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Policy implications of structural options in the development of real estate investment trusts in Europe

Lessons from the American experience

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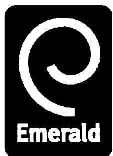
Abstract *This is a policy paper that examines the most important issues that must be addressed in designing the institutional structure for tax-advantaged public real estate companies in Europe. The real estate investment trust form of corporate structure was first created in the USA in 1960. In Europe, the real estate invstment trust (REIT) regime has been authorized only in The Netherlands, and very recently in Belgium. However, the establishment of REIT-like public investment vehicles is under discussion in the UK, and in several Continental European nations. Advocates of European REITs believe that these investment vehicles would reduce costs of capital, improve liquidity in local real estate markets, and promote more efficient allocation of capital. European countries that are moving toward the establishment of REITs face a series of important decisions regarding the features of the institutional environment in which these firms will operate. This paper summarizes the most important decisions that must be made, and considers the policy implications of each. We conclude that the US model should not be adopted uncritically in Europe; instead, structural options should be considered carefully. Problems of international taxation are identified, and the possible development of a pan-European REIT structure is discussed.*

Introduction

Real estate investment trusts (REITs, pronounced "REETs") are a special form of corporation created by the US Congress in 1960 to encourage liquidity and to improve efficiency of capital allocation in the real estate sector. Similar to European unit trusts and US closed-end mutual funds, but different from European listed property companies, REITs are not required to pay taxes on net income, as long as it is distributed to shareholders, where of course it is taxed at the shareholder level. Thus REITs allow individuals and institutions to make equity investments in real estate without incurring the high



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transaction costs related to direct investment, while at the same time avoiding the burden of double taxation. The tax advantage comes at a considerable cost to REITs, since it requires the acceptance of a restrictive institutional structure designed to limit unfair competition with taxable corporations.

To date, REIT-like public property companies have been authorized in only two European countries: Belgium and The Netherlands. But in recent months, the idea of creating similar investment vehicles has been seriously discussed in many other European countries. The primary motivations for these discussions vary, but all relate to the central issues of market liquidity and the efficient distribution of capital. In countries such as Germany, Finland and Sweden, REITs have been considered as an appropriate vehicle for privatising the ownership of the large quantities of rental housing that are in the hands of government and government-related non-real estate corporations. In the UK advocates advance the view that UK REITs are essential to provide the liquidity and market depth needed to allow UK property firms to stem the outward flow of UK real estate into the hands of direct foreign investors. Liz Hamson of *Property Week* summarizes the situation this way:

> UK property company culture comes under fire for failing to respond to the shift towards a more client-driven international market, losing ground to active management US companies in particular. Securitisation is seen as a potential life-line for the . . . sector (Hamson, 2001).

Policy makers in European countries that are creating tax-advantaged real estate companies face a series of decisions regarding the institutional restrictions that will be placed on these firms in order to prevent abuses of the tax privileges, and to minimize "unfair" competition with taxable firms. In the US, we have seen that REITs can be very effective in increasing real estate market liquidity and promoting more flexible allocation of capital. At the same time, these companies are associated with a variety of operational problems caused by the special restrictions imposed upon them. The purpose of this paper is to clarify the structure of US REITs, and to suggest guidelines for European policy-makers to follow as they consider the central issues related to the formation of REITs, including the question of whether or not they should be allowed to exist at all.

What are US REITs?

Three key elements are of essential importance in the structure of REITs are:

(1) Their assets and revenues are closely restricted to real estate, plus a limited portfolio of securities.

(2) Although they are usually public companies, they can avoid paying corporate taxes, so that their owners are not subject to the double taxation normally associated with public corporations.

(3) They are required to distribute essentially all of their accounting earnings, so that they become taxable at the investor level.

Regarding the first element, a US REIT must derive at least 75 percent of its gross income from real estate, and at least 90 percent of its gross income from the combination of real estate and its securities portfolio. Further limitations are imposed upon the securities portfolio itself. The REIT may not hold more than 10 percent of the outstanding voting securities of any one issuer, and no more than 5 percent of its total assets may consist of the securities of any one issuer, unless that issuer is another REIT.

Important additional restrictions are imposed even when income is derived from real estate. To restrict the REIT's ability to compete with developers and brokers by building or acquiring properties for sale, and at the same time to prevent the REIT from engaging heavily in securities trading, the tax rules specify that the REIT may not obtain more than 30 percent of its income from the sum total of securities held less than one year, and property held less than four years.

Regarding the matter of corporate taxation, US REITs are able to avoid corporate taxes because they are authorized to claim an income tax deduction for dividends paid. First, taxable income is computed in the usual manner using generally-accepted accounting principles (GAAP earnings). Dividends paid to shareholders are then deducted from taxable earnings, up to a maximum of 100 percent. There are no carry-forwards of dividends paid in excess of earnings.

Regarding the matter of income distribution, to assure that personal income taxes are assessed at the investor level, the tax rules require REITs to pay out at least 90 percent of earnings. In order to achieve the full deduction, however, most REITs pay out at least 100 percent of GAAP earnings. REITs usually elect to pay out more than 100 percent of accounting earnings, obtaining the extra money from cash flow that is excluded from earnings because of the depreciation tax shelter.

In addition to these three essential elements, which are fundamental to the definition of all REITs, US REITs are subject to a prolix set of restrictions on their structure, their financing, and their operations, that are established to reduce unfair competition with taxable entities. In general, these restrictions protect competitors by reducing the flexibility of REITs, and have the undesirable effect of impeding REIT efficiency. These restrictions have changed over time in response to business experience, and will be discussed in some detail later.

Classifications of US REITs

As is the case with standard corporations, REITs may be public firms, or they may be privately held. However, most REITs are public, and in fact the majority of them are listed on the New York Stock Exchange. Therefore US REIT shares are sold to investors world-wide in efficient markets, and are highly liquid.

The most fundamental distinction for US REITs is that between equity REITs, and mortgage REITs. Mortgage REITs specialize in originating and/or

holding mortgages, while equity REITs invest directly in properties. In the early 1970s, mortgage REITs outnumbered equity REITs by a three-to-one ratio in the membership of the National Association of Real Estate Investment Trusts (NAREIT). Currently, however, there are about 150 equity REIT members in the NAREIT, and only nine mortgage REIT members. To a large extent, mortgage REITs were displaced by the dramatic development of the market for commercial mortgage-backed securities in the US during the 1990s (Harding and Sirmans, 1997). The focus of our paper is on equity REITs.

Equity REITs are further categorized by the property type in which the REIT invests. Property-type specializations are normally classified as follows: apartment, office, industrial, retail, health care, and hotel. All of these categories are well represented among public REITs.

Motivations for establishing US REITs

When the US Congress first authorized REITs in 1960, two parallel objectives were identified. The first objective was to provide smaller investors a more realistic opportunity to participate in the real estate market. The large initial investment required, the need for managerial expertise, high transaction costs, and market illiquidity, all operate to discourage small investors from receiving the benefits of income property ownership through direct investment. REITs give small investors the opportunity to overcome all of these objections by allowing them to purchase real estate through a capital market intermediary. The literature establishes that real estate diversification is valuable. Recent studies show that balanced investment portfolios must include real estate in order to achieve full portfolio benefits (Liu and Mei, 1992).

The second objective for REITs was to provide greater liquidity to real estate markets by giving real estate owners and developers access to public markets without subjecting their investors to double taxation.

REITs and the European situation

The two primary objectives that motivated the development of REITs in the USA also apply to the European situation today. First, REITs would make the portfolio advantages of real property investment available to small investors without imposing on them the unreasonably high transaction costs associated with direct property ownership. By giving investors the opportunity to purchase equity interests in real estate in liquid public markets with small minimum capital requirements, while avoiding the burden of double taxation, governments can enhance the value of pension funds and other investment portfolios, without forcing investors to purchase shares in companies outside Europe.

Second, the authorization of REITs may reduce costs of capital for local real estate firms, enhancing their ability to compete, and encouraging a more efficient allocation of capital. Most European real estate is held privately, and therefore is dependent on private sources of capital. The development of REITs can encourage the formation of more public property companies that are

funded largely through capital markets, and therefore have an alternative source of capital available to them. The value of public sources of funding is particularly great during times of intense credit rationing from private institutions, and can have the effect of stabilizing property prices and costs of capital during times of market stress.

Another advantage to authorizing the REIT structure in some European countries is to provide a vehicle for privatising the ownership of real estate currently in the hands of government. Without REITs, European governments deciding to transfer large amounts of real estate into private hands may do so by writing a series of separately-negotiated contracts, each one of which may be subject to public scrutiny, and potential criticism with regard to pricing, structure, and enforcement of contract terms. The creation of publicly-traded REITs may reduce transaction costs and political risks as well. By establishing new publicly-traded REITs, the government can effectively transfer large amounts of publicly-owned housing, industrial or commercial property into the hands of private buyers, at prices determined by the operation of a free market. Using the REIT structure, the government would obtain better prices than they would otherwise obtain in public markets, since the REIT structure protects the purchasing investors from the costs of double taxation.

Europeans have an additional motivation for creating REITs in the current environment that did not exist in the US when REITs were first authorized there. Today, European countries need to respond not only to the internal advantages of REITs, but also to the fact that foreign REITs exist, and in most European countries are permitted to compete with local firms. Foreign REITs that are able to enjoy lower costs of capital because of their tax advantage pose a clear and present threat to local firms in countries where REITs are not authorized. US REITs have become increasingly interested in investment in Europe (Smith, 1998). The authorization of REIT-like corporate structures in The Netherlands and very recently in Belgium increase the threat that the existence of the REIT structure in foreign countries might reduce local ownership and control over the domestic real estate stock.

US equity REIT performance

Although equity REITs have existed in the US for more than 40 years, until ten years ago their success was modest and uneven. History suggests that US REITs do not perform well when financial and operational flexibility are especially important, as may often be the case during business contractions. The payout requirement makes it more difficult for REITs to respond to liquidity problems, and limits their ability to generate internal capital to finance growth opportunities. The close link between dividend payouts and operating cash flows, combined with the narrow limitations placed on their sources of revenues, make REITs particularly vulnerable to real estate market volatility related to changes in rents, vacancy rates or operating expenses. Because REITs attract a dividend-oriented investor clientele, small declines in earnings produce relatively large changes in firm value.

In 1971, 11 years after REITs were created, there existed only 12 equity REITs, with an average equity capitalization of less than $28 million each. Their numbers grew quickly to 20 in 1973, but in the ensuing economic recession 40 percent of all equity REITs liquidated or "de-REITed", reducing their numbers to 12 again by 1975, with an even lower average equity capitalization of $23 million. Another cycle of growth and decline followed. One third of the equity REITs that existed in 1981 perished in the period of economic stagnation and high inflation that followed. A total of 25 REITs with a total market capitalization of about $1.8 billion (NAREIT, n.d.) remained in existence in 1985 to enjoy the boom years of the late 1980s. The history of equity REIT market capitalization in the USA is presented in Table I.

Despite its troubled history, in the 1990s the equity REIT industry proved the value of its ability to provide liquidity to the real estate market during times of institutional credit rationing. Concerned about growing federal deficits in the 1980s, the US passed tax reforms in 1986 that eliminated almost entirely the generous tax advantages that had been given to real estate limited partnerships (RELPs), a very popular vehicle for real estate investment. The tax changes not only caused an immediate decline in the value of the RELPs, but also contributed to a sharp decline in property values generally. These problems were compounded by a general recession in the early 1990s, and by a bank crisis characterized by a wave of defaults in commercial real estate mortgages.

Because of these events, the early 1990s was a time of severe mortgage credit rationing in the USA. REITs were the heroes that played a key role in turning things around. Existing REITs expanded rapidly, and new REITs were formed in order to purchase distressed real estate at bargain prices. In the 1980s, REIT seasoned and initial public equity offerings averaged less than $2 billion a year, but in 1997 alone the total was more than $32 billion (NAREIT, n.d.). As a consequence, real estate prices found a floor, and started to increase. Later, after confidence was restored, institutional lenders returned to the market. Observers hailed the REIT revival as a classic example of free capital markets operating to solve problems caused by an injured private institutional structure. As a result of these events, the number of equity REITs reached 167 by the end of the decade, with a total equity capitalization of more than $118 billion. Equity REIT market capitalization had increased 65-fold in 15 years.

To REIT or not to REIT: the central tension

The first and most important decision that European policy-makers must make with regard to REITs is that of whether or not they want them at all. To date, The Netherlands and Belgium have authorized corporate structures similar to US REITs, but no other European country appears to be close to following suit.

One of the reasons for European reluctance to embrace the REIT structure may be that the extraordinary economic conditions that led to the rapid expansion of REITs in the USA has no parallel in the recent past in Europe. As a result, European policy-makers are understandably hesitant to embrace the

Table I.
Equity market capitalization outstanding of US equity REITS 1971-2001

End of year	Number of REITs	Market capitalization (US$ million at year end)
1971	12	332.0
1972	17	377.3
1973	20	336.0
1974	19	241.9
1975	12	275.7
1976	27	409.6
1977	32	538.1
1978	33	575.7
1979	32	743.6
1980	35	942.2
1981	36	977.5
1982	30	1,071.4
1983	26	1,468.6
1984	25	1,794.5
1985	37	3,270.3
1986	45	4,336.1
1987	53	4,758.5
1988	56	6,141.7
1989	56	6,769.6
1990	58	5,551.6
1991	86	8,785.5
1992	89	11,171.1
1993	135	26,081.9
1994	175	38,812.0
1995	178	49,913.0
1996	166	78,302.0
1997	176	127,825.3
1998	173	126,904.5
1999	167	118,232.7
2000	158	134,431.0
2001	151	147,092.1

Note: Market capitalization equals price of shares multiplied by the number of shares outstanding

Source: National Association of Real Estate Investment Trusts (NAREIT) (www.nareit.com)

concept of a new, tax-advantaged entity, and careful to consider both the advantages and disadvantages of the REIT structure.

We characterize the fundamental argument in the following way. When tax-advantaged REITs are created, investor dollars are attracted to them, and hence liquidity is provided to real estate markets. At the same time, institutional restrictions must be placed upon REITs to limit the competitive advantage over taxable firms. When the restrictions are great, taxable competitors are protected better, but more risks and operating inefficiencies are

imposed on the REITs, reducing or even possibly eliminating the value of the tax advantage. When restrictions are lifted, the tax benefit becomes more valuable, but growth in the REIT sector may be derived primarily from the comparative disadvantage imposed upon the competing taxable sector.

The advantages and disadvantages of adopting the REIT structure, as we see them, are summarized below.

(1) *Potential advantages*:

- Greater liquidity in domestic real estate markets, leading to more efficient allocation of capital.
- Greater price stability in local real estate markets, since REITs have access to alternative sources of financing during times of institutional credit rationing.
- Opportunities for pension funds and other investors to achieve portfolio diversification benefits from real estate, without accepting the burden of double taxation, or paying large transactions costs associated with direct property ownership.
- Availability of a potentially useful vehicle for privatising the ownership of government property.
- Enhanced ability of domestic firms to compete with tax-advantaged foreign real estate companies for control of local real estate.

(2) *Potential disadvantages*:

- Reduced revenues from corporate taxes, resulting in reallocation of tax burden to other firms, or to individuals.
- Taxable firms may find it difficult to compete with REITs because of their tax advantage, even though the taxable firms may have more operational flexibility.
- Reduced efficiency in the real estate business, since institutional limitations placed on REITs reduce their ability to adjust to market conditions.

On the positive side, REITs encourage liquidity and efficient capital allocation in the real estate sector, enhance diversification advantages for investors, and help to protect local ownership of property in the authorizing country. On the other hand, the REIT structure forces a reallocation of the tax burden, may damage the performance of taxable firms, and may give rise to a class of tax-supported firms that do not operate efficiently in other ways because of the institutional restrictions placed upon them.

It is very difficult or perhaps even impossible to develop empirical tests of whether or not the benefits from REITs exceed their costs. The resulting ambiguity is probably weighted in favor of the REITs, because their benefits are much more visible and measurable than their costs. For example, it is relatively easy to observe the growth of the REIT industry in the USA, and to

appreciate its effectiveness in supporting real estate prices at the bottom of a recession, but it is much more difficult to measure the price that might have been paid in terms of lost opportunities in the private sector, or lower revenues among real estate operating companies.

It is probably fair to say that despite the existence of credible arguments against REITs, the arguments in their favor remain strong, and we are likely to see more countries adopting REIT-like structures in Europe. In this context, it is important for policy-makers to draw fully on the US experience, in order to receive the promised benefits of REITs while minimizing the downside risks.

The policy decisions that we believe to be the most important ones are summarized in Table II. The primary advantages and disadvantages of implementing each choice are identified. These issues are discussed in detail in the following sections.

Cross-border taxation of European REITs

Perhaps the first policy decision that must be made when European countries authorize domestic REITs is whether or not REITs will be permitted to invest in other European countries. If cross-border investment is permitted, it means that the tax benefit to the domestic REIT is supporting the exportation of capital. On the other hand, if cross-border investment is not permitted, then domestic REITs will lose important benefits from diversification and investment flexibility.

US REITs are permitted to make foreign investments without restriction, but to date most have not. The situation in Europe is different because European real estate companies have a tradition of investing internationally, believing that international investment is essential for maximum efficiency (Eichholz, 1997).

As soon as a REIT invests in a foreign country, a tax problem arises. If the REIT owns and operates the foreign real estate, the foreign tax authority will classify the REIT as a foreign firm doing business in that country. Because the REIT has no favored tax status in the foreign country, it is subject to taxation upon its net current earnings, and on its capital gains (value added). Therefore, to the extent to which REITs invest across borders, they are in danger of losing their tax advantage. Foreign taxes have a greater incremental cost for REITs than they do for taxable firms, since foreign taxes paid by other firms are normally deducted from the domestic tax, providing a tax benefit that REITs are not able to receive because they pay no income taxes at home.

REITs both in The Netherlands and in Belgium are permitted to invest internationally. Managers of Belgian SICAFIs (REIT-like investment vehicles), maintain that cross-border taxation poses significant barriers to expansion (Fickes, 2001). In The Netherlands, where REIT-like Fiscale Beleggingsinstellingen (FBIs) have existed for a longer time, larger REITs have developed mechanisms for avoiding foreign taxes. For example, the FBIs can finance cross-border investments with mortgages from their own domestic subsidiaries, thus eliminating net operating profits by creating interest

Table II. Key decisions in the development of REIT structures in Europe, with primary advantages and disadvantages

Question	Benefits	Disadvantages
Allow cross-border investment?	Increases REITs ability to capture scale economies and to increase diversification	Local tax advantage encourages exportation of capital. May create unfair competition with taxable foreign firms
Should large ownership blocks greater than 10 percent be permitted?	Better monitoring may enhance value for small investors	Encourages more closely-held taxable corporations to covert to REIT status, which is not the primary goal of establishing REITs
Should institutions be permitted to hold large ownership blocks?	Large institutional blockholders may improve monitoring	Institutions may pressure REITs to increase growth rates by taking more risks
Should large earnings payouts of 90 percent-95 percent be required?	Protects investors from double taxation, and increases predictability of cash flows	Large payout requirement reduces REIT flexibility in difficult times
Should there be large barriers to de-REITing and re-REITing?	Barriers increase investor certainty, and increase protection from double taxation	Barriers limit REIT flexibility, may encourage REIT managers to make major corporate changes that might otherwise be avoided
Should REITs be permitted to manage the property of others?	Improves economics of scale and operating efficiency, and provides flexibility during difficult times	Increases potential for unfair competition with taxable REOCs
Should long-term debt be restricted?	Reduces volatility of net cash flows. Reduces liquidity risks	Providers of risky debt may be valuable monitors. Restrictions on debt limit firms' ability to seize growth opportunities during times of expansion
Should sellers of property to REITs be permitted to shelter capital gains through use of subsidiaries?	Encourages transfers of property to public sector, facilitating REIT growth	Gives rise to complex organizational structures, reducing transparency of REIT operations
Should REITs have special disclosure requirements?	Improves transparency, increasing investor confidence	Costly to firms, and may not be necessary for firms that are followed by market analysts
Should property types be restricted?	REIT structure is less suitable for some property types, such as hotels or golf courses	Cuts off flow of capital through REITs to prohibited property types

expense. While the expenses are legal deductions in the foreign country, this technique has the effect of converting taxable net income in the foreign country into tax-exempt REIT income in The Netherlands.

The use of such techniques implies that countries authorizing REITs may be able to gain a competitive advantage over domestic real estate firms in other European countries. The resulting conflict may be settled by writing international treaties on a case-by-case basis, by developing standard international policies through the European Commission (EC), or by authorizing REITs in the countries that believe they are suffering from unfair competition. In any case, the political and business implications of the international tax structure must be carefully considered as REITs continue to expand in Europe.

Issues related to the structure of European REITs

In this section we discuss the structural policy decisions that we regard as the most essential ones to the creation of REIT-like investment vehicles. We do not attempt to specify which choices are best for any particular European country. Instead, we focus on defining the issues, and clarifying the implications of each of these important decisions in the light of the US experience.

What restrictions should be placed on the concentration of REIT ownership?

Because US REITs are created in large part to provide an investment vehicle for small investors, the tax code places important restrictions on concentrations of REIT ownership. These restrictions prevent small groups of private investors from using the REIT institution as a way of avoiding corporate taxes on closely-held companies. Specifically, REITs must be owned by 100 different owners or more, and the five largest owners may not control as much as 50 percent of the firm. This second restriction, commonly called the “5-50” rule, has resulted in provisions in nearly all REIT charters that effectively limit the ownership share of any individual or non-REIT company to a maximum of 9 percent or less. These ownership restrictions have remained constant since US REITs were first formed, and in the main have been well accepted. However, some believe that the restrictions should be even tighter, to prevent small groups of six or more investors from controlling these tax-advantaged firms, while others believe that larger ownership blocks would benefit all shareholders, since the finance literature presents evidence that the monitoring activities of larger owners increase shareholder control over management (Shleifer and Vishny, 1986; Mikkelson and Ruback, 1985).

Should institutional investors be permitted to hold large ownership stakes in REITs?

Since 1992, REIT ownership blocks held by institutional investors such as mutual or retirement funds have not been subject to the “5-50” rule. In fact, institutional ownership of public REITs is not limited at all, since the tax rules maintain that the individual holders of the institution’s shares are really the

owners of the REIT, and not the institution itself. This change in the rules has greatly increased the level of institutional ownership among REITs, and also has contributed greatly to increasing their size and liquidity. Nevertheless, some observers believe that this change is not entirely for the good. They note that REITs were developed primarily to serve the interests of individual investors, not those of large institutions, which have the resources to invest in real estate directly. Moreover, some observers believe that the influence of institutional investors may become negative when their interests become too large (Glascock and Wachter, 1994), arguing that institutional investors often pressure REITs to produce earnings growth, thus encouraging too much risk-taking. On the other hand, the finance literature presents some evidence that large blockholders may also benefit firms, because it is more difficult for shareholders to form alliances to control management when ownership is highly fragmented (Shleifer and Vishny, 1997).

What portion of their annual accounting earnings should REITs be required to pay out to shareholders?

In the USA, this issue is one of the most hotly-debated ones related to REITs, but ironically its implications are probably the least significant. The finance literature clearly demonstrates that the minimum payout requirement is an effective constraint for few, if any, US REITs (Wang *et al.*, 1993; Bradley *et al.*, 1998). Currently US REITs are required to pay out at least 90 percent of net "taxable" earnings each year, but the average payout is well above 100 percent, and is related more closely to REITs' pre-depreciation cash flows than it is to their accounting earnings. REITs in The Netherlands and Belgium also have minimum payout requirements: 95 percent in The Netherlands, but only 80 percent in Belgium.

The primary argument in favor of high payout requirements is that they protect shareholders by preserving the uniform nature of the investment vehicle, which is a dividend-oriented investment with current returns that are closely related to the cash flows generated by the underlying assets. Opponents of the high payout requirement say that it restricts flexibility in difficult times, and therefore makes REIT market prices more volatile. They argue that the elimination of the payout requirement would be very easy to implement, and is fair to competitors. Because the tax deduction is achieved by subtracting dividends from taxable income, the non-payment of the dividend would automatically trigger the corporate tax.

How easy should it be to de-REIT and re-REIT again?

During difficult times, many REIT managers believe that the flexibility of the standard corporate structure is more valuable to shareholders than is the REIT tax advantage. In the USA, firms that de-REIT are prevented from using the REIT structure again for at least five years. The primary argument in favor of significant barriers to re-REITing is that they protect investors, who commit equity to the REIT with the understanding that they will not be subject to

double taxation. But some observers want to reduce the waiting period or eliminate it entirely, allowing REITs to decide at the end of each year whether or not they will claim REIT status. If this plan were implemented, the firm would be fully taxable in any year in which it failed to meet the criteria, but could reclaim REIT status at any time simply by demonstrating conformity to the requirements. Advocates of this position maintain that under the more rigid rules, REITs often merge or "go private" in order to change status, causing much greater disequilibria for investors that would exist if REITs had the option to de-REIT or re-REIT each year. They further maintain that this option would serve the interests of investors by providing more corporate flexibility during difficult times.

Should REITs be permitted to manage the properties of others?

In the USA, the level of activity permitted to REIT managers has undergone a clear evolution. When REITs were first authorized, equity REIT managers were not even permitted to operate the properties the REIT owned, but were required to engage the services of external management. In the Tax Reform Act of 1986, REITs were authorized to manage their own properties, but were not permitted to sell management services to others. The idea behind this restriction is to prevent REITs from competing unfairly with taxable real estate operating companies. Effective in 2001, US REITs are not only permitted to manage their own properties, but may also sell management services to others through taxable subsidiaries; but the size of the assets and revenues of these subsidiaries relative to the size of the REIT is severely limited to assure that the sale of management services does not become a primary activity of the REIT.

The new rule gives US REITs more operating flexibility, and diversifies their potential sources of income. At the same time, it creates a regulatory challenge for the Internal Revenue Service, which now must scrutinize the activities of these subsidiaries in an attempt to prevent inappropriate transfer of revenues out of the management subsidiary and into the tax-advantaged REIT.

From the European perspective, three possible approaches exist:

(1) *Permit REITs to manage the properties of others without losing the tax advantage*. This approach would give REITs the greatest amount of operating flexibility, but would also reduce corporate tax revenues the most, and would probably cause most real estate operating companies to convert to REITs in order to eliminate the competitive disadvantage of corporate taxation.

(2) *Prohibit external management*. This approach would protect real estate operating companies and would minimize unfair competition, but would limit operating flexibility for the REITs.

(3) Adopt the US model of permitting limited taxable subsidiaries, an approach that cuts between the other two.

Should long-term debt be restricted?

The problems that result from the inflexibility of the REIT structure during times of market contraction are made more severe when REITs are carrying large quantities of debt that they may have accumulated in the race to achieve earnings growth during times of expansion. Currently there are no debt restrictions for US REITs; but Campbell *et al.* (2001) find evidence that overleverage may be an important factor causing some REITs to merge or liquidate. Limiting REIT debt ratios to some maximum percentage of capital would level the competitive playing field, at least among REITs, and could reduce risks. Perhaps a limit in the neighborhood of 40 percent-50 percent should be considered, since that is the average debt ratio used by US REITs (NAREIT, n.d.). The idea of limiting REIT debt is not entirely novel. For example, in Belgium SICAFIs are limited to a maximum debt-to-assets ratio of 50 percent (Fickes, 2001).

Despite its potential value in reducing price volatility, the imposition of debt ceilings should be approached with caution, for two reasons. First, there are procedural problems. For example, what would be the policy toward a REIT that exceeded the limit entirely because of a decline in share value? Would that firm's value problems be compounded by regulatory pressures? Second, the literature presents evidence that suppliers of debt can be valuable corporate monitors, thus reducing agency problems and increasing efficiency, at least in some cases (Diamond, 1984).

Should private sellers of property to REITs be permitted to shelter capital gains (value added) from taxation?

As is commonly the case in Europe, most real property in the USA is in the hands of private owners or non-REIT corporations. When these owners transfer real property to a REIT, normally they are subject to a capital gain tax, whether payment is made in cash or in the common stock of the REIT. However, in the USA, the IRS has permitted REITs to form subsidiary partnerships that enable private sellers to defer capital gain taxes. By transferring property to the subsidiary in exchange for partnership shares that are convertible into shares of the REIT, private sellers are able to gain most of the advantages of REIT ownership in exchange for their properties, while deferring the capital gain. Structures of this sort probably encourage the transfer of property from private owners to public REITs, thus increasing liquidity in the property sector (Campbell *et al.*, 1998), but they also increase the complexity of REITs, reduce their transparency to potential investors (Ling and Ryngaert, 1997), and may give rise to potential agency problems (Sirmans, 1997). Transparency problems may be more troublesome in Europe than they are in the USA, and therefore the costs of introducing these complex structures may prove to be greater than their benefits.

Should European REITs be subject to special disclosure requirements?

One of the motivations for creating REITs in Europe is to develop an appropriate vehicle for individual investors to participate in the real estate

market, allowing them to benefit from property value increases in ways other than through home ownership. It is important to these investors that REITs minimize information problems, and become as transparent as possible. It is not clear that market forces alone will result in optimal levels of disclosure. To the contrary, US REITs have created complex and controversial organizational structures in many cases, including privately-held subsidiaries (Ling and Ryngaert, 1997) and large joint ventures, many of them in Europe (Campbell and White-Huckins, 2001). The degree of disclosure regarding these transactions is uneven. Potentially helpful disclosure requirements include: marking property values to market; identification of all preferred claims on cash flows (not just those for mortgages and bonds); and specified accounting standards for joint ventures (proportionate share accounting).

Should REITs be permitted to invest in all types of property?

In the USA, REITs are permitted to invest in and manage all kinds of real estate, including hotels, golf courses, and casinos. Some believe that there should be limits. Hotels are operationally-intense enterprises, in which real estate investors have traditionally held essentially passive interests, leasing out the real estate to professional hotel operators. Critics believe that self-managed hotel REITs compete unfairly with taxable rivals, arguing that the tax subsidy is their only advantage, since the REIT institutional environment reduces efficiency by limiting their scope of operation.

Property trusts and the European Union (EU): does one REIT fit all?

The importance of cross-border investment in Europe, combined with the need for more uniform accounting standards and a systematic approach to the elimination of international tax inequities, speak in favor of the development of a pan-European REIT with standards set by common agreement among European countries, with some measure of enforcement from the EC. A unified structure for REITs might also encourage investors from other continents to invest in European REITs, since it would be easier for them to understand the rules, and they could capture diversification benefits from investing in multiple European countries without sacrificing homogeneity in the definition of the investment vehicle itself.

It is probably inevitable that the EU will become involved in the administration of REITs to some degree, whether or not a uniform vehicle is developed. Tax changes in any EU country that create a comparative advantage in any particular business sector can be interpreted to be in violation of EU law, and may be directly struck down by the EC if other member nations object. These rules are intended to protect EU members from maverick nations that may attempt to achieve dominance in some industrial or service sector by offering large local tax incentives. It is probably inappropriate to consider real estate tax incentives in the same light as local incentives in the automobile or steel industries, but the tax

competition rules as they are written now leave the door open for EU intervention, and such intervention will become more likely if REITs are authorized in more European countries.

Therefore, the issue of whether or not to attempt to create a pan-European REIT is one that probably will be confronted in the near future. While the creation of a pan-European REIT has clear advantages, it also has important costs that should not be ignored. National REITs can be much more flexible. Their structures can be established in ways that address local economic conditions most effectively, and can be changed more readily in response to changes in local economic climates. Does Belgium, for example, wish for its REIT structure to be determined by a central authority in which it has very little power?

Finally, we note that if a diverse set of REIT structures emerges in Europe, a kind of competition is established that may yield important information regarding which approaches work, and which ones cause diseconomies. The US experience indicates that an ideal structure for REITs is not yet clearly established, if it exists at all. The emergence of multiple approaches in Europe might help all of us to develop structures for these vehicles that are more effective and more efficient than any of the approaches that currently exist.

Proposed framework for REIT planning in Europe

Table III presents a model for considering the manner in which different ideas for REIT structure may be evaluated in the context of a dynamic relationship with each other. Each column in Table III represents a feasible combination of policies. These policy combinations become less restrictive as we move from left to right; thus the most restrictive plan is presented in column A, and the least restrictive one in column E. Many other combinations could be formed, and the reader is invited to add other alternatives to the list.

	A	B	C	D	E
Allow large ownership blocks		×			×
Allow large institutional blocks		×		×	×
Impose high payout requirements	×	×	×		
Impose barriers to re-REITing	×	×	×		
Allow property management subsidiaries			×	×	×
Restrict long-term debt	×	×			
Permit gain shelter for sellers			×	×	×
Impose special disclosure requirements	×	×	×	×	
Restrict property types	×	×		×	

Notes: Examples of feasible policy combinations are presented in columns A-E

Table III. Instutitional structure choices for European REITs: dynamic analysis

Conclusion

This is a policy paper intended to give guidance to European lawmakers who are considering the development of structures for tax-advantaged public property companies in Europe. In their 40-year history, US REITs have shown that they can improve liquidity and the efficiency of capital distribution in the real estate sector. At the same time, the tax advantages afforded to REITs are accompanied by a restrictive institutional structure that reduces corporate flexibility and impairs performance, particularly during times of economic contraction. The challenge to policy-makers is to balance the REITs' need for flexibility against the degree of unfair competition with the taxable sector that may emerge if the tax-advantaged sector is unconstrained.

We do not advocate the simple adoption of the US model in Europe. Instead, we believe that legislators in Europe should consider the advantages and disadvantages of each important constraint that may be placed upon REITs, to tailor a structure that is optimal for them. The question of whether or not REITs should be adopted at all in some countries is regarded as a significant one that should be carefully considered, as is the question of whether or not a pan-European REIT structure should be developed.

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