Europe debates real estate investment trusts

Cristina Arumi and Jonathan Ivinson of Hogan & Hartson analyze the US REIT regime in the context of proposals for similar vehicles in the UK and Germany

Against the backdrop of a highly public campaign to purge the EU of so-called harmful tax competition, there does seem to be more than a hint of fiscal competitiveness in the present vogue among EU member states to introduce, or at least contemplate the introduction of, a tax-transparent property investment vehicle, similar in concept to the real estate investment trust (REIT) vehicle first introduced in the US in 1960.

French SIICs

In 2003 the French government introduced the SIIC (*sociétés d'investissements immobiliers cotées*), a property investment vehicle designed to foster the development of domestic property funds in order to compete with the more attractive tax regimes for property investment in neighbouring countries such as the Netherlands, Belgium and Luxembourg.

The SIIC vehicle allows income arising from the leasing of real property, capital gains from the sale or disposal of real property and dividends received from subsidiaries that are themselves derived from tax exempt income to be exempt from French corporate income tax.

Tax is levied on these profits only in the hands of the shareholders. Notwithstanding a one-off exit tax levied on conversion to become a SIIC, take-up in France was substantial.

All listed French property companies elected to become SIICs. The effect on the value of these companies has been extraordinary. The shares of these companies traded at an 8% premium to net asset value in the second half of 2004 as opposed to a historical average since 1990 of a 26% discount to net asset value. This remarkable turnaround is attributable entirely to the elimination of double taxation, that is, taxation at the corporate level and taxation of dividend income in the hands of shareholders.

The success of the SIIC has prompted other major EU economies to consider the adoption of a similar investment vehicle. As well as France, since 2001 similar vehicles have recently been established in Japan, Singapore, Hong Kong and South Korea.

Germany looks set to follow next, although as yet no detailed proposals have been issued. On January 19 2005 this year, Parliamentary Undersecretary Barbara Hendricks said that the German finance ministry was keen to enact a law introducing a REIT-type vehicle by the end of 2005.

In the UK despite the conclusion of a consultation process initiated by the Treasury, it is unlikely that legislation will be forthcoming until 2006 at the earliest.

In the meantime, debate rages about the scope and flexibility of the UK vehicle. The government's present views, as indicated in the consultation paper, are that the vehicle should be listed, closed-ended and internally managed with a maximum gearing limit of 50% of total asset value. Additionally, no development activity would be permitted and 90% of pre-depreciation income should be distributed as dividends to shareholders. The UK property industry in general found these restrictions onerous, recommending instead no restriction on gearing, the inclusion of development activity in the list of permitted investments and a minimum income distribution requirement of only 80% of pre-depreciation income.

Every tax transparent property investment vehicle established in Europe or elsewhere is inevitably compared to the US prototype. They are generally referred to as REITs, notwithstanding that they generally have their own distinctive acronyms.

The rules and fiscal characteristics of such systems are almost always compared to those which apply to the US REIT and it is almost certainly the case that all overseas governments who have considered the introduction of such a vehicle will have taken a long, hard look at the US REIT and its development.

In order to understand the current European debate, it is essential to know exactly what we mean when referring to a US-style REIT. What are the fiscal characteristics of the US prototype and to what extent are they responsible for the extraordinary success of the US REIT. If the UK and Germany were to adopt a more restrictive vehicle, would the benefits to the real estate market correspondingly diminish?

US REITs

US REITs were designed to facilitate investments in large-scale income-producing real estate by smaller investors. The model was simple, enabling small investors to acquire equity interests in vehicles holding large scale commercial property in the same way that they invested in other industry sectors, by buying shares in publicly-traded mutual funds.

In order to ensure that the REIT remains a mere conduit for passing rental and other passive real estate related income through to its investors, a REIT is subject to rather strict requirements relating to:

- the source of the REIT's income;
- the composition of the REIT's assets;
- the distribution of the REIT's earnings; and
- the number of beneficial holders of the REITs shares.

For the first quarter century of the REIT's existence, it languished in relative obscurity, in part because the restrictions on the REIT's activities even limited its ability to manage its own assets. Hence, a REIT was required to have an outside adviser or manager, which inevitably led to increased costs and created inherent conflicts of interest.

Table 1: Summary of Global REIT legislation

Country	Status	Market cap (US $ billion)	Number of REITs	Premium / discount to NAV	Structure	Comments
Australia	Enacted 1971	$51	29	Premium	LPT (Limited property Trust)	Firmly established. External management historically, shifting toward internal management; development allowed in stapled trust; foreign assets allowed; no leverage restrictions. LPT sector has outperformed general equities; considerable recent M&A / consolidation activity among LPT sector.
Belgium	Enacted 1995	$4	10	Premium	SICAFI (Societe d'investissements a capital Fixe)	Established. Internal management; development allowed but restricted; foreign assets allowed but mmay be taxed at source; leverage limited to 50% of asset value; not more than 20% of assets can be invested in one single property.
Canada	Enacted 1993	$12.1	24	Premium	REIT	Developing. Internal/external management; development allowed; foreign assets allowed; no leverage restrictions. Not as developed as the US REIT market; wave of IPOs in the late 1990s; still only modest-sized companies.
Finland	Pending	$1	N/A	Discount		Structure may be introduced as early as 2006, but there is a risk that the process will be delayed. Terms are not yet known due to recent changes in corporae taxation and taxation of dividends.
France	Enacted 2003	$17.3	9	Premium	SIIC (Societes d'investissements immobiliers cotees)	Establsihed. Internal management; development allowed; foreign assets allowed but may be taxed at source; no leverage restrictions. Structure considered to be liberal and has been a major success due to high adoption rate and significant improvement in sector valuation.
Germany	Pending	$2.6	N/A	Discount		Real estate predominately owned in tax-advantaged, open-end property funds. REIT structure should be highly successful, as German private investors are keen to invest in real estate. The volatility of REIT securities may be higher, but investors will likely prefer an internally managed REIT structure that trades at a modest discount to NAV but generates a higher dividend yield over an externally managed fund that trades at NAV but offers a lower dividend yield.
Hong Kong	Enacted 2003	$61.9	0	Discount	REIT	Undeveloped. Internal/external management; development prohibited; foreign assets. Currently, no companies have elected REIT status due to lack of tax transparency and overly restrictive limitations on geography and leverage. First REIT may be listed in 2005 or 2006.
Japan	Enacted 2001	$13.6	14	Premium	J-REIT	Established. External management; development allowed but >50% must be income producing; foreign assets allowed; no leverage restrictions. First country in Asia to introduce structure; secttor has grown rapidly
Netherlands	nacted 1969	$14	9	Premium	Dutch BI (Fiscal investment institution)	Firmly established. Internal management; development prohibited; foreign assets allowed but may be taxed at source; leverage limited to 60% of book value for real estate and 20% of book value for other investments. Long trading history; strong investor interest in property shares, especially from country's highly-developed pension industry.
Singapore	Enacted 2002	$2.9	4	Discount	REIT	Established. External management; development allowed up to 20% of total assets; foreign assets allowed; leverage limited to 35% of total assets. Includes first Asian cross-border REIT.
South Korea	Enacted 2001	$0.5 (CR-REIT sector)	7	Discount	REIT and CR-REIT	Undeveloped. REIT structure initially introduced to aid the corporate restructuring process. Conventional REIT market is currently non-existent due to the structure's lack of tax transparency. Corporate restructuring REITs (CR-REITs) exists and provide tax efficiency but have limited lifespans and are available only for corporate restructuring purposes.
UK	Pending	$47.6	N/A	Discount	PIF (Property investment fund)	Largest listed property sector market in Europe. Government currently actively reviewing the legislation of PIFs, and it is likely that an acceptable structure may be in place by 2005 or 2006. UK property companies have traded higher in anticipation of this legislation.
US	Enacted 1960	$247.4 (Excludes mortgage REITs)	146	Premium	REIT (Real estate investment trust)	Firmly established. Internal management; development allowed; foreign assets allowed; no leverage restrictions. Modern REIT era did not begin until the early 1990s.

Source: Morgan Stanley Investment, as of August 2004

Self-managed REITs

Reforms introduced in 1986, however, heralded the advent of the "self-managed REIT" that is able to manage its own assets and directly engage in leasing and property management activities. Nevertheless, REIT activities continue to be restricted to real estate operating activities. In order to ensure that REITs do not engage in other active businesses, 75% of a REIT's gross income must be derived from sources such as rents, real estate gains and mortgage interest and 95% must be derived from rents, real estate gains, mortgage interest and other passive sources.

Also, 75% of a REIT's assets must be real estate assets and a REIT generally cannot invest a significant portion of its capital in securities of other companies (unless those companies themselves qualify as REITs).

Jonathan Ivinson: The UK is clearly considering a very different vehicle from the US REIT

Non-qualifying assets and income

Most recently, legislative reforms in 2001 and 2004 have allowed REITs to have a limited amount of non-qualifying assets and income (for example, related to tenant service, development and dealing activities) through taxable corporate subsidiaries. The advantage of these developments is that a US REIT has increased flexibility to address more of its business needs internally, at a tax cost however.

In order to ensure that the US REIT is widely-held, REITs are required to have a diverse shareholder base. This is accomplished by requiring that, first, the REIT have at least one hundred shareholders.

Moreover, a REIT may not have five or fewer beneficial shareholders who are individuals that own more than 50% of the value of the total outstanding equity. This requirement, known as the 5-50 requirement, is applied with reference to complex ownership attribution rules that require that the REIT look through its shareholders that are other entities (whether or not fiscally transparent) to determine whether the 5-50 requirement is met.

For example, a REIT that is 60% owned by another publicly-traded company will not fail the 5-50 requirement so long as the publicly-traded company is itself widely held. A REIT, however, cannot be owned by a single individual or family, or by a small group of individuals. Finally, the REIT must be managed by one or more trustees or directors so as to ensure that the REIT is not run directly by one or more major shareholders and that the diverse shareholder base is represented.

A US REIT achieves its tax transparency by deducting from taxable income dividends paid to investors and the US REIT is required to distribute the vast majority (90%) of taxable income to investors on a current basis. Any undistributed REIT income will be subject to US corporate level tax in the hands of the REIT. The distribution requirement can limit a REIT's ability to reinvest its profits.

Practically speaking, a US REIT will distribute all of its net income in order to avoid paying any tax at the entity level, which would adversely affect the REIT's earnings. So, although a REIT can retain a small portion of its net income with out jeopardizing its REIT qualification, all of the REIT's net income normally will be passed on almost immediately to the investors to be taxed in their hands.

Most public REITs, therefore, look to continued access to the public debt and equity markets in order to fund growth and capital expenditures. Notably, there is no explicit maximum gearing limit for US REITs, although the capital markets effectively impose limits on debt for publicly-listed REITs by penalizing the value of the stock of a REIT that is perceived as too highly leveraged.

If the REIT qualification requirements are met, the income distributed by a REIT is taxed only in the hands of the investors as dividends, or in the case of capital gains realized by the REIT from the sale of property and distributed to investors, as capital gains (which for non-corporate US shareholders, are taxed at more favourable rates).

Ordinary REIT dividends generally are not eligible for the reduced 15% rate of tax that is applicable to dividends paid by non-REIT US companies since 2003. This ensures that the income of a REIT is subject to at least one full level of tax.

For non-US investors, ordinary REIT dividends are subject to 30% US withholding tax, unless it is reduced by treaty. As a result of recent legislative improvements, a non-US shareholder will be not be subject to the 35% FIRPTA (Foreign Investment in Real Property Tax Act) tax on capital gain dividends if the shareholder does not own more than 5% of the class of publicly traded stock on which the capital gain dividend was paid.

Cristina Arumi: REITs' regular distribution of earnings is attractive to institutional investors

The FIRPTA tax is intended to ensure that US real property gains are subject to at least one level of US tax, and generally taxes the non-US investor as if it were a US resident on real property gains. For non-US REIT shareholders that are not subject to the FIRPTA tax, the capital gain dividends will be subject to the same withholding rate as ordinary dividends.

The REIT boom

Since the early 1990s, the US REIT sector has boomed. The public market now has more than 200 companies with a total market value of $310 billion. REIT performance has been especially strong during the past three years – a recovery that followed a brief recession in the REIT sector from 1999 to 2001. The brief recession coincided with the dotcom era on Wall Street and the inverse relationship between the performance of REITs and the dotcoms has held true since the bubble burst in 2001.

The REIT sector has combined steady, if not extraordinary growth, with actual returns to shareholders in order to fuel this recovery. To be clear, the US REIT is not immune to trading at a discount to net asset value, but the discounts are significantly less than what is historically observed in non-REIT real estate companies and premiums are not unheard of.

Distribution of earnings

The REIT distribution requirement plays a significant role in the strong market performance of REITs in the US – REITs have recently outperformed companies in other sectors with respect to distribution of earnings, with the distribution percentage for REITs exceeding that of other companies by an average margin of two to three times, or more. For investors looking for regular distributions (like many institutional investors) a REIT investment is, therefore, very attractive.

Perhaps one of the most important factors in the growth of REITs since the early 1990s is that there are tax-efficient methods for taxpayers to enter into the REIT form. The 1990s saw the rise of the acquisition structure known as the "umbrella partnership REIT" or "UPREIT".

By using the UPREIT structure, in which the REIT owns substantially all of its assets through a partnership with outside investors, REITs are able to acquire properties from private holders in a manner that is tax-deferred to those private holders. This is a tremendous advantage for UPREITs engaged in competitive bids for commercial real property that the seller has held for a number of years and that is fully depreciated. In addition, existing non-REIT real estate companies have the ability to convert to a REIT form on a tax-free basis so long as the company does not sell its assets for a period of 10 years following the conversion. The REIT will be subject to a corporate level income tax on assets sold within the 10-year window.

By comparison, the new French model imposes a one-time corporation tax on newly converted SIICs but at a discount of about 50% on the normal tax rate for capital disposals and spread over a four-year period.

It is clear that the market for publicly-listed REITs is robust. Not to be overlooked, however, is the absence in the US REIT structure of any requirement that the REIT be publicly listed.

Private REITs

The so-called private REIT is a popular structure both for domestic joint ventures and for cross-border investment into the US. Due to the ownership restrictions outlined above – particularly the 5-50 requirement – not all investors can use the private REIT structure, but for a European pension fund or governmental entity with a suitable US co-investor, the tax benefits of a private REIT are quite impressive.

There have been a number of unsuccessful legislative attempts in recent years to curb the use of private REIT.

With careful structuring and the use of a private REIT, a European investor, especially one resident in a favourable tax-treaty jurisdiction, can enjoy a low rate of tax on ordinary REIT dividends and eliminate all capital gains tax on the disposition of the REIT shares, so long as at least 50% of the US REIT is beneficially-owned by US residents.

Understandably, there is some concern that the private REIT can be used to circumvent the purpose for which the US REIT vehicle was originally established. However, there is no compelling reason to require public listing if a private REIT vehicle is otherwise widely held as contemplated by the statutory requirements.

Lessons for the UK and Germany

The UK consultation exercise on what are tentatively described as property investment funds or PIFs reveal a good deal about the government's thinking on a number of key issues. What is clear is that we are not going to see a replica of the US REIT structure, at least for now.

The government's primary focus is to stimulate investment in property, particularly domestic property in order to deal with a perceived domestic housing shortage. The focus is not to put the property sector on an equal footing with other industrial sectors by eliminating double taxation and consequently to stimulate investment growth in the sector generally. In this regard, it should be remembered that PIFs are not the first attempt in the UK to introduce a tax-advantaged property investment vehicle.

In the past, schemes have been introduced to permit investment trusts to invest in low-value housing and these narrow initiatives have not been successful.

Somewhat ominously, the debate on REITs in the UK began life as a recommendation in a report commissioned by the government on the perceived domestic housing shortage in the UK.

In the 2004 Budget Statement, the chancellor stated that he accepted the recommendations of the Barker report for "British real estate investments trust to improve the supply of rented property". The consultation exercise extended the scope of that recommendation to cover commercial as well as residential property investment. That in itself should be sufficient for the new investment vehicle to out achieve previous failed attempts to stimulate the domestic property sector but the main focus remains allowing smaller investors access to the domestic rental property sector.

Notwithstanding the many lessons to be learned from the US, the UK government is clearly considering a very different vehicle from the US REIT. The key differences involve a mandatory listing requirement, permitted leverage ratios and the scope of permitted investments. Despite the fact that the private REIT is particularly attractive to offshore investors in the US, it appears from the consultation paper that the UK believes that all REITs should be listed.

The rationale for this is that the PIF should be easily accessible by small investors as well as the attraction to the government of market and listing authority scrutiny. But as the US experience shows, diverse shareholder base is achievable by legislating for a minimum number of shareholders, which in the case of the US is 100, and by limiting the concentration of ownership of REIT shares in the hands of a single investor.

The expense of listing and the compliance costs associated with reporting requirements would seem to impose an unnecessary financial and administrative burden on PIFs. As discussed above, the French SIIC has a mandatory listing requirement. But it remains to be seen whether this requirement will create a significant barrier to entry. It is one thing persuading the quoted property sector to convert, quite another to raise new capital and attract new entrants.

Maximum gearing ratio

The other area where the UK consultation exercise appears to diverge from the US model is in the maximum-gearing ratio.

In the US (not to mention Australia, France and Japan) there is no limit on the amount of borrowing that can be undertaken by a REIT. Control of leverage ratios is left to the markets. The government's logic here is that PIFs should be targeting income growth rather than capital growth. This may prove a disincentive for existing quoted property companies to convert, particularly given that average gearing in the quoted property sector is around 80%.

Again, it seems that the government wishes to restrict the risk-profile of these vehicles, notwithstanding the fact that many small investors already invest in the shares of companies in other market sectors with gearing ratios that exceed 50%.

Another risk-averse feature of PIFs is likely to be a restriction on development activity. The real driver here is to increase investment in the domestic retail sector, hence the government's determination that riskier, more speculative projects do not fall within the ambit of the PIF.

There are few indications yet of what the German government plan to introduce but as outlined above it appears that the UK government is focussing on a vehicle to encourage investment in the domestic housing sector rather than on developing a US style REIT to stimulate investment in the property sector generally. There is certainly time for that emphasis to change. But at the moment the UK government appears to be intent on creating its own distinctive vehicle rather than emulating the highly successful US prototype, the REIT.

Cristina Arumi (acarumi@hhlaw.com), Washington, DC and Jonathan Ivinson (jivinson@hhlaw.com), London