

## UK REITs

A summary of the regime

May 2018

# The UK REIT regime

The UK Real Estate Investment Trust (“REIT”) regime launched on 1 January 2007, immediately saw a number of the UK’s largest listed property companies convert to REITs. Since then, the regime has continued to evolve, with a number of developments in recent years increasing the attractiveness and accessibility of the regime to a wider pool of property investors and providers of capital.

## Key benefits of REIT status

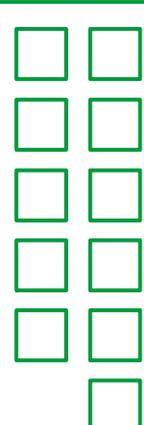
REIT status affords a number of commercial and tax benefits, including:



### An attractive vehicle for raising capital from a wide range of sources

REITs may be attractive to investors for the following reasons:

- Attractive for UK and overseas retail and institutional investors.
- Easier access to property investment compared to purchasing a property directly.
- Indirect investment into property through a readily tradeable investment asset.
- Access to parts of the property sector that private investors cannot usually access e.g. shopping centres or industrial property.
- Regular income returns.
- Lower transaction costs, e.g. 0.5% stamp duty on shares compared to 5% stamp duty land tax on direct property.



### Access to the global REIT “brand”

REITs are known and understood by both investors and analysts worldwide as tax efficient structures for investment in real estate. There are currently c.40 countries worldwide that have REIT or ‘REIT-like’ regimes in place.

### Attractors of international capital

REITs have a proven track record of attracting international capital. There are significant investment pools and fund allocations specifically designated for investment in REITs. Conversion to REIT status can often unlock new sources of funding.

### Effective elimination of latent capital gains

REIT status may reduce or potentially eliminate any discount to net asset value caused by latent capital gains.

REITs often have a competitive advantage on corporate acquisitions, as other non-REIT bidders may have to discount their purchase price for latent capital gains. REITs are therefore able to make commercial decisions in a tax-exempt environment, based on the commercial performance of individual assets.

Comparison of after tax returns in a UK taxable company and a UK REIT

Investor	After tax return from UK company	After tax return from UK REIT	Enhancement of return
UK pension funds/ISAs, SIPPs and Sovereign wealth funds	81	100	23.5%
Overseas investor (beneficial tax treaty)	81	85	4.9%
UK individual basic rate (20%) tax payer	75	80	6.8%
UK individual higher rate (40%) tax payer	55	60	9.7%
UK individual additional rate (45%) tax payer	50	55	9.7%
UK company	81	81	Nil

The table above is based on the rates effective for the 2018/19 tax year, and assumes a notional distribution by a REIT vs. UK fully taxable company of £100, which represents net rental income, ignoring capital gains and assuming no dividend tax allowance. Some small individual investors who are holding their shares outside an ISA/SIPP (and have unused annual dividend tax allowance), may enjoy higher after tax returns under the UK corporate structure rather than a REIT. This is because property income distributions (PIDs) from a REIT are not eligible for the annual dividend tax allowance (which is £2k in 2018/19).



# Requirements to achieve and maintain REIT status

There are a number of conditions that a company (or principal company of a group REIT) needs to satisfy in order to become a REIT and remain within the regime. If these conditions are breached, the penalty can range from automatic expulsion from the regime to additional tax liabilities for the REIT. Some of the key conditions are as follows:

- **Admitted to trading on a 'recognised stock exchange':**

The REIT must be 'admitted to trading' on a recognised stock exchange and either:

- 'listed' on such an exchange; or
- 'traded' on such an exchange in every accounting period, except the first three.

- **Not a close company:**

The principal company must either:

- Not be a close company (which means, broadly, it must not be controlled by five or fewer 'participators' taking into account aggregation of the holdings of associated persons, or it must meet the 'quoted company' exemption (see below);

or

- Be a close company only because it has as a participator one or more 'institutional investors' as specified in the legislation, which includes inter alia a person acting on behalf of a limited partnership which is a collective investment scheme, UK or overseas pension schemes, REITs, life insurance business, open-ended investment companies, authorised unit trust schemes, certain charities or sovereign immunity investors.

The 'quoted company' exemption:

If at least 35% of the voting power is beneficially held by the 'public' (as defined in the legislation) and those shares have been the subject of dealings on a recognised stock exchange (within the preceding 12 months), the company will not be close.

A three year grace period exists for new REITs to meet this condition. If the close company rules are not met by the end of the grace period, there should be no further penalty other than a loss of REIT status.

- **Distribution conditions:**

The REIT must distribute 90% or more of its tax-exempt income profits (not capital gains), as well as 100% of any property income distributions received from other UK REITs, by the filing date of the company's tax return (usually twelve months after each accounting period end).

- **Property rental business conditions:**

The REIT must hold at least three properties. Of these, no single property can exceed 40% of the total value of the properties in the property rental business. For these purposes, properties that would be regarded as 'owner-occupied' for accounting purposes in the REIT's consolidated accounts do not count as property rental business properties. However, each unit or floor that is designed, fitted or equipped for separate rental will be regarded as a separate property (e.g. in an office building or shopping centre).

- **Balance of business condition:**

At least 75% of the REIT's gross assets and at least 75% of the REIT's accounting profits, on an IFRS accounting basis, must relate to the property rental business.

- **Financing cost ratio:**

REITs are required to maintain a profit:financing cost ratio of greater than 1.25:1, otherwise a tax penalty may arise.

## Factors to consider when deciding whether to become a REIT

Companies will need to carefully consider a number of factors before deciding whether to become a REIT, such as:

- The impact of REIT conversion on shareholders' after-tax returns.
- The ongoing benefits of REIT status, together with costs of complying with the regime's requirement.
- The requirement for diversity of ownership (subject to the three year grace period and institutional investor diverse ownership rule).
- The requirement for the REIT's shares to be admitted to trading on a recognised stock exchange.
- Implications of complying with the company, distribution, balance of business and financing cost ratio conditions and tests.
- Whether the company needs to increase operational efficiency in order to provide attractive income yields to investors.
- Whether the company's existing reporting tools provide the outputs that will be required as a REIT (monitoring of conditions, accurate forecasting, accounting information etc.)

# Taxation of a UK REIT

A UK REIT needs to carry on a 'property rental business', and meet the various conditions for REIT status. This allows it to benefit from exemptions from UK corporation tax on profits and gains arising from its property rental business.



## Property rental business

Profits and gains are **tax-exempt**

- Property rental business profits and gains are tax-exempt within the REIT itself.
- Distributions to investors derived from tax-exempt rental profits or gains are generally subject to basic rate withholding tax at 20% except, for example, where paid to a UK pension scheme or UK resident company. Overseas investors may be able to reclaim part (or all) of the withholding tax under a tax treaty or because of sovereign immunity.
- Investors are taxed on the distributions of tax-exempt profits and gains at their normal tax rate on income (as profits and gains of a UK property business, rather than as a normal dividend receipt), with a credit for any tax withheld. However for overseas investors they will be taxed as a dividend under tax treaties.
- To ensure a regular flow of income is subject to tax at the investor level, REITs are required to distribute 90% of their tax-exempt profits. This distribution requirement does not include capital gains which can be retained within the REIT. REITs can satisfy this 90% distribution requirement by issuing shares in lieu of cash dividends.

Distributions taxed in the hands of investors as UK property income (generally 20% tax withheld)

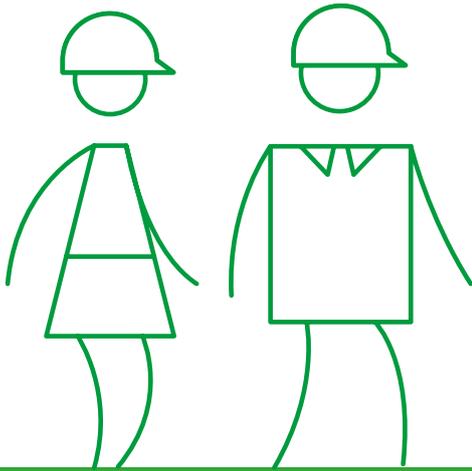


## Residual business

Profits and gains are subject to **UK corporation tax**

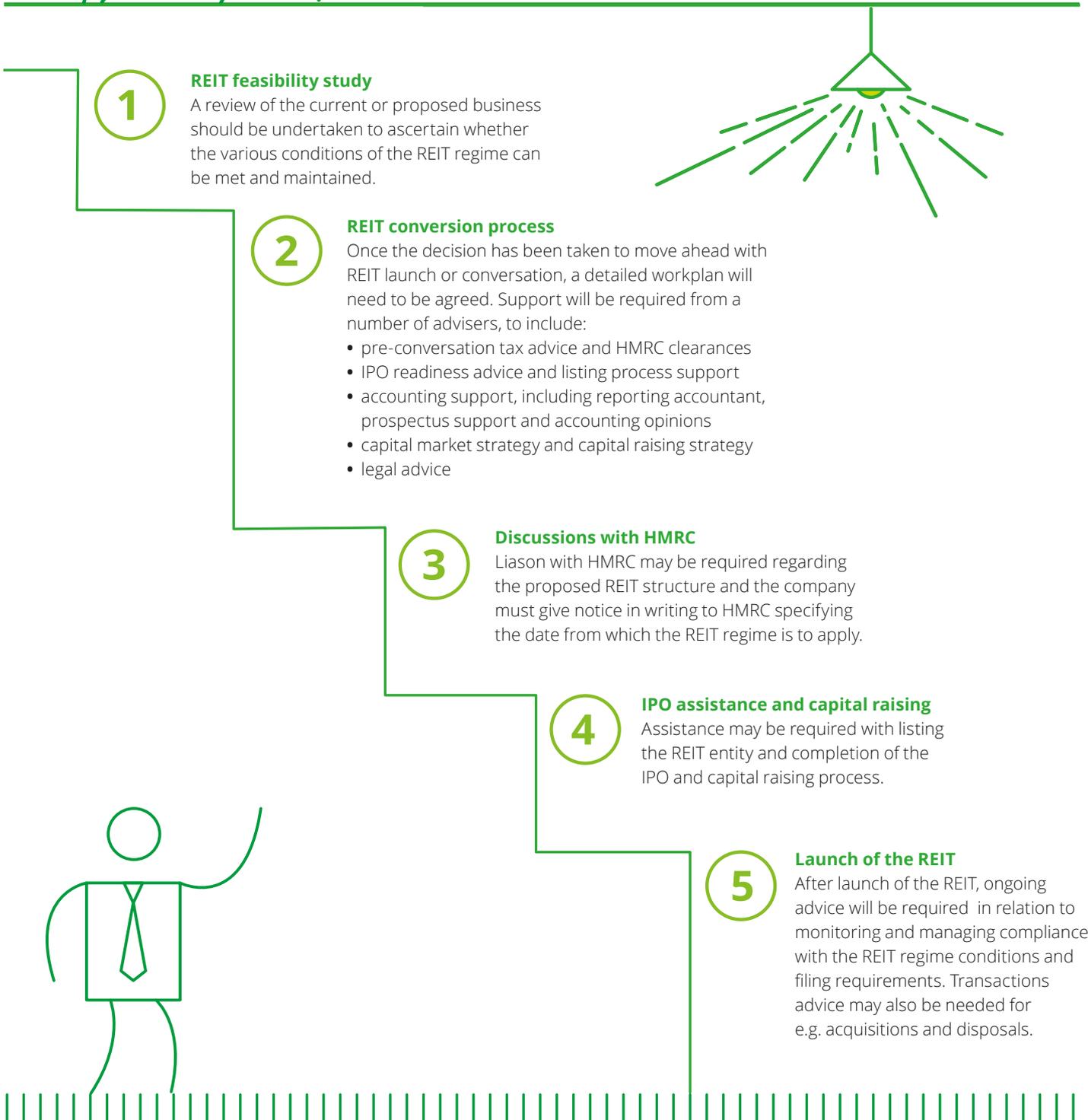
- Any profits and gains which are not derived from property rental activities are part of the residual business and will be subject to UK corporation tax in the normal way. This would include property trading activities, development and asset management fees and capital gains on disposals of shares.
- Distributions of profits and gains from the residual business will represent normal company dividends in the hands of investors when distributed.
- The majority of REITs will therefore have both a tax exempt business and a smaller residual taxable business.

Distributions taxed in the hands of investors as normal company dividends (no tax withheld)



# The REIT journey

A number of steps are needed to launch a REIT and a range of advisers will need to be appointed.



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