Germany to introduce REITs

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The German government plans to introduce German Real Estate Investment Trusts ("G-REITs") as a new form of tax-advantaged real estate investment vehicle in Germany with effect as of January 1, 2007. A first blueprint for G-REIT legislation ("Draft"), prepared by the Federal Ministry of Finance (*Bundesfinanzministerium der Finanzen*, BMF), has now become available. The BMF has pointed out that the Draft has not yet been formally adopted by the cabinet and will likely still be subject to changes. In its current form, the Draft contains the following key provisions (brackets indicate that the stated figures are still subject to further discussion):

- <u>Legal form</u>: G-REITs will have the form of German joint stock corporations (*Aktiengesellschaft*, AG), which must have their statutory seat and principal place of management in Germany. G-REITs must list their shares on a stock exchange in the EU or EEC. It is contemplated to include stock exchanges outside the EU / EEC.

- <u>Share-ownership restrictions</u>: G-REITs have to ensure that there will always be a minimum free float of their shares (shares representing at least 15% of their share capital). Shares held by investors owning less than 3% of the share capital count as free float. In addition, no shareholder may hold directly 10% or more of the share capital. The preamble to the Draft argues that there is no need for closely held REITs in Germany because the existing rules for closely held investment funds (so-called *Spezialfonds*) satisfy the need. However, as explained below, the less-than-10% restriction is primarily motivated by tax reasons. G-REITs must issue their shares in registered form to enable the G-REITs to monitor these share ownership restrictions. Share transfers will require the consent of the G-REIT. If the share-ownership restrictions are not observed, the G-REIT must undertake certain measures (*e.g.*, repurchase of own shares, capital increase without preemptive rights, mandatory sale of shares or redemption) to ensure compliance; otherwise, the G-REIT may lose its tax advantage (*see* below).

- <u>Topic REITs:</u> It is contemplated to permit so-called "Topic REITs" (*e.g.*, hotels, shopping centers, etc.) so that, for example, a hotel business can sell its real estate to a G-REIT and then lease the real estate back. The operative business (*e.g.*, the hotel business) will have to be conducted by a company separate from the G-

REIT. The Draft does not explain whether the operating company may control the G-REIT (or vice versa) or whether both may be under common control.

- Taxation at the entity level: Subject to certain requirements, the income of G-REITs will be exempt from taxation at the entity level starting from the year in which their shares have been listed on a stock exchange. To obtain the tax exemption a G-REIT will have *inter alia* to (i) distribute [90%] of its profit, (ii) earn at least [75%] of its profit from real estate (with a focus on rental income and a limitation on gains from the sale of real estate), and (iii) invest at least [75%] of its capital in real estate. G-REITs will only be allowed to take out loans up to 60% of their assets. The tax authorities will be authorized to assess penalties against a G-REIT that does not comply with these requirements; eventually, the G-REIT may lose the tax exemption.

- Taxation at the shareholder level: Since income of G-REITs will be exempt at the entity level, the Draft seeks to ensure that distributions can be taxed at the shareholder level. The participation exemption available for shareholdings in "regular" corporations will not be applicable. Distributions from G-REITs and gains from the sale of G-REIT shares will thus be subject to taxation at the shareholder level. The latter is true regardless of any ownership percentage or holding period. However, non-resident shareholders will only be taxed on gains from the sale of G-REIT shares if they hold (or have held at any time during the five-year period preceding the sale) 1% or more of the share capital. Even then, income tax treaties would typically exempt the gain from German taxation.

- Withholding tax: Distributions made by the G-REITs will be subject to a 25% withholding tax (plus a 5.5% solidarity surcharge thereon). The withholding tax is creditable (and refundable) to German resident shareholders (*i.e.*, it constitutes a prepayment against the shareholder's personal or corporate income tax). By contrast, the withholding tax is generally a final tax for non-resident shareholders. However, the statutory rate may be reduced under an applicable income tax treaty (usually to 15%). The restriction that no shareholder may hold directly 10% or more of the share capital ensures that non-resident shareholders cannot invoke the special reduction in withholding rates to 5%, or even 0%, typically granted in income tax treaties for participations. It has been a particular concern in the public debate over the introduction of G-REITs that non-resident investors could otherwise receive income from investments in German real estate without (or only with minimal) taxation.

- Exit Tax: The Draft explains that it is important for the success of this new asset class to provide attractive terms for real estate owners to transfer their German real estate to G-REITs. It is therefore intended to allow real estate owners to transfer their real estate to G-REITs under a favorable taxation regime ("Exit Tax"). It is still unclear how this Exit Tax will be designed. It is likely, however, that the Exit Tax will only be available for a limited [four year] period following the introduction of G-REITs in Germany and that such real estate will then be subject to a [three-year] holding period.

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