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**Real Estate Investment Funds:**

**Comparative analysis of REITs in the UK and in Germany  
and their potential impact on the social housing markets in both countries**

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## **Abstract**

This thesis investigates the relation between the investment vehicle 'Real Estate Investment Trust' (REIT) and the social housing market in the UK and in Germany.

REITs have only recently been introduced to both countries and their introduction raised quite different perceptions in relation to the consequences on social housing. While the British government seems to welcome REITs as a potential method to increase the level of housing supply in general and the supply of affordable housing in particular, the German government seem to anticipate negative impacts of REITs on the social housing sector and thus excluded all existing housing from REITs.

These perceptions frame the initial point of this thesis, which subsequently attempts to analyse them in relation to the objectives of an investment vehicle such as the REIT on the one hand, and the needs of the social and affordable housing sector on the other. Finally it discusses if these objectives are compatible or mutually exclusive.

**Acknowledgement**

The initial idea for my thesis and its further development partly relies on discussions with my supervisor, members of staff at the Bartlett, colleagues and fellow students. I would like to thank especially Professor Michael Edwards, Professor Yvonne Rydin, Mr. Richard Lee, my colleague Claudia Friedrichs and Mazen Touma for their professional advice and support.

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## List of Abbreviations

AIFA	Association of Independent Financial Advisers
AktG	German Stock Corporation Act / Aktiengesetz
BGB	Civil Code of Germany / Bürgerliches Gesetzbuch
BBR	Federal Office for Building and Regional Planning / Bundesamt für Bauwesen und Raumentwicklung
DIMAX	German real estate stock index / Deutsche Immobilienaktienindex
EEA	European Economic Area
EStG	Income Tax Act of Germany / Einkommensteuergesetz
FTSE	Financial Times Stock Exchange
GbR	Civil-law partnership / Gesellschaft bürgerlichen Rechts
G-REIT	Real Estate Investment Trust in Germany
HAs	Housing associations
HGB	German Commercial Code / Handelsgesetzbuch
HMT	Her Majesty's Treasury
HMRC	Her Majesty's Revenue & Customs
IAS	International Accounting Standard
ICTA88	Income and Corporation Taxes Act 1988
InvStG	German Investment Tax Act / Investmentsteuergesetz
InvG	German Investment Act / Investmentgesetz
IRR	Internal rate of return
ITTOIA05	Income Tax Trading and Other Income Act 2005
KAG	Investment Trust / Kapitalanlagegesellschaft
KG	Limited partnership / Kommanditgesellschaft
KStG	Corporation Tax Act / Körperschaftsteuergesetz
KWG	German Banking Act / Kreditwesengesetz
LA	Local authority
LSE	London School of Economics
NAV	Net Asset Value
OEIC	Open-ended Investment Company
PIF	Property Investment Fond
REIT	Real Estate Investment Trust
RSLs	Registered Social Landlords
UK REIT	Real Estate Investment Trust in the United Kingdom
WobauG	Second Housing Act, Germany / Zweites Wohnungsbaugesetz
WoFG	German Housing Space Act <sup>1</sup> / Wohnraumförderungsgesetz
WpHG	Securities Trading Act / Wertpapierhandelsgesetz

<sup>1</sup> Free translation, no official version available.

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## I. Introduction

The Real Estate Investment Trust (REIT) is a real estate investment vehicle that was first established in the US during the 1960s (Winograd 2004). In the following years several other countries such as Canada, Holland, Belgium, France, Australia, Japan, South Korea, Singapore, Hong Kong and Malaysia all developed REIT structures (REITs-Anleger n.d. a)<sup>2</sup>. Campaigns to introduce REITs in the United Kingdom (UK) and Germany started a few years ago and resulted in the introduction of UK REIT at the beginning of 2007.<sup>3</sup> Shortly afterwards the German REIT (G-REIT) was enacted in June 2007 with retroactive effect to the 1<sup>st</sup> January 2007 (REITs Deutschland 2007a)<sup>4</sup>.

The launch of REITs was accompanied by lively discussions in both countries. Among other issues the consequences for the social and affordable housing market was one of the crucial points of the discussion. It is quite remarkable that the national perceptions of the influence of REITs on the social and affordable housing market were controversial to such an extent. The scope of the discussion ranged from the expectation that REITs in the UK will increase the supply of social and affordable housing (HMT 2004a) to the exclusion of existing residential properties from REITs in Germany. The latter is owed to the anticipation that REITs would be disadvantageous to tenants and public authorities and would cause further issues in relation to sustainable town planning and social housing policy (Deutscher Bundestag<sup>5</sup> 2007). Obviously these differing perceptions raise a multitude of questions. Formulating the following questions might help at the outset to explore the subject and also frame the contours of this thesis.

Primarily this thesis will seek to answer the question whether the objectives of an investment vehicle such as a REIT and the needs of the social and affordable housing sector match or if these aims are mutually exclusive? Part of the answer depends on whether REITs will help to increase the housing supply, as anticipated by the British government, and whether this housing will be affordable? Further, is the concern in Germany that REITs will boost the rents unsubstantiated and why does this concern seem to be of less relevance in the UK? To what extent have these anticipated perceptions proved to be true?

In seeking to understand these issues, one need be aware that the answer to these questions is not only limited to national policy but that the wider public discussion has to be considered. Additionally it also has to be kept in mind that due to the relatively recent introduction of the REIT it might be too early to review the actual outcomes within this thesis.

Thus this thesis will seek to analyse if the social aspects of the housing sector in the UK and Germany are compatible with the concept of REITs. It attempts to observe if REITs can in some way be adapted to change the situation on the social and affordable housing market or if REITs are in principle incompatible with this sector.

The thesis is structured as follows: the methodology is followed by a section with a brief definition of REITs and of their typology.<sup>6</sup> A subsequent part then attempts to describe the introduction of REITs against the background of the property and investment markets in the UK and in Germany. It is followed by a description of the legal, financial and fiscal

<sup>2</sup> REITs-Anleger is an information portal for investors who are interested in REITs.

<sup>3</sup> Some sources use the term Property Investment Trust (PIF) when referring to the UK REIT.

<sup>4</sup> REITs Deutschland is an information portal for REITs in Germany.

<sup>5</sup> Deutscher Bundestag is the Federal Diet in Germany.

<sup>6</sup> Due to existing theses it was agreed during open discussions with Prof. Michael Edwards to condense the scope of this part and to elide the history of the REIT and its development in other countries.

structures of REITs in both countries and includes an assessment of the particular performance of REITs. The final part describes REITs in relation to the social and affordable housing market. This starts with a review of the sector in both countries giving a definition, an outline of its structure as well as a description current issues. It then passes into a discussion about the different national perceptions towards REITS and their potential implications on the social housing market. The thesis concludes with a general assessment of the compatibility of REITs and social housing and suggests how social housing could benefit from REITs.

## **II. Methodology**

The thesis is generally designed as comparative analysis between the relationship of REITs and social housing within the UK and Germany.

Part one seeks to give a general background to REITs and the different types of REITs. It mainly relies on secondary research about the main features of REITs. The scope of the research includes data gathered from articles written by specialists of the financial service and the commercial property sector.

Part two focuses on the introduction of REITs in each particular country against the background of the relevant markets and investment methods. It uses the method of comparative analysis to work out the differences and similarities of REITs in both countries. As an introduction it starts with a chronology leading to the adoption of REITs in the UK and Germany that is mainly based on publications of governmental institutions. The subsequent part is a comparison of the property market, the property investment market and existing investment instruments in each particular country and relies on secondary research derived from academic articles, investment market surveys, property market surveys and articles from specialists of the financial service as well as of the commercial property sector and official statistics. The following analysis of legislation of REITs depends mainly on primary research gathered from each particular bill and adjacent legal commentaries. The final description of the performance of REITs in each country includes professional market surveys and articles from legal and financial advisors.

The final part examines the social housing sector in both countries and seeks to discuss the relevant aspects of the REIT introduction in relation to social housing. The exploration of each social housing sector relies on secondary sources such as academic articles, newspaper articles, publications of governmental institutions and official statistic and partly on primary sources such as parliamentary bills and their adjacent commentaries. The subsequent discussion of the potential impact of REITs on social housing is mainly gathered from articles written by proponents or opponents such as tenants associations, politicians or representants of the investment industry.

It is important to note that some methodical problems arise from the use of sources from the investment sector in relation to REITs. Generally these sources tend to be very partial and they seldom review the disadvantages and problems related to REITs. On the other hand sources opposed to REITs are also often one-sided and ignore potential benefits from REITs.

Another methodical problem consists in the derivation of knowledge from primary sources of unfamiliar specialism such as legal and fiscal texts. Due to the lack of knowledge in this field it seems unlikely to perceive the entire impact of each legal or fiscal detail, but this might not be relevant in the wider scope of the thesis.

### III. Real Estate Investment Trust

A comprehensive definition of the term 'REIT' is complicated by the distinct structures in the different countries. Most national REITs vary in their nomenclature, their legal form, conditions for the REIT status and the tax treatment (REITs-Anleger n.d.a).

Since this thesis focuses on the adoption of REITs in the UK and Germany, it seems coherent to base the definition on the understanding existing in the UK and Germany. The following section attempts to suggest a rather general definition and paragraph two will give a more detailed description of the legal, financial and fiscal structures in the UK and Germany.

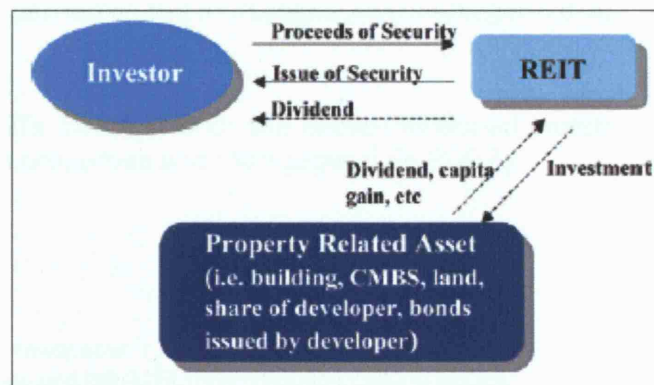
#### 1. Definition and operation principles

According to the London School of Economics (LSE n.d.) REITs are an investment vehicle that allows indirect, flexible and diversified investment into the property market. At this point it seems to be appropriate also to define the term property investment. According to the International Accounting Standards property investment is defined as holding property for the purpose of receiving rental and/or achieving capital appreciation. The meaning of property investment can be distinguished by the following activities that are outside of its scope:

- property held for use (production, supply of goods, services or administrative purposes)
- property held for sale or in the process of construction or development for such sale
- property being constructed or developed on behalf of third parties
- owner-occupied property (incl. future use as owner-occupied property, future development and subsequent owner occupation, owner-occupied property awaiting disposal and occupation by employees)
- property that is being constructed or developed for use as an investment property
- property leased to another entity under a finance lease

Property Investment – Outside the scope of IAS 40  
(Source: IAS Plus by Deloitte 2007)

REITs are required to invest and thus also to derive their income mainly from real estate either in terms of property and/or mortgages (REITs Deutschland n.d.a). Their income originates from rents, leases and sales of property and land as well as from interest and profits. The subsequent diagram visualises the operation principles of REITs:



Operation principles of REITs  
(Source: London School of Economics n.d.)

Depending on the tax treatment of the particular country, REITs are provided with certain tax privileges that are linked to a defined profit distribution among investors and further requirements. In detail, REITs are exempt from income and corporation tax and taxation on share appreciation and dividends are passed on to the investors (reita n.d. a). The resulting single taxation of the investor results in higher tax transparency (London Stock Exchange 2007).

Most REITs companies are listed on the designated investment exchange, even though, depending on national regulations, they can also be held privately. Therefore, REITs are tradable like stocks and offer the advantage of higher liquidity, easier access and more flexible investment in contrast to many other methods of investment in real estate (LSE 2007).

Besides liquidity REITs offer the possibility to invest in a diversity of properties at minimal expense as well as access to larger-scale and high-quality properties in a variety of locations and sectors (London Stock Exchange 2007)

More detailed information on REITs in the UK and in Germany is given in paragraph two. The following section attempts to give a brief description of the typology of REITs.

## 1.1 Typology of REITs

According to the Real Estate Dictionary of the German Immobilien Zeitung<sup>7</sup> (2005) REITs can generally be categorised either as an investment strategy<sup>8</sup> or as a type of investment<sup>9</sup>. The classification in equity, mortgage and hybrid REITs seems to be predominant and will be therefore adopted in the following section.

### 1.1.1 Equity REIT

The strategy of Equity REITs is mainly to invest in properties. The ownership of the properties means that the REIT is thus "responsible for the equity or value of their real estate assets" (LSE 2007). Their income mostly consists of their properties' rents. Additional income may result from interest originating from short-time investments available for the acquisition of new properties. They are considered as relatively immune to interest fluctuations and thus suitable for conservative and cautious investors (REITs-Anleger n.d. a).

### 1.1.2 Mortgage REIT

Mortgage REITs focus on the investment and ownership of real estate mortgages. There are three possibilities of investment: loans for mortgages to property owners, investment in "existing mortgages and mortgage backed securities" (LSE 2007). The income of these REITs consists generally of the interest earned on the mortgages (REITs-Anleger n.d. a).

### 1.1.3 Hybrid REIT

As the name suggests, the Hybrid REITs invest in both the above-mentioned investment forms and thus combine investments in properties and mortgages (LSE 2007).

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<sup>7</sup> The Immobilien Zeitung is a German property newspaper.

<sup>8</sup> The investment strategy cover equity, mortgage and hybrid REITs (Immobilien Zeitung 2005).

<sup>9</sup> The investment type could include office, retail, apartment, residential, health care and specialty REITs (Immobilien Zeitung 2005).



## 2. Introduction of REITs in the UK and Germany

According to reita<sup>10</sup> [n.d. b] the scheme of the British government to establish a REITs date back to 1997. These intentions became more tangible as the government announced in the 2003 Pre-Budget Report that it would consult on an "appropriate structure for a potential new property investment vehicle" (HMRC n.d.a). In April 2003 the Chancellor commissioned Kate Barker<sup>11</sup> to review the housing supply in the UK (HMT 2004b). Besides a set of policy recommendations to increase the housing supply, Barker approved the introduction of an investment vehicle to facilitate institutional investment (Barker 2004). The initial interim report (Barker, K. 2003) and the final 'Review of Housing Supply' (Barker, K. 2004) are seen as main drivers of the final implementation of the UK REITs (Chartered Institute of Housing 2004). The consultation paper 'Promoting more flexible investment in property', published adjacent to the Budget 2004 by HMT and Her Majesty's Revenue & Customs, and the subsequent responses resulted in the discussion paper 'UK Real Estate Investment Trusts' alongside Budget 2005 (HMRC n.d.a). The policy rationale for a UK REIT laid out in these documents was mainly driven by the intention to create a healthy, stable, efficient, flexible and fair property market and in a wider sense to secure economic growth and productivity. A special focus was laid on the residential market with the aim to "encourage development of new housing" (HMT 2004). Originally it was discussed to determine that REITs have to invest a certain percentage of assets in residential property (House of Commons 2006), but this potential condition was seen as inappropriate and therefore not realised (HMT 2005). Subsequently a draft legislation was issued in December 2005, the final legislation was laid before the House of Commons in November 2006 and came into force on the 1<sup>st</sup> January 2007 (HMRC n.d.b).

REITs-Anleger [n.d. b] states that the Initiative Finanzstandort Deutschland (IFD)<sup>12</sup> initiated the discussion about REITs in Germany in June 2004. The IFD aimed to improve the image of Germany as investment centre for foreign investors and prepared a detailed legislative proposal for the introduction of the G-REIT. The German ministry of finance generally demonstrated interest and commissioned expertise of the Zentrum für europäische Wirtschaftsforschung (ZEW)<sup>13</sup> and the Real Estate department of the European Business School. The expertise was published in May 2005 and recommended the introduction of REITs. Further progress was however delayed by the early elections in September 2005, but the new incoming government stipulated its intention to introduce REITs in their coalition agreement. Nevertheless, several disagreements about details of REITs held up the process. The first debate in the Deutsche Bundestag only took place on the end of June 2006 and the decision to adopt REITs in Germany happened at the beginning of November 2006 (REITs Deutschland 2007a). At the beginning of January 2007 the German government drafted a bill concerning the introduction of the G-REIT. The intention of this bill is to establish an indirect investment vehicle that is strengthening Germany as a business location and to achieve a more professional approach of the property sector and a more competitive position in comparison to other European financial and real estate investment markets. The protection of tenants and the continuation of social housing policy and sustainable town planning was another intention of the German government that led to the exclusion of existing housing for rent<sup>14</sup> (Deutsche Bundestag 2007). At the end of March

<sup>10</sup> Reita is an information portal created by 'The REITs and Quoted Property Group' who are supported and funded by companies in the financial service commercial property sector.

<sup>11</sup> Kate Baker was at that time a member of the Bank of England's Monetary Policy Committee (Her Majesty's Treasury (2004b)).

<sup>12</sup> Initiative Finanzstandort Deutschland (IFD) is an action group for the German financial sector.

<sup>13</sup> Centre for European Economic Research is a non-profit economic research institute.

<sup>14</sup> To symplify the sentence structure the term 'existing housing for rent' will be shortened to 'existing housing'.

the Deutsche Bundesrat<sup>15</sup> gave its consent, but due to formalities the passing of this into law was delayed until the 1<sup>st</sup> of June 2007. However, G-REITs came into retroactive effect dated back to the 1<sup>st</sup> January 2007 (REITs Deutschland 2007a).

## 2.1 The property investment market

In order to contextualise the adoption of REITs, as an indirect property investment vehicle, this section gives a brief overview of the residential property market in relation to the property investment market<sup>16</sup> and the introduction of REITs in both countries. Subsequently it examines existing investment instruments and closes with a comparison to REITs.

Corresponding with the focus of the thesis the emphasis of this section will be placed on the residential investment market. It is also necessary to note that the compatibility of the used figures and statistics might not be given since this section relies on sources of different origin and processing.

### 2.1.1 The UK property investment market

According to IPF the UK commercial property market has a market value of around £760bn. It is estimated that half of this can be attributed as investment property that is rented to tenants or is mostly owned by financial institutions, overseas investors or UK property companies (reita n.d.d).

The UK residential property market accounts for a market value of £3,400bn and exceeds the value of the commercial market by 5 times. However the major part of the residential property is not part of the investment market since over 70 percent is owner occupied (reita n.d.d). The existing forms of housing tenure can be broken down into owner occupation, private or public tenancy (Ball 2004). In the case of private or public tenancy private individuals, companies, not-for-profit organisations such as a housing associations (HAs) or governmental organisations such as public housing act as landlords. The following table shows the relation of different housing tenures to each other.

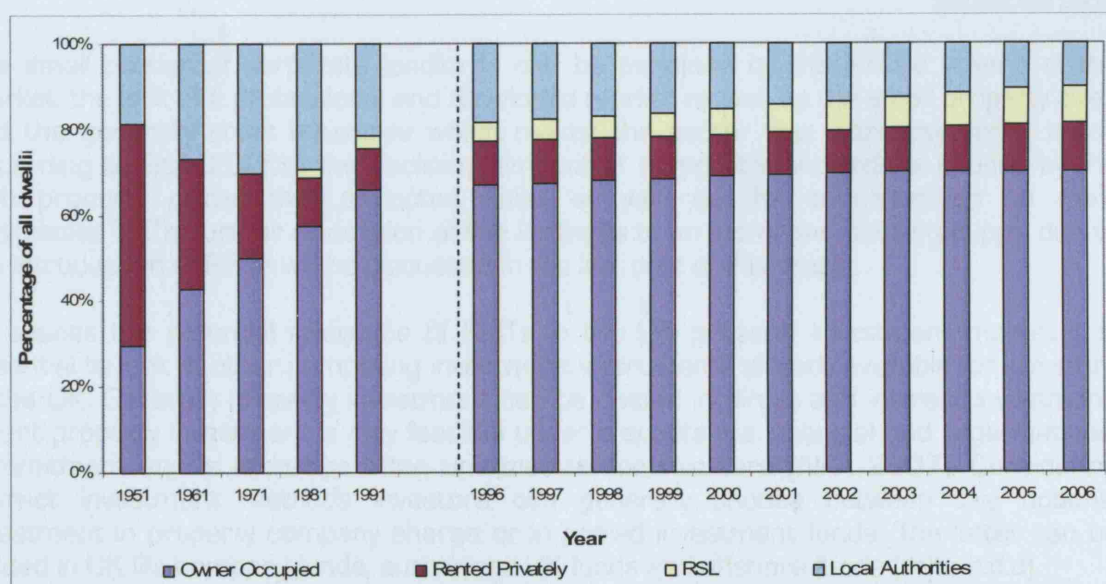


Chart 103 Dwelling stock: by tenure, Great Britain, historical series (chart)  
[Source: Communities and Local Government 2007]

<sup>15</sup> Deutscher Bundesrat is the upper house of the German parliament and can be translated as Federal Council of Germany.

<sup>16</sup> Property investment in the sense defined in part 1. Definition and operation principle.



The table specifies that the housing tenure in Great Britain be divided by 11.4 percent private tenancy, 18.5 percent public tenancy and the mentioned high percentage of owner-occupied housing. The public tenancy is delivered to 8.4 percent by registered social landlords and to 10.1 percent by local authorities (LAs) (Communities and Local Government 2007).

Considering these figures in relation to the investment market it can be assumed that in theory only the private rental market of the whole residential market is available as investment property. Even though REITs might open up parts of the public rented sector, i.e. HAs, for the investment market, since some HAs announced plans to enter the REIT regime (q.v. part 2.51 Current performance in the UK). Nevertheless this would still represent less than 20 percent of the residential market.

If, as argued by the British government, the REIT is the right measure to increase the housing supply it is necessary to examine the current status and the prospects of this comparatively small market<sup>17</sup>. Interest in the private rental market has increased substantially since the early 1990s (AIFA 2007). The revival of the private rental market then was mainly supported by policy changes, a liberalisation of the financial market and positive economic development (Ball 2004). The following table shows that private landlords dominated the private rental market in 2001 whereas corporate landlords accounted for little more than one third of the market.

%	1994	1998	2001
Private persons	47	61	65
Partnerships	3	4	5
Companies	25	22	13
Others	25	14	17

Type of residential landlord on the private rental sector  
(Source: Ball 2004)

The small portion of corporate landlords can be explained by the limited volume of the market, the lack of a professional and developed market as well as the small property sizes and the generally short tenancies which makes the sector less attractive (reita n.d.d). According to Ball (2005b) the declining amount of corporate landlords is caused by the high property prices that attracted sales as well as the concentration on main businesses<sup>18</sup>. The further discussion of the likeliness of an increased housing supply due to the introduction of REITs will be discussed in the last part of this thesis.

To assess the potential relevance of REITs in the UK property investment market it is essential to look at other competing investment instruments already available for investors in the UK. Generally property investment can be divided in direct and indirect investment. Direct property investment is only feasible under a substantial financial and organisational commitment and is therefore often unattractive for investors (AIFA 2007). Considering indirect investment methods investors can generally choose between two options: investment in property company shares or in pooled investment funds. The latter can be divided in UK life company funds, authorised UK funds and offshore funds (reita n.d.d).

The purchase of **property company shares** at the stock market is not a tax-efficient option since they are subject to double taxation. Capital gains and rental income are taxed at a

<sup>17</sup> The public rental market will be described in part 3.1.1 Social and affordable housing in the UK.

<sup>18</sup> The property business is for two thirds for the landlords only a sideline activity (Ball 2005b).

rate of 30 percent within the company and also shareholders are subject to taxation (reita n.d.b). Other disadvantages are the volatility of shares prices in relation to the underlying property values and the tendency for low yields with an average of fewer than 2 percent on the FTSE All-Share Real Estate Index [Knowlden Titlow Financial Services 2007].

**UK life company funds** are property funds that are offered by life assurance companies as part of their life and pension products. In comparison with authorised UK funds they show some substantial tax disadvantages such as an internal taxation of 20% on realised capital gains plus "a reserve of up to 20% on unrealised gains" [AIFA 2007].

**Authorised UK funds** are the generic term that stands for **unit trusts**<sup>19</sup> and **open-ended investment companies**<sup>20</sup> (OEICs). These funds are generally composed of "80-100 percent direct property holdings with the balance held" in indirect property holdings and/or cash to offer liquidity. Authorised UK funds are in comparison to property shares and life funds more tax-efficient since they are not liable for internal capital gain tax and income is taxed at a rate of 20 percent within the fund. [AIFA 2007].

**Offshore property funds** are pooled investment schemes that are located on tax beneficial financial centres such as the Channel Islands and their marketing is restricted in the UK by Financial Services Authority rules. They can be structured as a closed-end<sup>21</sup> or open-ended<sup>22</sup> fund and invest in property directly or indirectly [AIFA 2007]. They are tax-efficient in the way that they are not subject to internal taxes on gains and income, except that they are usually liable to withholding tax at a rate of 22 percent on rental income of UK properties [Knowlden Titlow Financial Services 2007] as well as dividends and capital gains which are taxed in the hands of UK investors [AIFA 2007]. They are deemed to be more risky than similar vehicles in the UK due to high gearing to expand the funds, but on the other hand returns are potentially higher [Knowlden Titlow Financial Services 2007].

In comparison to the above-mentioned indirect investment vehicles REITs are primarily advantageous with regard to taxation. Property company shares and UK life company funds are subject to double taxation and therefore in this respect are not competitive with REITs. Authorised UK funds are more tax-efficient since there is no double taxation. The income taxation for basic rate taxpayers is at a rate of 20 percent in comparison to 22 percent within REITs even a little bit advantageous. In contrast to that non-taxpayers<sup>23</sup> are disadvantaged due to the impossibility to reclaim income tax. Offshore property funds are tax-wise the most similar to REITs, even though they are disadvantaged due to their liability to withholding tax on UK properties [AIFA 2007]. From the tax aspect REITs seem to be more attractive for investment companies as well as for most investors than most existing investment instruments. But even then certain existing options might be a more appropriate investment vehicle depending on special needs or strategies such as higher returns, higher gearing, less distribution, less volatility or a higher amount of development. However from an investment point of view the introduction of REITs seem to complete the range of British investment products.

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<sup>19</sup> Unit trusts are open-end investment schemes where units are equitably issued and represent directly the fund's underlying asset value [Schulte et al. 2005].

<sup>20</sup> Open-ended investment companies are similar to unit trust, the main difference is stated as the single price for buying and selling [HSBC n.d.].

<sup>21</sup> A closed-end fund is a pooled investment scheme where the number of shares are limited [Deutsches Derivate Institut n.d.].

<sup>22</sup> An open-ended fund is a pooled investment scheme where the number of shares is not determined. Shares can be issued and redeemed at any time [Deutsches Derivate Institut n.d.].

<sup>23</sup> Non-taxpayers are individual saving accounts, personal equity plans, children trust funds or pension managers [AIFA 2007].

### 2.1.2 The German property investment market

According to Plesser (2006) German property assets account for €7,400bn<sup>24</sup> and it is estimated that the value will increase up to €8,000bn in the course of 2007 (Sieweck et al. 2007). Around €1,600bn is allocated to commercial properties and therefore the residential sector amounts for €5,800bn. Since there seems to be no figures available to show the relation of value to the different housing tenures, the following table<sup>25</sup> relates the above given figures from Plesser to figures about housing tenures given by Ball:

housing tenure	%	Housing tenure in relation to value of residential assets
	* given by Ball	* given by Plesser
total value of residential assets	100%	5,800 bn
owner occupation	43%	2,494 bn
private tenancy (such as housing companies)	45%	2,610 bn
public tenancy - local authorities	6%	0,348 bn
- housing associations	6%	0,348 bn

Housing tenure and value of residential assets in Germany  
[Source: Plesser et al. 2006 / Ball 2004]

Looking at the figures it can be said that the owner occupation at a rate of about 43 percent is much lower than in the UK and that in turn the private tenancy at around 45 percent is significantly higher. Public tenancy accounts only for 12 percent and is slightly lower than in the UK. The graph on the following page relates the different forms of housing tenures to the corresponding providers and the housing stock<sup>26</sup>

Considering a private tenancy rate of 45 percent it is generally assumed that more residential property is available for investment in Germany than in the UK. Subsequently it is supposed that the amount of professional managed rental properties is higher than in the UK. In this respect<sup>27</sup> the private rental market in Germany seems to be more attractive than in the UK.

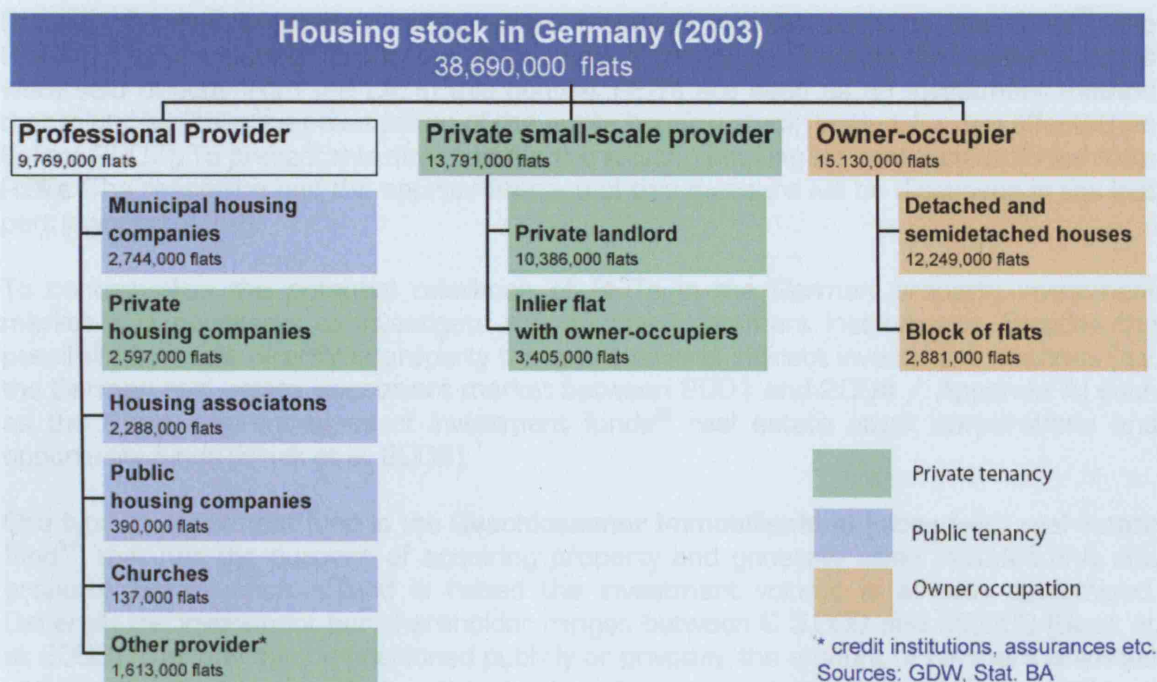
<sup>24</sup> In the original document the value of German property assets are quoted with €7.4bn, which means 7,400,000,000,000 or 7.4<sup>12</sup> whereas the English understanding of a billion is 1,000,000,000 or 10<sup>9</sup>. To maintain accuracy the number used in this thesis follows the English understanding.

<sup>25</sup> Since the figures originate from different dates and sources it has to be taken into account that this table might not be entirely coherent and therefore it should serve more as a guideline.

<sup>26</sup> Note that in connection with the previous table the figures differ slightly, which can be traced back to the fact that the figures originate from different dates and sources. Additionally it is important to notice that the figures concerning housing providers have changed a lot due to disposal of large residential portfolios.

<sup>27</sup> Other factors such as low prices or a low interest level also led to an increased interest in German property (Degi 2006).





Housing stock and tenure in Germany  
(Source: Deutsche Bank 2006) – modified

Correspondingly the German residential market raised in the last few years a lot of interest among investors, especially international investors, and Germany has seen some outstanding transactions in that area. In the first quarter of 2006 alone the transaction volume amounted to €10.1bn (Sieweck et al. 2007). The following table illustrates most of the previous transactions:

Year	Portfolio	Buyer	Investment	Price (€ bn)
2004	GSW corporation	Cerberus/Whitehall/ Goldman Sachs	65,700 residential units	2.1
	Hypo Real Estate	Lonestar	NPL/SPL-Portfolio (56% commercial real estate)	3.6
	GAGFAH corporation	Fortress	82,000 residential units	3.5
	WCM Residential Portfolio	Blackstone Group	31,000 residential units	1.4
	Thyssen Krupp AG	Corpus Immobilien Gruppe / Morgan Stanley	48,000 residential units	2.1
2005	Gehag corporation	Oaktree Capital Management	18,000 residential units	1.0
	Viterra corporation	Deutsche Annington	117,400 residential units	7.0
	NILEG corporation	Fortress	28,500 residential units	1.5
	BauBeCon AG	Cerberus	20,000 residential units	1.0
2006	Woba Dresden	Fortress	48,000 residential units + 1,300 commercial properties	1.7

Transactions of residential portfolios in Germany  
(Source: Black et al. 2006) – modified

Several of these property portfolios were disposed by HAs such as the GSW<sup>28</sup>, the GAGFAH<sup>29</sup> or the Gehag Corporation. In the case of the Woba Dresden the residential units were sold directly from the LA. In this context REITs are seen as an investment method that might facilitate the privatisation of the public housing stock (Institut für den öffentlichen Sektor 2007). To prevent this development the existing housing for rent was excluded from REITs. The reasoning and the appropriateness of this measure will be discussed in the last part (q.v. part 3.2.2).

To contextualise the potential relevance of REITs in the German property investment market it is necessary to investigate the existing investment instruments. Besides the possibility to invest directly in property there are several indirect investment methods (q.v. the German real estate investment market between 2001 and 2004 / Appendix A) such as the three different types of investment funds<sup>30</sup> real estate stock corporations and opportunity funds (Black et al. 2006).

One type of investment fund is the **Geschlossener Immobilienfond** (closed-end real estate fund<sup>31</sup>) that has the purpose of acquiring property and generally often includes only one property. Before such a fund is raised the investment volume is already determined. Generally the investment per shareholder ranges between € 5,000 and 50,000 (Black et al. 2006). The fund can be positioned publicly or privately, the amount of partners is limited and it is classified as closed when the investment volume is subscribed (REITs Deutschland n.d.c). Originally this type of fund was mainly used as a tax shelter for wealthy private investors, but this option was constrained and therefore REITs are seen as a potential exit strategy (DZ Bank AG 2006). The following table lists the main critical points concerning closed-end funds:

- lack of diversification due to the small number of properties
- lack of transparency in the closed-end fund market<sup>1</sup>
- lack of fungibility due to insufficient market capitalisation and limited free float

Critical Points of closed-end real estate funds in Germany  
(Source: Black et al. 2006 / DZ Bank AG 2006)

Generally closed-end funds seem to be still an attractive investment opportunity with a stable flow of funds of € 4-7bn each year (Black et al. 2006). The DZ Bank (2006) states that closed-end funds are the most interesting for investors who wish to invest in a specific property.

The second category of investment fund is the **Offener Immobilien-Publikumsfond** (open-end real estate mutual fund<sup>32</sup>) that has the purpose of investing in diversified, low-risk and

<sup>28</sup> The GSW corporation was the housing association of the Federal State of Berlin.

<sup>29</sup> The GAGFAH corporation was the housing association of the Bundesversicherungsanstalt für Angestellte (Federal Insurance Institution for Employees).

<sup>30</sup> There are three types of investment funds on the German investment market: closed-end real estate funds, open-end real estate mutual funds and open-end real estate special funds (REITs Deutschland n.d. c).

<sup>31</sup> The legal form of a closed-end real estate fund can be a Kommanditgesellschaft (limited partnership – KG) or a Gesellschaft bürgerlichen Rechts (civil-law partnership - GbR) and investors are limited partners with a liability for their investment or general partners with unlimited liability (Black et al. 2006).

<sup>32</sup> Open-end real estate mutual funds are regulated by the Investmentgesetz (German Investment Act – InvG) and the Investmentsteuergesetz (German Investment Tax Act – InvStG). The investment capital of the investors, the so-called Sondervermögen (separate estate), is separated from the capital of the open-end real estate mutual fund and managed externally by a Kapitalanlagegesellschaft (Investment Trust – KAG) that is controlled under the Kreditwesengesetz (German Banking Act – KWG) (Black et al. 2006).

fully rented properties in A-locations. The composition of the fund is regulated in the following way:

- single assets have to account for less than 15 percent of the total fund
- developments have to account for less than 20 percent on fund level
- currency risk has to account for less than 30 percent on fund level
- debt has to account for less than 50 percent on fund level
- maximum level of 49 percent of liquidity / minimum level of 5 percent liquidity

Regulation in accordance with § 67 InvG for the composition of open-end real estate mutual funds  
(Source: Black et al. 2006)

According to §§ 66-88 of the InvG the investment volume is not restricted and shares can be issued and redeemed at any time. Shares are available at a minimum of € 25. The fund is deemed to be tax neutral and taxation is passed on to the investor. This type of fund was established to enable private investors to participate in the property market. To protect private investors the fund regulations are very restrictive and annual valuations of all assets by a board of independent appraisers is compulsory (Black et al. 2006). Even though open-end real estate mutual funds are seen as relatively secure there are still some issues:

- relatively unattractive for international investors due to complicated legislation and the uniqueness of this fund type in Germany
- relatively low returns (versus low risk in return)
- potentially over-valued assets due to questionable independency of appraisers
- potentially hindered decisions concerning investment and financing policy due to fluctuant equity capital
- potentially negative effects on the fund performance can arise from the need to hold a certain amount of liquid funds such as commercial papers

Critical Points of open-end real estate mutual funds in Germany  
(Source: Black et al. 2006 / DZ Bank AG 2006)

Nevertheless open-end real estate mutual funds are still seen as relatively secure forms of investment and are seen as most attractive for risk adverse investors who accept lower returns. Even though this type of fund and REITs have similar basic concepts, they mainly differ in the way the share price is determined. In the case of mutual funds the price is calculated by dividing the fair market value of the separate estate by the amount of certificates, whereas the price for shares of REITs is determined by demand and supply. Hence their risk-return profiles are very different and will attract different types of investors (DZ Bank AG 2006).

The third type is the **Offener Immobilien-Spezialfond** (open-end real estate special fund) that is subject to the same laws applying for open-end real estate mutual funds (Black et al. 2006). The difference is that they are only designed for up to 30 specific institutional investors and that private investors are excluded (REITs Deutschland n.d.c). Special funds can be structured as Gemeinschaftsfond (multiple investor fund) or Individualfond (individual investor fund). As the name implies multiple investor funds are raised for a group of institutional investors whereas individual investor funds are launched for one individual institutional investor (Black et al. 2006). Within a special form of the individual investor fund investors have the possibility to release previously bound resources of their direct real



estate investments (Commerz Grundbesitz n.d.). Open-end real estate special funds exhibit the following issues:

- relatively unattractive for international investors due to complicated legislation and the uniqueness of the fund type in Germany
- nonmarketable (exit only possible if another investor assumes the share certificates or the fund is disposed)

Critical Points of open-end real estate special funds in Germany  
(Source: Black et al. 2006 / DZ Bank AG 2006)

Due to their capability to influence the investment strategy of the fund this type mainly attracts German institutional investors such as insurance companies. It was assumed that open-end real estate special funds would even retain their attractiveness after the introduction of REITs (DZ Bank AG 2006).

The **Immobilien Aktiengesellschaft** (real estate stock corporation<sup>33</sup>) has the purpose to invest mainly in property. The income of German real estate stock corporations listed on the Deutsche Immobilienaktienindex (German real estate stock index - DIMAX) has to originate with 75 percent from 'real estate business' which includes:

- leasing activity
- facilities management
- real estate commerce
- development
- real estate consulting

Definition of 'real estate business'  
(Source: Black et al.)

The definition of 'real estate business' describes a very broad investment scope and the German market of real estate stock corporations is thus relatively broad and inhomogeneous (Black et al. 2006).

- market with insufficient liquidity and thus low fungibility of the shares due to low volume and low degree of free float of most companies
- double taxation and lack of tax transparency (taxation for private investors is subject to the so-called half-income system to reduce double taxation)
- small market with 48 companies in 2006 and a market capitalisation of € 7.9bn
- insufficient corporate disclosure

Critical Points of real estate stock corporations in Germany  
(Source: Black et al. 2006 / DZ Bank AG 2006)

In comparison to other countries the German market for real estate stock corporations is underdeveloped. The market was more or less stagnant until 2005, but the potential introduction of REITs led to an increased investment (DZ Bank AG 2006). It is expected that some of the real estate stock corporations such as Alstria Office AG or IVG Immobilien AG will convert into REITs.

<sup>33</sup> Real estate stock corporations are subject to the same legislation as other corporations. They are also liable to the German Stock Corporation Act.

**Opportunity funds** are investment instruments of "investment banks, private equity firms or real estate companies" with an Anglo-American origin. These funds act globally and invest wherever opportunities arise. Opportunities in this sense are described as investments with "high target returns greater than 20% IRR per annum" (Black et al. 2006). Since 2003 opportunity funds actively invested some capital in German property portfolios and non-performing loans and achieved a market dominating position in 2005. A significant part of the transactions constituted acquisitions of large residential portfolios which raised fears that social housing was in danger of being sold off. It remains to be seen if opportunity funds will continue to invest in the same way after the recent American property crisis.

Considering the above description of German investment options in comparison with REITs it seems that the introduction of REITs enhances the German investment market. As already mentioned in the case of closed-end funds REITs seem to be an exit strategy for investors who seek a more tax-efficient option. Concerning open-end real estate mutual funds REITs with their different risk-return profiles represent only a limited alternative and a listed REIT is not seen as an alternative for open-end real estate special funds either. It is supposed that REITs would avoid the disadvantages of real estate stock corporations and would thus make the German investment market more competitive (DZ Bank AG 2006). Initiative Finanzstandort Deutschland<sup>34</sup> (n.d.) states that REITs would complete the German investment market in respect to portfolio efficiency for the investors, transaction costs and accumulation of capital for the emitters.

## 2.2 Legislation of REITs in the UK and Germany

Note that the structure and content of the following sections concerning the UK REIT will differ from subsequent sections regarding the G-REIT. This is due to the different legislative structure of REITs regulations in each particular country.

Since the scope of this thesis is not primarily the legislation of the UK or G-REIT, the following sections on the legislation are limited to the essential features of the legal, fiscal and financial structure of the REIT. Supplementary explanation is offered in the footnotes and the appendix.

### 2.2.1 Set-up of REITs in the UK

The following section, concerned with the set-up of the UK REITs, mainly refers to part 4 of the Finance Act 2006. This part is called 'Real Estate Investment Trusts' and acts as the primary legislation<sup>35</sup> that determines the boundaries within which the Treasury exercises its given power to implement the requirements of the Act.

#### 2.2.1.1 General regulations of the UK REITs

The Finance Act determines that the legal form of a UK REITs has to be a limited company (HMRC n.d.c). There are two underlying key concepts, which define the purpose of the UK REIT: one is the concept of 'property rental business' and the concept of the 'ring fence'

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<sup>34</sup> Entrepreneurial initiative to support Germany as a financial centre.

<sup>35</sup> The Statutory Instruments 2006 No 2864-2867 resulting from the Finance Act set out rules for breach of conditions, financial statements, joint ventures and the assessment and recovery of tax (HMRC 2006a). Even though Statutory Instruments are an important part of the UK legislation (House of Commons Information Office 2007), in relation to the scope of this thesis the content of the relevant Statutory Instruments seem to be too detailed to be taken into consideration.

[HMRC n.d.d]. Part 4 section 104 of the Finance Act 2006 describes 'property rental business'<sup>36</sup> as:

business that is or forms part of:

- "Schedule A business"<sup>37</sup> (within the meaning of section 832(1) of ICTA), or
- an overseas property business<sup>38</sup> (within the meaning of section 70A(4) of ICTA)."

Property rental business within the UK REIT  
[Source: Part 4 section 104 of the Finance Act 2006]

In brief, activities that can be specified as 'property rental business' deal with the "exploitation of land etc for rent", whereas activities with resulting income from the occupation of land is excluded as 'property rental business' (HMRC n.d.i).

All activities designated as 'property rental business' qualify a company for tax exemption and are ring fenced from other taxable activities of the company (see also section 113 Finance Act 2006). The 'ring fence' concept thus eliminates the chance that "income or expenses are attributed to the wrong source of income" (HMRC n.d.j) and therefore prevents tax distortion.

### 2.2.1.2 Conditions for the UK REIT status

To enter<sup>39</sup> the REIT scheme a company has to give notice to Her Majesty's Revenue & Customs<sup>40</sup> and meet the following conditions throughout the accounting year:

- the company has to be UK resident
- the company has to be listed on a recognised stock exchange<sup>41</sup>
- the company is not allowed to be an open-end investment company<sup>42</sup> (OEIC)
- the company is not allowed to be a close company<sup>43</sup>
- the company can only issue one class of ordinary shares<sup>44</sup> and non-voting fixed rate preference shares<sup>45</sup>
- the company is not permitted to borrow capital on terms that entitle the creditor to a part of the profits

Conditions of the UK REIT status  
[Source: Part 4 section 106 subsection 1-8 Finance Act 2006]

<sup>36</sup> The classes of business<sup>36</sup> and income or profit<sup>36</sup> that are excluded from the definition of 'property rental business' are specified in Schedule 16 of the Finance Act 2006 (LexisNexis 2006).

<sup>37</sup> Schedule A business includes all "business carried on for the exploitation, as a source of rents or other receipts, of any estate, interest or rights in or over land in the United Kingdom." (section 1 subsection 1 schedule 5 Finance Act 1998 (c. 36)). Land in this respect means: "buildings and other structures, land covered with water, and any estate, interest, easement, servitude or right in or over land" (HMRC n.d.e).

<sup>38</sup> According to HMRC (n.d.e) the definition of 'overseas property business' and 'UK property business' can be seen as identical, "except that the land from which the income arises is outside the UK."

<sup>39</sup> Further information about the conditions and effects entering and leaving the REIT regime can be found in Appendix B.

<sup>40</sup> For more details of the notice, see section 109 Finance Act 2006 (c.25).

<sup>41</sup> Recognised stock exchanges are defined in accordance to section 841 ICTA88 (part 4 section 106 subsection 5 Finance Act 2006 (c.25)).

<sup>42</sup> OEIC in the sense of section 236 of the Financial Services and Markets Act 2000 (c. 8) (part 4 section 106 subsection 4 Finance Act 2006 (c.25)). This is excluded because OEICs tend to vary the issued share capital depending on demand (HMRC 2006b).

<sup>43</sup> Close companies are companies that can be controlled by 5 or less participators (part 4 section 106 subsection 5 (a-b) Finance Act 2006 (c.25)).

With the entry of a company into the REIT regime a charge of 2 percent of the value of the REITs assets. This entry charge can be spread over four years<sup>46</sup> (part 4 section 112 Finance Act 2006 (c.25)).

To qualify as a tax-exempt property rental business it is necessary to comply with the following conditions throughout the accounting year:

- involvement of at least three properties<sup>47</sup>
- the value of each single property has to be below 40 percent of the overall value of all properties
- exclusion of properties that are classified as owner-occupied
- distribution of 90 percent<sup>48</sup> of the profits<sup>49</sup> as dividends by tax return filing date

Conditions for qualifying as a tax-exempt property rental business of the UK REIT  
(Source: Part 4 section 107 Finance Act 2006)

Following conditions have to be fulfilled concerning the balance of the REIT:

- during the accounting period at least 75 percent of the total profits<sup>50</sup> have to result from tax-exempt property rental business
- at the beginning of an accounting period the value of the assets involved in tax-exempt property rental business<sup>51</sup> have to account for at least 75 percent of the of total value of assets

Conditions for the balance of the UK REIT  
(Source: Part 4 section 108 Finance Act 2006)

### 2.2.1.3 Taxation, profits and capital gains of the UK REIT<sup>52</sup>

In respect to taxation section 113 Finance Act 2006 determines that the pre- and post-conversion company, the pre- and post-conversion business and the tax-exempt and non tax-exempt business of the REIT has to be separated from each other (q.v. part 2.3.11).

<sup>44</sup> "Ordinary shares" stand for all emitted share capital of a company of which the shareholders are entitled to dividends at a fixed rate (see also section 832 subsection 1 ICTA)

<sup>45</sup> 'Non-voting fixed rate preference share' can be generally determined as shares that exclude voting rights (except in the case of non-payment of dividends) and have only a right for dividends "of a fixed amount or at a fixed rate percent of the nominal value of the shares" (HMRC n.d.k respectively section 1 subsection 3 (a-d) Schedule 18 ICTA88).

<sup>46</sup> In this case the notional income is "treated as arising in four instalments". The charge for the first instalment is 0.50 percent and increases to 0.60 percent for the last instalment (part 4 section 112 subsection 5 Finance Act 2006 (c.25)).

<sup>47</sup> Property in this sense covers the exploitation of estates and interests or rights in land (part 4 section 107 subsection 6 (a) Finance Act 2006 (c.25)) and can encompass any unit which can be seen as a separate unit (part 4 section 107 subsection 6 (b) Finance Act 2006 (c.25)).

<sup>48</sup> In the case of a legal impediment or an impending tax penalty due to the payment of 10 percent or more to one shareholder it is possible to distribute less than 90 percent of the profits (part 4 section 107 subsection 9 (a-b) Finance Act 2006 (c.25)).

<sup>49</sup> Profits in that sense excludes "gains on disposal of rental property", but considers financing costs and capital allowances (HMRC 2006b).

<sup>50</sup> Total profits include profits from tax-exempt and not tax-exempt business (108 section 2 (a) Finance Act 2006 (c.25)).

<sup>51</sup> See section 107 section 6 (a) Finance Act 2006 (c.25) for the definition of 'assets involved in tax-exempt business'.

<sup>52</sup> Further information about taxation, profits and capital gains of the UK REITs can be found in Appendix B.

Following regulations about the off-set of losses<sup>53</sup> between the different company parts are specified:

- prohibition to set off losses between tax-exempt and non tax-exempt parts of a REIT
- prohibition to set off pre-conversion losses against tax-exempt profits after the entry into the REIT regime
- permit to set off pre-entry losses on non property rental business against post-entry profits of non tax-exempt business
- prohibition to set off losses of the tax-exempt REIT-business against profits of a post-REIT company
- prohibition to exempt pre-conversion income appearing in post-conversion accounts
- permit to set off losses of over sea tax-exempt property business against profits of British tax-exempt property business

Ring fencing of tax-exempt business of the UK REIT  
(Source: Part 4 section 113 Finance Act 2006)

It is required that REITs meet an interest cover ratio or otherwise it is imposed with a tax charge<sup>54</sup>. The ratio of profits to financing costs<sup>55</sup> (of the tax-exempt business) have to be less than 1.25 (part 4 section 115 Finance Act 2006 (c.25)).

In the REITs regime any kind of profits from tax-exempt property rental business are not subject to corporation tax, whereas profits from non tax-exempt business are liable to corporation tax at the current rate of 30 percent<sup>56</sup> (part 4 section 119 Finance Act 2006 (c.25)).

Even though the profits of the tax-exempt property rental business are not liable to tax, a mechanism to calculate the 'taxable' profits is needed to determine the annual distributions<sup>57</sup> among investors and the compliance with the interest cover ratio of 1.25<sup>58</sup>. Generally the calculation for domestic and over sea rental profits<sup>59</sup> is based on the regulations for UK rental profits detailed in Schedule A<sup>60</sup>. (part 4 section 120 Finance Act 2006 (c.25)).

UK resident and non-resident shareholders receiving a distribution from tax-exempt profits of a REITs are liable to tax. "Shareholder within the charge to corporation tax" is subject to taxation in accordance with Schedule A, whereas "shareholder within the charge to income

<sup>53</sup> Losses includes in this case also "deficit, expense charge or allowance" (part 4 section 113 subsection 4 Finance Act 2006 (c.25)).

<sup>54</sup> The charge depends on the "amount by which the financing costs the ratio to fall below 1.25 (HMRC 2006b).

<sup>55</sup> The financing costs consist of: "interest on loans and related costs with the exception of exchange losses; debits or credits arising on derivative contracts in relation to debt finance; finance costs arising und finance leases;" other generally accepted cost for financing costs (HMRC 2006b).

<sup>56</sup> For companies under the REITs regime the small company rate is not available part 4 section 119 Finance Act 2006 (c.25)).

<sup>57</sup> See section 107 Finance Act 2006 (c.25).

<sup>58</sup> See section 115 Finance Act 2006 (c.25).

<sup>59</sup> Schedule A ignores credit and debits from loan relationship, embedded derivative contracts and specific hedging relationships, but they have to be included concerning the calculation of profits of tax-exempt property rental business (section 115 subsection 3 (a-c) Finance Act 2006 (c.25)).

<sup>60</sup> Schedule A as referred in 21A ICTA88.

tax" is taxable as for profits of UK property business [part 4 section 121 Finance Act 2006 (c.25)]. It would go beyond the scope of this thesis to explain the taxation in relation to distributions to the different type of shareholders.

Some or all gains from the disposal of assets<sup>61</sup>, which have completely been used for tax-exempt business of a REIT, are not subject to corporation tax. That also applies for assets that have been used "during one or more periods of less than a year" for non tax-exempt business, but otherwise have been used for tax-exempt business. Gains from the disposal of assets that have been used for a longer period than a year as non tax-exempt business are liable to corporation tax during that period. All other gains of the REIT are subject to corporation tax [part 4 section 124 Finance Act 2006 (c.25)].

## 2.2.2 Set-up of REITs in Germany

As mentioned above the legislation of the G-REIT was only published in June 2007 and thus the amount of literature is still limited. Therefore, this section will mainly depend on primary literature of the Bürgerliches Gesetzbuch (BGB) as well as on some secondary sources<sup>62</sup>.

### 2.2.2.1 General Regulations of the G-REIT

In § 1 subsection 1 BGBI. I S. 914 of the so-called 'Gesetz über deutsche Immobilien-Aktiengesellschaften mit börsennotierten Anteilen' (2007) it is determined that REITs in Germany have to be public limited companies<sup>63</sup>, whose nature and purpose of the business is to acquire, hold, manage or the disposal of ownership rights or rights of use over:

- domestic immovable property (except existing housing<sup>65</sup> for rent that was built before the 1. January 2007)
- foreign immovable property
- and up to twenty-five percent<sup>66</sup> of other capital assets<sup>67</sup>.

Nature and purpose of the G-REIT  
[Source: § 1 subsection 1 BGBI. I S. 914]

REITs can register with the during the first financial year as a pre-REIT (taxable) if at the end of the year the nature and purpose of the business complies with the requirements of § 1 (§ 2 BGBI. I S. 914 2007). A pre-REIT is also permitted until the end of the second financial year to meet the requirements of § 12 BGBI. I S. 914 (see below the requirements of § 12).

The minimum nominal amount of the share capital has to be at least 15 million Euros (§ 4 ibid. 2007). All shares issued by the REIT should be entitled to vote and of the same class (§ 5 ibid. 2007).

<sup>61</sup> Assets in this respect are defined as part of an asset, "an interest in or rights in relation to an asset" (HMRC 2006b).

<sup>62</sup> The translation from the German legislative text was conducted to the best of the author's ability.

<sup>63</sup> Public limited companies (Aktiengesellschaften) are subject to the Aktiengesetz (German Stock Corporation Act – AktG), the HGB, the Wertpapierhandelsgesetz (Securities Trading Act – WpHG) and all relevant regulations concerning public limited companies in Germany.

<sup>64</sup> Housing is defined as property that is to 50 percent used for residential purposes (Linklaters 2007).

<sup>65</sup> See § 12 subsection 1 BGBI. I S. 914.

<sup>66</sup> See § 3 subsection 7 BGBI. I S. 914: Other capital assets are defined as all relevant objects for the management of the immovable property as well as bank deposits, money market instruments, particular liabilities and claims and the participation on property partnerships (Immobilienpersonengesellschaft), foreign property companies, REITs service companies and joint stock companies.

The name of the REIT has to be 'REIT-Aktiengesellschaft' or 'REIT-AG' (§ 6 ibid. 2007) and its use is limited to public limited companies in terms of the REIT legislation (§ 7 ibid. 2007).

### 2.2.2.2 Qualification for G-REIT status<sup>67</sup>

To be qualified as a REIT the following conditions have to meet:

- a registration with the commercial register
- registered seat and corporate headquarter in Germany (§§ 8-9 BGBl. I S. 914 2007)
- listed on the stock exchange of one of the EU or European Economic Area (EAA) member states (§ 10 subsection 1 ibid. 2007)
- registration as a REIT has to be undertaken at least 3 years after the registration as a pre-REIT (§ 10 subsection 2 ibid. 2007).

Conditions to qualify as a G-REIT  
(Source: § 8-10 BGBl. I S. 914)

Generally, 15 percent of the shares of a REIT have to be free floating<sup>68</sup>, but at the time of the registration 25 percent of the shares have to be the free floating (§ 11 subsection 1 ibid. 2007). The amount of shares of one single investor should not exceed 10 percent (§ 11 subsection 4 ibid. 2007).

At the end of each financial year the immovable property has to amount for 75 percent of the total assets<sup>69</sup> and assets of REIT-service companies can only account for 20 percent of the total assets (§ 12 subsection 2 ibid. 2007). Likewise, the same principle applies to the gross yields which also have to originate from renting out, leasing or disposing of immovable property (§ 12 subsection 3 ibid. 2007).

Moreover, the REIT is obligated to distribute 90 percent of the annual surplus among the investors within the following financial year (§ 13 subsection 1 ibid. 2007).<sup>70</sup>

Generally, it is prohibited for REITs to trade with their immovable property. Trade in this sense takes place if the gains from disposing immovable property over a period of 5 years are higher than the value of half of the average stock of immovable property during the same period (§ 14 subsection 1-2 ibid. 2007).

At the end of a financial year the shareholders' funds are not allowed to be below 45 percent of the assessed value of the immovable property of a REIT (§ 15 ibid. 2007).

<sup>67</sup> Further information about qualification for G-REIT status can be found in Appendix B.

<sup>68</sup> Free float is defined as the amount of all shares held by investors who each individually hold less than 3 percent of the REIT's voting rights (§ 11 subsection 1 ibid. 2007).

<sup>69</sup> Total assets in accordance to consolidated accounts or individual financial statements and less the allocation to reserves and the dividend distribution among shareholders (Linklaters 2007).

<sup>70</sup> The distribution of the annual surplus is debased of the allocation to reserves and increased by the dissolution of reserves (according to § 13 subsection 3 and sentence 1-2 BGBl. I S. 914). The calculation of the annual surplus permits scheduled depreciation only in constant annual rates (according to § 13 subsection 2 BGBl. I S. 914). Half of the gains from amortised immovable property can be allocated as reserve for the purchase of further immovable property. This has to be dissolved at least until the end of the second year ensuing the allocation of the reserve (according to § 13 subsection 3 BGBl. I S. 914).

### 2.2.2.3 Tax treatment of the G-REIT<sup>71</sup>

REITs that fulfil the requirements of §§ 8-15 BgBl. I S. 914 are exempt from trade and corporate tax (§ 16 subsection 1 BgBl. I S. 914 2007). The tax exemption occurs at the beginning of the financial year during which the company was registered with the commercial register (§ 17 subsection 1 ibid. 2007).

Reasons for the loss of tax exemption are:

- loss of stock exchange permission<sup>72</sup>,
- trade with immovable property in the sense of § 14 BgBl. I S. 914<sup>73</sup>,
- less than 15 percent free floating shares over 3 consecutive years<sup>74</sup>,
- more than 10 percent of the shares held by one single investor over 3 consecutive years<sup>75</sup>,
- a shortfall over 3 consecutive years of the shareholders' funds below 45 percent of the assessed value of the immovable property of a REIT<sup>76</sup>
- regular fines for the same infringements<sup>77</sup> against the REITs' regulation according to § 16 subsection 3-6 BgBl. I S. 914. 2007 over 3 consecutive years or regular fines for different infringements over 5 consecutive years (§ 18 subsection 1-5 ibid. 2007).

Reasons for the loss of tax exemption within a G-REIT  
(Source: § 17-18 BgBl. I S. 914)

In the case of a transfer of an existing company to a REIT it is, according to the Körperschaftsteuergesetz [Corporation Tax Act - KStG], necessary to disclose all hidden reserves (Linklaters 2007). The same applies for REITs that are shareholders of a property partnership (§ 17 subsection 2-3 ibid. 2007). The disclosure of these hidden reserves is deemed as disposal of all assets belonging to the company (Linklaters 2007).

In the case of a transfer of assets to a pre-REIT or a REIT the fiscal legislation in Germany grants for a certain time<sup>78</sup> and under certain conditions<sup>79</sup> a tax reduction called "Exit Tax"<sup>80</sup> of up to 50 percent to the contributor. Subsequently it is possible for the contributor to leaseback the asset. This regulation intends to stimulate transfers of assets to the REIT to support the establishment of the G-REIT (Lachner et al. 2007).

The distribution of the annual surplus among the investors as well as other additional or substitutional benefits by the REIT, other REIT-corporations, REIT-associations of individuals

<sup>71</sup> Further information about tax treatment of the G-REIT can be found in Appendix B.

<sup>72</sup> The tax exemption expires at the end of the preceding financial year (§ 17 subsection 1 BgBl. I S. 914).

<sup>73</sup> The tax exemption is ceased in the same financial year (§ 17 subsection 2 BgBl. I S. 914).

<sup>74</sup> The tax exemption ends at the end of the third financial year (§ 17 subsection 3 BgBl. I S. 914).

<sup>75</sup> The tax exemption ends at the end of the third financial year (§ 17 subsection 3 BgBl. I S. 914).

<sup>76</sup> The tax exemption ends at the end of the third financial year (§ 17 subsection 4 BgBl. I S. 914).

<sup>77</sup> These fines are imposed for: less than 75 percent of the total assets of the REIT is immovable property; less than 75 percent of the gross proceeds is derived from transactions in relation to immovable property; less than 90 percent distribution of the annual surplus among the investors; nongratuitously secondary occupation of the REIT or a subordinated property partnership (§ 17 subsection 5 BgBl. I S. 914).

<sup>78</sup> The tax reduction applies after the 31.12.2006 and before the 01.01.2010 (Linklaters 2007).

<sup>79</sup> The tax reduction only applies if the asset belonged for more than 5 years to the contributor. The reduction becomes inapplicable if the pre-REIT does not enter the REIT regime or if the contributor has a holding of more than 50 percent of the REIT in the following 2 years (Linklater 2007).

<sup>80</sup> In accordance with § 3 Nr. 70 EStG. The Exit Tax does not exclude the real estate transfer tax of 3.5 percent depending on the particular Federal State in Germany (Lachner et al. 2007).



or REITs-assets<sup>81</sup> are deemed as income from capital and thus subject to income tax<sup>82</sup> or corporation tax<sup>83</sup> (§ 19 subsection 1 *ibid.* 2007). Likewise, the disposal of shares of a REIT, REIT-corporations, REIT-associations of individuals or REITs-assets are liable to income or corporation tax<sup>84</sup> (§ 19 subsection 2 *ibid.* 2007). Losses<sup>85</sup> are as well subject to income tax, however the losses have to be set against capital gains and dividends from REIT shareholdings (§ 19 subsection 4 *ibid.* 2007).

From the distributions withholding tax on dividends must be deducted (§ 20 subsection 1 *ibid.* 2007). The percentage of the withholding tax varies: it is 25 percent if the debtor, i.e. the shareholder, bears the withholding tax on dividends, 33 1/3 if the debtor bears the withholding tax on dividends, nothing in the case of non-profit corporations and 15 percent in the case of other tax-exempt corporations or domestic public authorities (§ 20 subsection 2 *ibid.* 2007). Generally, foreign shareholders are liable to the withholding tax, but due to double tax agreement refunding is possible (§ 20 subsection 3 *ibid.* 2007).

### 2.3 Summary of the REIT legislation in both countries

Generally it can be said that the REIT legislation in both countries exhibit a lot of similarities in respect to provisions such as legal form, stock exchange listing, tax-exemption, distributions, maximum shareholding and the balance of REITs. Differences in the legislation arise from determinations such as the initial capital for the G-REIT, the preliminary G-REIT, free floating shares in the G-REIT or the entry charge of the UK REIT. For the scope of this thesis the exclusion of existing housing from the G-REIT can be seen as the most prominent difference. This and the underlying different perceptions in both countries, laid out in section '2.2 Policy rationale', form the background for the subsequent discussion. In a way the exclusion of existing housing from the G-REIT on one hand and the inclusion of housing in the UK REIT on the other might serve, as far as it is currently possible, as a kind of test arrangement to study the impact of the REIT on the social and affordable housing market in both countries.

### 2.4 Current performance of REITs

This section aims to reveal how the REIT regime was received in both countries by firstly giving an overview of the companies converted to REITs and the amount of newly launched REITs. Subsequently it will then examine the current situation of the REIT market and finally seek to relate the investment in REITs to the different sectors and particularly to the residential sector.

#### 2.4.1 Current performance in the UK

According to CBRE (2007a) most of the newly established UK REITs emerged from existing property companies. The expected wave of start-up REITs failed to appear since only one REIT, named Local Shopping Reit, was set up in May. Other announced start-up REITs such as the residential REIT by Invista Real Estate or the hotel REIT called Vector<sup>86</sup> were abandoned due to legislative constraints and a lack of interest from investors. (Stanley

<sup>81</sup> Other REIT-corporations, REIT-associations of individuals or REITs-assets are synonymous with foreign REITs (§ 19 subsection 5 *BGBI. I S. 914*). In terms of taxation that implies that shareholders of a foreign REIT shall be taxed like shareholders of domestic REITs (Linklaters 2007).

<sup>82</sup> Applies if the shareholder is a private person, cf § 20 subsection 1 sentence 1 *ESTG*.

<sup>83</sup> Applies if the shareholder is a company, cf § 20 subsection 1 sentence 1 *ESTG*.

<sup>84</sup> According to § 17, § 22 Nr. 2, § 23 subsection 1 sentence 1 Nr. 2 *ESTG*. Or regarding the determination of taxable income in terms of § 4-5 *ESTG*.

<sup>85</sup> Losses in this sense encompass reductions of the business property (*Betriebsvermögensminderung*), business expenses and costs of disposal (§ 19 subsection 4 *BGBI. I S. 914*).

<sup>86</sup> Information about the launch of Vector is not clear since other sources state that Vektor will be established soon (REIT World UK 2007)

2007/ Robinson 2007]. The following table shows all companies that entered the REIT regime since the 1<sup>st</sup> of January 2007.

Converted REIT	Conversion date	Investment scope	Market Cap £m	Yield %	Share price 07/07	Rise/Fall in % since Jan 1st	% Premium to NAV
British Land	01.01.2007	retail + office	7357	2.3	1412	-17.6	-15
Brixton	01.01.2007	industrial + warehouse	1286	3.3	477	-17.2	-16
Great Portland Estates	01.01.2007	retail + office	1258	1.6	695	0.1	12
Hammerson	01.01.2007	retail + office	4379	1.4	1509	-4.3	-3
Land Securities Group plc	01.01.2007	commercial	8706	2.9	1859	-20	-19
Liberty International	01.01.2007	commercial + residential	4355	3.8	1204	-13.8	-10
Primary Health Properties	01.01.2007	primary health care	145	3.2	436	-18.5	-
Segro - Slough Estates Group	01.01.2007	commercial + industrial	2940	2.8	679	-13.9	-13
Workspace Group	01.01.2007	office	740	0.9	436	-12.4	30
Big Yellow	15.01.2007	warehouse	683	1.6	579	-17.9	26
McKay Securities	01.04.2007	commercial	201	2.6	431	-5.7	-
Shaftesbury	01.04.2007	Retail, office + residential (6%)	847	0.9	631	-19.5	0
Warner Estate Holdings	01.04.2007	commercial	403	2.6	760	-12.1	3
Local Shopping REIT	11.05.2007	retail	-	-	-	-	-
Derwent London	01.07.2007	office	1971	0.8	1959	-6.6	5
Mucklow Group Plc	01.07.2007	commercial + industrial	252	3.4	420	-18	-10

Companies under the REIT regime in the UK  
(Source: Merrill Lynch cited in CBRE 2007 / reita 2007)

The comments on the start of the UK REIT have been mixed. Generally most UK REIT companies trade "at a consistent discount to the net value of the underlying property assets" whereas REITs are globally traded "on an average premium to NAV of about 35%". Additionally UK REITs offer comparatively lower dividends and returns in commercial property dropped around 8.3 percent in comparison to the previous year (Faithful 2007). Analysts such as the Lehmann Brothers already downgraded the UK REITs in April and remarked that the "gold rush" was over (Goldstein 2007). In June CBRE (2007a) also

pointed out "the FTSE REIT index has fallen 20 % since the launch on January 1, 2007". They explained this situation to some extent with "an appreciation of over 30 % in the FTSE all real estate index" preceding the REIT introduction. Later in August 2007 the Lehmann Brothers observed that UK REITs "lost one-quarter of their value this year and the FTSE Real Estate Index is the worst-performing equity market sector". It was also specified that, even though the sector is well backed in regard to "portfolio quality, robust financial ratios, and prudent development exposure", it only covers 10 percent of UK property stock (Reuters 2007). In contrast to that some of the REIT companies such as British Land, Hammerson or Land Securities argue that it is too early to assess the outcome of REITs. In their opinion the difficult start of the UK REIT does not suggest a failure of the REIT but that the negative development mainly depended on a market adjustment that was due after the preceding boom. The re-pricing of the market is seen as inevitable event that was necessary to return to a more realistic market. CB Richard Ellis, as indicated above, held a similar opinion and added that the UK REIT just happened to arrive at the inflexion point of the cycle (Faithful 2007). The examination of the UK REIT performance seems to be difficult due to different viewpoints and strategic objectives of the commentators. However it is obvious that the UK REIT introduction was far from positive and it remains to be seen how the British REIT will evolve.

The investment focus of the converted REITs is clearly on commercial property including industrial, office, retail and warehouse properties. Only two, Liberty International and Shaftesbury, are investing to some degree in residential properties (reita n.d. c) and there is evidence that this might not change in the near future. Besides the cancelled residential REIT by Invista, the launch of a social housing REIT by a consortium of HAs<sup>87</sup> was announced for July 2007 (Levenson, D. n.d.). Since no further information is available this seems to be postponed. The only other chance to set up a residential REIT so far, seems to be the development of the Olympic Village by Lend Lease that might convert into a residential REIT (CBRE 2007). Therefore the wish of the British government to encourage residential investment via the REIT vehicle has not been satisfied so far.

#### 2.4.2 Current performance in Germany

Currently no company in Germany has established a REIT. Even though the legislation was retrospective, most companies waited until the details were published. Beforehand several companies announced that they are interested in the REIT scheme and the following table lists the companies that are still interested (REITs Deutschland 2007b):

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<sup>87</sup> Affinity Sutton, Catalyst, Genesis and Thames Valley are named as among the 22 housing associations that form the consortium (Cooper 2007).

Company name	Status	Planned transfer	Conversion date	Investment scope	Market Cap €m
Alstria Office	unknown	conversion	unknown	office	850
Boetzel Real Estate AG	unknown	conversion	postponed	retail	500
CA Immo REIT AG	unknown	conversion	end of 2007 / first half of 2008	office	2000
Colonia Real Estate / Oaktree	unknown	conversion	end of 2007 / beginn 2008	office	1000
Commerzbank	unknown	unknown	unknown	unknown	unknown
DR Commercial 1 AG	preliminary Reit	unknown	in progress	diversified	unknown
Fair Value REIT AG	unknown	unknown	4th quarter 2007	office and logistic	500
German One	unknown	start-up	1st half 2008	office	1000
GIG Grundbesitz Immobilien AG	preliminary Reit	start-up	in progress	diversified	200
Helaba Landesbank Hessen-Thüringen / Hannover Leasing	unknown	start-up	end 2007	unknown	1500
IVG Immobilien AG	unknown	unknown	2008	office	3500
Polis Immobilien AG	unknown	conversion	3rd quarter 2007	office	150 - 500
Prime Office REIT	preliminary Reit	start-up	in progress	office	1300
TAG Gewerbe	unknown	start-up	unknown	diversified	300
Triton Asset Management	unknown	conversion	1st quarter 2008	diversified	unknown

Companies with interest in the G-REIT regime  
 (Source: REITs Deutschland2007b)

According to REITs Deutschland (2007c) 10 companies applied to obtain preliminary REIT<sup>88</sup> status. At present only three companies, DR Commercial 1 AG, GIG Grundbesitz AG and Prime Office REIT, received the preliminary REIT status. None of these companies appointed a date for the initial public offering and the legislation allows a transition up to 3 years.

Since the German REIT market is still developing and REITs are not publicly traded yet, it is impossible to assess the market performance. Generally it can be said that the number of applications nearly meets the estimated dozen REIT launches until the end of the year by Jones Lang Lasalle. Nevertheless it seems that the initial regulations are very restrictive and thus the expected launches seem to be less realistic (CNBC European Business 2007).

Similarly it is only mere speculation to analyse the investment scope of the prospective G-REITs. Certain directions can be derived from the planned investment strategies of the particular companies listed in the table above. This indicates that a better part of the companies prefer to invest in office or diversified properties. Due to the current legislation it is more or less impossible to invest in residential property unless it is invested in housing for rent that was constructed after the 31. December 2006 (§ 1 subsection 1 BGBI. I S. 914). However, some market participants speculate that further legislative changes will allow for the inclusion of existing housing for rent (CNBC European Business 2007).

<sup>88</sup> Q.v. '2.3.2.1 General Regulations of the G-REIT' for the meaning of preliminary REIT.

### 3. REITs and the social and affordable housing sector in the UK and Germany

#### 3.1 Social and affordable housing in the UK and in Germany

##### 3.1.1 Definition, structure and current issues of social housing in the UK

The British term social housing is often used in relation to affordable housing and therefore by analysing social housing, it implies that one is to look at affordable housing as well. This is also relevant in relation to REITs as potential measures to increase not only the housing supply but also the amount of affordable housing as anticipated by the British government (HMT 2004).

In the UK social housing is defined as "housing of an adequate standard which is provided to rent (or on a shared ownership basis) at below market cost for households in need by Local Authorities or Registered Social Landlords" (RSLs) (Communities and Local Government 2007). In a way affordable housing is meant to close the gap between social housing and housing at market prices that are unaffordable for most low-income households (Levenson n.d.). Affordable housing is determined as housing of any tenure providing "an adequate standard which is cheaper than that which is generally available in the local housing market". Possible measures are the subsidisation of rented housing, low cost ownership, shared ownership and depending on the economic situation cheap disposable housing. The land use planning system is used as an instrument to provide for affordable housing (Communities and Local Government 2007).

LAs<sup>89</sup> as provider of social housing amount currently for around 10.1 percent whereas RSLs account for 8.4 percent of the [social] housing sector (Communities and Local Government 2007). The amount of social housing provided by LAs is still higher than the share of RSLs, but this ratio has undergone a significant shift in the recent past. Berry (2006) states that LAs disposed parts of the social housing stock to RSLs at a transfer price<sup>90</sup> that was defined depending on the quality of the estates. These so-called 'estate transfers' constituted for around 1 million council units and it is expected that more housing is transferred in the near future (Ball 2005a).

RSLs in respect to these 'estate transfers' typically refer to HAs. Generally the term RSLs is used for not-for-profit organisations providing housing with the approval and under the funding and regulation of the English Housing Corporation<sup>91</sup> and on behalf of the government (BBC 2006). Since the Housing Act 2004 funding is available for all kind of bodies. HAs<sup>92</sup> are dominating the RSL sector and only a few independent social housing providers such as "housing co-operatives, charitable trusts, developers and local housing companies" act as RSLs alongside them (Greater London Authority n.d.).

The social housing sector is not only changing it is also declining. In the 1980s social housing in the UK still accounted for one third of the total stock (Ball 2005a), whereas today social housing only adds up to 18.5 percent of the housing stock (Communities and Local Government 2007). The decrease of the sector was mainly caused by the implementation of the so-called 'Right-to-Buy' scheme in the 1980s. This scheme entitled

<sup>89</sup> LAs are often referred to as council and social housing provided by local authorities is called council housing.

<sup>90</sup> The transfer price was defined by the government in respect to potential income, costs and investments and differed from a high price range to the need of capital grants through the central government (Berry et al. 2006).

<sup>91</sup> The constituent countries of the UK have differing governmental institution in charge of the RSLs: the Housing Corporation in England, the Northern Ireland Housing Executive in Northern Ireland, the Communities Scotland in Scotland and the Welsh Assembly in Wales (BBC 2006).

<sup>92</sup> Housing associations can be bodies of trustees, societies or companies that supply various groups of economically and socially disadvantaged people with accommodations (Levenson, D. n.d.).

tenants of council housing to acquire their accommodation at subsidised prices (Ball 2005a). It is estimated that around 2 million council units were disposed within this programme (Munro, cited in Berry et al. 2006). The following graph illustrates the process of the social housing sales:

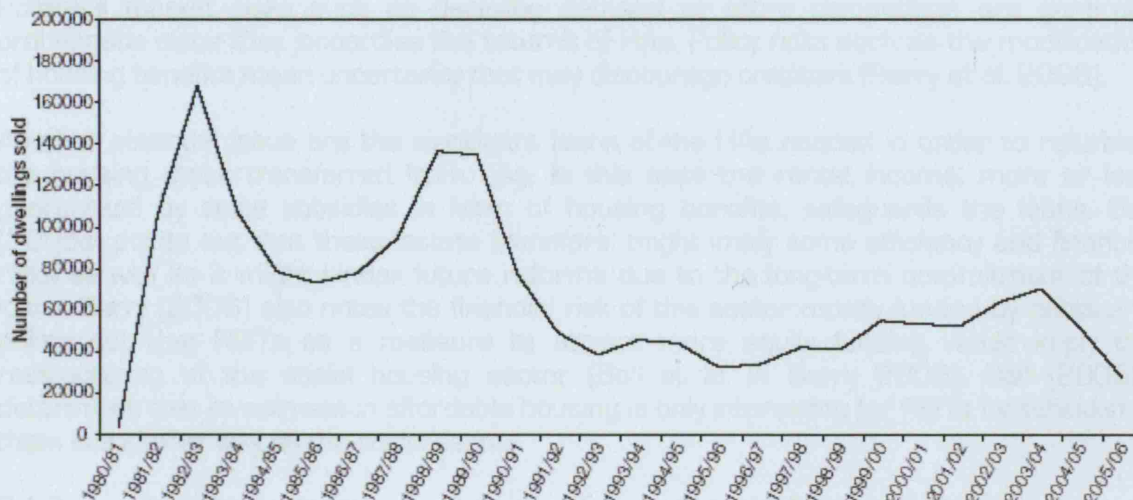


Chart 10a - Social housing sales: sales of local authority dwellings through the right-to-buy scheme, England  
(Source: National Statistics 2006)

Detailed figures on the provision of affordable housing in relation to the total housing stock do not seem to be available (Communities and Local Government n.d.), but Berry (2006) states that loans to the HA sector exceeded £35bn and that 60 percent of that amount was allocated to the provision of affordable homes<sup>93</sup>. Shared ownership schemes for social tenants and key workers by the HAs increased the amount of owner-occupation by around 100,000 units. Furthermore the Section 106 agreement, that commits residential developers to provide a certain amount of affordable housing, resulted in 12,500 affordable homes.

In general the decrease of social housing as well as the insufficient housing supply<sup>94</sup> [q.v. table 241/ Appendix C] in comparison to increasing household [q.v. table 401/ Appendix C] and population numbers [q.v. table 421/appendices] is especially alarming against the background of the still ongoing upward trend in rent, house [q.v. table 571/ Appendix C] and land prices.

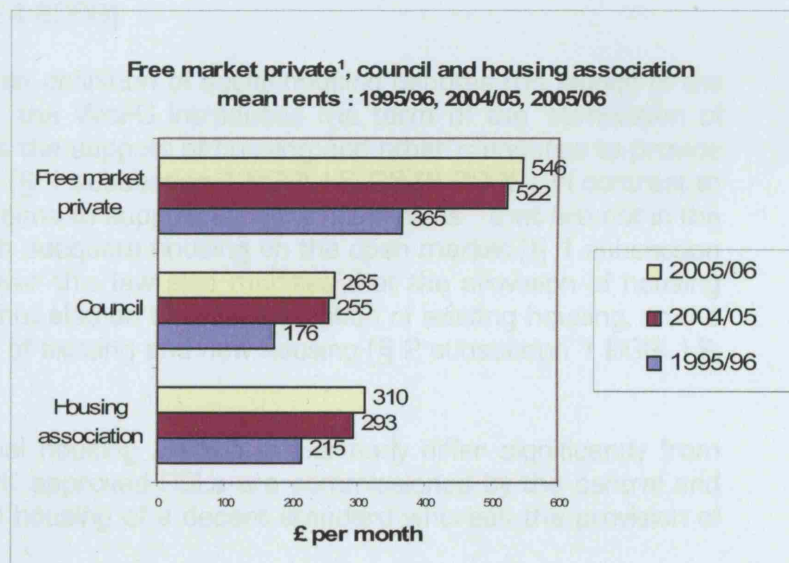


Chart 732: Average rents for free market private, council and housing association tenants  
(Source: Communities and Local Government 2007)

<sup>93</sup> Affordable homes in the sense of rented flats and shared ownership (Berry 2006).

<sup>94</sup> Cf Baker 2004.

This hinders an increasing part of the population to access decent homes and therefore is one of the challenges that the social and affordable housing market faces.

Potential market risks such as declining demand or more competition are generally problematic since they jeopardise the returns of HAs. Policy risks such as the modification of housing benefits mean uncertainty that may discourage creditors (Berry et al. 2006).

Another potential issue are the significant loans of the HAs needed in order to refurbish the housing stock transferred from LAs. In this case the rental income, more or less guaranteed by state subsidies in form of housing benefits, safeguards the loans. Ball (2005a) points out that these 'estate transfers' might imply some efficiency and financial risks as well as it might hinder future reforms due to the long-term commitment of the loans. Berry (2006) also notes the financial risk of this sector mostly funded by debts and points out that REITs as a measure to attract more equity funding would imply the restructuring of the social housing sector (Ball et al. in Berry 2006). Ball (2005b) determines that investment in affordable housing is only interesting for REITs by subsidising them in a similar way as the social sector.

### 3.1.2 Definition, structure and current issues of social housing in Germany

The understanding of the social housing in Germany has substantially been altered so much, so that it diverges from its original concept. In this context and in the wider context of the thesis it seems necessary to give more detailed background information to contextualise current issues concerning social housing as well as the introduction of REITs.

Originally social housing was defined in § 1 BGBI. I S. 2137 of the Zweites Wohnungsbaugesetz (Second Housing Act, Germany - II. WoBauG) as state-aided housing with a preference to support the construction of housing of an adequate size, interior and rent determined for a wide range of the population. The BGBI. I S. 2376 Wohnraumförderungsgesetz (German Housing Space Act - WoFG) overruled this Act in 2002, but in accordance with § 50 of the WoFG certain regulations are still effective for existing social housing (Immothek24 2006).

A substantial change in the German definition of social housing denotes the launch of the WoFG. Instead of 'social housing' the WoFG introduces the term of the 'stimulation of social housing space'<sup>95</sup> that covers the support of housing and other measures to provide households with accommodation<sup>96</sup> (§ 1 subsection 1 BGBI. I S. 2376 2002). In contrast to the previous legislation the WoFG aims to support indigent households<sup>97</sup> that are not in the position to provide themselves with adequate housing on the open market (§ 1 subsection 2 BGBI. I S. 2376 2002). Moreover this law also modifies that the provision of housing depends not only on construction but also on the modernisation of existing housing, on the purchase of occupancy rights and of existing and new housing (§ 2 subsection 1 BGBI. I S. 2376 2002).

Generally, the procedures of social housing system in Germany differ significantly from other European systems. In the UK approved RSLs are commissioned by the central and local government to provide social housing of a decent standard whereas the provision of

<sup>95</sup> 'Stimulation of social housing space' might not be the definite translation. As a simplification the remaining text continues to use the term 'social housing'.

<sup>96</sup> Including housing associations and home ownership (§ 1 subsection 1 BGBI. I S. 2376 2002).

<sup>97</sup> Entitled to social housing are low-income households as well as families, other household with children, single parents, pregnant women, elderly people, disabled people, homeless person and other indigent people (§ 1 subsection 1 BGBI. I S. 2376 2002).



social housing in Germany relies on a subsidy system (Ball 2005a) and underlies the responsibility of the federal states since 2006 (Meyers Lexikon n.d.). Subsidies are granted towards private investors or public housing companies in form of construction and expenditure grants, provision of securities, provision of cheap building lots and interest subsidies. These grants are defined within administrative deeds or agreements under public law where details such as duration, amount and type of the subsidy or purpose are specified. Additionally it is determined for how long rents are fixed and thus for how long the property remains in the socially rented sector<sup>98</sup> (§ 13 subsection 2 BGBI. I S. 2376 2002). In turn for granted subsidies the social housing providers are bound to offer rents below market level with an upper limit defined as *Kostenmiete*<sup>99</sup> (economic rent) (Meyers Lexikon n.d.).

Generally, it has to be mentioned that the level of housing supply in Germany is quite high (Brech n.d). According to Ball (2005a) major shortages and price rises in housing as seen in other European countries have been prevented by the disproportional construction boom in the 1990s in the course of the German reunification. In comparison to the UK housing is quite cheap and scarcities only occur in the main metropolitan areas. Quite the contrary is the case in most regions in East Germany where over 1 million units are vacant and it is planned to demolish one-third by 2009. Also some former industrial cities in the West show high vacancies. Therefore the housing supply of the past years is seen as more or less sufficient and the WoFG is based on the assumption that an efficient housing market will guarantee the housing supply of the predominant part of the population (Kuhnert 2001).

The above-mentioned assumption led to a change in the housing policy (q.v. part 3.1.2) and a cutback in the promotion of social housing. The WoFG's narrowing focus on indigent households, its emphasis on modernisation of existing housing as a solution for scarcity in social housing supply and its intensified promotion of common hold ownership comes along with a steady decline of subsidised housing completion as shown in the following graph:

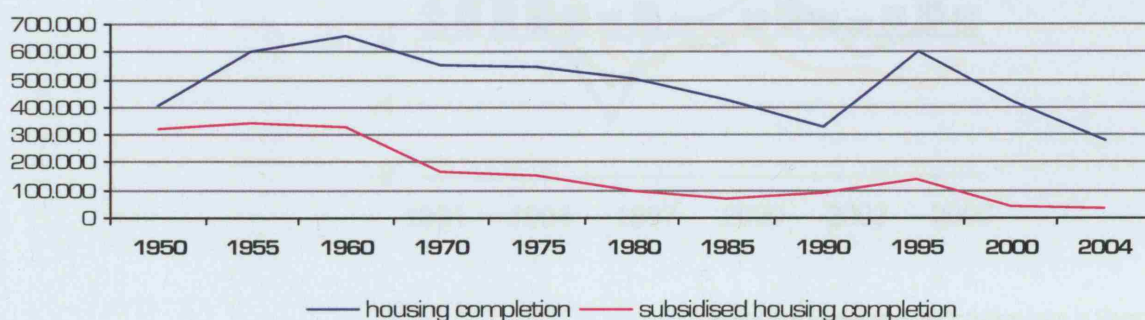


Table 10: Permanent dwellings completed, share of subsidised completion, Germany  
(Source: Statistisches Bundesamt 2006)

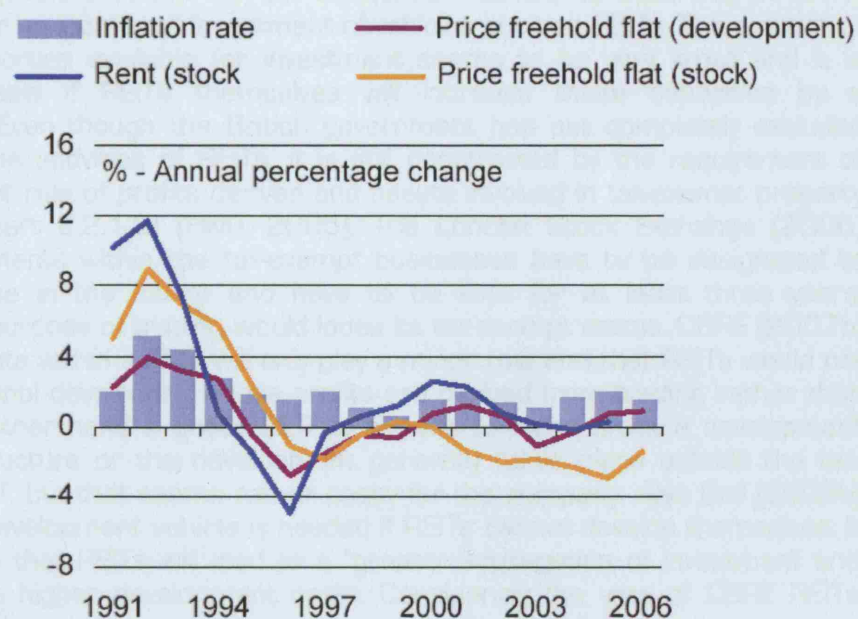
<sup>98</sup> How long rents remain within the social sector is regulated by each particular deed or agreement and is thus variable (§ 13 subsection 2 BGBI. I S. 2376 2002). When the Second Housing Act applied these periods lasted for the duration of the subvention plus 10 additional years, which generally meant around 40 years (Ball 2005a).

<sup>99</sup> Economic rents are calculated on the basis of a cost effective analysis that includes all relevant costs (construction, land, capital and running expenses) to determine the rental limit. The responsible governmental institution pays the difference between economic rent and affordable rent if the rent is still too expensive for the social tenant (ZEIT 2003).



Also the amount of existing social housing is declining and its reduction is mainly caused by the expiry of fixed rents applying to social housing units built under the Second Housing Act. After the expiry these units (around 100.00 annually) will no longer be available for the social housing market and compensation for the loss is not planned (Schulte 2003). It can be assumed that the rents of units belonging to HAs or public housing companies will still remain under market level rents and can thus act as an alternative. However also HAs that lost their status as not-for-profit organisations in 1988 (Schader Stiftung 2006), have to act more economically and a lot of them as well as public housing companies have been privatised (q.v. part 2.1.2) within the last few years (Ball 2005a).

In general it seems questionable if the current supply of social housing is meeting future needs. First of all social housing has to meet actual housing standards and therefore the construction of modern social housing is essential (Kuhnert 2001). Moreover it seems important to note that the assumption of the government about the accessibility of the housing market is based on market factors such as low rents, low house and land prices (q.v. the following graph) during an economic recession. It seems unlikely that these factors will remain the same in the near future since an upward economic trend is already underway (Simons 2007).



Rents, flat prices and the inflation rate in Germany  
(Source: BulwienGesa, Stat. Bundesamt, DB Research 2006) - modified

On the other hand factors such as the development of the population and the size of households also have an influence on the housing demand in general and in particular on the need for social housing. The Bundesamt für Bauwesen und Raumordnung (Federal Office for Building and Regional Planning – BBR) (2004) states that the German population is declining (q.v. population development in Germany/ Appendix C), but the trend to smaller households (q.v. household development in Germany/ Appendix C) will lead to increasing household numbers until 2017. After 2017 the decline in population will lead to a decreasing social housing demand.

Rents and house prices have been always more expensive in metropolitan areas with economic power such as Munich, Frankfurt or Hamburg and are likely to increase

furthermore. Housing shortages in these cities are known to be a problem and in some southern cities housing is already unaffordable for households with low or middle income. This is not only relevant in social terms but also in economic terms since positions remain vacant due to the unaffordable housing costs (Kuhnert 2001).

Overall it is essential to note that there is a great regional distinction in social housing demand and therefore it is impossible to regulate the need for social housing on a national or even federal level. Regional knowledge is necessary to create a need-based housing market.

### **3.2 REITs in relation to social and affordable housing in the UK and Germany**

#### **3.2.1 UK REITs in relation to social and affordable housing**

The general question of the UK REIT in relation to social housing is, if REITs are, as anticipated, the right measure to increase the level of housing supply and the affordable housing supply.

Generally it seems arguable that the current residential market, as described in 2.1.1, offers the capacities for an increased investment of vehicles such as REITs. The amount of large-sized rental properties available for investment seems to be very small and it is furthermore questionable if REITs themselves will increase these capacities by a considerable amount. Even though the British government has not completely excluded development<sup>100</sup> from the activities of REITs, it is still constrained by the requirement of meeting the 75 percent rule of profits derived and assets involved in tax-exempt property rental business (q.v. part 2.2.1.2) (HMT 2005). The London Stock Exchange (2006) specifies that developments within the tax-exempt businesses have to be designated to generate rental income in the future and have to be kept for at least three years. Developments for the purpose of trading would lose its tax-exempt status. CBRE (2007b) states that developments within a REIT will only play a minor role and that REITs would not be attractive to traditional developers whose profits are derived from trading rather than from rentals. On the other hand a group REIT is allowed to incorporate a development company within its structure or the development generally takes place outside the tax-exempt part of the REIT, but that seems rather costly for the company. Also Ball (2005b) points out that some development vehicle is needed if REITs cannot develop themselves. It is generally anticipated that REITs will lead to a "greater segregation of investment and development" and thus higher development costs. Considering the view of CBRE REITs appear not to be the right measure to increase housing supply via development.

However it can be argued that even if REITs do not actively develop property they might still attract more investment that in turn encourages the development of new housing. This was also anticipated by the British government who hoped to see REITs increasing the development activity in the residential market (Crook 2002). Even though it is very likely that REITs attract more investment on the long-term it is still questionable if the raised investment will benefit the residential sector. As mentioned in part 2.1.1 the features of the British rental market seem to be less attractive for institutional investors than the one of the commercial market. The generally lower returns of the residential market (cf. IPD 2007 or Lizeri et al. 2004) compared to the commercial market is also not in favour of the residential market. Moreover it seems less unlikely that it would be then financially rewarding to invest in affordable housing for people with low incomes.

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<sup>100</sup> Generally developments are more risky and therefore often excluded or limited within REITs to protect shareholders from these risks (Ball et al. 2005b).

Therefore there must be an incentive for REITs to invest in residential property and especially in affordable housing. One possibility, as Ball (2005b) suggests, might consist in finding specific niches<sup>101</sup> of the residential market that are more lucrative than others. More relevant for this thesis is the already mentioned proposal to provide a REIT vehicle with subsidies for the provision of "particular types of housing" or for allocating housing for "specific types of tenants". This would necessitate changing the set of rules concerning social housing subsidies and their recipients. At the moment only LAs and RSLs receive subsidies and it might be very unlikely that profit-making entities such as REITs would be entitled to obtain them. Additionally it is still questionable if this would then be equally or more attractive than other investment opportunities, but the judgement of this would exceed the scope of this thesis.

Instead of creating an incentive for REITs to invest in housing it was planned to require by law that REITs have to invest a specific amount in housing, but this idea was not implemented (HMT 2005). One of the possible reasons for that might have been the fear of creating a too restrictive REIT regime as happened with the Housing Investment Trusts (HITs) that did not convince investors (Inside Housing 2004/ Property Week.com 2001).

Generally it is also worth considering if the construction industry is able and willing to increase the supply. Barker remarked that the building industry might "hold back production rates" (Baker 2004). Possible reasons for that behaviour might be: market and planning risks, controlled production to achieve price rises, reluctance in long-term investment and long-term employment, rising labour costs or shortage of skilled labour. Additionally the availability of building land and high density schemes are restricted by planning law (DTZ Consulting & Research 2006).

Considering the above-mentioned factors it seems implausible that REITs are the appropriate measure to increase the overall housing supply. It might increase the housing supply to a certain amount, even though that amount would not reflect the actual demand. Furthermore it seems very unlikely that REITs would increase affordable housing, since it is first of all an investment vehicle that holds property for the purpose of realising profits. However it is at this stage not predictable how UK REITs themselves and in correlation with the rental market will develop and thus it remains to be seen if REITs will help to increase the housing supply or not.

### 3.2.2 G-REITs in relation to social housing

Since existing housing and thus also social housing is excluded from the G-REIT, REITs have currently no direct influence on social housing in Germany. Therefore the purpose of this section is to analyse the general reasoning, the appropriateness of the exclusion and hypothetical effects in respect to social housing.

As mentioned above (part 2) the German government excluded existing housing from REITs in order to protect tenants and to safeguard the social housing policy and sustainable town planning (Deutscher Bundestag 2007). The general aim of this decision seems to be to prevent the further privatisation of public housing and thus the conversion of housing from a social good to a commercial good (Voigtländer 2006). In previous years large public housing portfolios were mainly sold off to Anglo-American opportunity or private equity funds. These funds mainly deal as intermediate investors who restructure and subsequently resell the portfolio or parts of it in order to achieve a maximum return. REITs

<sup>101</sup> Such niches could be specialised REITs for target groups such as students or affluent and mobile people living in "high employment opportunity locations" such as London. The named niche markets are only interesting in the wider scope of providing housing supply in general, but they are not approaching the need for social housing (Ball et al. 2005b).

are one possible exit strategy<sup>102</sup> for these funds (DEGI 2006) and in this respect REITs are seen as a kind of promoter for the privatisation of further housing stock and as a threat for the local stability by allowing speculation in the real estate sector (Unger 2007a).

To begin with it has to be understood why it was deemed necessary for the German government to protect tenants from REITs. Generally it is anticipated that the need of REITs to maximise their return and to stay competitive on the stock exchange will lead to increasing rents and to neglect properties in the long run (Deutscher Bundestag 2007).

It seems very likely therefore that REITs as an investment vehicle will demand comparable higher rents compared to those of public housing companies or HAs and it is indisputable that this would be harmful for social tenants. It is necessary however to note that the German rent control is powerful and determines a cap for rent increases that prevents excessive increases. Representatives of the investment sector also refer to the rent control and confirm that drastic rent increases are highly unlikely. It is also pointed out that the state of the housing market would not allow such measures and that REITs with their long-term investment strategy have an interest to hold onto tenants for as long as possible (Simons 2007). This would also answer the fear of tenants associations that REITs would refurbish flats and this cost would in turn be used to increase rents with the effect of displacing tenants (Deutscher Mieterbund e. V. 2006). However it is argued that REITs offer more active and professional management and that the resulting efficiency gains would be beneficial for the tenants (Deutscher Verband für Wohnungswesen 2006 or Plessner et al. 2006). However it is also admitted that considerable rent increases happen even though it is highlighted that the increases are mostly reasonable (Simons 2007). Nevertheless it is obvious that even small rises in rent might be unaffordable for social tenants. This argument is countered by the investment sector by pointing out that housing benefits are the accurate measure to support social tenants (Voigtländer 2007). That might be true, but increasing housing benefits affects public expenses, which is exactly what the legislator wanted to prevent (Deutscher Bundestag 2007). The spokesman of the German Tenants' Protection Association criticised REITs in that they are likely to pass on costs to LAs (Bündnis 90/Die Grünen 2006). Some critics of REITs even compare the practice of US REITs with the potential behaviour of G-REITs (Unger 2006), which appears a bit disproportional since the protection of tenants in Germany is greater than in the USA. Altogether it seems impossible to prove that REITs will increase rents or to what extent they raise rents without any evidence from actual data. Additionally it is essential to note that attitudes might vary depending on each particular corporate policy. However it seems still evident that REITs are not the right measure for social tenants unless there is some kind of permanent protection mechanism or social charter.

The other argument that REITs would neglect the maintenance of their properties seems to be less evident. It is often argued that the requirement of high distribution of profits towards shareholders leaves not enough capital for maintenance (Unger 2007a). From understanding the German REITs legislation allowances for maintenance are made before the calculation of the annual surplus (q.v. § 13 subsection 1 BGBI. I S. 914 2007) whereof 90 percent is then distributed (Deutscher Bundestag 2007). However REITs might consider more carefully the amount of money that is spent on maintenance, but it is argued that it is also in their interest to keep properties in a good condition due to the target of enhanced values and steady income from rents (Simons 2007). Moreover it is indicated that most of the public housing stock in Germany urgently needs refurbishment, but that most LAs cannot afford it whereas REITs could raise the funding and in this respect REITs

<sup>102</sup> Other exit strategies are the disposal of single flats to tenants, housing companies or other investment funds (DEGI 2006).

would be a suitable alternative (Voigtländer 2006). Again it is difficult to judge if G-REITs will neglect maintenance without any evidence from potential market behaviour of REITs.

Another aim of the government was to safeguard the social housing policy which is seen in danger due to the LAs' loss of influence on the housing market and its pricing (Bündnis 90/Die Grünen 2006) which would be especially negative in terms of social tenants. It is essential to make clear that it is at the sole discretion of each LA if and how they want to privatise their social housing stock (IDWR 2007). Even though it seems undeniable that most LAs are highly in debt and in the need of capital to consolidate their budgetary planning there might be still another solution than privatisation. The ongoing privatisations of housing portfolios before the REIT was introduced shows that REITs are not the only possible way to privatise. Therefore REITs cannot be seen as the initiator of privatisations and it is essential to be aware that the underlying reasons are perhaps more political in nature. Additionally REITs cannot be held responsible for the retreat of the German government from parts of the social housing sector. It was a political decision-making process that started in the 1990s (Sinz 2006) and led to the decision to phase out fixed rents of social housing built under the Second Housing Act and to reduce the commitment to social housing within the WoFG (q.v. part 3.1.2). It seems evident that the discussion about REITs would have had a different tenor without these changes and without the over-indebtedness of LAs. Therefore it seems necessary to clarify that REITs cannot be related the loss of social housing in the first place and that it would be more appropriate to reconsider the social housing policy in Germany as a whole. Furthermore it would be of consequence to analyse the potential impact of REITs on the housing and social housing sector on the base of methodically collected data (IDWR 2007).

Generally it has to be taken into consideration that even if REITs facilitate the privatisation and actually have a damaging impact on social housing, it is still questionable why other investment methods are not restricted in the same way (IDWR 2007). At the moment LAs still have the opportunity to dispose of their housing to other investment vehicles such as opportunity or private equity funds and even German property companies can establish REITs on foreign property markets that would allow them to hold German residential property (Eurohypo 2007). Therefore the legislation, as it is, is not complete and it would be necessary to modify it.

Altogether it seems that the legislation that excluded existing housing from REITs was not thoroughly and perhaps inappropriate. It did not provide full protection for tenants nor did it solve issues concerning the social housing policy and it is generally questionable why commercial property is not also relevant for sustainable town planning.

In respect to social housing it seems difficult to evaluate the potential effect of the exclusion of existing housing from REITs. This is not only due to the contemporary nature of the REITs introduction, but also the absence of a precedent in other countries, as well as the fact that social housing can be still affected by other investment instruments makes it impossible to draw conclusions. Nevertheless it is assumed that even though REITs might not be the most beneficial way to hold social housing, it might be deemed as more favourable than other investment methods that are even more yield oriented (Bündnis 90/Die Grünen 2006). Generally it would be sensible to seek other alternatives to solve the issues of social housing in Germany such as reconsidering the social housing policy.



## IV. Conclusion

Following on from previous chapters the conclusion of this thesis will begin by exploring the different national perceptions of REITs in relation to social housing, followed by a general discussion of the compatibility of REITs and social housing and a subsequent suggestion how REITs could serve the needs of social housing.

The previous investigation of the national perceptions of REITs and social housing in both countries illustrated once again how far apart they are from each other. Within the British government REITs are seen as beneficial towards social housing whereas the German government attempted to protect social housing from REITs. It seems useful to explore this discrepancy in order to come to a balanced understanding.

One possible explanation of these differing perceptions might be that the different forms of ownership transfer within the social housing sector (q.v. parts 3.1.1 and 3.1.2). In the UK the ownership was transferred from LAs to council tenants or non-for-profit RSLs whereas social housing in Germany was mainly transferred from the public sector to the private sector (Ball 2005a). Therefore it is possible that the German experience may have caused a general distrust towards the investment sector, which might explain the negative attitude of parts of the German government towards REITs.

Additionally it is possible that different ownership structures in both countries imply that housing for rent is of lesser importance in the UK than in Germany and therefore tenant organisations have a much greater influence in Germany than in the UK.

Furthermore it seems that the UK government is generally more sympathetic in allowing private funding for public institutions. The use of Private Public Partnerships or Private Finance Initiatives is standard in the UK whereas these measures in Germany are still relatively new. Additionally it might be that the lobby of the financial sector in the UK is more pronounced in driving policy.

It is finally assumed that the more positive perception of REITs in the UK is mainly affected by a generally more favourable attitude towards private funding to undertake former tasks of the public sector whereas the influence of the tenant associations in Germany definitely provoked a negative response (Unger 2007b). However it is necessary to note that further investigations about the nature of these different national perceptions would be suitable.

After the examination of these opposed attitudes towards REITs concerning social housing it seems sensible to pass into a brief general discussion about the compatibility of REITs and social housing.

It can be said that REITs and social housing come from different lobbies and have completely opposed agendas. REITs can be seen as a product and part of the market economy whereas social housing can be understood as a response to the drawbacks of the market economy. Social housing depends on subsidies that are used to provide people outside the market with housing. In contrast to that REITs tend to aim at realising maximal profits available at the market. In principle it could therefore be assumed that REITs and social housing are incompatible since the provision of social housing seems to be unprofitable for REITs. Otherwise REITs and social housing might be possibly be compatible under certain conditions.

If it has to be assumed that the public sector is not in the position anymore to provide social housing it then has to be accepted that even social housing has to be operated according to market principles even though it still has to be socially responsible. On the

other hand it should be theoretically possible to operate a profitable REIT that is socially responsible, at the same time even though it has to be accepted that the profits might be lower. Although this concept might sound utopian, especially in regard to the viewpoint of the investment industry, it should be, depending on the corporate philosophy, nevertheless feasible. Several companies taking part in international initiatives such as 'UN Global Compact', which campaign among other things for social responsibility, demonstrate the viability of this idea (Rieth 2003).

HAs or public housing companies in both countries are very likely to possess the necessary philosophy and they could establish a socially responsible REIT with specific social standards. The concept of this type of REIT would also be in line with the growing trend of social responsible investment that combines both increases in financial profits and social gains (UK Investment Advice 2006). For the HAs or public housing companies this REIT could offer the advantage of raising capital for maintenance or development by selling their properties to the REIT. At the same time they could retain their co-determination and could furthermore manage the properties. As mentioned above there is already one consortium of HAs in the UK which plan a so-called HA-REIT (Levenson 2007) and this was also proposed in Germany (Bündnis 90/Die Grünen 2006). Exactly how such REIT is to be implemented definitely needs to be examined in more detail, but this would go beyond the scope of this thesis.

To conclude this thesis it has to be admitted that the scope of the topic was miscalculated in terms of the size and level of research and a more limited approach would have been more suitable. Due to the limited evidence about the REITs in both countries it could furthermore be assumed that the thesis would have benefited from a later realisation. Finally, in hindsight, it is possible to be critical to the use of primary sources from an unfamiliar specialism such as law or taxation.

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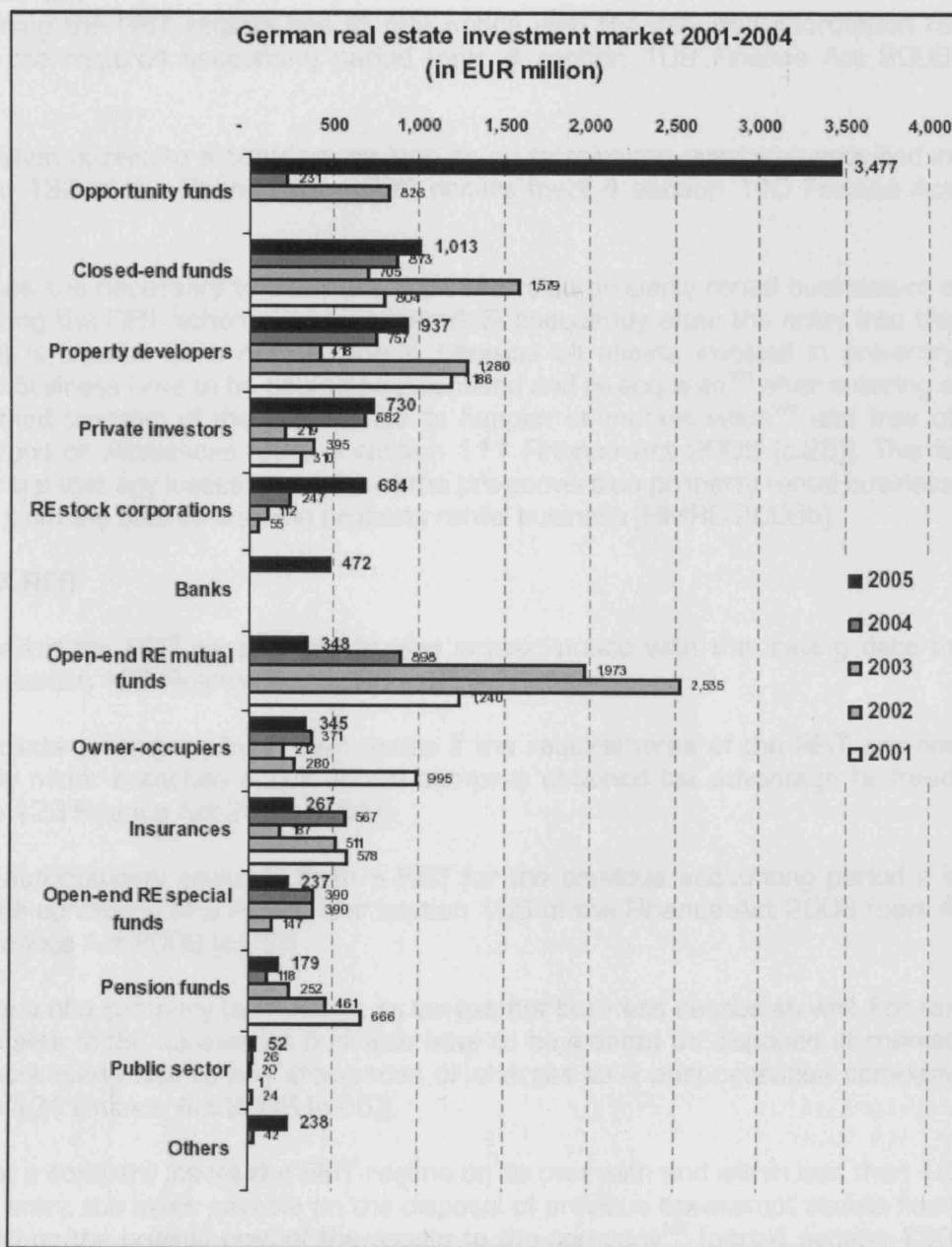
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## APPENDIX A



Real estate investment market between 2001 and 2004 in Germany  
(Source: Black et al. 2006)

## APPENDIX B

### Entering the UK REIT

A company joining the REIT regime has to give notice with the required information to HMRC before the required accounting period (part 4 section 109 Finance Act 2006 (c.25)).

The REIT legislation applies to a company as long as no termination events as specified in section 128 to 130 of the Finance Act 2006 occurs (part 4 section 110 Finance Act 2006 (c.25)).

For tax purposes it is necessary to treat any pre-conversion property rental business of a company entering the REIT scheme as terminated. Subsequently after the entry into the REIT regime, it is treated as a new business. Likewise all assets involved in pre-entry property rental business have to be deemed as disposed and re-acquired<sup>103</sup> after entering a REIT. The deemed transfer of the assets has to happen at market value<sup>104</sup> and free of balancing charges or allowances (part 4 section 111 Finance Act 2006 (c.25)). This is done to guarantee that any losses or profits of the pre-conversion property rental business are separated from the post-conversion property rental business (HMRC 2006b),

### Leaving the UK REIT

A company leaving the REIT regime has to give written notice with the leaving date to HMRC (part 4 section 128 Finance Act 2006 (c.25)).

HMRC can exclude a company by written notice if the requirements of the REIT are not met, repeatedly minor breaches occur or the company obtained tax advantage by fraud (part 4 section 129 Finance Act 2006 (c.25)).

A company is automatically excluded from a REIT for the previous accounting period if it fails to meet the conditions of a REIT under section 106 of the Finance Act 2006 (part 4 section 130 Finance Act 2006 (c.25)).

If the REIT regime of a company terminates, its tax-exempt business ceases as well. For tax purposes all assets of the tax-exempt business have to be treated as disposed at market value and without giving rise to any allowances or charges to a post-cessation company (part 4 section 131 Finance Act 2006 (c.25)).

In the case that a company leaves the REIT regime on its own wish and within less than 10 years after its entry, the taxes payable on the disposal of previous tax-exempt assets have to be calculated on the original cost of the assets to the company<sup>105</sup> (part 4 section 132 Finance Act 2006 (c.25)).

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<sup>103</sup> It is determined that the deemed re-acquisition has to happen free of charges or other allowances (section 112 Finance Act 2006 (c.25)).

<sup>104</sup> Market value is determined as the price an asset is likely to achieve on the open market (section 142 (c) Finance Act 2006 (c.25)).

<sup>105</sup> I.e. the tax calculation has to ignore all deemed disposals in relation to the REIT regime (HMRC 2006b).

### Taxation, profits and capital gains of the UK REIT

Section 114 of the Finance Act 2006 determines that “distributions to investors with 10 percent or more of the company's dividends, share capital or voting rights” can cause a tax charge<sup>106</sup> for the REIT (HMRC 2006b).

In the case that the REIT does not comply with the conditions of tax-exemption and the business balance (q.v. Conditions for the exemption of tax; Conditions for the balance of the REIT), which are seen as minor or inadvertent breaches, the Treasury is entitled to make regulations such as to “charge an amount of tax” or “make provision by reference to the number of requirements not satisfied” (HMRC 2006b). The Treasury implemented this section besides parts of section 114, 115, 122, 129(2) (a-b), 134(1) and 144 of the Finance Act 2006 into the Statutory Instrument 2006 No. 2864 ‘Real Estate Investment Trusts (Breach of Conditions) Regulations 2006’.

The commissioners of HMRC are authorised to cancel the tax advantage<sup>107</sup> and to impose an additional charge on a REIT that “has tried to obtain a tax advantage for itself or another person” (part 4 section 117 Finance Act 2006 (c.25)).

Proceeds from disposed assets that were involved in tax-exempt business have to be re-invested into tax-exempt assets. If the proceeds are held in cash they will be treated for 24 months as part of the tax-exempt business, but any profits or losses on the money invested in any loan relationship will be regarded as part of the non tax-exempt business and therefore will be taxed (HMRC 2006b).

The Treasury is authorised to set up detailed regulations concerning “assessment, collection and recovery of tax” for the distribution of REITs profits from tax-exempt property rental business. Generally a REIT has to deduct a basic rate of income tax<sup>108</sup> from the tax-exempt distributions. Some shareholders are exempt from this deduction and the Treasury has to define these groups (part 4 section 122 Finance Act 2006 (c.25)). The Treasury transferred this section into the Statutory Instrument 2006 No. 2867 ‘Real Estate Investment Trusts (Assessment and Recovery of Tax) Regulations 2006’. Again this is seen as far too detailed for the setting of this thesis.

Under the REIT regime there are certain regulations<sup>109</sup> to attribute the distributions of tax-exempt property rental business and thus disburseable under deduction of the basic rate of income tax. Furthermore all other payments have to be identified that are deemed liable to taxation and thus without the need of deduction (HMRC 2006b). Further details can be found under section 123 of the Finance Act 2006.

If an asset is passed over from tax-exempt business to a non tax-exempt business of a REIT, the transfer is deemed as disposal at market value. The deemed disposal has to take place without generating any balance charges or allowances. If an asset from tax-exempt business of a REIT is sold for trading purposes to a non tax-exempt business, it has to be

<sup>106</sup> The charge refers to the correspondent interest percentage (HMRC 2006b).

<sup>107</sup> Tax advantage is defined in accordance to section 709 ICTA88. It was extended to cover tax advantages in relation to the REIT entry charge (HMRC 2006b).

<sup>108</sup> The basic rate of income tax is currently 22 percent. (HMRC 2006b).

<sup>109</sup> For example, section 107 of the Finance Act 2006 where a distribution of 90 percent from tax-exempt property rental business is required.

treated as the disposal<sup>110</sup> of a non tax-exempt business. In this case it is possible for the REIT to reclaim parts of the entry charge<sup>111</sup> (part 4 section 125 Finance Act 2006 (c.25)).

If assets move into the ring fence the disposal has also to be treated as disposal equal to market value and without arising any charges or allowances (part 4 section 126 Finance Act 2006 (c.25)).

### Groups UK REITs

Generally, a group of companies joining the REIT regime are subject to the same regulations applying for single companies even though some modifications, as set out in Schedule 17 of the Finance Act, are necessary. Groups are formed of the 'principal company' and its '75 percent subsidiaries'<sup>112</sup> as well as of their 75 percent subsidiaries<sup>113</sup> etc.<sup>114</sup> Further details can be found under Schedule 17 of the Finance Act 2006 (part 4 section 134 Finance Act 2006 (c.25)).

In a group REIT the "transfer of assets between members of the group at no gain/ no loss" is excluded between tax-exempt and non tax-exempt parts of the group (HMRC 2006b).

For tax purposes the tax-exempt and non tax-exempt parts of a group REIT are treated as separate groups as well as they are treated separately from groups before the entry and after cessation of the REIT regime. Further related rules of the existing tax legislation can be found in section 136 subsection 2 of the Finance Act 2006 (HMRC 2006b).

### Qualifikation for G-REIT status

REITs are bound to undertake consolidated accounts in accordance with § 315 Handelsgesetzbuch (German Commercial Code - HGB) or at least an individual financial statement in accordance with § 325 subsection 2a HGB. In relation to this, the fair value in accordance with IAS 40 is applicable for all immovable property held as a financial investment. (§ 12 subsection 1 ibid. 2007).

### Tax treatment of the G-REIT

A REIT is not losing the right of tax exemption if an investor holds 10 or more percent of company's shares. Likewise the investor is not losing his right to vote or his entitlement to dividends, but they can only enforce rights of a shareholding of less than 10 percent (§ 16 subsection 2 ibid. 2007).

If at the end of a financial year the amount of immovable property is below 75 percent of the total assets of the REIT then a penalty fee is imposed by the responsible financial

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<sup>110</sup> This is generally changing the computation of profits on disposal, they are treated as trading profit based on the acquisition price paid by the REIT or its former company (HMRC 2006b).

<sup>111</sup> The mechanism to calculate the repayment claim is: asset market value (value of the asset at entry in the REIT) divided through the aggregate market value and multiplied with the tax paid as entry charge in accordance with section 112 of the Finance Act 2006 (part 4 section 125 subsection 8 Finance Act 2006 (c.25)).

<sup>112</sup> 75 percent subsidiary is a company that is held to 75 or more percent of its ordinary share capital by another company (HMRC 2006b).

<sup>113</sup> The number of levels concerning the subsidiaries is limited due to the exclusion of companies that are "not an effective 51 percent subsidiary of the principal company" (part 4 section 134 subsection 3 Finance Act 2006 (c.25)).

<sup>114</sup> Insurance companies, their subsidiaries or open-end investment companies are excluded from Group REITs ((part 4 section 135 subsection 3 Finance Act 2006 (c.25)).

authority (§ 16 subsection 3 *ibid.* 2007).<sup>115</sup> The same applies if less than 75 percent of the gross proceeds are derived from transactions in relation to immovable property (§ 16 subsection 4 *ibid.* 2007).<sup>116</sup> Furthermore, the REIT is fined if the distribution of the annual surplus among the investors lags behind the required 90 percent (§ 16 subsection 5 *ibid.* 2007).<sup>117</sup> In addition, a REIT or a subordinated property partnership is fined if a secondary occupation is performed nongratuitously (§ 16 subsection 6 *ibid.* 2007).<sup>118</sup>

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<sup>115</sup> The penalty is between 1 and 3 percent of the amount that is missed out to fulfill the 75 percent (according to § 16 subsection 3 BGBl. I S. 914).

<sup>116</sup> The penalty is between 10 and 20 percent of the amount that is missed out to fulfill the 75 percent (according to § 16 subsection 4 BGBl. I S. 914).

<sup>117</sup> The penalty is between 20 and 30 percent of the amount that is missed out to fulfill the 90 percent (according to § 16 subsection 5 BGBl. I S. 914).

<sup>118</sup> The penalty is between 20 and 30 percent (according to § 16 subsection 6 BGBl. I S. 914).

## APPENDIX C

Year	Thousands of people					
	England	Wales	Scotland	Great Britain	Northern Ireland	United Kingdom
1996	48.519	2.891	5.092	56.502	1.662	58.164
2001	49.450	2.910	5.064	57.424	1.689	59.114
2006	50.714	2.977	5.108	58.800	1.733	60.533
2011	51.967	3.037	5.120	60.124	1.767	61.892
2016	53.276	3.102	5.126	61.504	1.800	63.304
2021	54.605	3.165	5.127	62.897	1.830	64.727
2026	55.823	3.219	5.109	64.151	1.851	66.002

Table 421 Population estimates and projections: United Kingdom, 1996-2031  
[Source: Communities and Local Government 2007]

	Thousands of households				
	England	Wales	Scotland	Great Britain	Average household size England
1996	19.727	1.172	2.126	23.025	2,40
2001	20.523	1.209	2.195	23.927	2,36
2006	21.519	1.272	2.287	25.046	2,32
2011	22.646	1.338	2.337	26.235	2,25
2016	23.837	1.406	2.446	27.526	2,20
2021	24.973	1.468	2.510	28.732	2,15
2026	25.975	1.516	..	..	2,11

Table 401 Household estimates and projections: Great Britain, 1961-2026  
[Source: Communities and Local Government 2007]

Year	Number of dwellings			
	Private Enterprise	Registered Social Landlords	Local Authorities	All Dwellings
1996	154.108	33.102	1.758	188.968
1997	161.221	28.344	1.543	191.108
1998	155.809	24.097	1.095	181.001
1999	157.936	24.627	331	182.894
2000	154.468	23.448	276	178.192
2001	152.361	22.332	355	175.048
2002	162.483	20.078	249	182.810
2003	172.241	18.082	250	190.573
2004	R 181.899	21.044	133	203.076
2005	R 184.912	24.076	238	209.226
2006	..	..	..	..

Table 241 Housebuilding: permanent dwellings completed, United Kingdom historical calendar year series  
[Source: Communities and Local Government 2007]



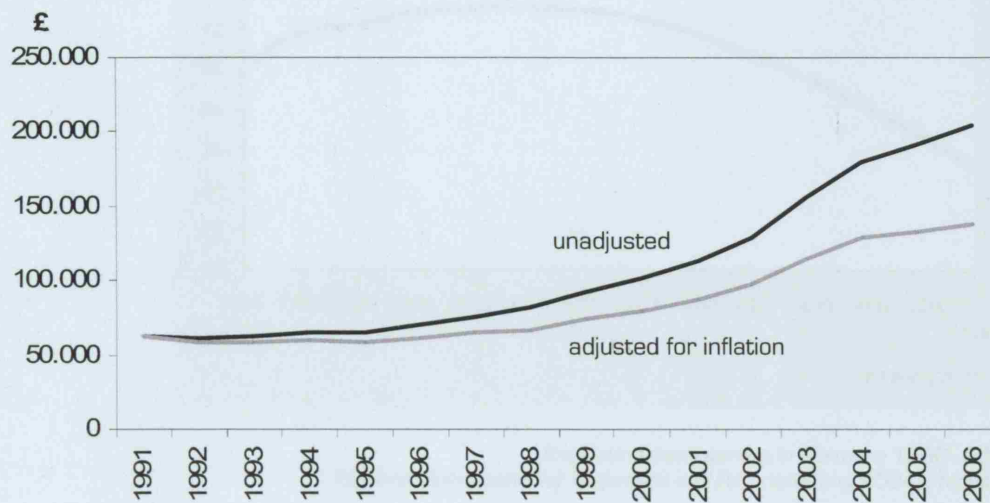
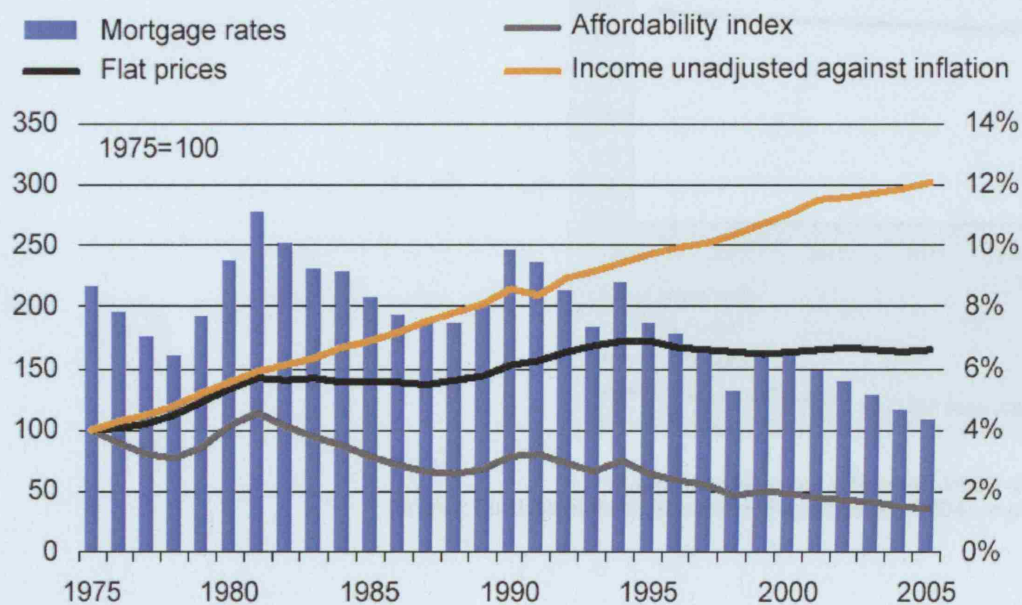
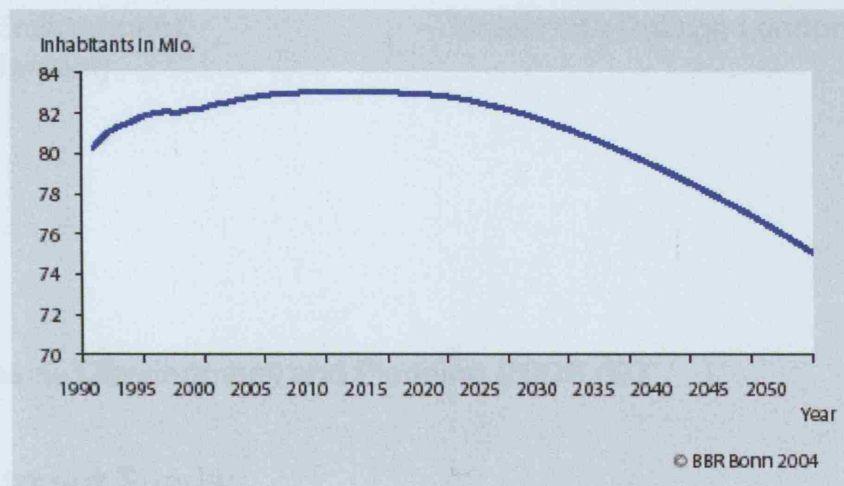


Table 571 Housing market: simple average house prices, United Kingdom (chart) 1  
 (Source: Communities and Local Government 2007)

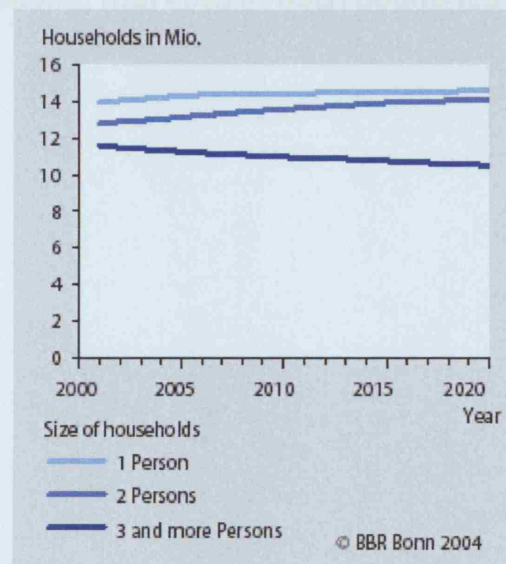


The affordability index measures the mortgages rates (duration 25 years) of an average flat with 80 sqm in relation to the disposable income per capita in Germany

Affordable index, flat prices, mortgages rates and income in Germany  
 (Source: BulwienGesa, Stat. Bundesamt, DB Research 2006) - modified



Population development in Germany 1990–2050  
[Source: Bundesamt für Bauwesen und Raumordnung 2004] - modified



Household development in Germany 2000–2020  
[Source: Bundesamt für Bauwesen und Raumordnung 2004] - modified

**Faculty of the Built Environment  
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**Real Estate Investment Funds:**

**Comparative analysis of REITs in the UK and in Germany  
and their potential impact on the social housing markets in both countries**

**Levke Jensen**

Being a Report submitted to the faculty of the Built Environment as part of the requirements for the award of the Msc European Property Development and Planning at University College London:

I declare that this Report is entirely my own work and that ideas, data and images, as well as direct quotations, drawn from elsewhere are identified and referenced.

Signature

17.09.2007

Date