



JONES DAY  
**COMMENTARY**

## REAL ESTATE INVESTMENT TRUSTS: A NEW INVESTMENT TOOL FOR THE SECONDARY GERMAN REAL ESTATE MARKET

On May 28, 2007, the German legislature implemented a law on German real estate investment trusts ("REITs"), effective retroactively to January 1, 2007.

This *Commentary* will outline the most important provisions of the German Law for the Creation of German Real Estate Investment Trusts (the "REIT Law").

### GENERAL

REITs are already implemented in 20 countries, including the U.S., Australia, Japan, and France. They enable a wide range of investors to invest indirectly in real estate. Prior to the implementation of the REIT Law, the German market included three different possibilities for indirect real estate investments: closed property funds, open property funds, and real estate corporations, of which the most popular was the open property fund, because its fund shares must be repurchased by the investment company and are

therefore fungible at any time. Unlike open property funds, REITs shall own and administer the real estate capital themselves rather than have a capital investment company do so.

According to the REIT Law, the business of a REIT must be limited to the acquisition, holding, administration, and sale of domestic and foreign real estate; the easement rights (*dingliche Nutzungsrechte*) of such real estate; certain other immovable assets; and interest in real estate partnerships, in REIT service companies, in foreign real estate corporations, and in corporations that are the general partners of real estate partnerships. REITs are allowed to render non-gratuitous services (such as facility management) only through a separate REIT service company rather than directly to third parties. The REIT service company has to be a corporate entity and a 100 percent subsidiary of the respective REIT. The business purpose of a REIT service company must be limited to the rendering of nongratuitous, real estate-related additional business

to third parties on behalf of a REIT. Every REIT must have at least €15 million in registered capital.

## THE REIT REQUIREMENTS

A REIT is organized in the legal form of a stock corporation (*Aktiengesellschaft*) but enjoys certain tax privileges. In essence, to qualify for a REIT tax privilege, a stock corporation must meet the following requirements:

**Listing at a Stock Exchange.** The stock corporation must be listed in an organized market in the European Union or the European Economic Area.

**Widely Held Stock.** When initially listed on a stock exchange, a REIT must have at least 25 percent widely held stock. “Widely held stock,” for purposes of the REIT Law, is the stock of shareholders who individually hold no more than 3 percent of the voting rights. After the initial listing, it is sufficient if 15 percent of the shares are permanently widely held stock. Furthermore, no shareholder shall own more than 10 percent of the shares or of shares granting 10 percent or more of the voting rights.

**Assets and Earnings.** At least 75 percent of the REIT’s assets must consist of immovable assets (*i.e.*, real property, land, building rights equivalent to real property, or comparable rights from other countries), and at least 75 percent of a REIT’s revenue and other income out of real property must derive from the lease or sale of real property.

However, REITs cannot acquire immovable property that is predominantly for residential purposes if such residential property has been built prior to January 1, 2007—so-called continuous tenement immovable properties (*Bestandsmietwohnmobilien*). The German REIT is therefore a reduced version of its foreign counterparts. The German government has exempted “tenement REITs” from the REIT Law because of pressure from interest groups.

Finally, the total assets of REIT service companies shall not exceed 20 percent of the assets as shown in the consolidated financial statements, and the revenue and other income derived from real property from REIT service companies shall not exceed 20 percent of the REIT’s consolidated total gross income.

**Profit Distribution.** The REIT must distribute 90 percent of its profits to the shareholders. Fifty percent of the REIT’s capital gains from sales, however, can be temporarily kept aside in a reserve.

**No Trade With Real Estate.** Within a period of five years, the gross income of the REIT and its subsidiaries from the sale of real estate shall not exceed 50 percent of the average value of the REIT’s immovable assets within the same period, pursuant to the REIT’s consolidated financial statements prepared within the above five-year period.

**Minimum Own Capital Resources.** The own equity of a REIT, as recorded in its consolidated financial statements, shall not fall below 45 percent of the immovable assets of such REIT pursuant to the same consolidated financial statements.

## TAXATION

REITs are exempted from the corporate income tax (*Körperschaftsteuer*) and from the trade income tax (*Gewerbsteuer*). This is a significant difference from the taxation of “normal” corporations, the profits of which are subject to corporate and trade income tax.

The taxation of REITs is instead shifted from the company level to the investor level. REITs are insofar treated like open property funds, the profits of which are also taxed on the investor level. The obligatory 90 percent profit distribution shall ensure a regular taxation on the level of the investors.

**Dividends.** The REIT profit distributions (dividends) are 100 percent taxed as investment income (*Einkünfte aus Kapitalvermögen*) if the dividends are not operating revenues of the shareholder. In contrast to the dividends received from “normal” corporations, the dividends from REITs are not subject to the so-called half-income method (*Halbeinkünfteverfahren*) or to the so-called partial-income method (*Teileinkünfteverfahren*), which will replace the half-income method starting January 1, 2009, because the REIT Law denies its applicability. (The half-income method provides for taxation of only 50 percent of the dividend income, and the partial-income method will provide for taxation of 60 percent of the dividend income.)

The dividends of a REIT are furthermore subject to a 25 percent dividend withholding tax (*Kapitalertragsteuer*), if the dividend withholding tax is borne by the shareholder, or to 33-1/3 percent of the actually paid-out dividend amount, if the dividend withholding tax is borne by the REIT.

However, also effective January 1, 2009, the German government implemented a uniform taxation of income (such as dividends) and profits arising from the sale of private capital investments at a uniform tax rate of 25 percent (the so-called compensatory tax (*Abgeltungssteuer*)). Such reform will also affect the taxation of REIT dividends.

The REIT Law does not distinguish between investments in domestic and foreign real estate. Thus, if a REIT invests in foreign real estate, the income from such foreign investment will be taxed twice—once in the foreign country and once in Germany—because income from foreign real estate is usually already taxed in the foreign country. A REIT will therefore not be a suitable vehicle for investments in foreign real estate. The taxation of open property funds, on the other hand, makes allowances for the foreign taxation of investments abroad: If Germany has waived the right to taxation in a double-taxation agreement (*Doppelbesteuerungsabkommen*), the income from such foreign real estate is not subject to income tax and corporate income tax in Germany. If Germany has not waived its right to taxation, the amount of the foreign tax paid is to be deducted from the investor's German tax obligations.

**Income From the Sale of REIT Shares.** With respect to the taxation of capital gains from the sale of REIT shares, the general rules apply. The sale of private investments in REITs below 1 percent and within one year of the acquisition of the shares is therefore tax-free. However, the half-income method does not apply either, and any capital gain from the sale of REIT shares is fully taxable. Furthermore, the German government abolished the general threshold of 1 percent for a tax-free resale of private investments within a year of their acquisition with respect to private investments acquired after December 31, 2008. As a consequence of this, any resale of private investments will be subject to taxation, regardless of the previous holding period. This will affect all shareholdings, not only REITs.

## SANCTIONS AND PENALTIES FOR NONADHERENCE TO CERTAIN REIT REQUIREMENTS

### With Respect to the Corporation:

- a) If, at the end of a fiscal year, the assets of a REIT do not consist of at least 75 percent immovable assets, the responsible finance authority shall impose a payment obligation in the amount of at least 1 percent but no more than 3 percent of the difference between the REIT's actual amount of immovable assets and the required amount of 75 percent on the REIT.
- b) If less than 75 percent of a REIT's gross income derives from the lease or sale of immovable assets, a payment of at least 10 percent but no more than 20 percent of the difference between the actual and the required gross income from immovable assets shall become due.
- c) The responsible finance authorities shall also impose a payment obligation on the REIT if it fails to distribute at least 90 percent of its annual net profits to the shareholders at the end of a fiscal year. Such payment shall amount to at least 20 percent but no more than 30 percent of the difference between the actual and the required profit distribution amount.
- d) If the REIT or a real estate partnership subsidiary provides nongratuitous additional business services to a third party, the responsible financial authority shall impose a payment obligation in the amount of at least 20 percent but no more than 30 percent of the income deriving from such services on the REIT.
- e) If less than 15 percent of the REIT's shares are widely held stock within three successive fiscal years, the tax privilege shall cease at the end of the third fiscal year, provided, however, that the REIT was able to become aware of such violation from the announcements pursuant to the German Securities Trade Act.
- f) In the event that shareholders of the REIT individually hold more than the 10 percent maximum amount of stock during three successive fiscal years, the tax exemption shall cease at the end of the third fiscal year, provided, however, that the REIT was able to become aware of such violation from the announcements pursuant to the German Securities Trade Act.
- g) If a REIT's trade with real estate leads to a gross income in excess of 50 percent of its total gross income, the

tax exemption shall cease for the fiscal year in which the threshold of 50 percent has been exceeded for the first time.

- h) If the own equity of a REIT, as recorded in its consolidated financial statements, falls below 45 percent of the immovable assets of such REIT pursuant to the same consolidated financial statements for three successive fiscal years, the tax exemption ceases at the end of the third fiscal year.
- i) Finally, if a REIT has committed one of the violations referred to in a) to d) (*i.e.*, every year the same violation) in three successive fiscal years, the tax exemption ceases at the end of the third fiscal year. If a REIT commits any of the violations referred to in a) to d) (*i.e.*, every year a different violation) within five successive fiscal years, the tax exemption shall cease at the end of the fifth fiscal year. In exceptional cases, the responsible finance authority may decide that the tax exemption shall not cease. In this event, the finance authority must impose the highest possible payment obligation on the respective REIT.
- j) After the tax exemption for a REIT ceased pursuant to the foregoing, it cannot be revived before the expiration of four years starting from the cease of the tax exemption.

#### **With Respect to the Shareholders:**

If a shareholder holds 10 percent or more of a REIT's stock, the tax exemption of the REIT will not be affected. Furthermore, the excess of the maximum amount of shares does not affect the respective shareholder's right to receive dividends or his voting right. However, all of his shareholder rights are limited to the rights of a shareholder holding less than 10 percent of the REIT's shares.

## **TAX PRIVILEGES FOR THE TRANSFER OF PROPERTY TO REITS**

In order to support the transfer of real estate to REITs, the REIT Law exempts, subject to certain requirements, capital gains from the sale of real estate to a REIT from the tax liability:

The income and the increase of business assets resulting from the sale of real property and buildings to a REIT, or to a REIT that is still in the course of formation ("Pre-REIT"), are, as a general rule, 50 percent tax-free, provided that the underlying purchase agreement has been concluded between December 31, 2006, and January 1, 2010, and provided that the real property was owned by the seller at least five years on January 1, 2007. However, such tax exemption ceases retroactively if, within a period of another four years starting from the conclusion of the purchase agreement, the buyer resells the property or if, within the same period, the Pre-REIT that acquired the property is not registered in the commercial register as a REIT. In this case, the REIT has to bear the additional taxes accrued.

## **PERSPECTIVE**

REITs can be established by the formation of a new stock corporation or by the transformation of an existing stock corporation. Whether the implementation of the German REIT will lead to a flourishing secondary real estate market remains to be seen. The implementation of the German REIT, however, closed the gap in the current real estate investment market in Germany, and German companies, which have a relatively high proportion of own real estate, are now able to transfer unused real estate to REITs and by this means are able to use their capital for their own core business. This may increase sale and leaseback transactions within the next few years.

## **LAWYER CONTACT**

For further information, please contact your principal Firm representative or the lawyer listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at [www.jonesday.com](http://www.jonesday.com).

**Andreas Koester-Boeckenfoerde**

49.69.9726.3968

[akboeckenfoerde@jonesday.com](mailto:akboeckenfoerde@jonesday.com)

**Christian Funke**

49.69.9726.3939

[cfunke@jonesday.com](mailto:cfunke@jonesday.com)

Jones Day publications should not be construed as legal advice on any specific facts or circumstances. The contents are intended for general information purposes only and may not be quoted or referred to in any other publication or proceeding without the prior written consent of the Firm, to be given or withheld at our discretion. To request reprint permission for any of our publications, please use our "Contact Us" form, which can be found on our web site at [www.jonesday.com](http://www.jonesday.com). The mailing of this publication is not intended to create, and receipt of it does not constitute, an attorney-client relationship. The views set forth herein are the personal views of the author and do not necessarily reflect those of the Firm.