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Real Estate

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UK REITs
A summary of the regime

The changing REIT landscape

The UK Real Estate Investment Trust ("REIT") regime launched on 1 January 2007, and immediately saw a number of the UK's largest listed property companies convert to REITs. The following years have seen further REIT conversions as well as the launch of a number of start-up REITs. As at August 2014 there are over 30 UK REITs.

Significant changes to the REIT regime came into effect in July 2012. Those changes to the REIT regime were far-reaching and significantly increased the attractiveness of the regime to a wider pool of property investors and providers of capital. The changes reduced barriers to both entry and investment in REITs. Further smaller changes in both 2013 and 2014 have continued to enhance the attractiveness of the regime.

The 2012 changes to the REIT regime were far-reaching and significantly increased the attractiveness of the regime to a wider investor pool.

The changes to the REIT regime benefit many

Those benefitting most significantly from the changes include:

All existing and future REITs

- The abolition of the original 2% entry charge for companies entering the regime significantly reduces the cost of entering the REIT regime, and may also result in more properties being acquired and sold within corporate wrappers.

- Allowing cash to be a 'good' asset for the purposes of the balance of business assets test makes it easier for start-up REITs to raise funds to be spent over time. It also makes it easier for existing REITs to raise additional capital from shareholders.

Institutional investors

- The diverse ownership rule for institutional investors enables small 'clubs' of diversely-owned institutions to form REITs, where this previously may not have been possible (although the REIT's shares still need to be either 'listed' or 'traded' on a recognised stock exchange).

- The 2013 changes to allow one REIT to invest tax efficiently in another REIT, and the inclusion of UK and overseas REITs in the definition of 'institutional investors', are of particular benefit to REITs seeking to establish their own REITs as joint venture vehicles or as a platform for UK investments.

Start-up and closely held/family owned property companies

- The three year grace period for new REITs to meet the close company condition enables property companies to build sufficient reputation to attract new shareholders without prejudicing their ability to enter the REIT regime at the beginning of the three year period. There is also a relaxation for the 'traded' requirement (see below).

AIM (and overseas equivalent) traded companies

- Relaxation of the requirement for a REIT to be listed on a 'recognised stock exchange' enables AIM (and overseas equivalent) traded companies to obtain REIT status without requiring e.g. a full London listing.

Offshore property companies

- The abolition of the 2% entry charge for companies entering the regime may encourage offshore vehicles holding UK properties (that are already outside the scope of UK Capital Gains Tax) to consider converting to a REIT.

Key benefits of REIT status

- **Access to the global REIT "brand".**
- **Attractors of international capital.**
- **A liquid and publicly available source of property investment.**
- **Improved after-tax returns for shareholders.**
- **Effective elimination of latent capital gains.**

Key benefits of REIT status

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

Access to the global REIT "brand"

REITs are recognised globally as tax efficient structures for investment in real estate. As at September 2013, there were 34 countries worldwide that have REIT or 'REIT-like' regimes in place. They are known and understood by both investors and analysts worldwide.

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, and conversion to REIT status can often unlock new sources of funding.

A liquid and publicly available source of property investment

Depending on what exchange a REIT is listed on, the REIT regime provides a method by which investors can tap into a liquid and publicly available source of property investment.

REITs may be attractive to investors for the following reasons:

- Easier access to property investment compared to purchasing a property directly.
- Indirect investment into property through a readily tradable investment asset, as compared to direct investment into property, which is generally illiquid.
- Diversity of investments across a range of property assets.
- 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, i.e. 0.5% stamp duty on shares compared to 4% SDLT on property.

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

Example – Assumes £100 return before tax relating to property rental business activities and 21% UK corporation tax rate

Investor	After tax return from UK company	After tax return from UK REIT	Enhancement of return
UK pension fund/ISA	79	100	27%
Overseas investor (typical tax treaty country)	79	85	8%
Overseas investor (no tax treaty country)	79	80	1%
Individual basic rate tax payer	79	80	1%
Individual higher rate tax payer (40%)	59	60	1%
Individual additional rate tax payer (45%)	55	55	<1%
UK company	79	79	Nil

Improved after-tax returns for shareholders

The broad intention of the REIT regime is to replicate the tax treatment of a direct investment in property. REIT status therefore effectively removes the traditional 'double-layer' of taxation, where profits are taxed at both the property company and shareholder levels.

Instead, tax is generally only payable at the shareholder level, giving improved after-tax returns for shareholders.

Effective elimination of latent capital gains

On entering the REIT regime any latent capital gains on rental properties are effectively eliminated. In addition to the obvious tax benefits of exemption from corporation tax on capital gains, this may have the following additional benefits:

- Likely to 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. This benefit can potentially be shared with the vendor to increase their post-tax proceeds and reduce the REIT's purchase price.
- REITs are able to make commercial decisions in a tax-exempt environment, based on the commercial performance of individual assets (without having regard to which assets would give rise to taxable capital gains on disposal).

Overview of the UK REIT regime

The summary below represents a broad overview of the UK REIT regime.

A UK REIT is a UK tax resident company, that carries on a 'property rental business', meets the various conditions for REIT status, and has given notice that it wishes to enter the UK REIT regime. For the purposes of the REIT regime, a 'property rental business' excludes the letting of owner-occupied buildings.

A REIT may be either a single company REIT, or a group REIT. A group REIT will include, broadly, the principal company of the REIT and all of its 75% subsidiaries. There are specific anti-avoidance rules that prevent groups deliberately manipulating their structures to include or exclude companies from the REIT group where this is done to enable certain REIT conditions to be met. REITs may also give notice for joint ventures in which they hold at least a 40% beneficial interest to become proportionately part of the REIT.

REITs do not need to be pure property companies and some of the existing REITs are hybrid businesses such as self-storage.

Property rental business profits and gains

REITs are exempt from UK corporation tax on rental profits and capital gains arising from their property rental business.

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 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 such 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, 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 rental profits (calculated on a tax basis). This distribution requirement does not include capital gains which can be retained within the REIT. (However, note that investors are also taxed at the income rate if they do receive exempt capital gains as distributions.) REITs can satisfy this 90% distribution requirement using stock dividends.

From July 2013, property income distributions received by one REIT from another REIT are exempt from UK corporation tax in the upper-tier REIT (subject to a requirement to onward distribute to the upper-tier REIT's shareholders). Previously, such distributions were treated as taxable in the upper-tier REIT.

Residual business profits and gains

Any income 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.

Conditions

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. The conditions are broadly as follows:

Company conditions

The company (or principal company of a group REIT) will need to satisfy the following conditions:

- Tax resident in the UK only.
- Not an open-ended investment company.
- Listed/traded on a 'recognised stock exchange' (see below).
- Not a close company (see below).
- One class of ordinary shares.
- No 'non-commercial' loans.

With effect from July 2012, the 'listed/traded on a recognised stock exchange' condition requires that the REIT is 'admitted to trading' on a recognised stock exchange and either:

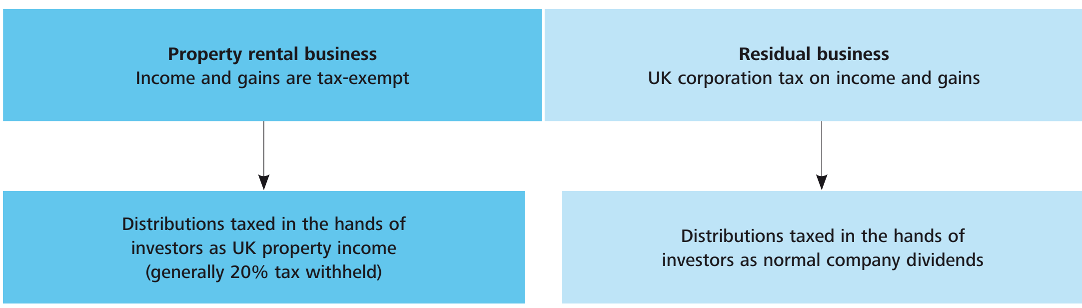
- 'listed' on such an exchange (which includes most major 'main' markets including London, Channel Islands, Luxembourg, New York, Euronext etc.); or

- 'traded' on such an exchange in every accounting period (which would apply to AIM traded companies and their overseas equivalents).

There is also a three accounting period relaxation of the listed/traded requirement, such that new REITs will effectively have until the end of their third accounting period as a REIT to meet the listed/traded condition (although they still need to be 'admitted to trading' during that period).

The 'close company' condition prevents the principal company of a group REIT from, broadly, being under the control of five or fewer persons. Certain exemptions have always been available, for example where very broadly at least 35% of the shares are held by the 'public' (as defined, which includes persons holding 5% or less of the shares and in certain circumstances shares held by registered pension schemes) and are subject to dealings.

UK REIT



However, the usual close company exemption for companies that are themselves controlled by non-close companies is currently disapplied for the purposes of the REIT regime (such that a company owned by a small club of institutional investors would not, absent the specific relaxations outlined below, meet the close company condition).

With effect from July 2012, the close company condition was relaxed with the introduction of two new rules:

- A diverse ownership rule for institutional investors. This recognises the fact that such shareholders are themselves diversely owned and enables small 'clubs' of (and potentially individual) institutions to hold REITs. The legislation defines institutional investors as including sovereign wealth funds, UK pension schemes, insurance companies, unit trusts and open-ended investment companies (and each of their overseas equivalents), charities, registered social landlords and (from 1 April 2014) UK REITs and their overseas equivalents. Furthermore, secondary powers give Treasury the flexibility to revise this list from time to time by regulaltion.

- A three year grace period for new REITs to meet the close company condition. This will enable property companies to build sufficient reputation to attract new shareholders without prejudicing their ability to enter the REIT regime. If the close company rules are not met by the end of the grace period, there will be no further penalty other than a loss of REIT status.

Property rental business conditions

- The REIT must hold at least three properties and, 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 REITs 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).

- At the beginning of each tax accounting period, at least 75% of the REIT's gross assets (on an IFRS accounting basis) must relate to the property rental business or be cash and cash equivalents.

- In each tax accounting period, at least 75% of the REIT's accounting profits (on an IFRS accounting basis) must relate to the property rental business.

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). This condition can also be met by way of stock dividends.

Other considerations

There are other aspects that a REIT needs to consider, including:

- There are restrictions whereby a penalty tax charge is payable by a REIT if it pays a dividend to a corporate shareholder who is beneficially entitled to 10% or more of the REIT's dividend payments or share capital, or controls 10% or more of the voting rights of the REIT. It is normally possible to structure around this 10% limitation using HMRC approved methods.

- REITs are required to maintain a profit:financing cost ratio of greater than 1.25:1, otherwise a tax penalty may arise. "Financing costs" for these purposes is broadly interest paid on borrowings and regular swap payments, rather than the total accounting finance costs incurred in borrowing.

- Properties that are part of the tax-exempt business and are redeveloped and sold may fall outside of the exempt activities and into the residual business if the redevelopment costs exceed 30% of the fair value of the property (at the later of entry date or acquisition) and the disposal is within three years of practical completion of the development.

Breach of conditions

If a REIT breaches one or more of the REIT regime conditions, the penalty can range from automatic expulsion from the regime to additional tax liabilities for the REIT.

Entry into the REIT regime

In order to enter the regime the company must give notice in writing to HMRC specifying the date from which the REIT regime is to apply and whether it will be a company REIT or a group REIT.

On entering the REIT regime the rental properties are treated as sold and immediately reacquired at market value. The gains or losses arising on these deemed disposals are ignored for tax purposes.

Prior to July 2012, an entry charge was payable, calculated as 2% of the market value of the rental properties as at the date of entry. However, this 2% entry charge was abolished with effect from July 2012.

Factors to consider when deciding whether to become a REIT

Entering the REIT regime will impact the whole business of the company. Therefore, companies will need to carefully consider a number of factors before deciding whether to become a REIT.

The factors may include:

- The ongoing benefit of tax exemption, together with costs of complying with the listing 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 listed or traded on a recognised stock exchange (subject to the three accounting period grace period).
- Implications of complying with the company, distribution, balance of business and interest cover 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).

Contact

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