

# REIT Subsidiaries

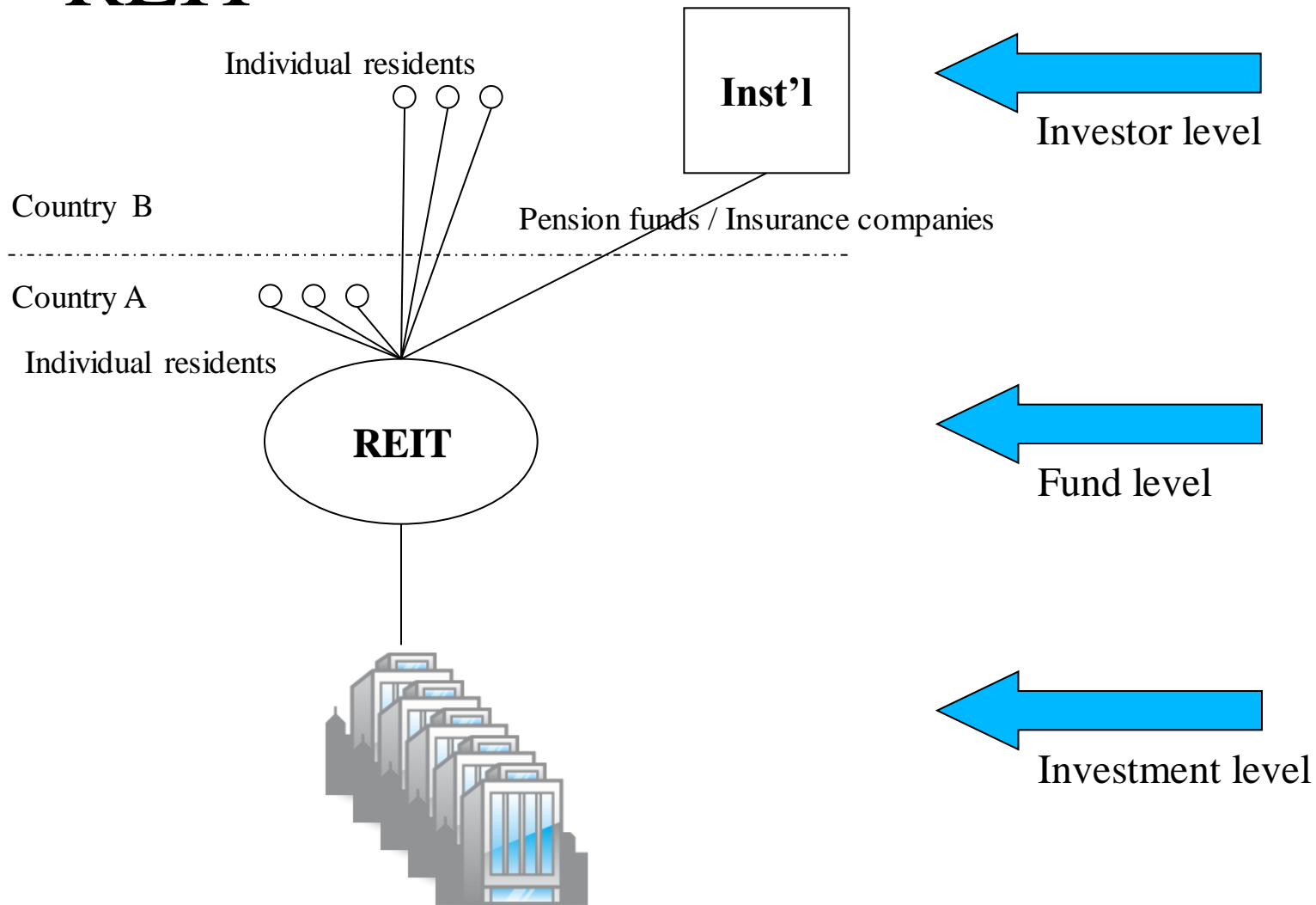
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Hein Vermeulen  
*Amsterdam Centre for Tax Law - PwC*

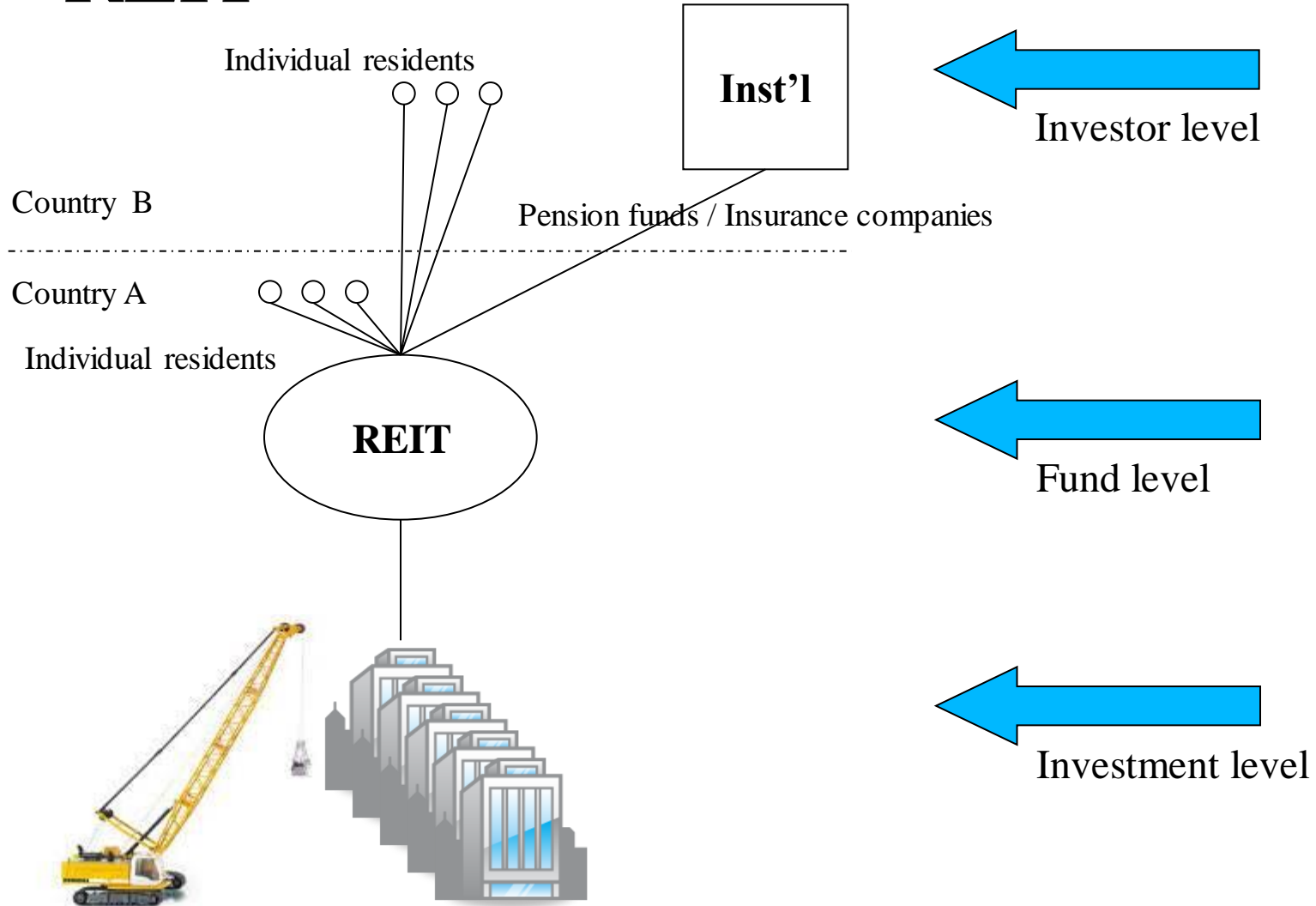
# Agenda

- REIT's activities
- Investment activities
  - Good v. bad activities
- Possible solutions
  - Safe harbour rule
  - Ring-fencing, i.e. through Taxable REIT subsidiary
  - Stapling
- REIT subsidiaries
  - US REIT TRS
  - G-REIT TRS
  - Dutch REIT TRS
- Comparative overview
- Conclusions

# REIT



# REIT



# REIT Subsidiaries

- REIT subsidiaries  $\neq$  ‘investment level’
- REIT subsidiaries = ‘fund level’
  
- Entity level taxation is eliminated
  - At fund level
  - Based on principle of tax neutrality
    - Investors who *invest* collectively may not be placed in a worse tax position than that which they would be in had these investors *invested* directly, i.e. without a REIT
  
- Problem: what is investment?

# REIT Subsidiaries

- Problem: what is investment?
  - As opposed to a trade or business
- There is no consensus of what constitutes investment and what not
- Views differs internationally
  - U.S.: Income and Asset Tests ('objective')
    - What constitutes real estate?
  - NL: Activity Test ('subjective')
    - What is still investment?
  - Australia
    - Development for sale  $\neq$  investment
  - Singapore
    - Development for holding = investment
  - U.K.: HMRC's Badges of Trade

# HMRC's badges of trade

1. Profit-seeking motive
  2. The number of transactions
  3. The nature of the asset
  4. Existence of similar trading transactions or interests
  5. Changes to the asset
  6. The way the sale was carried out
  7. The source of finance
  8. Interval of time between purchase and sale
  9. Method of acquisition
- “These ‘badges’ will not be present in every case and of those that are, some may point one way and some the other. The presence or absence of a particular badge is unlikely, by itself, to provide a conclusive answer to the question of whether or not there is a trade. The weight to be attached to each badge will depend on the precise circumstances.”

# Real estate investment

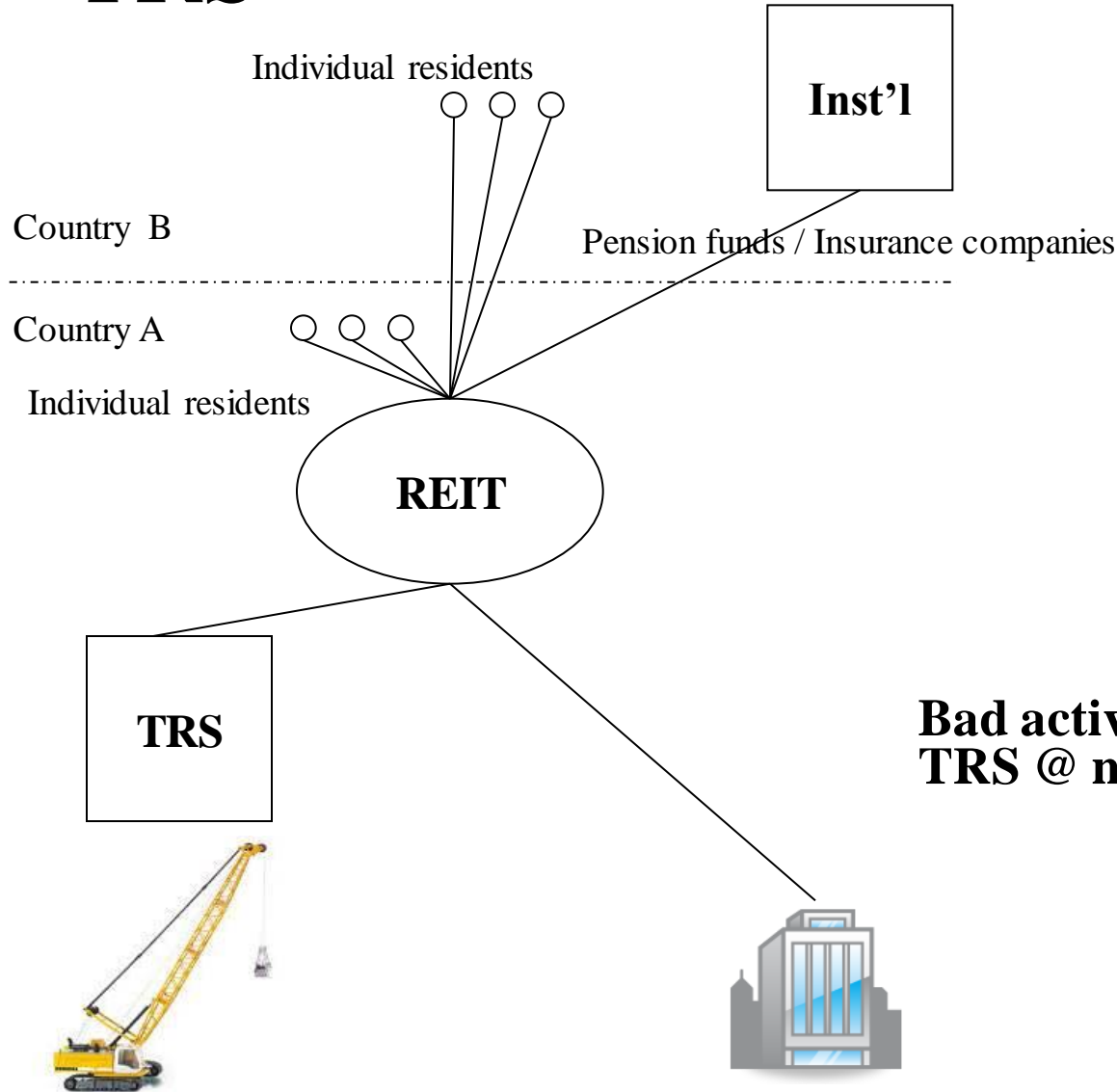
- Conclusion: views differ
- Real estate is a special investment class
  - If you do nothing → value drops
    - Maintenance is required
  - If building is empty → value drops
    - Conversion / diversion
  - Central governments have ‘green agenda’
    - Investment in solar panels, Underground Thermal Energy Storage (UTES), and so forth
  - Internet shopping
    - Challenges for shopping area’s
    - Local governments tackle decay by teaming up with owners



# Possible solutions

- Safe harbour rule
  - REIT should limit ‘bad’ activities to a certain percentage
    - Threshold, *e.g.* at least 90% passive, than all income exempt
- Ring-fencing ‘bad’ activities through
  - Objective exemption for non-investment at REIT level
    - Anything that is passive is exempt:
      - Box for active income @ normal rate
      - Box for passive income @ preferential rate
        - *e.g.* U.S. dealer income
  - Taxable REIT Subsidiary
    - Spin off ‘bad’ activities to Sub that is taxed @ normal rate  
TRS = Taxable REIT Subsidiary
    - The Netherlands already from 1947 to 1969
- Stapled stock (Australia, Singapore)

# TRS



**Bad activities are performed in TRS @ normal rate**

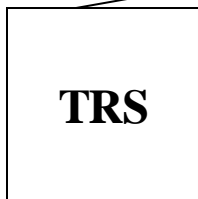
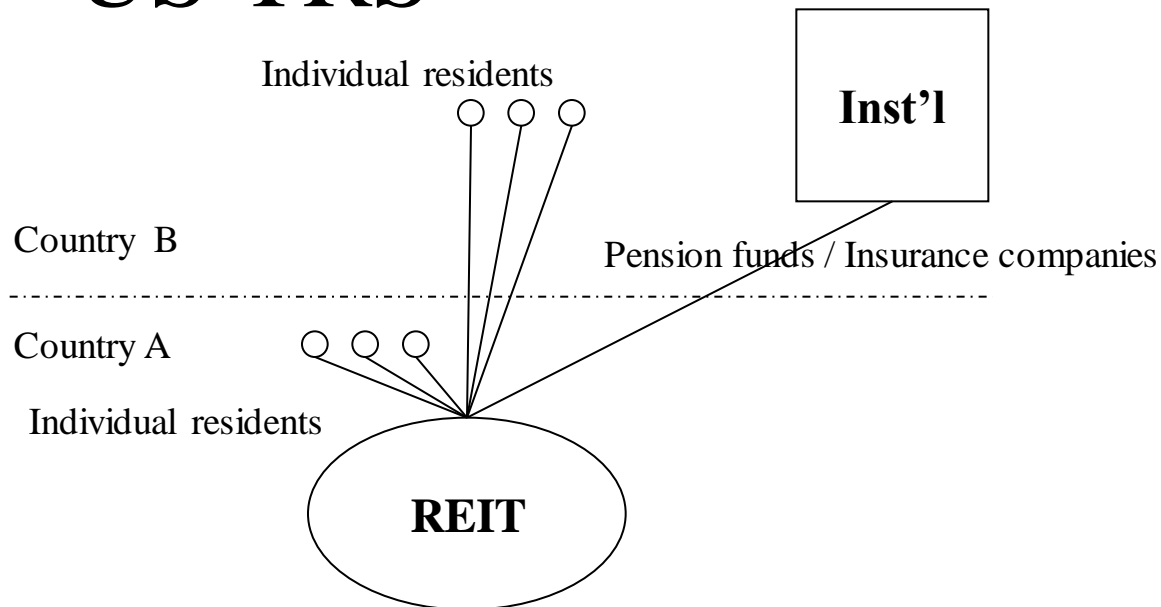
# Taxable REIT Subsidiaries - U.S.

- One size fits all TRS
- The purpose of the income and asset requirements was to restrict REITs to “passive” investments in
  - Real estate
  - Mortgages secured by real estate
  - Government securities, such as US Treasury Bills
- Bad income is normally taxed
  - *E.g.* dealer income

# Taxable REIT Subsidiaries - U.S.

- Originally, ‘customary’ services income from tenants  $\neq$  rent
  - *I.e.* does not meet income test
  - Originally, this was relaxed at REIT-level
  - Since 1999: TRS
    - Can provide any service to tenants
    - Therefore, one size fits all TRS
    - However, 25% asset test at REIT-level for TRSs
  
- In the meantime, ‘customary’ services income from tenants = rent
  - So now at REIT-level

# US TRS



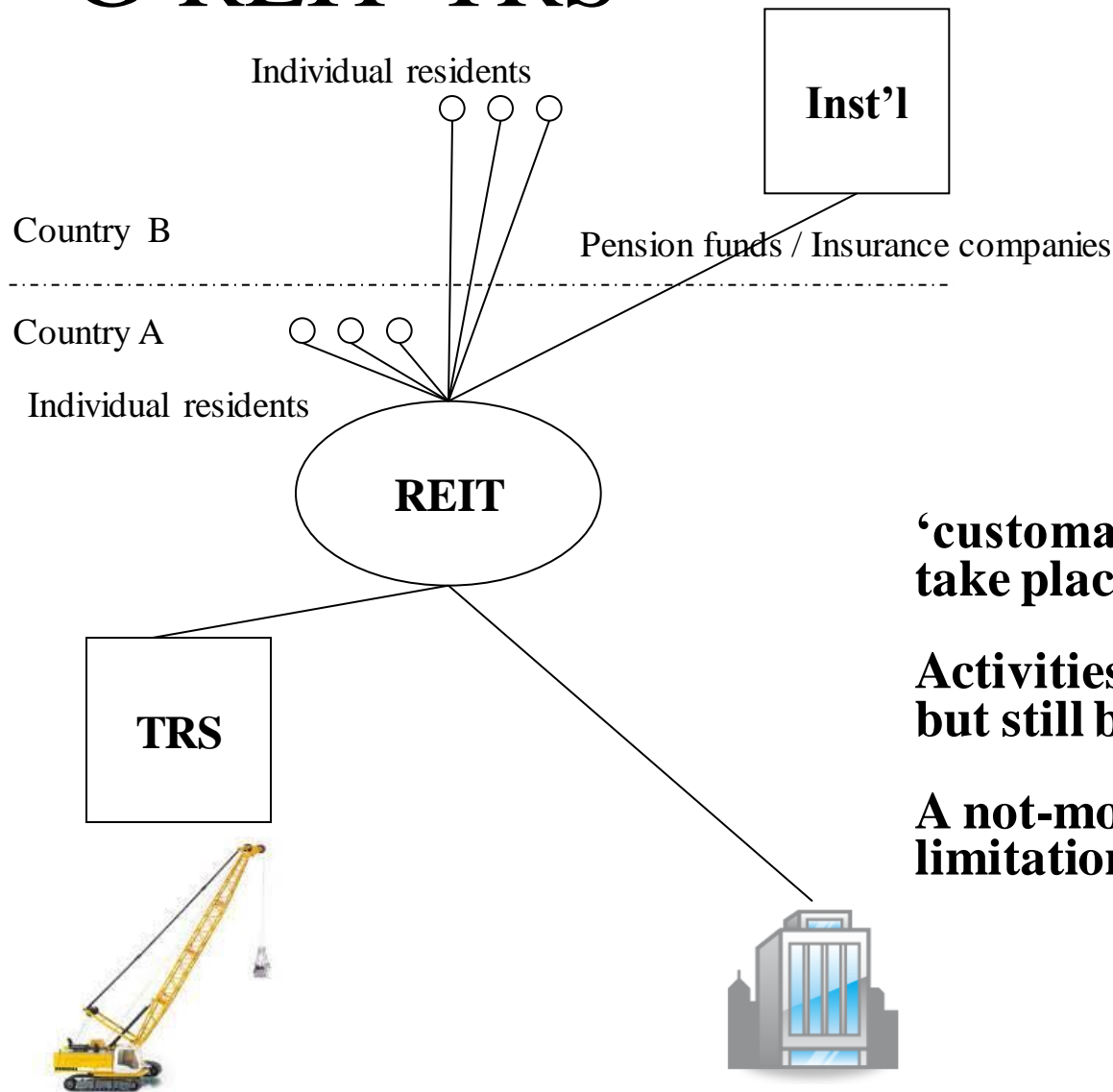
**Activities of US TRS not limited**

**A not-more than-25%-of assets limitation applies**

# Taxable REIT Subsidiaries - Germany

- Trading is not allowed
  - An objective test is used to determine this
- Activities that serve the principal activity, letting of *self held real estate* is allowed
  - Management
  - Maintenance
  - Refurbishment
- Such activities rendered to *third parties* must be performed in a Taxable Service Company
  - *G-REIT Dienstleistungsgesellschaft*
    - *E.g. facility management, project control, development control, brokerage*
  - Therefore, not one size fits all TRS
  - A 20% asset test at REIT-level for this TRS

# G-REIT TRS



**‘customary’ services for own real estate take place at REIT-level**

**Activities of G-REIT TRS limited, but still broad**

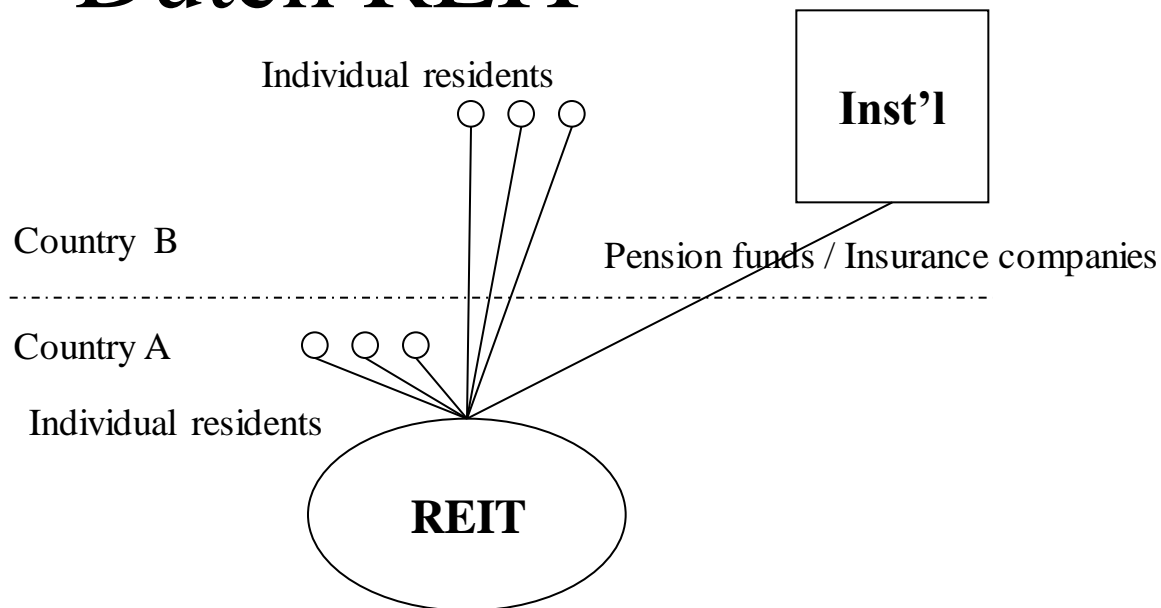
**A not-more than-20%-of assets limitation applies**

# Taxable REIT Subsidiaries - NL

- The Netherlands had to overcome the “ban on management”
- A CIV may not own and manage a subsidiary that engages in business or trade
  - It would indirectly engage in a business or trade
- A CIV may own and manage a subsidiary that engages in investment activities without restriction
  - It does not indirectly engage in a business or trade
- Bad income jeopardizes REIT status
  - In theory, one bad asset can ruin REIT status
  - Compare U.S.: dealer income normally taxed!



# Dutch REIT



Pension funds / Insurance companies

Country B

Country A

Individual residents

Individual residents

**Inst'l**

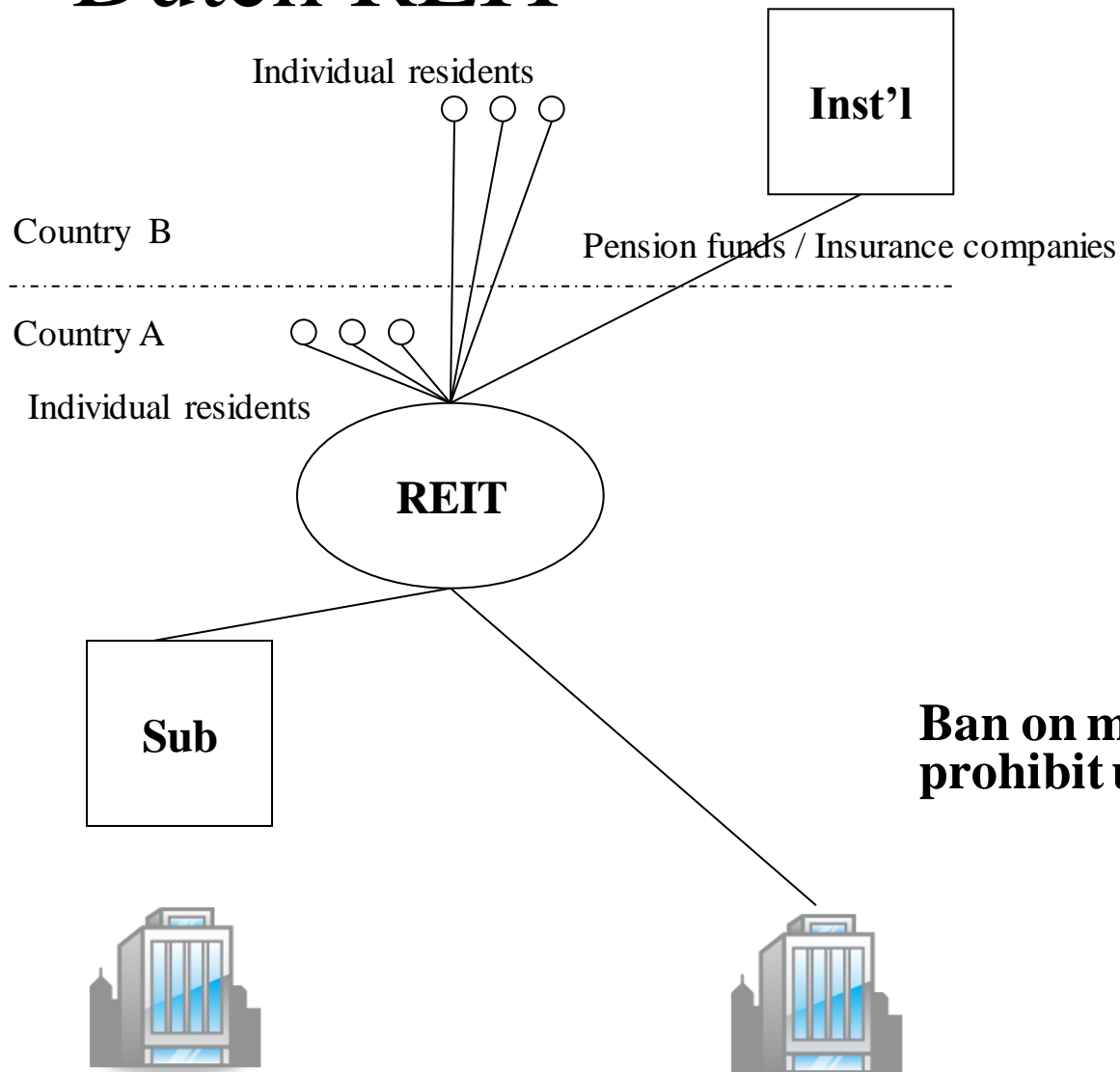
**REIT**

**Sub**

**Ban on management prohibits use of an active Sub**



# Dutch REIT

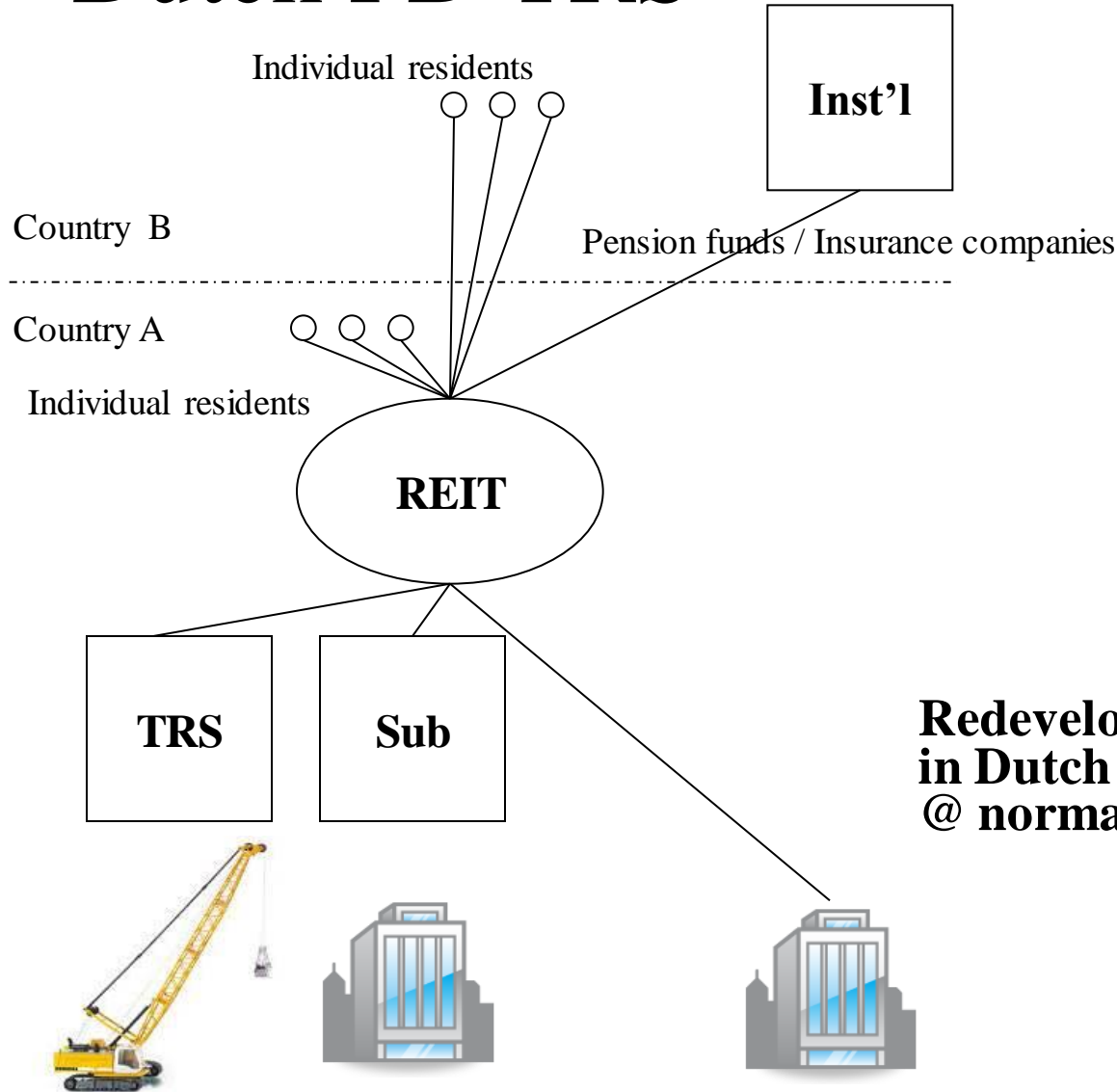


**Ban on management does not prohibit use of a passive Sub**

# Taxable REIT Subsidiaries - NL

- ‘Project Development’ TRS
  - Following legislation that combines intensity of the redevelopment activity with holding period
    - “Vetoed” by Dutch Council of the State
  
- 2007 TRS Law: REIT may own and manage (*Cf.* “ban on management”)
  - TRS that engages in
  - Investment activities
  - Redevelopment activities for
  - Affiliated entities (parent REIT, REIT subs)
  - PD TRS is taxed @ normal rate

# Dutch PD TRS

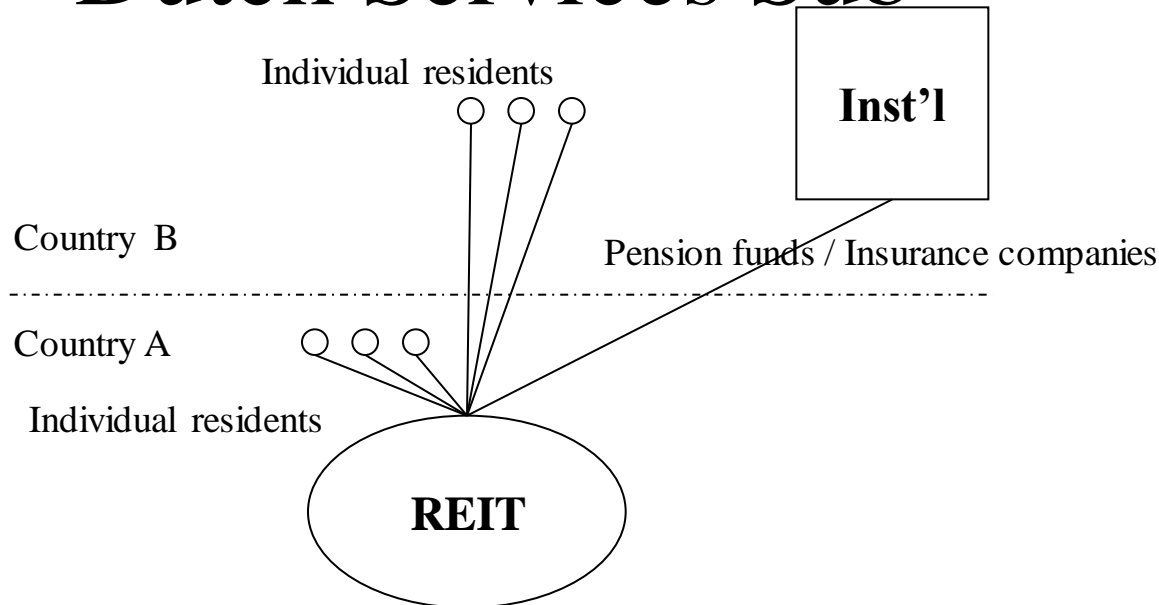


**Redevelopment activities are performed in Dutch Project Development TRS @ normal rate, but only within 'group'**

# Taxable REIT Subsidiaries - NL

- Another TRS for ‘ancillary activities’
  - 2014 TRS Law: a REIT may own and manage (Cf. “ban on management”)
    - TRS that engages in
    - Investment activities
    - Services that are secondary to the investment in real estate owned by
    - Affiliated entities (parent REIT, REIT subs)
    - TRS is taxed @ normal rate
  
- TRS for ‘ancillary activities’
  - Ban on debt
    - Means that TRS will not invest itself in real estate
  - Turnover test: 25% of real estate income
  - Value test: 15% of value of Dutch REIT
- No TRS available for other activities

# Dutch Services Sub



**Dutch Services Sub can perform 'customary' services within 'group'**

**Dutch Services Sub cannot deduct interest expense due to ban on debt**

**A not-more than-15%-of assets limitation applies**



# Development activities

- Comparative analysis
  - Where are development activities performed?

Country	REIT		TRS
France	√		
Germany			√
Netherlands			√
U.K.	√		
U.S.			√

# Ancillary activities

- Comparative analysis
  - Where are ancillary activities performed?

Country	REIT		TRS
France	√		
Germany	√		√
Netherlands			√
U.K.	√		
U.S.	√		



# Conclusions

- Use of Taxable REIT Subsidiaries is getting more common
  - Offers a good solution for the quest for the answer to the question what constitutes investment and what not
  - Ring-fencing of a problem
    - Circumvent breach of principle of tax neutrality
    - Circumvent loss of REIT status
- Challenges for governments
  - Arbitrage between taxable and non-taxable spheres
    - No interest deduction at TRS-level
    - Regulate activities of TRS
- Challenges for REITs
  - Transfer Pricing
    - But every taxpayer has to deal with TP