

Real Estate Investment Trusts

What are REITs?

1. REITs or Real Estate Investment Trusts to give them their full title are now common to many economies with a developed property market. Generally they are companies or trusts that hold, manage and maintain real estate for investment purposes, which is leased out to tenants for a rental return.
2. The REIT is already available in most of the key developed countries such as the USA, Australia, Japan, Hong Kong, France and the Netherlands. REITs tend to have a broad shareholder or unitholder base and are often, but not always, traded on a public stock exchange.
3. By Part 4 of the Finance (No.2) Bill 2006 REITS are now to be introduced into the UK.
4. A key feature is that the tax treatment of real property investment held indirectly through a REIT is broadly comparable to that of property held directly. This means the combined tax from indirect investment at both vehicle and investor level is broadly equivalent to the tax levied on direct property investment. This ensures that investors are able to make decisions about the appropriate form of property investment based on risk and return profiles, without tax having a disproportionate influence.

The Current Property Investment market

5. Hitherto, if you wished to invest in the property market in this country you had essentially two options:
 - **Firstly buy to let:** the current position for UK residents investing directly in UK property is that they are taxed on rental income at their appropriate marginal rate of income tax, for example 22% for basic rate taxpayers and 40% for higher rate taxpayers. Small time investors have of course historically been deterred from investing in the UK

property market directly by virtue of the large capital outlay necessary in order to purchase property for themselves.

- **Investment through Property Companies:** Investors in property companies suffer double taxation in that the company is taxed on its profits (corporation and capital gains tax) before they are distributed to investors to be taxed again.

Policy Rationale for UK Reits

6. The stated objectives in introducing the REIT regime to the UK are to improve efficiency in property investment, to expand property investment to a wider range of investors and to ensure fairness for all tax-payers.
7. The consultation paper published alongside the Budget in 2004, to consider how the Real Estate Investment Trust (REIT) might be developed in the UK, identified the following barriers in the current UK property market:
 - There is limited secondary trading and liquidity in the property sector and thus insufficient information to ensure efficient market pricing and capital allocation;
 - Access to commercial property investment is limited for smaller scale investors without significant capital outlays, potential risk or tax efficiency;
 - Property companies may be unable to raise optimal amounts of equity and therefore rely more heavily on debt markets, with potential consequences for wider economic and financial stability;
 - High levels of owner-occupied property in the corporate sector, in part driven by tax rules, may restrict the full potential for efficient asset management; and
 - There is limited institutional investor participation in the residential property market.
8. The Government believes that UK-REITS can lead to improvements in the market by:
 - Providing a more liquid complement to the current range of property investment vehicles;
 - Allowing smaller scale investors the opportunity to access commercial property returns, currently unavailable without significant capital outlays or tax inefficiency;
 - Improving stability in the property investment market by rebalancing some debt with equity among property companies;

- Providing the opportunity for companies to release property assets from corporate balance sheets into professionally managed companies;
 - Potentially improving the housing market through greater professionalism in the private and social rented sectors, and
 - Alongside wider reforms to the planning system, providing a route into which newly developed rented accommodation can be sold, thereby increasing the willingness of house builders to increase supply.
9. The economic case for REITS is difficult to refute. The UK is the only G7 country without a REIT-style vehicle. The US model, upon which a British REIT is expected to be based, is also persuasive. Congress created the first REIT in 1960 and a period of rapid growth followed legislative enhancements in the early 1990s. The US market now has an estimated market capitalisation of £173bn-\$180bn across 173 REITs.
10. According to one briefing document to the Treasury, countries that have introduced REITs and other tax-transparent unitised indirect investment vehicles “have witnessed a 830% aggregate increase in their total property market capitalisation since 1989”.
11. In contrast, those countries, including the UK, that do not possess such vehicles have experienced a 28% decline in total property market capitalisation over the same period.

What is a UK REIT?

12. A UK-REIT is a listed incorporated company that carries on qualifying activities (referred to as ring fenced business or tax exempt business) which are exempt from tax at the REIT level, and non-qualifying activities (referred to as non-ring fenced business or taxable business) in respect of which the company will pay corporation tax at 30%. The legislation prescribes the extent to which non-qualifying activities may be carried out without losing REIT status.
13. In broad terms tax effects similar to those of direct investment will be achieved by making the REIT tax exempt so that it neither pays tax on the income that it receives from (broadly) property letting nor pays tax on the capital gains arising from the sale of its investment properties. Instead, tax is collected at the level of the shareholder.

How to qualify

14. Various conditions need to be satisfied for a limited company to obtain and maintain REIT status. The necessity for compliance is continual and if a condition is breached in a particular accounting period REIT status will be lost with effect from the end of the previous accounting period.

15. It is anticipated that inadvertent breaches might occur and therefore the draft legislation allows for the Revenue to make regulations that will permit HM Revenue & Customs to continue to allow REIT status to be enjoyed on condition, perhaps that a tax penalty is paid.

The specific conditions

16. To obtain and keep REIT status in the UK a company must comply with the following conditions:
 - It must be a company that is resident in the UK and not resident elsewhere / dual residence companies do not qualify;
 - It must not be an Open Ended Investment Company (i.e. section 236 of the Financial Services and Markets Act 2000 does not apply to the company)
 - Its shares must be listed on a recognised stock exchange
 - It must not be a close company for the purposes of section 414 Income and Corporation Taxes Act 1988 (unless it is a close company only by virtue of having as a participator a limited partnership which is a collective investment scheme)
 - Its issued share capital must consist only of one class of ordinary shares.
 - It must not be a party to a loan that is not a “normal commercial loan”. Accordingly it must not be a party to a profit-linked, asset-linked or non-commercial interest rate loan.

What specific conditions need to be met in relation to the activities of the company?

17. It must throughout the accounting period have a “**property rental business**” that :
- includes at least 3 properties. A single property is one that is designed, fitted or equipped for the purpose of being rented as a single unit, so a block of flats is not treated as a single property. Similarly, a shopping centre of 50 units will be treated as 50 properties for this purpose.
 - The value of any one single property must not however exceed more than 40% of the total value of the properties held by the company in its property rental business
 - The company’s property rental business must not include a property that under generally accepted accountancy practice is treated as occupied by the REIT or another company whose shares are stapled to the shares of the REIT.
18. 90% of the profits of the REIT’s property rental business arising in the accounting period must be distributed by way of dividend either in the accounting period in which they arise or in the first 6 months of the next accounting period. This condition is relaxed if to comply with it would be unlawful under statute. Therefore the REIT would not be required to distribute more than its distributable reserves.

Conditions for balance of business

19. While the REIT must carry on a property rental business and will be exempt from tax on income profits arising from that business and capital gains arising on disposals of assets relating to that business, the REIT will also be permitted to carry on non-qualifying activities within specified limits without losing REIT status. These activities will be subject to tax under the normal rules.
20. In order to maintain REIT status the following two conditions relating to the balance between qualifying and non qualifying activities needs to be satisfied:
- In any one accounting period the profit from qualifying activities must be at least 75% of the total profit. Profit from qualifying activities is calculated in accordance with Schedule A after finance costs and compulsory capital allowances. Profit from non-

- qualifying activities means the remaining profits of the company “calculated in accordance with the Corporation Tax Acts”.
- At the beginning of any one accounting period the gross value of the assets used in the qualifying business is at least 75% of the total gross value of assets held by the REIT. Assets are valued in accordance with generally accepted accountancy practice except that no account is to be taken of liabilities secured against or relating to the asset and where there is a choice of costs or fair value, cost must be used.

But at what cost?

21. In order to enter the regime a tax liability equal to 2% of the market value of the property investment assets is incurred. No losses of the company can be set off against this liability. The initial payment can be spread to four annual instalments of 0.5%, 0.53%, 0.56% and 0.6%.

Maximum Shareholding

22. As originally drafted the Government also wished to make it a pre-condition of REIT status that no person either directly or indirectly was allowed to have control over 10% or more of the shares or voting rights. It was this condition about which the most concern was expressed. It was stated that the condition was to be imposed to encourage wide share ownership of REITS but it was realised during the consultation period that to make this a pre-condition of REIT status was too draconian.
23. Now what is proposed is that the REIT will be subject to tax on the proportion of its income payable to any shareholder holding 10% or more, unless it can show it has taken reasonable steps to avoid paying distributions to that shareholder.

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