The REITs race is on

As Europe wakes up to the benefits of US-style real estate investment trusts, which EU member state will ultimately provide the more attractive vehicle? By **Chris Berry** and **Simone Greaves**

It was as long ago as the 1960s when the US introduced a tax transparent property investment vehicle know as the real estate investment trust (REIT) and it seems that, finally, albeit in a somewhat piecemeal fashion, EU member states have accepted that similar European vehicles would provide the flexibility augured for so long by the commercial property market.

REITs, and their ilk, enable ordinary investors to place money into a vehicle specially created to make major property or land acquisitions. Such instruments operate similarly to unit trusts in relation to equity holdings and have a major fiscal advantage over quoted property companies in that (fundamentally) tax is paid only once, at investor level. Provided the REIT operates within the appropriate rules, it is tax transparent so that it has no liability for tax on income and capital gains and investors only pay tax on their dividends and any capital profits arising from the sale of their share investment.

REITs are subject to restrictions on the type of activities they are permitted to undertake: the greater part are to be passive, income-producing investments rather than property development or dealing. This is, of course, reflected in the fact that they are not taxed at entity level.

The appetite for REIT structures in Europe is such that there now appears to be an element of competition among EU states to provide the most attractive tax regime for local and international property investment. Some believe that the European REIT market will become more attractive than that in the US, where US REITs are generally thought to be overvalued.

Inspired by the US REIT, the French government introduced the SIIC (*sociétés d'investissements immobiliers cotées*) in 2003. This allows income arising from the leasing of real estate, capital gains from the sale or disposal of real estate and dividends received from subsidiaries that are themselves derived from such tax exempt income to be exempt from French corporate income tax. Tax is levied on these profits only in the hands of the shareholders.

The SIIC regime is available, upon election, to companies listed on a French regulated market the share capital of which is at least €15 million. The company must have been formed with the predominant purpose of acquiring or constructing property which is then let or holding shares (directly or indirectly) in companies which have this as their core business purpose. There is no restriction on the place of residence of SIIC shareholders or indeed on the location of the underlying property asset; nor are there special conditions as to the level of debt in the SIIC, though there are restrictions governing the proportionate value of assets which can be held by it for certain purposes.

The SIIC tax exemption also applies to 95 per cent subsidiaries of SIICs and to the profits of tax flow-through partnerships 95 per cent of the interests in which are owned by a SIIC partnership, provided such entities make a SIIC election and they carry on the requisite property activity. In order to benefit from the tax-exemption, a SIIC must distribute at least 85 per cent of rental income to shareholders and any subsidiary company must distribute 100 per cent of rental income to its parent SIIC. In addition, the SIIC is required to distribute at least 50 per cent of new capital gains realised on the disposal of interests in real estate or interests in SIIC partnerships or shares in SIIC subsidiaries to its shareholders within two years of the relevant disposal.

A SIIC is allowed to carry on certain activities which are ancillary to its SIIC property activities, albeit the profits from such activities are then subject to French corporate income tax in the normal way.

The SIIC vehicle has proved to be so popular that, notwithstanding the levy of a one-off exit charge equating to 16.5 per cent of latent capital gains imposed on conversion to become a SIIC, all listed French property companies elected to become SIICs and with a consequent radical turnaround in their value. Further changes in the French Finance Act 2005 introduce a reduced tax rate for companies that contribute (between January of this year and 31 December, 2007) buildings or real estate leasing contracts to SIICs in return for shares. Whilst these changes are modest in scope, they provide an encouragement for companies to transfer their real estate assets into a SIIC, although the 16.5 per cent exit charge will apply at the time of the contribution. In addition, income and gains from the subleasing of property leased by a SIIC under a finance lease and from the sale of leasing contracts will now be tax-exempt, and a tax-neutral regime for mergers of SIICs has been introduced.

Whilst the Netherlands, Belgium and Luxembourg have all had REIT-equivalent investment vehicle structures for some time, the success of the SIIC concept in France has led other major EU economies to contemplate their adoption.

Germany looks set to follow France next, although, as yet, there are few indications of what the government plans to introduce. Parliamentary state secretary Dr Barbara Hendricks has said recently, however, that the German ministry of finance is keen to enact a regime introducing a REIT-type vehicle by the end of this year. Industry experts, along with the major players in the German real estate market, strongly support this initiative hoping, among other things, to open up the real estate 'blocked' in German enterprises for national and international investors. It is perhaps instructive to note that 70 per cent of German companies own their real estate, compared to 54 per cent in the UK and 25 per cent in the US.

While there is no official draft bill to introduce a German REIT, various organisations have presented their views and suggestions regarding the possible legal framework as well as the preferred method of treating them from a fiscal standpoint. The indications are that the taxation of such REITs, especially the realisation of latent gains, will be a decisive factor in determining their future success. The present budget situation in Germany does not allow for a general tax-neutral realisation of such latent gains, though a mandatory taxation of latent gains triggered by conversion of a company to REIT status (or by transferring real estate to a REIT) is likely to give German REITs a competitive advantage *vis-à-vis* competing investment structures.

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Other issues which are currently being debated within the German real estate community are the minimum level of profit distribution, the extent to which property portfolios may be re-structured and the requirement for a REIT to be a listed stock corporation.

In the UK, the conclusion of the consultation process initiated by the Treasury last year has led to the establishment of a working group to discuss the challenging issues which the property industry raised. As a result, legislation for the introduction of the UK REIT is unlikely to be forthcoming until 2006 at the earliest.

In the meantime, although the government discussion paper on UK REITs (published as part of the recent UK budget) clearly shows that the government has taken on board some (if not most) of the industry's concerns, debate still rages about the scope and flexibility of the UK vehicle. Certainly, the government is seemingly not contemplating a replica of the highly successful US REIT structure. Its primary focus in creating a UK REIT is to stimulate investment (principally by smaller investors, but also by institutional players) in residential rental property in order to deal with a perceived domestic housing shortage. However, it is currently proposed that UK REIT status will be open to UK and overseas companies alike and that there will be no limit on the type or location of the underlying property asset.

Whilst ultimately commercial property has been included within the scope of UK REIT investments, the initial consultation contained a number of restrictions which the UK property industry thought unduly onerous. In particular, it favoured a vehicle that should be listed, closed-ended and internally managed with a low gearing limit of debt to total asset value. A limitation on development activity, when taken with the prospect of a constraint on gearing ratio, evidence a determination on the part of the government to restrict the risk-profile of UK REITs, notwithstanding the fact that many small investors already buy shares of companies in other market sectors with gearing ratios that exceed 50 per cent. The government's thinking here is that UK REITs should be targeting income rather than capital growth but underlying this proposed feature is the evident concern that the government's tax take should not be reduced.

Whilst the liberalisation of some aspects of UK REITs in the latest government paper has been welcomed by industry, there are some important issues which have yet to be thought through – most notably gearing levels and how the UK can comply with its international obligations in relation to non-UK companies with UK REIT status without, in either case, a tax loss to the Exchequer. Details of an 'exit/conversion charge' have yet to be finalised and, naturally, this is one of the key concerns for industry. The solutions to such matters and the detail on outstanding points will have to be carefully thought out if they are not to prove a disincentive to conversion for existing quoted property companies, the more so given that the average gearing in the quoted property sector is somewhere around 80 per cent. Even if such companies do convert, new capital still has to be raised and new entrants enticed. ■

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