends paid in respect of the PRB are treated in the hands of shareholders as UK property income, and are subject to withholding tax at 22%. Up to 25% of a Reit's activities can be non-PRB (such as property dealing), but these activities are taxable. Dividends paid out in respect of non-PRB profits are treated in the hands of shareholders as normal UK dividend income.

For leverage on the Reit structures, loans cannot be linked to profits or assets and cannot be at non-commercial rates or provide for repayment of more than the amount lent (or amount repayable in respect of comparable listed securities). Debt convertible into ordinary shares is permitted, but there is a penal tax charge if the financing cost ratio is less than 1:25. The financing cost ratio is:

$$\frac{\text{Profits} + \text{Financing Costs}}{\text{Financing Costs}}$$

Tax is 30% on excess.

Germany

In November 2006, the German federal government passed a draft German Public Reit Introduction Act. The draft provides for a tradable real estate investment instrument that meets international standards. A German Reit (G-Reit) is a stock corporation that generates profits from real estate activities and is exempt from German corporate income and trade tax, whereby the dividend distributions are taxable at the shareholder level. The tax privilege is granted only if the G-Reit fulfils certain requirements. In particular, it must distribute at least 90% of its earnings, generate at least 75% of its income from real estate and invest at least 75% of its assets in real estate.

As far as leverage is concerned, loans may not exceed 60% of the G-Reit's net asset value.

As an incentive for German companies to transfer real estate to G-Reits, or to transform themselves into a G-Reit, German Reit legislation provides tax privileges for these transactions (exit tax). If the transfer of real estate to G-Reits results in a realization of

hidden reserves, only half of the capital gain is subject to German corporate income and trade tax. The tax privilege applies to transactions between January 1 2007 and December 31 2009.

The draft does not allow G-Reits to acquire residential property constructed before January 1 2007. According to real estate experts, the exclusion of residential properties from G-Reit compliant properties could reduce the total volume of G-Reits by a third. It is also unclear how the legislator will handle a G-Reit's prior-taxed income, which leads to concerns regarding income from foreign real estate that was subject to taxation in the source state. Unlike a direct investment in foreign real estate, where a G-Reit is not used, the draft bill would lead to double taxation of the real estate income in the state where the property is located and at shareholder level when the G-Reit distributes profit.

As a consequence, and in the absence of further legislative amendments, it is thought that the G-Reit will focus on domestic investments rather than investing in foreign real estate.

It is expected that the German Reit legislation will have passed all legislative bodies by March 2007, at which stage it should become effective retroactively as of January 1 2007.

France

Inspired by the US Reit regime, a favourable

tax regime applying to listed real estate companies (*sociétés d'investissements immobiliers cotées* or SIIC) was introduced as Article 208C of the French Tax Code in 2003. It allows SIIC companies to benefit from total exemption from corporate income tax (CIT) on profits derived from the rental of their real estate assets, or on gains made from the sale of these assets under several requirements.

This new status has proved successful: the SIICs' stock-exchange capitalization has trebled within three years and their number has doubled. It has made the French property market more liquid and has resulted in an increasing number of real estate outsourcing operations, notably in the hotel industry and among office and retail outlets. However, it has also generated certain undesired effects such as allowing foreign investors full tax exemption (not available to French investors) in public takeover bids (for example, the public bids of Spanish actors for Gecina or Société Foncière Lyonnaise) or captive SIICs (that is, those almost fully owned by one investor).

To remove these effects, recent reform introduced additional requirements regarding the ownership of share capital, as well as a 20% tax on dividends in cases where the foreign shareholder is exempt from CIT on those dividends.

The French Reit regime has been modified each year since its introduction into the French Tax Code to better meet real estate operators' constraints and objectives. Further changes affecting foreign investors are likely as a result of the Denkvit Internationaal ECJ decision, which ruled (on the grounds of the freedom of movement of capital and establishment within the EU) that withholding tax should no longer be applied to foreign investors who, had they

Taxation at Reit level

UK	<ul style="list-style-type: none"> No UK tax on tax-exempt business. If tax-exempt business includes non-UK properties, foreign taxes might be payable. Non-exempt business taxable in accordance with normal rules.
France	<ul style="list-style-type: none"> Income derived from the real estate activity: exemption of CIT unless the SIIC does not fulfil the conditions for the favourable tax regime over 10 years from election for the SIIC regime. Income from accessory activity: CIT at standard rate (34.43%).
Germany	<ul style="list-style-type: none"> Fully exempt from German corporate income tax (including solidarity surcharge) and German trade tax. The tax exemption does not apply to the income of the G-Reit's service companies. Where certain requirements are not met, this does not necessarily result in a denial of the tax exemption. The draft bill provides for different sanctions depending on the violation. However, if the G-Reit conducts real estate trading or does not meet the free float or leverage requirement for three successive business years, the G-Reit loses its tax-exempt status.
US	<ul style="list-style-type: none"> Subject to US income tax, but receive a tax deduction in the amount of dividends of taxable income paid to equity holders (so that, as a practical matter, Reits pay little or no income tax). If a Reit has operations that generate excessive non-qualifying taxable income that threatens its Reit status, it may place those operations in a taxable Reit subsidiary (TRS), which will pay income taxes on its income but will shelter the Reit's tax status from that non-qualifying income.

been French, would not have been subject to such tax liability. This decision could also challenge the application of the new 20% tax levied on CIT-exempt foreign investors.

The other outstanding question concerns the application in time of the SIIC regime, which is due to end on December 31 2008. There is little doubt that French real estate practitioners will strongly plead for a further extension of this regime, if not for a permanent one.

United States

Reits were created under the US Internal Revenue Code in 1960 as an investment vehicle that permits passive investments in real estate in a securitized form while allowing the Reit to deduct dividends paid to equity holders in calculating its US federal income tax. Reits are not tax-exempt, but they pay little or no federal income tax. Investors are able to invest in the securities of a Reit, potentially providing greater liquidity than traditional direct investments in real estate, while avoiding federal income tax at the Reit level. A Reit can be a corporation, trust or other form of business entity taxable as a domestic

corporation. Reits may (but need not) be publicly traded.

Today, publicly traded and privately owned Reits are common in the US. They fall into two main categories: those that invest in mortgages (mortgage Reits) and those that invest directly in property (equity Reits), although there are hybrids that combine both types of investments. Reits are attractive to investors for their yields (dividend payments), especially when traditional equity markets are unstable. Mortgage Reits will frequently borrow against their assets and invest the loan proceeds, creating leverage (debt to equity) ratios that often exceed 10:1. For these reasons, the market capitalizations of Reits are highly affected by prevailing interest rates and the levels of their dividend payouts. Moreover, the market capitalizations of equity Reits might not reflect the underlying values of their real estate, especially those properties that have not been developed to their highest and best commercial use.

To qualify as a Reit, an entity must meet certain criteria:

- At least 100 persons must own the Reit's equity.

- Five or fewer individuals may not own more than 50% of the value of the Reit's stock.
- The Reit must pay annual dividends to its equity holders equal to at least 90% of its taxable income.
- At least 95% of the Reit's gross income must be derived from dividends, interest, rents from real property, and certain other sources of income.
- At least 75% of the Reit's gross income must be derived from rents from real property, interest on mortgage debt, gain from the disposition of real property held for investment, distributions on and gains from the disposition of transferable shares in other Reits, and certain other sources of income.
- At least 75% of the value of the Reit's total assets must consist of real estate assets, cash, receivables, and government securities.

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Taxation of Reit investors

	Domestic investors	Foreign investors
UK	<ul style="list-style-type: none"> • Dividends paid from tax-exempt business treated as UK property income, subject to 22% withholding tax. • Dividends from non-exempt business treated as UK dividend income and not subject to withholding tax. • Tax payable in respect of income will depend upon shareholder's particular circumstances (for example, individual, corporation, or pension fund). • Capital gains are taxed on general UK taxation principles. 	<ul style="list-style-type: none"> • Dividends paid from tax-exempt business treated as UK property income, subject to 22% withholding tax. • Dividends from non-exempt business treated as UK dividend income and not subject to withholding tax. • For most non-UK resident shareholders, there will be no further UK tax to pay other than that (if any) withheld. Limitation of 10% shareholding for corporations will prevent claims for refund of withholding tax under double tax treaties. • Non-UK resident shareholders are normally outside the scope of UK tax on capital gains.
France	<ul style="list-style-type: none"> • General taxation principles for dividends; no application of the participation-exemption on dividends from SIIC-exempt profits. • Capital gains are taxed on general French taxation principles. 	<ul style="list-style-type: none"> • Withholding tax of 25% on dividends. Subject to the application of tax treaties, no application of the Parent Subsidiary Directive on dividends from SIIC-exempt profits. 20% tax if the foreign shareholder: (i) is not subject to CIT on such dividends in its own state; and (ii) owns at least 10% of the dividends rights in the SIIC. • General taxation principles on capital gains. Taxation in France if the individual or the company held at least 25% of the share capital of the SIIC at any time during the five years before the disposal, subject to the application of tax treaties.
Germany	<ul style="list-style-type: none"> • Dividends are fully taxable at the level of the domestic individual and institutional investor. • Dividends are subject to a 25% withholding tax, which could be credited against the investor's income tax liability. • Capital gains are taxed on general German taxation principles. • According to the draft bill, the investor cannot credit foreign taxes against its income tax liability. 	<ul style="list-style-type: none"> • Withholding tax of 25% on dividends, subject to the application of tax treaties. No application of the Parent Subsidiary Directive on dividends from G-Reits. • Capital gains of an institutional and individual investor are subject to German taxation if the investor has held at least 1% of the G-Reit shares at any time during the five years before the disposal, or if the investor has not held the G-Reit shares for more than one year. However, if the individual or institutional investor is treaty-protected, the capital gains are usually tax-exempt in Germany.
US	<ul style="list-style-type: none"> • US equity holders are normally taxed on Reit dividends as ordinary income, but a Reit distributing capital gains may make an election to permit equity holders to treat the distribution as capital gains. 	<ul style="list-style-type: none"> • Unless covered by a treaty, ordinary dividends are subject to a 30% withholding tax, and capital gains distributions are subject to a 35% withholding tax.

Criteria for Reit status

	Stock exchange listing / private Reit	Minimum capital	Free float / shareholder structure	Distribution obligation
UK	<ul style="list-style-type: none"> Listed on recognized stock exchange such as London Stock Exchange (not AIM), but also many non-UK exchanges, such as Channel Islands, Dublin, Luxembourg and Nasdaq. 	<ul style="list-style-type: none"> No minimum capital requirement other than exchange listing requirements. Can only have one class of ordinary shares – but may have non-voting fixed rate preference shares. 	<ul style="list-style-type: none"> Requirements of relevant stock exchange. No corporate investor can have 10%+ shareholding Cannot be close for UK tax purposes. 	<ul style="list-style-type: none"> 90% of profits of tax-exempt business must be distributed (unless prohibited by law). No obligation to distribute capital profits of tax-exempt business. No obligation to distribute income or capital profits in respect of non-exempt business.
France	<ul style="list-style-type: none"> French corporations (SA or SCA) listed on a French regulated stock exchange. 	<ul style="list-style-type: none"> €15 million. 	<ul style="list-style-type: none"> Participation of a shareholder or shareholders acting jointly (<i>de concert</i>) is capped to 60% of the share capital. Free float (sum of shareholders owning less than 2% of share capital): at least 15% of the share capital, only on the first day of the option for the regime. 	<ul style="list-style-type: none"> 85% of profits derived from renting of buildings or from sublease of buildings leased under financial lease agreements within their year of realization. 50% of gains derived from the sale of assets within the two following years. 100% of dividends paid by subsidiaries subject to the SIIC regime within a year.
Germany	<ul style="list-style-type: none"> German stock corporations (<i>Aktiengesellschaft</i>) listed on an EU stock exchange in the EU or the European Economic Area. 	<ul style="list-style-type: none"> €15 million. 	<ul style="list-style-type: none"> No shareholder can have 10%+ shareholding. Free float (sum of shareholders owning less than 3% of share capital): at the time of the IPO at least 25% and thereafter 15% of the share capital. 	<ul style="list-style-type: none"> 90% of profits must be distributed.
US	<ul style="list-style-type: none"> Stock exchange listing is optional. Private Reits owned by at least 100 persons are permitted. 	<ul style="list-style-type: none"> No minimum capital requirement other than exchange listing requirements. 	<ul style="list-style-type: none"> Reit must be owned by at least 100 persons. Five or fewer individuals may not own more than 50% of the value of the Reit's stock. 	<ul style="list-style-type: none"> 90% of profits must be distributed.

Composition of Reit assets / income

- At least three different investment properties allocated to tax-exempt business.
 - No single property can exceed 40% of value of tax-exempt portfolio.
 - No property occupied by Reit itself.
 - At least 75% of gross assets and gross income must be allocated to tax-exempt business.
 - Reit can be structured as a group (including non-UK companies), and can hold properties outside the UK.
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- Main corporate purpose of a SIIC: the acquisition or the construction of buildings for renting or the direct or indirect ownership of shares in companies, the corporate purpose of which fulfils this condition.
 - Non-real estate activities may be carried out if accessory (for example, estate agent, marketing and real estate development). The value of the assets used in respect of these activities should not exceed 20% of the gross value of the assets of the company.
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- At least 75% of a G-Reit's net asset value must be real estate.
 - Can hold real estate directly or through real estate (domestic or foreign) partnerships.
 - Investments in real estate corporations limited to 100% investments in foreign corporations that exclusively hold real estate abroad. An indirect real estate investment through domestic corporations is excluded.
 - Can provide services that are linked to the management, maintenance and development of real estate through a subsidiary whose assets may not exceed 20% of the G-Reit's net asset value.
 - At least 75% of the G-Reit's gross revenue must be rental income from the lease or sale of real estate, whereby the G-Reit may not sell more than 50% of the fair value of its real estate portfolio within five years.
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- At least 95% of the Reit's gross income must be derived from dividends, interest, rents from real property, and certain other sources of income.
 - At least 75% of the Reit's gross income must be derived from rents from real property, interest on mortgage debt, gain from the disposition of real property held for investment, distributions on and gains from the disposition of transferable shares in other Reits, and certain other sources of income.
 - At least 75% of the value of the Reit's total assets must consist of real estate assets, cash, receivables, and government securities.

Taxation upon formation of Reit

	Entry / exit tax on transfer of assets to Reit	Transformation of existing real estate company into Reit
UK	<ul style="list-style-type: none"> • None. But usual 4% stamp tax payable by Reit on acquisition of UK property. 	<ul style="list-style-type: none"> • 2% of gross value of properties allocated to tax-exempt business.
France	<ul style="list-style-type: none"> • Contribution or sale of real estate assets to a SIIC or one of its subsidiaries elected for the SIIC regime: <ul style="list-style-type: none"> - Taxation of the gain derived by CIT payers from the asset transfer at the reduced rate of 17.04%, provided the SIIC undertakes to keep the real estate assets for five years. - Registration duties: application of the general principles of contribution to a CIT company. <p>(For a merger with a SIIC or a non-SIIC company, the operation would have tax neutrality)</p>	<ul style="list-style-type: none"> • The election for the SIIC regime is considered a termination of activity, with a favourable tax regime, and: <ul style="list-style-type: none"> - Immediate taxation of income realized in the fiscal year. - Latent gains: on the real estate assets and on the shares in real estate flow-through entities: taxed at the CIT flat rate of 17.04%. - Tax losses from before admission to the SIIC regime: offset against the income that becomes taxable at the standard rate or at the 17.04% rate upon the election. The excess, if any, would be lost. - Registration duties: taxation at the rate of 5% or fixed duty of €500, if the contributor keeps the real estate assets for three years.
Germany	<ul style="list-style-type: none"> • If the transfer of real estate to G-Reits results in a realization of hidden reserves, only half of the capital gain is subject to corporate income tax and trade tax, if the real estate has belonged to the fixed assets of the transferor for at least 10 years. • It is limited to transactions between Jan 1 2007 and Dec 31 2009. • The exit tax regime should also apply to sale and lease back transactions. • The exit tax regime also applies to those that pursue a G-Reit but do not yet fulfil: the listing requirement (Pre-Reit). These rules apply if the corporation is registered with the Federal Tax Office as Pre-Reit and fulfils certain requirements. • Half the expenses from tax-privileged transfers can be deducted, though not if the transfer leads to a capital loss. The loss is deductible in total. • The transfer of real estate to a G-Reit or a Pre-Reit triggers German real estate transfer tax. 	<ul style="list-style-type: none"> • The exit tax regime also applies to a transformation of an existing real estate company into a G-Reit.
US	<ul style="list-style-type: none"> • Investors contributing property to a Reit for Reit equity is a taxable event. An alternative is to create a limited partnership (LP) in which the Reit is general partner, and the investor gives property to the LP in exchange for limited partner interests that track the economic benefits of Reit stock – an umbrella partnership Reit (UPReit). 	<ul style="list-style-type: none"> • Any existing entity taxable as a domestic corporation can elect to become a Reit, but it must first pay a dividend equal to all accumulated earnings and profits. Conversion to a Reit is usually accomplished through a contribution of existing real estate to a new UPR Reit.