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## “Real Estate Investment Trusts (REITs): An overview of Structure & Legislative Framework”

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### ABSTRACT

*This Study focuses on the Real Estate Investment Trusts (REITs) in the Global markets. The evolution of REITs, growth, structure and legislative framework have been deliberated in the study. We have illustrated the evolution of the REITs industry by describing the legislative requirements to be adhered to in order to set up a REIT and characteristics of the REITs focusing on the countries like United States, Philippines, Germany & France. This study is divided into four sections namely Overview of REITs, Statutory Requirements of REITs, Advantages of REITs, Comparison between the REITs practiced by sample countries & Conclusion.*

**Keywords : REITs, real estate, investment**

### 1.0 REITs Overview

Real Estate Investment Trusts (REITs) are investment vehicles that allow investors to pool real estate assets with beneficial tax consequences. Congress created REITs in the U.S. in 1960 as a way to make investment in large-scale, income-producing real estate accessible to all investors in the same way they typically invest otherwise – through the purchase and sale of liquid securities. Prior to the creation of listed real estate equities, access to the investment returns of commercial real estate equity as a core asset was available only to institutions and wealthy individuals having the financial wherewithal to undertake direct real estate investment. Organizations which are qualified as REITs do not need to pay federal tax on the income or gains and can opt to pass their income through to share-holders. REITs investors also enjoy the advantages of limited liability and transferability of shares (i.e., liquidity) that a corporate structure offers, without incurring the costs of double taxation. Thus, a REIT can be considered as a combination of a corporation and a partnership which enjoys the benefits of a being a corporation along with the pass-through nature of a partnership.

### 2.0 Basic Structure of REITs:

A REIT is defined as any corporation, trust, or association that meets the requirements of section 856 of the IRC. REITs are being owned by two kinds of parties i.e. (a) The Sponsor & (b) The Investor. The Sponsor is the person who contributes through real estate property and The Investor is the person who contributes through capital by holding shares in the REIT. In order to get the REIT status an organization needs to adhere to the following requirements.

- a. Organizational Requirements.
- b. Distribution Requirements.
- c. Investment Requirements.
- d. Income Requirement

### 1.1 Organizational Requirements:

United States: (i) The REIT must be managed by one or more trustees or directors for the entire taxable year. (ii) Beneficial ownership of the REIT must be evidenced by transferable shares. (iii) The entity must be one and it would be taxable as a domestic corporation or trust. (iv) The entity can be neither a financial institution, as defined in section 582(c)(5) of the Code, nor an insurance company pursuant to Subchapter L of the Code. (v) The beneficial ownership of a REIT must be held by 100 or more persons. (vi) Not more than fifty percent

of a REIT's outstanding stock can be held by five or fewer persons, in accordance with the personal-holding company provisions in section 542.

Philippines (i) A REIT must be a stock corporation established in accordance with the Corporation Code of Philippines. (ii) A REIT must be a listed public company and have at least 1000 public shareholders each owning at least 50 shares of any class who in aggregate own at least 40% of the outstanding capital of REIT provided that minimum ownership shall be increased to 67% within 3 years from the listing. (iii) A REIT must have minimum paid up capital of Three hundred million pesos either in form of cash or property. No part of paid up capital can be used to pay prior debts or encumbrances of its real property assets.

Germany: A REIT Stock Corporation must be organised in the legal forms of a stock corporation and have its registered seat and place of management in Germany. The company name of a REIT Stock Corporation must include the words 'REITAktiengesellschaft' or 'REIT-AG' and must be applied for registration with the commercial register at the competent court. A uniform class of shares (bearer shares or registered shares) is prescribed, with the shares giving voting rights. The shares of the REIT Stock Corporation must be admitted to trade on an organised market in an EU member state or stock corporation with listed shares having its registered seat and place of management in Germany. Minimum share capital of €15m is requisite for formation of REIT. No shareholder directly holding 10 percent or more of the shares or voting rights. At least 15 per cent of the shares in free float; at the time of listing at least 25 percent free float.

France: They must be listed companies on a regulated stock exchange market that meets the requirements of the EU Directive relating to financial instrument markets. The "Société d'Investissements Immobiliers Côtée" (SIIC Regime) should have minimum share capital of €15 million At the time of entry into the SIIC Regime, at least 15% of the share capital must be held by shareholders holding, directly or indirectly, less than 2% of the share capital.

### 1.2 Distribution Requirements:

United States: At least ninety-five percent of the REIT's annual income must be distributed to shareholders as dividends. If the REIT meets the dividend distribution requirements as specified above, it is allowed to deduct the amount of divi-

dends paid from the taxable income. This dividend deduction allows a REIT to avoid double taxation and is the primary difference between a REIT and a normal corporate entity.

Philippines: A REIT must distribute 90% of its income as dividends to shareholders not later than the last day of the fifth month following the close of the fiscal year.

Germany: An organisation must distribute at least 90 per cent of the net income of the year, calculated under German Generally Accepted Accounting Principles (GAAP), in order to retain its REIT status.

France: At least 85% of the SIIC's rental income must be distributed annually before the end of the following financial year. At least 50% of the SIIC's capital gains must be distributed within two years. One hundred percent of dividends from SIIC subsidiaries must be redistributed by the SIIC within a year.

### 1.3 Investment Requirements:

United States: At comprised least seventy-five percent of the value of a REIT's assets must be represented by real estate assets, cash & cash items and government securities. In addition, not more than twenty-five percent of a REIT's total assets may be comprised of securities, not more than five percent may be the securities of a single issuer, and the REIT cannot own more than ten percent of the outstanding voting securities of a single non-REIT issuer.

Philippines: A REIT must not undertake property development activities on its own or joint venture with others or by investing in unlisted property development companies unless it intends to hold the developed property on completion. REIT may not invest more than 15% of its investible funds in one issuer's security except with respect to govt securities in which the limit is 25%. REIT may invest in foreign assets subject to the terms of articles of incorporation.

Germany: The REIT Stock Corporation is not permitted to trade with its real estate.

France: The main corporate purpose must be the acquisition or construction of buildings for rental purposes and/or the direct or indirect holding of shares in companies having the same corporate purpose. Assets pertaining to ancillary activities (e.g., real property trading) are not eligible for the SIIC regime and must not exceed 20% of the SIIC's total assets. There is a 50% maximum limit on assets leased under finance lease arrangements.

### 1.4 Income Requirement

United States: A REIT must satisfy three different income tests. These tests are complicated, mechanical tests intended to limit the investments of a REIT to real estate sector and certain other types of passive investments.

Philippines: At least 75% of the income must be derived from the investments in assets in income generating Real Estate.

Germany: At least 75 per cent of the assets must be real estate; at least 75 per cent of the gross earnings must derive from that real estate.

France: SIIC regime has defined strict norms for the income tests which are to be complied with by each entity in order to retain its REIT status and enjoy the tax benefits. The income must be derived only from the investments made in real estate assets.

### 3.0 Comparative Study of REITs Structure & Legislations

This section of the study focuses on the organizational structure, taxability and other legal aspects of the REITs for the sample countries covered in the study.

Regulations	France	Germany	Philippines	USA
Operational Rules	They must be listed companies on a regulated stock exchange market that meets the requirements of the European Union (EU) Directive	REITs must be organised in the legal form of a stock corporation and have its registered seat and place of management in Germany	A REIT must be a stock corporation established in accordance with the Corporation Code of Philippines	A REIT must have at least hundred shareholders. Five or fewer "individual" shareholders cannot hold more than 50% of the value of the REIT
Capital Requirement	€15 million	€15 million	300 million pesos	No Minimum Capital Required
Legal Structure	Corporation	Corporation	Corporation	Corporation
Management Structure	N/A	N/A	External	Internal or External
Listing on Exchange	Must be Listed on Stock Exchange	Required to be listed	Required to be Listed	Not Mandatory
Investment in Real Estate	Principal activity must be passive real estate investment (Olivier Mesmin & Christine Deric, report of EPRA "Global REIT Survey - France" year 2010)	At least 75% of assets (Tim Hackemann, report of EPRA "Global REIT Survey - Germany" year 2010)	At least 75% in income generating Real Estate (Global REIT Report - Asia Pacific by Wirat Sirikajornkij, year 2011)	At least 75% of assets (Tony Edwards, Global REIT Report - Americas, year 2011)
Development Activities	Development permitted to the extent of 20% gross assets	Not Allowed	Not Allowed	Development for third parties not allowed.
Leverage	Thin Capitalization Rules	Maximum 66.25% of assets	Maximum 35% but in case of Investment Graded rated REIT, limit is up to 70%	No statutory limit

Distribution Rules	At least 85% of rental should be distributed	At least 90% of taxable income	Minimum 90% of net income	Minimum 90% of taxable income
Taxation at REIT Level	Tax Exempted	Tax Exempted	Subject to income tax on its net income after distribution of dividends	Corporate Income tax on retained income
Taxation at Investor Level	Dividend & Capital Gained taxed at normal rates. No withholding tax	Subject to Dividend Distribution tax	Generally taxed except domestic corporations, resident foreign companies, & overseas Filipinos	35% on capital gains & ordinary income distribution

**4.0 Conclusion**

REITs have been a popular form of investment vehicle in the developed markets and have shown rapid growth in the last decade. The study also represents that the countries that have launched REITs in the markets during the last decade came up with more stringent rules in respect of listing requirements, investment restrictions, leverage & development restrictions like Philippines & France as discussed above. Even though REITs provides several advantages over other assets classes, they need to be carefully evaluated by the countries in respect of their applicability, need, economic & social scenario before launch in their capital markets so that REITs get a proper platform and prove to be better investment option for the each party related to REITs. As discussed by the International Organization of Securities Commission (IOSCO), in order to become an efficient tool for financing, REITs have to ensure that they comply with the governance of Collective Investment Schemes (CIS), and also ensure that they are organized and operated in the interests of REIT investors and not for the interests of REIT insiders, such as managers and sponsors.

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