

bulletin



National Association of Real Estate Investment Trusts®

German Barriers To Investing In U.S. REITs Lifted

In November 2003, Germany passed tax legislation, effective January 1, 2004, that classified a U.S. REIT as a foreign investment fund the ownership of which would subject German residents to onerous taxation. On June 9, 2005, the German government released a final interpretive letter sought by NAREIT that:

1) eliminates the adverse tax consequences applicable to German residents owning listed U.S. REIT stock; and, 2) allows the German residents to claim a lower tax rate on listed U.S. REIT dividends they receive. This letter codified an interim ruling the government issued on December 13, 2004. The German Ministry of Finance informally has stated that these new rules also apply for regulatory purposes, *e.g.*, to the rules that apply to a listed U.S. REIT's sale of stock in Germany.

2003 German Tax Legislation

On November 28, 2003, Germany enacted a new law (the "Investment Tax Law") regarding investments in certain entities. Unfortunately, the new law made it substantially less favorable from a tax perspective for a German investor to invest in a U.S. REIT and more favorable for a German investor to invest in a German-based investment fund investing in U.S. real estate.

While prior law also disadvantaged German investors in U.S. REITs relative to German investment funds, the new law heightens this disadvantage.

Under the prior law, only one-half of the dividends distributed by a non-REIT U.S. corporation are included in an individual German taxpayer's income for tax purposes (the "50% exclusion"). Even though REITs are, by law, corporations or business trusts taxable as corporations, Germany did not consider them so. Instead, for historical reasons, Germany considered REITs to be "foreign investment funds," different than other German corporations, German investment funds and other U.S. corporations, to the extent that they invest in more than three different real estate projects. As a result, dividends from REITs were not eligible for the same favorable 50% reduction in tax rate. Furthermore, the German investor in a U.S. REIT faced severe additional "penalty" taxation each year-end on a portion of the U.S. REIT's annual appreciation unless the U.S. REIT appointed a German "tax representative" to act on its behalf in Germany. As a result, many U.S. REITs appointed such a representative.

Under the 2003 law, a U.S. REIT was considered a foreign investment fund, rather than a foreign corporation. However, Germany also ended the option of appointing a tax representative to escape punitive taxation. Consequently, unless a

U.S. REIT published a significant amount of detailed financial information with respect to each of its distributions to German shareholders shortly after such distributions are made, and obtains the certification of a German tax advisor that this information is correct under German tax and investment law principles (as opposed to U.S. GAAP or U.S. tax law principles), a German shareholder in such a REIT faced being subject not only to regular taxation on the REIT's distributions, but also to additional "penalty" taxation on the REIT stock's annual appreciation. As a practical matter, it was impossible for most REITs to comply with these financial certification requirements, and as a result, most German investors in U.S. REITs could have faced even more discriminatory tax treatment as a result of this new law.

NAREIT And EPRA Seek Changes

In order to seek a solution to the discriminatory taxation faced by German investors in U.S. REITs and other non-German publicly traded real estate companies under the 2003 Investment Tax Law, NAREIT aligned itself with its European counterpart that represents European public real estate companies, the European Public Real Estate Association (EPRA).

Specifically, NAREIT and EPRA jointly engaged the legal services of Dr. Hans Volkert Volckens of Beiten Burkhardt to seek a regulatory solution. NAREIT and EPRA officials and Beiten Burkhardt educated representatives of the German government to distinguish investment funds from U.S. REITs and European property companies. We advised

the Ministry of Finance officials that unless they acted before year-end, many German investors would sell their shares in U.S. REITs to avoid being taxed on the value of their REIT shares as of December 31, 2004 without the benefit of having any sales proceeds to pay the "market to market" tax under the Investment Tax Law.

2004 Ruling

On December 13, 2004, the Ministry of Finance released a formal, binding ruling concluding that the Investment Tax Law did not apply to German investors of listed real estate companies such as U.S. REITs for any taxable year of the company starting in 2004, so long as they were not subject to regulatory supervision similar to the United States 1940 Investment Company Act. Instead, listed U.S. REITs were treated as any other listed U.S. corporation for German tax purposes.

Because of this ruling, German investors in U.S. REITs were not subject to tax on 2004 appreciation (referred to in Germany as the "dividend equivalent amount") of their investment unless they sold their shares. Further, German investors could claim the 50% exclusion with respect to listed U.S. REIT 2004 dividends that generally applies to corporate dividends.

The ruling meant that listed U.S. REITs did not have to use a German tax representative for 2004 in order to have the favorable tax treatment available to German investors.

2005 And Beyond

On June 9, 2005, the Ministry of Finance issued a final “interpretive letter” that essentially adopted the interim advice. Under the letter, a listed U.S. REIT organized as a corporation (or any entity such as a business trust that is considered a corporation under German law) is not treated as an investment fund so long as it is not subject to supervision akin to that which regulates German open-end funds (the 1940 Investment Company Act is the closest analogy in the U.S.).

This letter brings certainty to the German market and allows German investors to buy listed U.S. REIT stock on the same favorable tax basis as other U.S. corporations. Further, the Ministry of Finance informally confirmed to Beiten Burkhardt that the letter also applies for regulatory purposes, *e.g.*, the rules governing how and to what extent a company may sell and advertise its shares in Germany.

For further information, please contact Dara Bernstein, dbernstein@nareit.com or Tony Edwards, tedwards@nareit.com.

This publication is designed to provide accurate information in regard to the subject matter covered. It is distributed with the understanding that NAREIT is not engaged in rendering legal, accounting, or professional service. If legal advice or other expert assistance is required, the service of a competent professional should be sought.