

DEVELOPMENTS

The Introduction of Real Estate Investment Trusts [REITs] in Germany

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A. Introduction[°]

The German Real Estate Investment Trust – or, G-REIT – is in the centre of interest in Germany these days and expected to be introduced in Germany in the beginning of 2007. After a preparation phase initiated in 2003 by a lobbying group (“IFD”)¹ under the former² German government, the new government has most recently drafted a bill with respect to the introduction of G-REITs (“bill”).³ This bill remains to be subject to parliamentary discussion and is likely to be partially modified before its final adoption: in addition to its passage in the *Bundestag* (Federal Parliament), it requires the approval of the *Bundesrat* (German Federal Council). Following its first reading it will be committed to the Financial Committee, which will conduct hearings. However, the legislator intends to pass the bill in the first quarter of 2007 to take retroactive effect as of 1 January 2007.⁴ This essay intends to outline fundamental corporate, capital market, and tax related G-REIT parameters provided for by the G-REIT Act in its present form.

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¹ “Initiative Finanzstandort Deutschland” (www.finanzstandort.de).

² German general elections took place in September 2006, resulting in a change of government.

³ *Entwurf eines Gesetzes zur Schaffung deutscher Immobilien-Aktiengesellschaften mit börsennotierten Anteilen* (Draft of an Act introducing German Real Estate Stock Corporations with listed shares), dated 2 November 2006, available online at: http://www.bundesfinanzministerium.de/lang_de/nn_82/nsc_true/DE/Aktuelles/Aktuelle_Gesetze/Gesetzentwuerfe_Arbeitsfassungen/007.templateId=renderPrint.html (last visited 22 December 2006)

⁴ Art. 7 of the bill. The G-REIT Act will be published in the *Bundesgesetzblatt* (German Federal Law Gazette).

B. Background of the G-REIT Legislation

By introducing REITs, Germany follows various international paradigms.⁵ Yet, the present bill testifies to a considerable number of specific variations 'made in Germany'. The bill is the outcome of political discussions between the *Bundesfinanzministerium* (Federal Ministry of Finance - BMF), the political parties, the IFD as most involved lobbying group, and other interest groups⁶ about considerable tax issues raised by the planned Act. The taxation-related linchpin of the REIT legislation is the idea of tax exempting the REIT company, binding it to distribute most of its profits to its shareholders, and collecting taxes on shareholder level, a concept conceived as supporting above all tax transparency.

The first aspect, the tax exemption, has been highly controversially disputed, as it privileges the REIT company towards other company forms. The BMF considers the REIT necessary to preserve Germany's competitiveness on international financial markets and to maintain jobs for highly skilled employees. Furthermore, the introduction of REITs is expected to have strong positive fiscal and economic impacts:⁷ Germany has by far the largest real estate reservoir in Europe, which at this time remains, for the most part, not yet institutionally invested, but owner-occupied or held by private owners.⁸ Channelling these assets to REITs would make bound resources more fungible, release current owners from the complex everyday management of real estate, opening up substantial efficiency gains. As highly regarded investment vehicles, REITs are expected to be more attractive to foreign investors. Different from traditional real estate investments, a REIT investment is independent of the individual financial capacity of the investor.

⁵ E.g. US-"REITs" (since 1960), Dutch "Fiscale Beleggingsinstelling" ("FBI", since 1969), Australian "Listed Property Trusts" (since 1971), Canadian "REITs" (since 1994), Belgian "Société d'Investissement à Capital fixe en Immobilière" (SICAFI, since 1995), Japanese "J-REITs" (since 2001), South Korean "K-REITs" (since 2001), Singaporean "S-REITs" (since 2002), French "Sociétés d'Investissement Immobilières Cotées" ("SIIC", since 2003), Hong Kong "H-REITs" (since 2003), British "Property Investment Funds" ("PIF", starting 2007).

⁶ E.g. the "Deutscher Mieterbund" (German umbrella organization of tenants - DMB, www.mieterbund.de).

⁷ See the purpose of a G-REIT Act under A. I. of the bill's explanatory statements.

⁸ There is a total estimated real estate reservoir of about 7,200 billion €. So far, only a very small fraction of it – valued approximately 400 billion € – is held by institutional investors. The value of real estate held by other companies is estimated to be 1,500 billion €. About 73% thereof is owner-occupied commercial real estate, e.g. production sights, office buildings etc. In comparison, British companies occupy only 54% of their real estate assets, and in the US the respective figure is only 25%. By far, the lion's share of German real estate is owned by private individuals (approx. 5,300 billion €), see A. I. of the bill's explanatory statements.

As a consequence of the tax exemption, REIT legislation has to take into account specific taxation issues on the shareholder level, especially with respect to the taxation of foreign investors, which in many cases may fall under double taxation agreements. Central here is the problem of tax equity applied when taxation on shareholder level only affects German investors, whereas foreign investors enjoy tax reduction or even tax exemption.

C. The G-REIT

I. Corporate Structure of a G-REIT

According to Section 1 para. 1,⁹ a G-REIT is a stock corporation whose business purpose is limited to:¹⁰

(a) acquiring, holding, managing by renting out and leasing, including essential property-related ancillary business, and selling of real property¹¹ or rights of use of real property, except for apartments built before 1 January 2007¹², and

(b) acquiring, holding, managing, and selling shares in real estate business partnerships,¹³

and whose shares are listed on an organized market within the European Economic Area ("EEA"), not necessarily in Germany.¹⁴ Therefore, the *Aktiengesetz* (German

⁹ If not stated otherwise, quotations within this essay refer to the regulations of the bill.

¹⁰ Specifically, the G-REIT may not engage in trading real estate; the bill considers as trade if the G-REIT has, within five years, gross revenues from the sale of real estate which exceed 50% of the value of the average holdings of real estate within the same period, Section 14.

¹¹ Real property may be located in or outside Germany.

¹² The exception of apartments built before 1 January 2007, so called "*Bestandsmietwohnungen*", has been most recently included into the bill as concession to opponents of the G-REIT Act who fear that profit maximizing G-REITs will raise rents and reduce tenant protection to a minimum; however, this exception and its argumentation is highly disputable and may be questioned again.

¹³ Specifically, the G-REIT may not hold shares in limited liability companies that in turn own real estate.

¹⁴ The listing shall assure that G-REITs do not compete with, but rather complement existing real estate investment vehicles such as Open Property Funds. If listed in Germany, G-REITs may be listed on the organized market in terms of Section 2 para. 5 of the Securities Trading Act, i.e. on the so called official market in terms of Sections 30 et seq. of the *Börsengesetz* (Stock Exchange Act - BörsG) ("*amtlicher Markt*") or the organized market in terms of Sections 49 et seq. of the Stock Exchange Act ("*geregelter Markt*"),

Stock Corporation Act - AktG) and the *Handelsgesetzbuch* (German Commercial Code - HGB) apply to G-REITs as long as the G-REIT Act does not provide otherwise.¹⁵ Moreover, due to the requirement of listing the codes of conduct with respect to listed stock corporations of the *Wertpapierhandelsgesetz* (Securities Trading Act - WpHG) are observed.¹⁶

The G-REIT has to have its official residence¹⁷ and its management¹⁸ in Germany. It requires a share capital of at least 15 million Euro,¹⁹ which has to be fully paid up; each share must grant the same rights.²⁰ The company name has to include the words “REIT-Aktiengesellschaft” or “REIT-AG” which are exclusively reserved to G-REITs.²¹ As such it is to be registered with the Commercial Register.²²

Before becoming a G-REIT, the stock corporation passes the stadium of a pre-REIT.²³ This is a stock corporation resident in Germany,

- (a) having the same limited business purpose as a G-REIT,
- (b) complying with the G-REIT requirements regarding its asset structure,²⁴ and
- (c) being registered as pre-REIT with the *Bundeszentralamt für Steuern* (German Federal Central Tax Authority - “BZSt”).²⁵

but not on the inofficial market in terms of Sections 57 of the Stock Exchange Act (“*Freiverkehr*”); see the bill’s explanatory statements under B. Article 1 Section 10.

¹⁵ Section 1 para. 3.

¹⁶ E.g. insider rules according to Sections 12 et seq. of the Securities Trading Act, etc.

¹⁷ Section 1 para. 2.

¹⁸ Section 9. The bill does not exclude consulting external investment advisors, such as asset managers; this might be recommendable, however, calling external advisors may smoothly blend to turning away from the AG’s corporate structure if the board of directors only controls the advisors.

¹⁹ Section 4; the legislator considers this amount as usual minimum capitalisation for listing; see the bill’s explanatory statements under B. Article 1 Section 4. However, experience shows that by far higher capitalisation is recommendable for listing.

²⁰ Section 5.

²¹ Sections 6 and 7.

²² Section 8.

²³ Section 2.

²⁴ Section 12, see below.

The pre-REIT already enjoys certain tax privileges²⁶ as long as it applies for listing on an organized market within three years²⁷ after its application for registration with the BZSt.²⁸

II. G-REIT Requirements

To enjoy G-REIT tax privileges²⁹ on an ongoing basis and to prevent being sanctioned by the imposition of penalty fees³⁰, the G-REIT has to meet a number of legal requirements ruled in the second chapter of the bill, Sections 8 to 15, and set forth as follows.

The G-REIT requires a free float of at least 15% of the shares or, in the moment of listing on the organized market, of at least 25%, in order to allow small investors to participate in fungible real estate investments.³¹ The free float is defined as the sum of all shares held by shareholders, who each individually have less than 3% of the G-REIT's total voting rights.³² The G-REIT has to annually notify the *Bundesanstalt für Finanzdienstleistungsaufsicht* (German Federal Financial Supervisory Authority - "BAFin") of the free float quota, who in turn notifies the BZSt, if the free float quota falls below 15%.

No shareholder may directly hold 10% or more of the shares. Shares held for third-party account are deemed to be held by the third party.³³ Holding 10% or more of the shares in the short term³⁴ does not affect the G-REIT's tax exemption, nor does

²⁵ The stock corporation is registered as pre-REIT if in the application it asserts, and if necessary proves, that it complies with the other pre-REIT requirements.

²⁶ With respect to the Exit Tax, Article 2 of the bill.

²⁷ This term may only be extended under certain external conditions for another year, Section 10 para. 2.

²⁸ Section 10.

²⁹ See *infra*.

³⁰ See in each case the footnotes of a requirement.

³¹ See the bill's explanatory statements under B. Article 1 Section 11.

³² Section 11.

³³ Section 11 para. 4.

³⁴ If the 10% limit set forth in Section 11 para. 4 is ignored for three consecutive years, the G-REIT loses its tax exemption, Section 18 para. 3.

the respective shareholder lose his dividend or voting right;³⁵ however, he may not take advantage of the violation.³⁶

After dividend distribution and allocation to reserves, at least 75% of the G-REIT's total assets have to consist of real estate.³⁷ At least 75% of the gross yields have to arise from renting out, leasing, and selling of real estate.³⁸ The G-REIT may raise credits only to the maximum of 60% of its total assets, on marketable conditions, and if provided for in the Articles of Association.³⁹

The G-REIT may provide additional services to third parties such as real estate management only by a REIT service company. These service company's assets may not exceed 20% of the G-REIT's total assets after dividends and reserves, and its gross yields may not exceed 20% of the G-REIT's total gross yields.⁴⁰

At least 90% of the G-REIT's distributable profits (according to the annual accounts) have to be distributed to the shareholders within the following business year.⁴¹

D. Taxation with respect to G-REITs

I. Tax Exemption on G-REIT Level

According to Section 16 para. 1 of the bill, a G-REIT complying with the requirements according to Sections 8 to 15 is exempted from trade tax. Furthermore it is exempted from corporate tax, if it is (i) in principle subject to corporate tax and

³⁵ Section 16 para. 2.

³⁶ E.g. as regards the withholding tax rate according to an applicable double taxation agreement, see the bill's explanatory statements under B. Article 1 Section 16.

³⁷ As a first sanction of non-complying with this requirement in the end of the business year, the Tax Authority in charge determines a penalty fee dependent on the extent of non-compliance, Section 16 para. 3.

³⁸ Section 12. Assets are evaluated at their market values. Non-compliance with this requirement is sanctioned by the Tax Authority in charge by means of a penalty fee dependent on the extent of non-compliance, Section 16 para. 4.

³⁹ Section 15. The bill only provides for bank financing; it is to be hoped that the G-REIT Act will provide for financing on capital markets by floating bond issues or participating certificates, too.

⁴⁰ Section 12. Assets are evaluated at their market values.

⁴¹ Section 13. Non-compliance with this requirement is sanctioned by the Tax Authority in charge by means of a penalty fee dependent on the extent of non-compliance, Section 16 para. 5.

(ii) not deemed to be resident in another state according to any double taxation agreement.⁴²

Tax exemption is for the first time applicable with respect to the business year in which the G-REIT as such is registered with the Commercial Register.⁴³ Tax exemption is limited to the G-REIT itself and does not apply for its subsidiaries. Tax exemption ends if:

(a) the G-REIT loses its listing on an organized market within the EEA, effective as of the end of the business year preceding the loss;⁴⁴

(b) the G-REIT engages in trading real estate, effective as of the beginning of that business year;⁴⁵

(c) within three consecutive business years less than 15% of the shares are in free float, effective as of the end of the third year;⁴⁶ or within three consecutive business years the 10% maximum shareholding limit set forth in Section 11 para. 4 is ignored, effective as of the end of the third year;⁴⁷

(d) within three consecutive business years raised credits exceed the maximum of 60% of the G-REIT's total assets, effective as of the end of the third year;⁴⁸

(e) within three consecutive business years the G-REIT qualifies for being sanctioned by imposition of a penalty fee, each year according to the same Section 16 para. 3, 4, or 5, effective as of the end of the third year;⁴⁹

⁴² Different from the REIT legislation in the U.S., Great Britain, and France, the G-REIT's tax exemption is fully granted; especially, it is not limited with respect to distributed profits or profits generated by characteristic REIT business. Thereby, the legislator intended to assure the inapplicability of the EU Parent Subsidiary Directive, see the bill's explanatory statements under B. Article 1 Section 16. In international comparison, quite a substantial part of the G-REIT's income is privileged.

⁴³ Section 17.

⁴⁴ Section 18 para. 1.

⁴⁵ Section 18 para. 2; for definition of trade see footnote no. 10.

⁴⁶ Section 18 para. 3.

⁴⁷ Section 18 para. 3.

⁴⁸ Section 18 para. 4.

⁴⁹ Section 18 para. 5.

(f) within five consecutive business years the G-REIT qualifies for being sanctioned by imposition of a penalty fee, each year according to any of the Sections 16 para. 3, 4, or 5, effective as of the end of the fifth year.⁵⁰

II. Exit Tax

Under specific circumstances and limited in time, a so called "Exit Tax" grants tax reduction to those who contribute real estate to a G-REIT. Generally, the initial transfer of real estate to a pre-REIT or G-REIT discloses hidden reserves in real estate. This disclosure of hidden reserves leads to an increase in value, which in turn leads to a realisation of profits. According to applicable German tax law, these profits are subject to full taxation. By the Exit Tax, the legislator intends to give the necessary incentives, since the G-REIT is reliant on substantial contributions of real estate to establish itself on financial markets.⁵¹

According to Article 2 of the bill, only 50% of the profits realised by the disclosure of hidden reserves are subject to income tax, if the real estate to be transferred belonged to the contributor's assets for more than 10 years and the contribution sale is effectively agreed upon after 31 December 2006 and before 1 January 2010.⁵² Sale and lease-back is permitted.

However, the acquiring pre-REIT or G-REIT has to own the contributed real estate for at least four years. Otherwise, or if the pre-REIT does not become a REIT within that period, the Exit Tax exemption is retroactively inapplicable and the acquirer is liable to pay residual taxes.

III. Real Estate Transfer Tax

The above mentioned Exit Tax does not affect the provisions regarding real estate transfer tax. Therefore, the transfer of real estate triggers the ordinary transfer tax.⁵³ In this respect, the legislator expects substantial increase in tax earnings.

⁵⁰ Section 18 para. 5.

⁵¹ Furthermore, the financial administration expects an increase in tax earnings due to the disclosure of hidden reserves.

⁵² The Exit Tax is also applicable to transfers of real estate to pre-REITs and German real estate special assets in terms of Section 66 of the *Investmentgesetz* (German Investment Act).

⁵³ So far, the transfer tax rate is 3.5% in Germany; however, in consequence of the reform of federalism in Germany, each state ("*Bundesland*") may determine its own tax rate. The communal estate of Berlin, for example, plans to invent a transfer tax rate of 4.5%.

IV. Taxation on Shareholder Level

The main taxation is intended to occur on the shareholder level. Distributed profits and all other benefits granted to the shareholders are income from capital and therefore subject to corporation tax, if the shareholder is a corporation, or income tax, if the shareholder is an individual. This shall also apply for profits gained outside Germany which will then be subject to double taxation. In case of income from a shareholding in a G-REIT, general reductions of the taxable income, as provided for under German Tax Law, such as the exemption of 95% of the dividends distributed to corporate shareholders or the exemption of 50% of the dividends distributed to individuals ("*Halbeinkünfteverfahren*"), do not apply.⁵⁴

As far as profits by the sale of shares are concerned, they are subject to general taxation rules; however, again, the *Halbeinkünfteverfahren* does not apply. Accordingly, gains from the sale of shares held privately are tax exempted if a participation of less than 1% of the shares of the G-REIT was held for more than a year. Dependent on the applicability of double taxation agreements, foreign investors may be tax exempted in Germany. Otherwise, capital gains from the sale of shares are fully taxable.⁵⁵

In any case, the G-REIT's profit distributions are subject to withholding tax at a rate of 25%.⁵⁶ When setting up the bill, this taxation at source led to a highly discussed issue in Germany: the risk of a substantial loss in tax revenues, from the Tax Authorities' point of view, to the advantage of foreign shareholders who may refer to applicable double taxation agreements and reduce their tax rates.⁵⁷ Therefore, Section 11 para. 4 of the bill provides for a 10% maximum shareholding.⁵⁸

⁵⁴ Section 19 para. 1. This applies also to income from foreign REITs, Section 19 para. 2 and 6.

⁵⁵ Section 19 para. 5. This leads to double taxation of income from G-REIT service companies and foreign subsidiaries holding real estate. The legislator has realized this double taxation; it is to be hoped that ways of exemption will be opened.

⁵⁶ Section 20 para. 1 and 2. This guarantees that, in principle, every investor is subject to tax in a first step and may – under certain circumstances – apply for repayment or set-off of tax paid. In comparison to taxation of other stock corporations' distributions, the higher tax rate of 25% is justified for tax transparency reasons.

⁵⁷ According to the "OECD Model Convention with Respect to Taxes on Income and on Capital" from 2003 (OECD-MC), income from dividends may be subject to taxation under the regulations of the investor's home country. Then, taxation in Germany is generally limited to 15% according to Article 10 para. 2 of the OECD-MC.

⁵⁸ Instead, G-REIT income could have been classified as "income from immovable property" according to Article 6 OECD-MC, with the consequence of full taxation in the country where the property is

E. Perspectives

There are great expectations placed in the G-REIT: accordingly, a swift introduction of G-REITs is expected to fill a national gap in the international range of real estate investments, to vitalize the business location Germany, and to professionalize the German real estate economy. By planning to enforce the G-REIT Act retroactively as of 1 January 2007, the German legislator proves to strive for competitiveness of the German financial business to other European locations.

situated. According to Article 6 para. 2 OECD-MC, the term "immovable property" shall have the meaning which it has under the law of the country in which the property is situated.