Introduction of the Real Estate Investment Trust (REIT) in Germany

Completely updated edition, February 2008
Introduction

The introduction of the Real Estate Investment Trust (REIT) by the Act of 28 May 2007 creates opportunities for many real estate companies, real estate investors and businesses with substantial real estate holdings in Germany. The creation of the German REIT (the G-REIT) might permanently alter the German real estate industry. This new investment vehicle enables all owners of real property – public sector owners as well as investors – to transfer assets, including fixed assets, to the capital market. For industrial companies, the creation of the REIT opens up a way for them to unlock the built-in gains tied up in their real property and invest the proceeds in their core business. The G-REIT also makes investing in German real estate much simpler, in particular for international investors.

From the outset, KPMG has actively participated in the professional discussion surrounding the introduction of the German REIT. Our worldwide network Building, Construction & Real Estate rsp. Property & Infrastructure in Europe gives us access to an extensive body of experience with foreign REIT structures, such as those in the United States or Australia.

Our experienced real estate professionals include individuals with commercial, accounting, tax and legal backgrounds. They are at your disposal both to answer your questions of a general nature and to help you prepare the launch of specific REITs. Our specialists can provide needed support both with regard to the requirements of the capital market and on tax, accounting, legal and financial issues – so that your company is well prepared for the challenges associated with REITs and is in a strong position to take complete advantage of the resulting opportunities.

Please contact us – we will gladly advise you!

Oliver Zucker
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Corporate Finance – Real Estate
Head of Property & Infrastructure

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* The act on German real estate stock corporations with listed shares ("REIT Act") was adopted by the Bundestag (lower house of German Parliament) on 23 March 2007 and passed the Bundesrat (Upper House of German Parliament) on 30 March 2007. The REIT Act entered into force on 28 May 2007 with retroactive effect from 1 January 2007 in Germany.
I. What is a REIT?

A REIT is a publicly-traded real estate stock corporation (public limited company) that is exempt from both corporate income tax and trade tax. Two years of discussions on the introduction of this fourth real estate asset class (concerning indirect investments) were brought to an end by passage of the Act of 28 May 2007 (Act for the Creation of German Real Estate Stock Corporations with Publicly Listed Shares – hereafter referred to as the REIT Act, abbreviated REITG). Upon its promulgation on 1 June 2007, the REIT Act entered into force with retroactive effect from 1 January 2007. In order to qualify as a tax-exempt G-REIT, real estate must be the primary focus of the corporation’s business activities and it must pay out at least 90 per cent of its distributable earnings to its investors in the form of dividends.

If ownership of a G-REIT’s shares is sufficiently dispersed, it resembles a publicly held corporation. Unlike an open-end mutual fund, a G-REIT has real estate of its own and is not an investment company managing discrete segregated asset funds. No regulation by the German Federal Financial Supervisory Authority (Bundesaanstalt für Finanzdienstleistungsaufsicht – BaFin) is provided for.

Since the G-REIT is itself tax exempt, its dividends do not qualify for the standard dividends-received exemptions at the shareholder level (50 per cent exemption on dividends paid to individuals and 95 per cent exemption on dividends paid to corporations – so-called “half-income system” and “shareholding exemption” respectively). Instead, the full personal income tax applies to G-REIT dividends paid to individuals and the full corporate income tax and trade tax apply to dividends paid to corporations and other legal persons. In order to make conversion to a G-REIT attractive and promote the goal of mobilizing built-in gains (unrealized appreciation) on a considerable scale, half of the gain on sale of land and buildings to a G-REIT is tax exempt under new § 3 no. 70 EStG (Income Tax Act). For transactions subject to the Reorganization Tax Act (Umwandlungssteuergesetz – UmwStG), this preferential tax rate (so-called exit tax) applies only if the reorganization is effected at fair market value. The exit tax preference is denied in certain situations under the many anti-abuse provisions inserted in the final REIT Act in the legislative process.

Investors wishing to invest indirectly in German real estate previously had to choose between closed-end and open-end real estate mutual funds and real estate stock corporations. Open-end real estate funds, which have enjoyed an enormous influx of capital since the year 2000, currently find themselves in a difficult situation as a result of the performance of certain funds but have recently enjoyed new attractiveness. The options with regard to real estate stock corporations are limited, since only three of the approximately 40 such corporations currently listed on stock exchanges are of international caliber based on their size and stock exchange trading volume. Although Germany is the largest real estate market in Europe, the combined market capitalization of the three largest real estate stock corporations still remains slightly above Euro eight billion and that of the two G-REITs already quoted is Euro 649 million only. By contrast, open- and closed-end real estate mutual funds manage some Euro 250 billion in assets. At present, they hold the lion’s share of institutionally owned real estate in Germany. Banks and real estate firms expect the market capitalization of G-REITs to top Euro 100 billion within the next few years. However, the current development is somewhat disappointing.
REITs combine the advantages of investments in real estate with those of stock ownership. Compared with other investments, real estate offers usually a low price risk, steady income, and a relatively high dividend yield. Stock, on the other hand, is an extremely fungible investment form that does not require an overly large commitment of capital. This combination puts REITs into a new investment asset class. By buying shares in a REIT, investors can add an asset to their portfolio which has a risk and earnings profile that lies between that of shares in listed non-real estate related companies and government bonds. Additionally, the low correlation of a REIT’s performance with those of other asset classes can add to portfolio diversification. The disclosure obligations applicable to publicly traded corporations also provide a high degree of transparency. The valuation of the real estate portfolio is likewise transparent, as this is performed by the market itself. Finally, REITs are subject to the same corporate governance requirements as other joint stock corporations, so that the shareholders and supervisory board of a REIT constitute a check on its management.

II. The REIT from a global perspective

REITs as an asset class already have a long history in a number of countries. The United States introduced REITs in the late 1960s, although their reputation as a successful investment vehicle was not made until the 1990s. Further REIT structures can be found in the Netherlands (BI), Australia (Listed Property Trust), Kanada (REIT), Belgium (SICAFI), Japan (J-REIT), Korea (K-REIT/CR-REIT), Singapur (S-REIT), Hongkong (H-REIT), France (SIIC). Countries with investment vehicles whose structures are similar to those of REITs are New Zealand, South Africa, Italy, Luxembourg and Spain. And like Germany, Great Britain also enacted REIT legislation effective from January 2007, creating the UK REIT or Property Investment Fund (PIF).

The introduction of the G-REIT is capable of having a positive macroeconomic impact on the German real estate industry. Real estate markets with a high percentage of REITs are considered relatively transparent and efficient with regard to their use of capital. This attracts foreign investors to enter the market. In comparison to a direct investment, they can invest in German real estate immediately at almost no cost (for due diligence, advisors, etc.). The other side of the coin is, that an investor can usually get out of the REIT investment immediately. A result are the up and downs on the REIT stock price, amongst others.

German enterprises have traditionally owned real property outright and used it for their own business purposes. The local market can therefore anticipate a significant influx of commercial real property from this source in the coming years. The mobilization of the capital previously tied up in real estate will result in increased real estate market liquidity. The latter is an observation from other mature REIT markets, which might have relevance for Germany as well.

The REIT experience in the United States

The United States has the most extensive experience with REITs. The U.S. Congress enacted REIT legislation in 1960 in order to enable private investors to invest in commercial real estate on a large scale. Since then, the REIT sector has grown dramatically in size and significance, making particular strides in the 1990s. Currently, some 180 REITs are registered with the U.S. Securities and Exchange Commission and traded on the more important exchanges – the majority on the New York Stock Exchange. The market capitalization of the 152 REITs included in the FTSE NAREIT index amounted to US-Dollar 312 billion as of 31 December 2007.
The principal factors driving this trend and focusing investor interest on REITs are as follows:

- Over the last three decades, REITs have proved to be significantly less volatile than most other major market benchmarks.
- REITs operate commercial and residential properties in practically all U.S. metropolitan areas as well as at a variety of international locations; most REITs limit their activities to one type of property or the other.
- In 2001, Standard & Poor’s recognized the development and growth of the REIT sector as a major investment form by adding REITs to its principal indices, including the S&P 500.

The FTSE NAREIT All REITs Index outperformed the S&P 500 Index over the past 20 years up until November 2007, when the share prices of REITs significantly underperformed the broader index as a result of negative sentiment flowing from the US subprime crisis.

Real estate companies continue to operate at or above the level of corporate governance seen in other industries. Independent, third-party data collated by Institutional Shareholders Services (ISS) shows that for the third year in a row, the real estate industry ranked second only to the utilities industry in overall corporate governance performance*.

Since REITs have to distribute practically their entire taxable income to their shareholders, REIT investors benefit from being able to count on comparatively regular dividends in significant amounts. An analysis of historical data concluded that the relatively low correlation between REITs and other stocks and bonds made REITs a valuable tool for risk diversification, thus reducing price risk. Market observers have determined in this connection the following:

- REITs offer an attractive risk-return ratio.
- The correlation between the returns of REITs and those of other investments has declined over the last 30 years.
- REITs bolster returns and/or reduce price risk when included in a broadly diversified portfolio.

Domestic private investors may likewise play an important role

REITs can be an attractive investment for both private and institutional investors, who are in turn ultimately backed by individual investors.

From the perspective of private investors, REITs combine a degree of security normally associated with savings accounts with returns usually obtainable only from significantly riskier investments. From 1 January 2009 onwards, there will be the added benefit of lower overall taxation due to the flat tax on income from capital (see part V on page 7).

* Source: ISS Corporate Governance Quotient Rankings as of April 2007

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III. The REIT from the capital market’s perspective

In all, REITs, or similar publicly traded entities, exist in 18 countries around the world. The United States and Australia have so far been the leaders in this investment category. Most recently, REITs were successfully introduced in Japan and France. Their expansion in these countries may be characterized as “moderate” to “roaring.”

How many initial public offerings are to be expected?
In the early discussion under the light of the property portfolio hype mainly caused by foreign private equity houses banks expected 30 initial public offerings per year. However, until now two G-REITs only are quoted. Even the number of registered Pre-REITs do not longer support this expectation. The main reason seems to be, that the premium on NAV turned into a discount in 2007 making it unattractive for property owners to go public with their portfolio. We are convinced, if the discount turns again into a premium, the number of IPOs will increase immediately. The party is not over: the party has not started yet.

Which performance indicators are used to evaluate REITs?
The evaluation of REITs using quantitative benchmarks is important because it permits REITs to be compared to other types of investments in accordance with the requirements of the capital markets. Only certain standard indicators of performance used in other sectors are applied to REITs. Such indicators include EBITDA Multiples, EPS, Dividend Yield, Debt Ratio, and Interest Coverage. In addition, there are several real-estate-specific indicators such as NAV, NNNAV, and ROAA. Particularly in the United States, other REIT-specific indicators are also commonly used, such as FFO, FAD, FFO Payout Ratio, and Same Property NOI Change. The REIT’s information system must reliably deliver such indicator data over time and provide analysts with a basis for forecasting performance. This applies as well to the production of quarterly reports.

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Definitions</th>
</tr>
</thead>
<tbody>
<tr>
<td>EBITDA-Multiple</td>
<td>(Market value of borrowed capital plus market capitalization less liquid assets)/EBITDA</td>
</tr>
<tr>
<td>EPS (Earnings Per Share)</td>
<td>Net income for the year/Number of shares of stock outstanding</td>
</tr>
<tr>
<td>Dividend Yield</td>
<td>(Anticipated) dividends/market capitalization as of valuation date</td>
</tr>
<tr>
<td>Debt Ratio</td>
<td>Ratio of interest-bearing financial liabilities to total capital</td>
</tr>
<tr>
<td>Interest Coverage</td>
<td>Ratio of EBITDA to interest expense in the relevant period</td>
</tr>
<tr>
<td>NNNAV (Triple Net Asset Value)</td>
<td>Market values of all real estate plus value of other assets less market value of borrowed capital less deferred taxes</td>
</tr>
<tr>
<td>ROAA (Returns on Average Assets)</td>
<td>Annual profit (loss) before interest/lavergage of the values of assets at the beginning and end of the period</td>
</tr>
<tr>
<td>FFO ( Funds From Operations)</td>
<td>Net income for the year less Income from sale of real estate and refinancing plus depreciation and amortization</td>
</tr>
<tr>
<td>FAD ( Funds Available for Distribution)</td>
<td>FFO less (investments generating no additional income)</td>
</tr>
<tr>
<td>FFO-Payout-Ratio</td>
<td>Distribution/FFO</td>
</tr>
<tr>
<td>Same-Property NOI-Change</td>
<td>Change in net operating income of the real estate assets included in the portfolio in the two prior reporting periods</td>
</tr>
</tbody>
</table>

Note: The definitions are not always applied uniformly.
What are the capital market’s main requirements for REITs?
To begin with, the capital markets expect the initial public offering of a REIT to meet the same requirements as that of any other company that is going public. The National Association of Real Estate Investment Trusts (NAREIT) in the United States lists five key points that firms should pay attention to:

1. Dividends
2. Liquidity
3. Performance
4. Transparency
5. Diversification

At least the first four of these five points should be uncontroversial. In addition, a successful REIT must be able to cover its own capital costs.

For which investors are REITs particularly attractive?
Because it is required to distribute most of its earnings, a REIT has only limited internal financing capability and thus lacks an important source of financing for organic growth. REITs are regarded as an investment class with a risk profile intermediate between that of bonds and a direct investment in real estate.

A key factor in choosing this type of investment is the security provided by regular cash flow in combination with the option of making a comparatively quick and inexpensive exit. REITs are accordingly appropriate for institutional investors with a moderate risk/return profile. In countries with “developed” REIT markets, such investors make up two thirds of REIT shareholders. In Germany, an even greater percentage of institutional investors is expected in some cases. This risk/return profile also matches that of many private investors.

What assets are best suited for REITs?
We believe that, where possible, the real estate to be placed in a REIT should meet the following criteria in order to avoid valuation discounts:

1. Liquidity – it should be possible to liquidate the properties at any time
2. Value for third parties – the properties should be suited for as many other investors as possible
3. No specialty properties – this would complicate and delay liquidation
4. No distressed assets – the properties should on the contrary produce consistent cash flow
5. Transparency – the portfolio data should be easy for third parties to analyze and assess

What must I do today to be REIT ready in 2009?
Besides selecting suitable properties and deciding on the appropriate legal and tax structure, there are a number of other factors that are critical to the success of a public offering:

- Management information system: conversion to IFRS for quick delivery of transparent financial data to the capital markets
- Business plan: the main portfolio/business strategy must be integrated into an understandable, comprehensive business plan (equity story)
- IPO plan: the key aspects of the public offering must be determined: e.g. financing structure, legal entity structure, underwriters, and placement volume
- Corporate governance: definition of structures for managing the corporation and monitoring performance, including appropriate forms of compensation and incentives
- Investor relations: a clear communications strategy for institutional and private investors must be developed
- Management Team: Identification and formation of an experienced internal management team with expert knowledge

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Conditions of entry to the REITs segment of the Frankfurt stock exchange
With the introduction of the first REIT, Deutsche Börse AG is starting a REITs segment for this asset class. Under the entry conditions established by Deutsche Börse AG, companies are entitled to listing in the REITs segment only if:

- they hold REIT status and
- their shares are admitted to trading on the Regulated Market (General Standard or Prime Standard) or are included in the Open Market (or Entry Standard.)

Admission requires a written application (filed by the issuer in the case of admission of the shares to the Regulated Markets and by the Open Market participant in the case of inclusion in the Open Market).

Application documents
The following documents must be submitted for admission of shares to the REITs segment under the General Standard or the Prime Standard:

- Stock exchange listing application (signed by the company and by the supporting bank or financial service provider)
- Prospectus (approved or certified by the German Federal Financial Supervisory Authority, publication prior to application filing)
- Current articles of incorporation and current excerpt from the Commercial Register
- Report on formation, if the company was formed in the last three years
- The resolutions on which the public offering is based (shareholders, board of management, supervisory board)
- Sample stock certificate (individual certification) or copy of the global certificate (global certification)
- Application for entry with appropriate proof of REIT status

In case of inclusion in the Open Market or (Entry Standard), the following documents are required for the REITs segment:

- Approved or certified prospectus (for public offerings)
- Non-published exposé (for private placements)
- Application for entry with appropriate proof of REIT status

Also required for Entry Standard:

- An undertaking to comply with the rules of the Entry Standard and to monitor compliance with the transparency requirements to be fulfilled by the company
- Proof of appointment of a Deutsche Börse Listing Partner

Transparency requirements
The General Standard is in general subject to the requirements of the German Securities Trading Law (WpHG) and to the entry conditions of the REITs segment:

- Publication of annual and semi-annual financial reports according to IFRS or U.S. GAAP, Canadian GAAP, Japanese GAAP
- Publication of interim reports for the first and third quarters
- Disclosure of Directors’ Dealings
- Ad hoc disclosure obligations
- Prompt notification of Deutsche Börse AG in case of loss of REIT status
- Publication in German language
For the Prime Standard, the supplemental obligations defined by the Stock Exchange Rules and Regulations (Börsenordnung) and the entry conditions of the REITs segment apply in addition to the aforementioned General Standard requirements:

- Publication of annual financial statements and quarterly reports in accordance with IFRS or U.S. GAAP
- Publication of current corporate action timetables
- Holding at least one analyst conference per year
- Publication in German and English languages

The Entry Standard segment is subject to the General Terms and Conditions for Open-Market Trading and to the entry conditions of the REITs segment:

- Publication of audited (consolidated) financial statements (for German companies in accordance with German GAAP or IFRS) including (group) management report, within six months
- Publication of an interim report within three months of the end of the first half of each fiscal year
- Publication of brief, up-to-date company profiles and a corporate action timetable
- Prompt publication of important corporate news
- Prompt notification of Deutsche Börse AG in case of loss of REIT status

V. Taxation of the G-REIT

Act of 28 May 2007

The implementation of the G-REIT has been the subject of spirited discussion in Germany since 2004. The discussion centered around the recommendations published by the financial action group IFD (Initiative Finanzstandort Deutschland) in early 2005. The German Federal Ministry of Finance gave specific form to these proposals in a draft bill dated 25 September 2006. After a number of further changes, above all by the Finance Committee of the German Bundestag (lower house of parliament), the bill was passed by the Bundestag on 23 March 2007, now entitled the Act for the Creation of German Real Estate Stock Corporations with Publicly Listed Shares. The German Bundesrat (upper house of parliament) approved the measure on 30 March 2007. The legislation defines the requirements a stock corporation (public limited company) must fulfill in order to qualify for preferential tax treatment as a G-REIT. These requirements are as follows:

- The stock corporation must have its registered office in the Federal Republic of Germany and must be listed on a stock exchange in a member state of the European Union or a treaty state of the European Economic Area. At least 25 per cent of its shares must be widely held at the time of the stock exchange listing and at least 15 per cent of these shares must continue to be widely held thereafter.
- All shares of stock must be constituted as voting stock belonging to a single class.
- The corporation must prepare financial statements according to German GAAP.
- The business purpose must be limited to acquiring, holding, managing (for purposes of renting and leasing, including necessary real-estate-related ancillary activities), and selling title to, or rights in rem of use and exploitation in, (i) domestic real property, excluding build before 1 January 2007 residential rental properties (as defined), (ii) foreign real property, to the extent the law of the situs state permits ownership by a REIT corporate entity, association, or fund or by a corporate entity, association, or fund that is comparable to a REIT, and (iii) other property within the meaning of § 3 (7) of the REIT Law.
- At least 75 per cent of the assets must consist of real property.
• At least 75 per cent of the gross revenues must be derived from the rental, lease, or sale of real estate.
• At least 90 per cent of net income for the year as determined under German GAAP must be distributed to the shareholders. In determining the annual net income under German GAAP, straight-line depreciation is the only permitted scheduled depreciation.
• Paid ancillary activities for third parties may be performed solely through REIT service companies and may not account for more than 20 per cent of sales revenue.
• The corporation may not trade in real estate. In this context, a corporation is considered to trade in real estate if its gross revenues from the sale of real property during any five year period exceed the value of half of its average real property holdings during the same period.

Regulatory restrictions apply in the following areas:
• Shareholder structure:
  direct shareholdings must in general be less than 10 per cent to avoid negative corporate and tax law consequences
• Capital structure:
  minimum share capital of 15 million euro
• Minimum equity:
  The equity of a G-REIT must equal at least 45 per cent of the fair value of its real property.

While there is in general no federal regulatory oversight by the BaFin (German Federal Financial Supervisory Authority), the Securities Trading Law (WpHG) requires shareholders to make reports and disclosures to the REIT and to the BaFin if certain investment limits are reached (so-called reporting threshold).

Tax preference for transfer of real estate to REITS
Half of the gain on the sale of land and buildings is tax exempt provided (i) the property sold had, as of 1 January 2007, been held for at least five years as a fixed asset of a domestic trade or business owned by the taxpayer, (ii) the sale takes place between 1 January 2007 and 31 December 2009, and (iii) the purchaser is a REIT or a Pre-REIT (§ 3 no. 70 EStG – Income Tax Act). This provision also applies in the event of a change in the legal form of a business association. The tax exemption is retroactively denied in certain cases, e.g. where the land and buildings are re-sold within four years of the time of contracting. No exemption or relief from real estate transfer tax is provided. Sale-and-lease-back arrangements are in principle permissible. However, the law stipulates that the 50 per cent tax exemption for capital gains will be retroactively denied if the real estate is subsequently made available to the seller or to a party related to the seller in which the seller still holds a direct or indirect ownership interest of more than 50 per cent two years from the time of the purchaser’s entry in the Commercial Register as a REIT.

Periodic taxation of a G-REIT
If the REIT fulfills the requirements outlined above, it is completely exempt from corporate income tax and trade tax, provided 90 per cent of its distributable income is in fact distributed to the shareholders. If a REIT ceases to qualify for the tax exemption, this at first triggers penalty payments and then leads to revocation of the exemption in the event of failure to comply for a protracted period. Detrimental ancillary activities for third parties must be located in so-called REIT service companies, which are subject to standard taxation.
Periodic taxation of investors

The shares held in the REIT cause the shareholder to derive income from capital. As a consequence of the tax exemption at the level of the REIT, distributions are generally fully taxable at the level of the shareholder. The 50 per cent exemption that normally applies to dividends received by individuals (so-called half-income system) and the 95 per cent exemption normally applicable to dividends received by corporations do not apply to dividends paid by a G-REIT.

The taxation of the following types of income is not explicitly addressed by the law.

- Income from the lease, rental, or sale of foreign real property on which foreign tax has been imposed where the right of taxation is assigned to the foreign situs state under a tax double treaty. We believe that the logic of the law requires the exemption of such foreign pre-taxed income in the hands of the domestic investors, hence the REIT’s dividends should be received free of tax to this extent.

- Pre-taxed dividends received by the G-REIT from its shareholdings in subsidiaries that are themselves subject to standard taxation. We believe that the logic of the law requires that such income be subject to the standard 50 per cent exemption when distributed by the REIT to shareholders who are individuals and to the 95 per cent exemption under § 8b KStG (Corporate Income Tax Act) when distributed to corporate shareholders (so-called non-REIT income).

- German-source income from real property (REIT income) is fully taxed in Germany in the hands of the investor. If a REIT’s income is taxed in the hands of the REIT due to its failure to comply with the requirements for tax exemption, this means that the REIT is subject to standard taxation. In this event, we believe that the standard tax rules should also apply to dividends paid to shareholders.

- The Finance Committee has therefore requested that the German government agree with the German states on a proposal taking account of situations involving pre-taxed dividends and present this proposal in time for enactment and implementation by the end of 2007.

REIT distributions are subject to a creditable withholding tax of 25 per cent plus solidarity surcharge. Dividends paid to non-resident investors are subject to German taxation as German-source income. In these cases, the tax is collected by withholding at the source in Germany. The tax so withheld satisfies the German tax liability of the non-resident investor. The withholding tax amounts to 15 per cent if the investor has tax-exempt status. Non-profit corporations are completely exempted from withholding tax. Withholding tax on dividends paid to non-resident investors may be reduced or eliminated entirely where a tax treaty is applicable. As a rule, no tax treaty relief from withholding tax will apply because of the limit on percentage ownership of REITs. A REIT corporation does not forfeit its tax exemption merely because an investor holds a share of 10 per cent or more. The investors, likewise, do not lose their dividend or voting rights. However, their rights under the shareholding are limited to those which a shareholding of less than 10 per cent would confer.

Under the 2008 Business Tax Reform Act, dividend distributions are taxed at a definitive 25 per cent flat rate from 1 January 2009 onwards. In other words, the future income tax rate for income from capital will be 25 per cent regardless of an individual’s own marginal tax rate, even for REIT dividends, which are paid out of pre-tax income. Together with the 50 per cent exit tax discussed above, the year 2009 will provide REITs with a nice advantage compared to the listing of a corporate tax-burdened non-REIT property company. This might spark a REIT-IPO-hype, if the financial markets are in the appropriate condition.
Gains on the sale of REIT shares are taxed just like gains on the sale of other stock. This means that private investors who do not hold the REIT shares as business property can sell their shares tax free after meeting the 12 month holding period requirement of § 23 (1) no. 2 ESTG. Under the 2008 Business Tax Reform Act, capital gains not covered by § 17 ESTG (Income Tax Act) from the sale of corporate stock, i.e. gains on the sale of shareholdings of less than 1 per cent, are in the future generally taxable whether or not a twelve month holding period has been observed.

Foreign resident taxpayers derive German-source income that is subject to German taxation. The distribution is subject to 25 per cent withholding tax. However, the withholding tax satisfies in full the tax liability of non-resident taxpayers.

The provisions respecting income from shares in German REITs also apply to resident taxpayers who hold shares in foreign REITs.

**Taxation upon sale, transfer, and reorganization**

The transfer of real property to a G-REIT triggers the realization of any hitherto unrealized appreciation (built-in gains, hidden reserves). Contributions of real property are in general subject to both income tax (personal or corporate) and to trade tax, unless the 50 per cent exemption applies for gains on the sale of land (§ 3 no. 70 ESTG).

**Pre-REIT**

It will as a rule only be possible to list a G-REIT on a stock exchange after a preparatory phase, especially where real property must be collected from different sources. Corporations that meet all regulatory requirements for a REIT, except listing on a stock exchange, are not given the benefit of the full tax exemption. However, the preferential taxation under the so-called exit tax is extended to a Pre-REIT. This preference is retroactively denied if the Pre-REIT is not entered in the Commercial Register. A period of four years is available for this purpose. A Pre-REIT must meet the business purpose requirements of a REIT (acquiring, holding, managing (for purposes of renting and leasing), and selling title to, or in rem rights of use and exploitation in, real property) by the end of the fiscal year following that of its registration. A Pre-REIT must meet the asset and income requirements of a REIT (real property comprising at least 75 per cent of gross assets; gross revenue deriving at least 75 per cent from the rental, lease, and sale of real estate) by the end of the fiscal year following that of its application for entry in the Commercial Register.
VI. Overview of accounting treatment

1. General information

The REIT Act contains no comprehensive rules on the accounting treatment of REITs. The relevant aspects may, however, be inferred indirectly, in particular from §§ 12 and § 13 of the REIT Law (“Asset and Income Requirements” and “Distribution to Investors” respectively).

First of all, it follows from these provisions that a REIT corporation must prepare single-entity financial statements according to German GAAP, since these are the basis on which distributions are determined. Under § 12 (1) of the REIT Law, the amount of the required distribution is measured with respect to annual net income under German GAAP.

The asset and income requirements in § 12 of the REIT Law define, in conjunction its §§ 14 and 15, certain quantitative structural criteria that corporations must meet in order to qualify as a REIT (see Fig. 6).

![Fig. 6: Primary quantitative structural criteria under the REIT Law](image)

Fulfillment of these criteria is determined on the basis of consolidated financial statements prepared according to § 315a HGB (German Commercial Code) or, if none such are mandated, on the basis of single-entity financial statements in accordance with § 325 (2a) HGB. Since both provisions require IFRS accounting, IFRS thus constitute the basis for REIT financial accounting in both cases.

The standard IFRS principles apply for purposes of the annual or consolidated financial statements. Only for determining the quantitative structural criteria do special rules apply. These limit the options available under IFRS, such as valuation at fair value under IAS 40.

Instead of establishing a new accounting regime specifically for REITs, the REIT Act thus in general relies on single-entity financial statements in accordance with German GAAP for purposes of distributions, and otherwise on IFRS consolidated financial statements. Single-entity IFRS financial statements are also required in some cases.

Practically speaking, however, this results in a REIT-specific variant of IFRS accounting, since there is no reason to suppose that the policies REITs follow in preparing their annual financial statements will differ from those indicated by the need to meet the quantitative structural criteria.
2. Important specific aspects

2.1 Details on distributions

Section 13 of the REIT Act requires a REIT to distribute at least 90 per cent of its annual net income as defined by German GAAP, specifically § 275 of the German Commercial Code. This distribution calculation basis is reduced by any amounts placed in a rollover reserve for profits from the sale of real property (up to half thereof) and increased by amounts released from this reserve (after a maximum duration of two years), unless applied in the interim against the cost of purchase or production of new assets. Under § 13 (3) of the REIT Act, a distinction is drawn between Capital Gain I and Capital Gain II. Only the latter can be considered as addition when calculating the net in come for distribution purposes.

The provision of the Stock Corporation Law that requires establishment of a statutory reserve (§ 150 AktG) does not apply to REITs.

In making annual net income determinative, the legislature apparently failed to note that, under German GAAP, distributions are made with reference to “income available for distribution” (Bilanzgewinn), which may be affected also by profits or losses carried forward.

Accordingly, the annual financial statements under German GAAP necessarily have great importance in addition to the IFRS single-entity accounts. This means that unrealized valuation gains and losses under IFRS are not included in the distribution calculation basis.

On the other hand, straight-line depreciation is the only scheduled depreciation permitted in the accounts prepared under German GAAP.

One might ask whether the statutory minimum distribution requirement could give rise to an accounting obligation in the annual financial statements (under German GAAP and/or IFRS). Since the provision in question is merely a minimum requirement and it is still necessary to first adopt a profit appropriation resolution, this is most likely not the case.

2.2 Real property

Real property is valued at its fair value for purposes of determining the quantitative structural criteria of a REIT. The provisions of IAS 40 apply to tangible real property. Under § 3 (7) of the REIT Act, interests in other companies are also considered to be real property, which raises the question as to how their fair value should be determined. To the extent that such shareholdings are included in consolidated accounts, the problem ultimately becomes one of valuing the real estate itself. However, in the case of non-consolidated interests in real estate partnerships (minority interests), this strictly speaking requires carrying out a business enterprise valuation. It should nonetheless be possible to simplify this process, e.g. by using a net asset value determination based on the fair value of the real estate, in order to avoid unreasonable expense.

2.3 Minority interests in consolidated financial statements

Interests held in real estate partnerships will generally not be 100 per cent interests (e.g. for real estate transfer tax reasons). Under the terms of IAS 32, interests in partnerships must currently be treated as debt. Hence, minority interests in such partnerships that remain in the consolidated financial statements must be accounted for as debt, which in light of the aforementioned minimum equity requirements further restricts the scope for outside financing.
2.4 Role of the statutory auditor
The responsibilities assigned to the statutory auditor by the REIT Act go beyond those associated with the statutory audit of the annual or consolidated financial statements.

The auditor must also audit compliance with the above described quantitative structural criteria (§§ 12, 14 and 15 of the REIT Act) at the end of each fiscal year and present its findings in a “special notation” (§ 1 (4) of the REIT Act).

It is unclear whether this audit must be separately commissioned and whether the “special notation” is to be included in the financial statement audit report or issued as a separate document.

Furthermore, with regard to a Pre-REIT, the Federal Central Tax Office may request that the statutory auditor confirm compliance with the requirements of § 12 of the REIT Law as of the close of the fiscal year following that of the Pre-REIT’s filing with the Commercial Register.

2.5 Financial reporting of a REIT
In connection with the above described accounting requirements (single-entity and consolidated financial statements, IFRS + German GAAP), it is especially important for a REIT to ensure that its external self-presentation adequately depicts the core aspects of its business activities. The EPRA recommendations may provide additional guidance in this regard.

This applies during the fiscal year as well, for instance for quarterly or semi-annual reporting.

Appropriately designed internal systems are a necessity in this regard. The generation of consistent and transparent information is naturally necessary throughout the year, not just at year’s end.

This applies as well for general requirements under German stock corporation law, such as the establishment of an appropriate risk management system. It should be noted that year-end financial reporting under IFRS is also more extensive and requires, among other things, segment reporting.

3. Conclusions
The preparation of a REIT accordingly requires timely modification of the necessary accounting and reporting systems, including the risk management and controlling systems.

In this process, it is important to realize that a clear concept and appropriate documentation are needed in order to construct the necessary systems.

The time factor should also not be underestimated. The requirements of IFRS, such as those regarding the notes or segment reporting, are comparatively much more complex than those necessary under German GAAP. More preparation time must also be allowed.

This also applies with regard to establishing the systems required for efficient determination of fair value for real estate valuation purposes under IAS 40. Diligence and careful time planning are indispensable requirements for successful implementation of a REIT concept.
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