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# THE REGULATION OF REAL ESTATE INVESTMENT TRUSTS (REIT) IN SOME EUROPEAN COUNTRIES AND ITS EFFECT ON THE IFRS FINANCIAL STATEMENTS

Review  
Article

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## Abstract

*Real estate investment trusts or REITs are "companies that own or finance income-producing real estate across a range of property sectors (including offices, apartment buildings, warehouses, retail centers, medical facilities, data centers, cell towers, infrastructure and hotels). These real estate companies have to meet a number of requirements to qualify as REITs. Most REITs trade in major stock exchanges, and they offer a number of benefits to investors." (REIT, 2019). REITs operate worldwide from the USA to Hungary. The article focuses on the REIT-regulation in some European countries, mainly in the United Kingdom and in Hungary. As REITs are listed on stock exchanges, they have to prepare their financial statements based on International Financial Reporting Standards (IFRS). The paper looks at the presentation and specificities of the REIT status in the IFRS financial statements.*

## INTRODUCTION

There are several standards in the IFRS system that may be related to real estate, but the system of standards regulates their recognition and measurement in financial statements according to the purpose for which the property is used. In the case of listed REITs the application of fair value concept and the relevant IFRS evaluation methods is obligatory.

When a REIT generates income from their property management activities, it is free from corporate and local taxes, and it will be paid out to shareholders in the form of dividends, and then shareholders pay the income taxes on those dividends. According to the IFRS, corporate and local business taxes are considered to be income taxes under IAS 12, i.e., the related deferred tax effects should also be considered.

### SOME EXAMPLES OF REIT REGIMES IN EUROPE THE BRITISH SYSTEM

REITs are continuously present in the modern British economy. They were originally established in 2007 and are governed and controlled by the British Tax Law. The HM Revenue and Customs supervises them. The accession procedure and supervision are extremely rigorous and extensive as the government gives high priority to this area. There is an official manual published by HMRC that guides the participants through the whole procedure from accession to exit (KPMG, 2013).

The UK-REIT regime is optional thus applicants need to submit notice of intent voluntarily during the pre-accession period. In order for the company to qualify for tax-exempt on its property rental activities, two initial conditions must be met:

- the company has a UK residency,
- the company is not an open-ended investment fund.

After submitting the application, participants will be required to meet four further criteria:

1. Trading: stocks are issued and traded in official British stock exchange markets
2. Stock issue: the issued share is restricted to ordinary shares or non-dividend preference shares
3. Loan prohibitions: they cannot be in a loan partnership the outcome of which is dependent on the regular profit
4. Cannot be "closely owned": not less than 5 participants (KPMG,2013).

In case the holding company gives notice to introduce the REIT regime, 75% of its subsidiaries will also participate in the system. Determining an absolute and decisive limit between tax-exempt and taxable activities is a key aspect of operating as a REIT. The so called "sale – and – reacquisition" is

a common method in order to treat assets participating in the property rental activities properly. Generally speaking, it means that assets from the real estate activity are treated as if they were sold by the REIT just before enrolment and reacquired after joining the regime. The calculated price is always at market value and never results in a chargeable gain. After enrolment, the entity is liable for an Entry Charge payment which is 2% of the recalculated rental-properties' market values. It is optional to pay it in total or four yearly installments (which charges additional costs due to the time value of money). The entity remains in the system until it (or the HMRC) submits its withdrawal or breaches any of the requirements mentioned before (HMRC, 2016).

In order to get a wider point of view about the tax-exempt activities the property rental income has to be calculated. Calculations are based on normal property income rules on rental profits. These rules are specified in the Property Income Manual (the collection of rules about the calculation of property income). In the case of groups, the property income is aggregated from each subsidiary's financial statements. The traditional income is then adjusted to further "financing costs" that are generated by non-trading loan agreements or derivative contracts. Furthermore, rental profits from loan relationships, embedded derivative contracts and some specific hedging instruments also benefit from a certain amount of the tax-exempt revenue. If a property has dual purposes, incomes and expenses, the income is apportioned in accordance with the dual activities (HMRC, 2016).

In the case of REITs, maximum 25% of the generated profit can be the so called residual income. These incomes come from non-rental activities. There are no supervisions over these operations, although residual incomes are calculated in the traditional way. Also maximum 25% of the REIT's total assets will contribute to these businesses. Residual income is chargeable to tax. If revenues generated by property rental activities are tax free, then capital gains generated on assets used for these operations are also tax-exempt (HMRC, 2016).

A look at financial reports from companies that operate in accordance with these rules may show these systems in practice. Table 1 contains information that reflects these systems properly. All of the data presented below were collected from 3 British companies from the official annual statements of 2018 of Capital & Regional PLC, Schroder European REIT PLC and The Scottish Investment Trust PLC. All three companies are flagships of the British real estate market and their financial reports duly illustrate the typical aspects of REITS systems. In table 1 all three companies have a significantly higher rental investment asset ratio than the compulsory minimum (75%). Except

for Schroder PLC, most companies have a loss on revaluation of rental property. The profit or loss on revaluations comes from fair value adjustments on rental property. Only Schroder had profit on fair value adjustments during 2018.

The other comprehensive income (OCI) is generated by several calculations but in this case revaluations of own properties are the only ones which have been observed. Under IAS 16 – Property, plant and equipment, comprehensive income/loss (OCI) is generated when companies revalue their own properties in accordance with the revaluation model. In this case the asset is revalued regularly to its market value and the difference is registered in the OCI. When the asset is sold the so called revaluation surplus is transferred to the net income. Except for Capital & Regional PLC, the observed companies have no properties of their own, which means that OCI could be generated by other transactions such as FVTOCI financial instruments, actuarial gains or losses and the effects of changes in foreign exchange rates.

Apart from the effects of fair value adjustments, it is interesting that all three companies operate with a rather high budget, though their tax liabilities (calculated for the residual activity only) are rather low. This shows us the true advantage of REIT systems.

## THE HUNGARIAN REIT REGULATION

Act CII of 2011 on regulated real estate investment companies (referred to as REIT) came into force in Hungary in 2011. Based on practical experience, the regulatory environment created in 2011 was not favourable enough for joint-stock companies with significant real estate portfolios to continue their business in this form, i.e. no company applied for registration until 2017 (Deloitte, 2017). In line with the market environment, the REIT Act was amended at several points in 2017, thereby significantly simplifying and clarifying the legal requirements for the establishment and operation of regulated real estate investment trusts (REITs). Currently, only publicly traded companies can apply for the status providing favourable taxation environment. Since 2017, these companies have fulfilled their reporting obligations in accordance with the International Financial Reporting Standards (IFRS), and, as a result of their stock exchange presence, companies with REIT status must apply the property valuation principles as defined by IFRS. IFRSs give preference to market valuation rather than to book value, which is mandatory for companies when choosing the REIT status (REIT Act). Based on the favourable tax environment, REITs are exempt from the payment of corporation tax and local taxes, and the realised

income is taxed only at the shareholders' level: in the form of dividend and foreign exchange gain tax (Act LXXXI of 1996, Act C of 1990).

A regulated real estate investment trust (REIT) may only be a public limited company that fulfils all the conditions set out in section 3 of Act CII of 2011 and has been registered as such by the state tax authority. To qualify for the REIT status, businesses must meet a number of strict conditions, including the following:

- they may carry out only such activities that are prescribed by law. According to the law, the following main activities may be carried out under the Uniform Sectoral Classification of Activities (TEÁOR):
  - sale and purchase of own real estate (TEÁOR 6810),
  - rental and operation of own real estate (TEÁOR 6820, including, in particular, building investment for the purpose of own operation; renting and operating state-owned or government-owned property in use; operation of own warehouse, renting out an empty warehouse),
  - property management (TEÁOR 6832) and building management (TEÁOR 8110),
  - asset management (TEÁOR 6420),
  - organization of a building construction project (TEÁOR 4110);
  - a minimum initial capital of 5 billion HUF (this initial capital was 10 billion HUF before the amendment);
  - at least 90% of their profits are paid to their owners as dividends;
  - they do not own any shares in a company other than a project company and other regulated real estate investment trust (REIT Act).

In addition to the above main requirements, there are a number of details that companies applying for REIT status must meet.

The concept of regulated real estate investment pre-trust (hereinafter referred to as REIPT) and project company is defined separately by law. Accordingly, REIPT is essentially a prelude to REIT, a company that does not yet meet all conditions of REIT but undertakes to meet them and obtain the REIT status. The project company is a 100% owned company of REIPT or REIT, which carries out only the real estate-related activities listed above and does not have any shareholding in any other company (REIT Act).

Based on these favourable terms, not only the companies registered as regulated real estate investment trusts or pre-trusts but also the project companies 100% owned by them can operate in a favorable tax environment. Based on the prevailing favourable tax conditions registered companies

- are exempt from corporation tax and local business tax (Act LXXXI of 1996, Act C of 1990);

- in the case of the acquisition of property ownership rights, valuable rights and valuable deposits with a company holding a domestic real estate property, a preferential 2% duty on onerous transfer of property shall be applied instead of 4% (Act XCIII of 1990).

Since both corporate and local business taxes are considered income taxes in the IFRS environment, the requirements of IAS 12 Income Tax are normally applicable when calculating such taxes.

According to the REIT law, a regulated real estate investment trust is required to evaluate its real estate portfolio at least quarterly on market value, on the last day of the business quarter in question. Consequently, these trusts account for the difference between the market value and book value of the property according to the prevailing accounting policy, but at least quarterly. Non-listed companies operating as project companies, which prepare their individual accounts in accordance with the requirements of the Hungarian Accounting Act, are required to apply in their accounting the market evaluation and value adjustment requirements set out in paragraphs 58-59, as well as section 3 of paragraph 57 of the Accounting Act. If a regulated real estate investment trust, regulated real estate investment pre-trust or a project company of such enterprises prepares its annual accounts in accordance with IFRSs, it shall determine the value of the property in accordance with the principles of the IFRS revaluation model or fair value model.

According to the records of the National Tax and Customs Administration (hereinafter referred to as NAV), only one company applied for registration as a pre-trust before 2017, but this was canceled on 05.12.2016.

Based on the data provided by the NAV, the companies listed in Table 1, or their project companies, are currently registered in REIT status. Currently, three companies, BIF Nyrt., Graphisoft Park SE Ingatlanfejlesztő Európai Részvénytársaság and Finext Vagyonkezelő Nyrt. are operated in REIT status on the Budapest Stock Exchange (BÉT). However, in recent months, there have been numerous reports that an increasing number of companies are currently preparing for registration.

Hungarian REITs prepare consolidated IFRS financial statements in view of the obligation to consolidate the activities of their subsidiaries and project companies; only Graphisoft does not have a separate project company, which is also reflected in the values it achieved. Revenue from the rental of investment property was recognized as income by the companies and Finext also realized revenue from the sale of investment property. All three companies closed the year with a positive fair valuation of their investment properties, generating revenue for this title. Due to residual activities,

each company has an actual tax liability and one company has a deferred tax claim, but this is where the benefit of the REIT status is most visible: the tax payable on their profits is negligible. Other comprehensive income items do not reflect the effects of fair value measurements of own-account properties, but the effects of other transactions (e.g. the effects of exchange rate, cash flow hedges, etc.). The value of investment properties covers a large percentage of total assets for BIF and Graphisoft, while for Finext it is only 34.5%. However, if reclassified investment properties are included in inventories, the proportion of investment properties and those in inventories is 73.5% of the total assets, which is significant.

## OTHER EXAMPLES

Most companies have already discovered the advantages of REIT regimes. They are widespread in the modern European real estate market. In France, FR-REIT regimes have been introduced since 2003. They are governed by the AMF (Autorité des Marchés Financiers) and operate in accordance with Tax Law (KPMG, 2013).

Similarly to France, Italy also revises its REITs by Tax Law and supervises them through the Bank of Italy and Consob. In Italy a company has to be an Italian resident joint stock company and be admitted to the Italian stock exchange market (its minimum of capital share is 40 million EUR). The company's name also has to include the SIIQ acronym that refers to Listed Real Estate Investment Company (KPMG, 2013).

In the Netherlands and Belgium REITs have been integral parts of modern economy for over 20 years. Both countries apply the national tax laws on REITs but Belgium also governs them by regulatory laws. In Belgium only Belgian limited liability companies can apply with a share capital of 1.2 million EUR. In contrast, the Netherlands allows public limited companies with only a 45 000 EUR share capital (KPMG, 2013).

## CONCLUSION

The legal form of the real estate investment trust is very popular worldwide in the real estate sector. REIT status implies regulated, stringent operation, which on the one hand, increases investor confidence and on the other hand, high-yielding shares can be a real alternative for market participants. Furthermore, thanks to favourable tax conditions, the market expects companies with significant real estate portfolios to maintain and further expand their real estate portfolio by taking advantage of their stock exchange presence.

Advantageous tax conditions such as income tax exemption with REIT status also have a significant impact on the accounting result from the mandatory fair valuation and the related tax effects. For these companies, no deferred tax is recognised under IFRS, which affects the earnings per share and the dividends payable.

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- [18] 2018 Consolidated Annual Statement of Graphisoft Park SE, 2018
- [19] 2018 Consolidated Annual Statement of Finext Vagyonkezelő Nyrt., 2018.

FIGURES

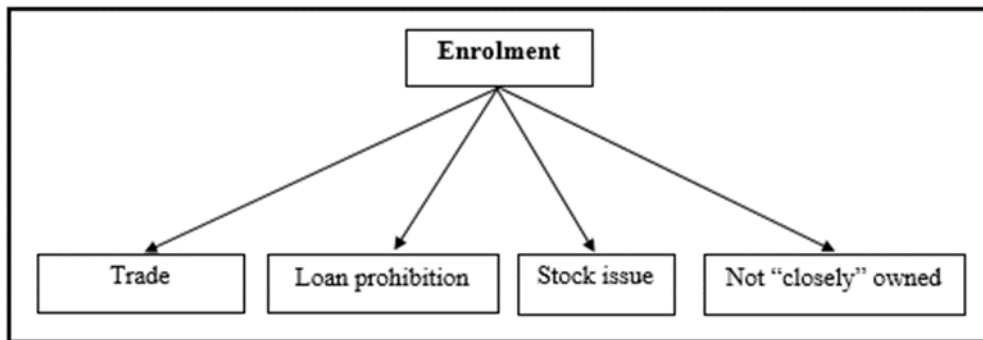


Figure No. 1  
**Criteria of application**  
Source: Own editing based on HMRC manual

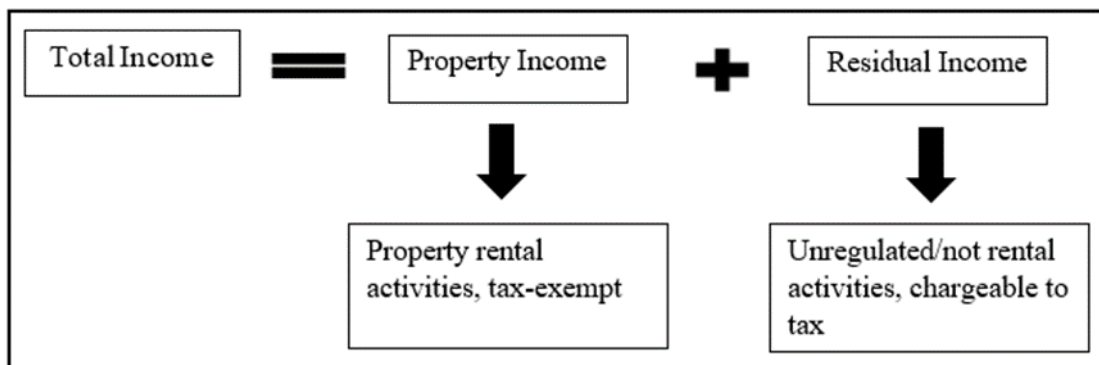


Figure No. 2  
**The content of the total income of REITs**  
Source: Own editing based on HMRC manual, 2019

Table No. 1  
**Presentation of properties in the IFRS financial statements of some REIT in the United Kingdom**

Name / Statement of Comprehensive Income	Capital & Regional PLC (£'000)*	Schroder European REIT PLC (£'000)**	The Scottish Investment Trust PLC (£'000)***
Profit/loss from fair value adjustments on rental property	(47 500)	4,599	(14,566)
Tax on ordinary activities	(100)	(1,413)	(1,697)
Other comprehensive income/loss	0	(3,72)	0
Total comprehensive income/loss	(25 600)	14,494	(18,573)

<b>Statement of Financial Position (Balance sheet)</b>			
<b>Investment properties</b>	<b>898 200</b>	<b>182,206</b>	<b>717,547</b>
<b>Plant and equipment</b>	<b>200</b>	<b>0</b>	<b>0</b>
<b>Investment-total asset ratio</b>	92.9%	81%	89.6%

\* based on the 2018 Annual Statement of C&R PLC

\*\* based on the 2018 Annual Statement of Schroder

\*\*\* based on the 2018 Annual Statement of The Scottish Investment Trust

Table No. 2

**Taxpayers registered as a regulated real estate investment trust on 30.06.2019**

Name of the enterprise	Quality	Date of registration	Name of the project company
BUDAPESTI INGATLAN HASZNOSÍTÁSI ÉS FEJLESZTÉSI Nyrt. (BIF Nyrt.)	Regulated real estate investment trust	31.12.2018	Harsánylejtő Ingatlanforgalmazó és -kezelő Kft.
GRAPHISOFT PARK SE INGATLANFEJLESZTŐ EURÓPAI RÉSZVÉNYTÁRSASÁG	Regulated real estate investment trust	01.01.2018	-
FINEXT VAGYONKEZELŐ Nyrt.	Regulated real estate investment trust	30.09.2018	Portfolio Real Estate Hungary Ingatlanfejlesztési Kft.
			Futureal Béta Ingatlanforgalmazó Kft.
			Futureal New Ages Ingatlanfejlesztő Kft.
			BP1 Első Ütem Ingatlanfejlesztő Kft.
Nerium Park Ingatlanfejlesztő Zrt.	Regulated real estate investment pre-trust	31.01.2019	-

Source: Own construction based on the data of the National Tax and Customs Administration, 2019

Table No. 3

**Presentation of properties in the IFRS financial statements of some REIT in the Hungary**

Name / Statement of Comprehensive Income	BUDAPESTI INGATLAN HASZNOSÍTÁSI ÉS FEJLESZTÉSI Nyrt.(BIF) (000HUF)*	GRAPHISOFT PARK SE INGATLANFEJLESZTŐ EURÓPAI RÉSZVÉNYTÁRSASÁG (000EUR)**	FINEXT VAGYONKEZELŐNyrt. (000HUF)***
Revenue (rental fees)	3.792.057	12.411	1.623.664
Income from sale of investment properties			20.556.629
Profit/loss from fair value adjustments on rental property	6.700.510	4.858	10.674.342

<b>Tax</b>	(16.551)	(45)	(5.246)
<b>Deferred tax</b>	522		
<b>Other comprehensive income/loss</b>	<b>0</b>	<b>(992)</b>	<b>(1.669.463)</b>
<b>Total comprehensive income/loss</b>	8.280.576	14.091	28.450.130
<b>Statement of Financial Position (Balance sheet)</b>			
<b>Investment properties</b>	<b>39.799.004</b>	<b>239.633</b>	<b>68.708.659</b>
<b>Property, Plant (and equipment)</b>	<b>94.240</b>	<b>2.074</b>	<b>0</b>
<b>Property investment</b>	<b>790.475</b>		
<b>Inventory</b>	<b>2.160.522</b>		<b>77.724.799</b>
<b>Investment-total asset ratio</b>	74.5%	95.2%	34.5%

\* based on the 2018 Consolidated Annual Statement of BIF Nyrt.

\*\* based on the 2018 Consolidated Annual Statement of Graphisoft Park SE

\*\*\* based on the 2018 Consolidated Annual Statement of FinextVagyonkezelőNyrt.