Real Estate: International Comparisons. Reits

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Key words: *US REITs – European REITs Comparison, REIT requirements, REIT Taxation, The legal regime, Management of REITs*

Abstract: *This study approach the real estate international comparisons - US REITs vs French and German RE markets - such as : REIT Requirements, REIT Taxation, REIT Shareholder Taxation, Entity requirements to qualify as a REIT, Ongoing requirements to remain in REIT status, Management of REITs, REIT Qualification, Special capital gain rules*

1. Characteristics of a REIT

A REITs must have legal structures like *Corporation* or *Trust*. It is usually, a public corporation, but could be a private one, as well.

REIT must be organized as Corporation, Trust or Association.

The types of assets that are allowed to be owned by a REIT*, are:*

- Investments in real estate and/or loans to finance real estate (Equity REITs, Mortgage REITs, Hybrid REITs)
- other assets allowed (normally 25 % max.)

The types of earnings that are allowed to be owned by a REITs, are*:*

- From property activities (lending, possibly development, services, trading);
- other earnings allowed (normally 25 % max.)

The profit could be distributed to shareholders or could be reserved by the corporation in 5 – 10 percent, normally.

To qualify as a REIT, the US law stipulate that any entity must comply with the demands bellow:

- Be organized as a corporation, trust, or an association
- Be managed by one or more trustees or directors
- Have transferable shares or certificates
- Be taxable as a domestic corporation “but for the REIT regulations”
- Not be financial institution or insurance company
- Be owned by 100 or more persons
- Not be closely held
- Make an election to be taxed as a REIT

Management of REITs must be professionally, it must be one or more trustees or directors. Must not be required to seek shareholder ratification for their business decisions. Rights and powers of trustees must satisfy the “centralization of management” test. The management must be characterized by exclusive authority.

Congress intended that REIT’s income should be “passive” in nature and not derived from the active operation of business.

The Code requires the trustees to delegate certain management of the REIT's rental properties to an independent contractor.

The independent contractor's employees rather that the REIT's employees provide certain services furnished to REIT tenants.

2. REITs – the global perspective. Development

Introduced in the USA in the late 1960's, the REITs are also established in Canada, South-America, Asia and Australia. Increasing acceptance in Europe: Belgium, Netherlands, Italy, Luxembourg, Spain.

The REITs was introduced in France in 2003 and are expected to be introduced in the near future in the UK. Also, it is discussion about this problem in Germany.

3. US REITs vs European REITs

In the USA, REIT was introduced in the late 1960's. The US RE law stipulate that a REIT must be organized as a corporation, trust, or an association.

Foreign corporations, trusts or associations do not qualify as a REITs even if qualifying under other sections of the code. This requirement is available both a corporation and domestic. Domestic must be organized under the U.S. Law.

The US law stipulates that the ongoing requirements *to remain in REIT status* are:

- Quarterly assets tests
- Annual income tests

Assets tests

A REIT must satisfy six interacting assets tests at the close of **each quarter** of the taxable year, like the follow:

1. At least 75% of the value of its total assets must consist of real estate assets, cash and cash items (operating A/R), and government securities
2. Not more than 25 % of the values of its total assets may consist of securities, other than those includible under the 75% test
3. Not more than 20% of the value of its total assets may consist of securities of one or more "taxable REIT subsidiaries"
4. Not more than 5% of the value of its total assets may consist of securities of anyone issuer, except with respect to a taxable REIT subsidiary and those securities includible under the 75% test
5. Not more than 10% of the outstanding total voting power of the outstanding securities of anyone issuer may be held, except with respect to a taxable REIT subsidiary and those securities includible under the 75% test
6. Not more than 10% of the outstanding total value of the outstanding securities of any one issuer may be held, except with respect to a taxable REIT subsidiary and those securities includible under the 75% test.

Failure to meet tests could disqualify REIT unless due to reasonable cause not willful neglect, or is correct failure within certain time frame, or if it pay penalties.

Income Tests it is applied on annual basis, evaluating gross income, using two methods:

- 75% gross income test
- 95% gross income test

75% must be derived from:

- Rents from real property
- Interest on obligations secured by mortgages on real property
- Abatements and real property tax refunds
- Income gain derived from foreclosure property

95% of a REIT's gross income must be from the following sources:

- Sources mentioned under the 75% test
- Dividends
- Interest and
- Gain from the sale or other disposition of stocks or securities

If a REIT fails one or two of the income tests in any year, it may be disqualified from the REIT status. The REIT may still qualify for REIT status provided that the failure to meet income tests was due to reasonable cause and not willful neglect. If it fails the tests, it is subject to a penalty tax.

An entity will not qualify as a REIT if is closely held. If during the last half of the taxable year more than 50% of the value of its outstanding stock is owned directly or indirectly by five or fewer individuals

Operations of a REIT

The requirements of minimum distribution are 90% of the REITs taxable income. It can deduct the dividends paid.

REIT Qualification

Congress intended that REITs be holders of real estate assets in a “portfolio type” manner. While the original REIT provisions have been relaxed to allow REITs to become integrated real estate operating companies, the REIT qualifications tests still provide for significant operational constrains.

Election to be Taxed as a REIT:

- Must make an Election
- Election, once made, continues until revoked or terminated by the entity’s failure to qualify as a REIT for a taxable year
- Cannot re-elect REIT until the fifth year after initial revocation

Accounting period for a REIT must be the *calendar year*.

Taxable income is less than cash flow, is depreciation and amortization.

The distribution could provide the shareholder with a return on capital (non-taxable) distribution. Taxable income is greater than cash flow - non-cash income (phantom income).

Subtracted from amount that would otherwise be distributable (not all non-cash income can be adjusted). Distribution of its stock may qualify for dividend paid deduction and is treated as a distribution of property.

Dividends actually paid during the taxable year are taken into account. Dividends declared in the follow months: October, November, December, but paid in January the following tax year. Will be deemed paid by the REIT and received by shareholders on December 31 of that year. Dividend declared prior to October and paid following January will NOT qualify.

Tax of the REIT and its shareholders

REIT’s taxable income is similar to other domestic corporations. The exception is that a REIT is entitled to a dividend paid deduction.

A REIT is potentially subject to entity level tax if all REIT taxable income is not distributed.

Calculation of minimum dividend distribution

REIT’s taxable income before dividend paid deduction:

Net Capital gains		$20
Other net income		100
Total taxable REIT income before divided paid deduction	$120	

Basis for calculation minimum distribution:

REIT Taxable	$120	
Less net capital gain	<20>	
Basis for calculation 90% minimum distribution		$100
90%		<90>
Retained income	10	
Capital gain		20
Potential taxable income at REIT level	30	

In the USA a REIT must distribute $90 ordinary dividend, may distribute $20 capital gain dividends and may distribute $10 addition ordinary dividends.

Taxation of REIT shareholders

Dividends treated as ordinary dividends to extent of current or accumulated earnings and profits (E&P). Dividends in excess of E&P are non-taxable return of capital to extent of the shareholders basis in the shares. Any dividends in excess of basis is treated as taxable gain from the sale of shareholders shares.

Capital gains distributions:

Subject to a withholding rate of 35% (or 15% to the extent provided for in regulations). Capital gain distributions are subject to U.S. Tax. Capital gain distributions made by a REIT to a foreign owner is not treated as income effectively connected with a U.S. trade or business.

Treated a as REIT dividend that is not a capital gain distributions if REIT publicly traded and foreign investor owns less than 5% of the stock on date of distribution.

In France, the REIT was introduced in 2003.

The legal forms are:

- SIIC – listed sector,
- SCPI – non-listed sector
- and the new OPCI

Main elements of SIIC

In the SIIC case is a *derogatory rule* that says: until the December 31, 2007, any company contributing a RE asset to a “RE company” (i. e. a SIIC) may benefit from a reduced tax rate of 16.5% + additional levies (= “exit tax” vs. the standard corporate income tax rate: 34.95% in 2005). The *condition* is that the contributed RE asset must be kept 5 years.

In case of non respect, *the sanction*: a fine equal with 25% of the value of the contributed asset.

A *listed company.*

Full exemption for *profits generated by the SIIC main business activity* different ancillary business activities liable to French income tax. Has to fulfil *distribution commitments*, namely at least:

- 85% of rental income (profits generated by letting buildings)
- 50% of capital gains (resulting from the transfer of buildings and stakes held in RE subsidiaries)
- 100% of dividend (profits received by subsidiaries)

Counterpart of the contribution:

► “SIIC 2” : only shares of the RE company

► “SIIC 3” (Finance Law for 2006) : cash + extension for the sale of RE financial lease (“credit-bail”)

Main elements of SCPI (*“société civile de placement immobilier”)*:

The SCPI has 2 different *capital regimes*:

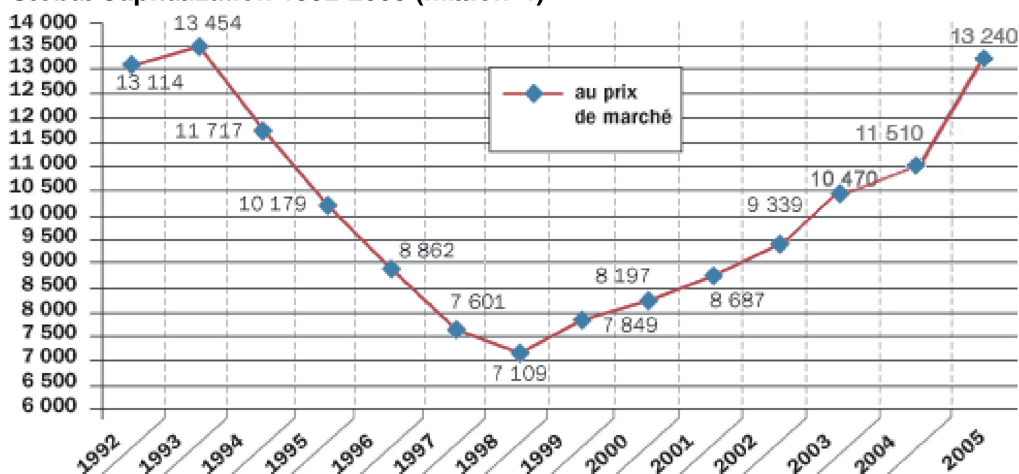
- *closed-ended funds* : transfers made on the “secondary market”, see “*The unachieved reform*”
- *open-ended funds*

It also has 2 different *asset categories*: the *“basic SCPI” and* the *“tax friendly SCPI”*: about 25% of the issued capital in 2005.

The SCPI is a non-trading company; developed more than 30 years ago (Law dated Dec. 31, 1970). Until 2005 the SCPI numbered 133 entities and 27 managing companies. The percentage of the individuals is about 80% vs. 20% owned by other legal entities.

SCPI : dynamism of the non-listed sector

Global Capitalization 1992-2005 (million €)



Source : www.scpi-aspim.com

The SCPI has major restrictions on asset management:

► *Corporate purpose*: limited to acquisition and management for buildings to let (i.e. no possible construction, no indirect investment).

► *Sales within the portfolio*: only assets owned for six years can be sold with a limit of 15% of the portfolio per annum.

► *Expansion works*: only allowed three years after acquisition of the building in the limit of 10% of its surface.

► *Refurbishment works*: only allowed three years after acquisition in the limit of 3% of the global value of the portfolio.

► *Borrowings and debts*: subject to approval from the Annual General Assembly.

OPCI (“organisme de placement collectif immobilier”)

The legal regime refers to a subdivision of the CIS existing in France (“organisme de placement collectif”). It is an open-ended vehicle. A real estate CIS has 60% minimum of RE assets through direct and indirect investment, 10% minimum of liquid assets (cash and near cash), remaining 30% are RE assets and rights, liquid assets and financial assets.

Exist 2 different legal forms:

► The *“fonds de placement immobilier”, “**FPI**”*: joint-ownership of RE assets without legal personality.

► The *“société de placement à prépondérence immobilière à capital variable” (“**SPPICV**”)* : limited liability company with variable capital.

It is one main difference between two of this forms - the tax treatment.

OPCI has 3 different client targets, like follow:

► For Individuals (*“**grand public**”*) with stringent diversification rules (see “*A strengthened security and additional transparency*”)

► Accessible to certain Individuals (*“OPCI fiscal”*) and institutional investors: ***“RFA 1”***

► Reserved to opportunistic investors: ***“RFA 2”*** has to fulfil only one ratio = 60% minimum of RE assets.

It has also 3 main goals: a better liquidity, a largely cited drawback of this sector: “Illiquidity”, how to match difference in the clients and assets turn-over.

The “OPCI solution” refers to investors which will be allowed to subscribe shares and redeem them upon request (an “*open-ended vehicle*”) thanks to a 10% minimum of liquidity reserve.

The control of management

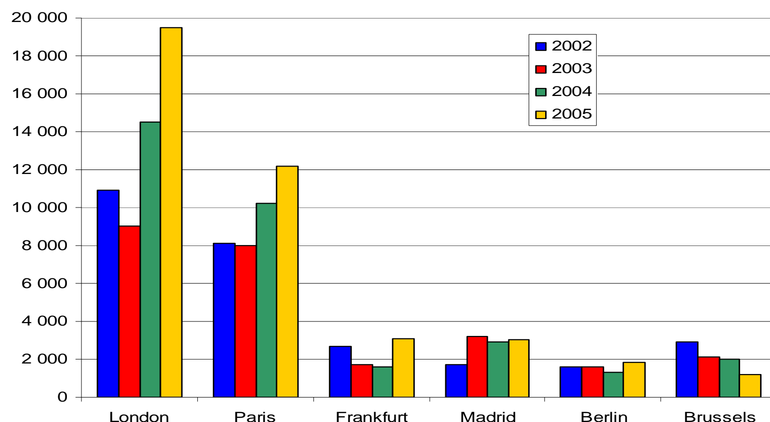
The management company is approved by the *“AMF”.* Exist an independent deposit bank (*“dépositaire”*) who is a regulated financial institution, is independent from the management company, custody of the financial assets of the OPCI, control of compliance with rules and investors’ interest.

The OPCI has a specific Supervisory board (*“Conseil de surveillance”*) in the “FPI” who has between 5 and 9 shareholders. It is a discretionary management - no intrusion in the management decision. They have external auditors to review the accounts.

OPCI Tax Regime

No more registration duties on transfers of OPCI shareholdings (exception for shareholders representing more than 20% of capital). Exist the possible choice between two different tax regimes. It is exempted from the corporation tax which is equal with “tax transparency”. Only dividends are taxed in the OPCI (≠ SCPI: tax is calculated on net income on company level). But, in compensation exist a high distribution level.

A European View on French RE markets
Global Investments 2002-2005 (million €)



Source: AtisReal Int’l Research Feb. 2006

Reform purpose

To facilitate **growth in long-term (pension savings) vehicles** by French individuals it is necessary to invest in long term RE assets investment, with low volatility (non-listed sector), keeping the CIS “virtues”. Also, to build a modern tool allowing French institutional investors to take fully **part of their own domestic markets.** To be in phase with **corporate holdings “externalization” current trend**: see rate of companies’ buildings held by investors in the US (70%), Europe (50%) and France (only 30%).

Perspective

► The SCPI – OPCI transition issue: 5 years to adopt by vote the new status without incurring taxation on conversion. Idea of smooth replacement of the SCPI by the OPCI.

► Potential development - the current size of the RE non-listed sector represents 0.8% of the size of the French non-listed industry (≠ 8% in Germany). Assuming the same percentage: €150 bn (ten-fold increase)

► will be a step on the way to a European REIT?

‘”G-REIT” – the German approach

Business activities

Core business (ring fenced): purchase, construction, sale, rent and lease of real estate. Less then 75% of assets consist of real estate; also, less then 75 % of earnings derive from main business activities; it is restrictions for sales.

Ancillary activities with G-REIT status (ring fenced): support of main business activities (administration etc.), conservative investment of liquid funds

Other activities (non-ring fenced) conducted by subsidiaries and its are restricted.

Legal form and accounting

Legal form is german corporation *("Aktiengesellschaft" -"AG")* with both registered seat and place of management and control in Germany. It listed at German stock exchange. Financial statements is in accordance with IFRS

Profit distribution

In principle, at least 90 % of profit must to be distributed to shareholders. The distribution quota measured according to IFRS

The exceptions refer to the possibility to reinvestment the capital gains. Also are excluded Valuation gains

Capital structure

Authorized capital is, at least, € 5 million. Overall capitalization is more than €50 million

Is no legal restriction for debt-equity-ratio, but factual restriction because of high distribution quota.

Structure of shareholders

Minimum 25 % must to be free float. Maximum holding requirement in discussion is less then 10 %, tax reasons .

Tax issues

a) One-time taxation on foundation

- Taxes on income. Realization of hidden reserves in real estate, even if no transfer of property, but only qualification of existing listed company as G-REIT. The tax advantages are: only 50 % of the difference between market value and book value taxable; tax deferral (tax payment over a 4-years-period, no interest); it is only applicable for a restricted time after introduction of REIT-legislation
- Real estate transfer tax - if actual transfer of property to another entity. The tax rate is 3.5 %

b) Ongoing taxation of G-REIT

- Principle. G-REIT is not subject to tax. Rents deriving from foreign property (direct investments or investments in foreign property companies) taxable abroad. It is applicable the standard tax regime for subsidiaries with auxiliary activities.
- Breakdown of profits: Basket 1: Tax-free, Basket 2: Taxed abroad, Basket 3: Taxed on the level of subsidiaries

c) Ongoing taxation of German shareholders

- Basket 1 (tax-free). The dividends are fully taxable. It is no half-income system for individuals, no tax-exemption for corporations.
- Basket 2 (taxed abroad)
  - Direct investments. Imputation of foreign tax (it is no treaty or treaty with imputation system): dividend fully taxable, foreign tax credit. It is exemption of foreign income (treaty with exemption method): dividend tax exempt.
  - Investments in foreign Real Property Companies: it is half-income system for individual, tax-exemption for corporate shareholders.
- Basket 3 (taxed on the level of domestic subsidiaries). This refers to half-income system for individual and the tax-exemption for corporate shareholders of G-REIT. The imputation of tax are withheld by subsidiaries.

d) Ongoing taxation of foreign shareholders

- Parent Subsidiary Directive: Not applicable because of tax exemption of G-REIT
- Tax treaties: Applicable because of treaty entitlement of G-REIT
  - Taxation right for state of residence of the shareholder
  - Limited withholding tax on dividends for Germany
    - Individual shareholders: usually 15 %

Upon close examination we can see that the G-REIT has three major ***Problem***:

- First of all – it is no tax on income of G-REIT in Germany.
- The second problem refers to the facts that only low withholding tax on dividends, if any
- And the third problem is tax leakage

The Possible Solutions at G-REIT problems are***:***

- Revisions of double tax treaties
- No reduction or only limited deduction of withholding taxes in case of REITs (example: Art. 10 of the tax treaty between Germany and the United States)
- Difficult and time consuming, results doubtful
- Qualification of dividends as rental income (different models)

- Maximum holding requirement (< 10 %)
- EURO-REIT-Directive

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