UK REIT briefing

Episode 1: the momentum continues

There are now approximately **70 UK Real Estate Investment Trusts**. With a changing market landscape and major UK tax developments in the pipeline, the vehicle is now more relevant than ever.

This is the first of two papers looking at the key UK REIT conditions, dispelling some myths and considering what UK REITs may be used for and why they are likely to be an increasingly attractive choice of vehicle for investment into UK real estate.

Basics of the UK REIT

A UK REIT is tax exempt on income and gains from its property rental business (“**PRB**”), with investors taxed in a way broadly similar to a direct property interest (with a potential withholding tax on property income distributions (“**PID**”), unless the recipient qualifies for gross payment). While the REIT brand is well known internationally, the detailed conditions for the UK REIT (which we will refer to simply as a REIT going forward) are specific to the UK.

A REIT can be a single company or (more commonly) a group of companies, with special rules which apply to the single company or principal company of the group (“**principal company**”) only, but with the tax position generally applying to the group as a whole.

Principal company conditions
• It must be a “closed-ended” company. Closed-ended for this purpose means, broadly, that the shares cannot normally be redeemed by the company, so liquidity is by share transfer
• It must be UK tax resident only
• It must not be a “close” company or must be close only because an “institutional investor” is a participator - see below. Broadly, the company will be “close” if it is controlled by 5 or fewer participators or by participators who are directors
• The ordinary shares of the company must be admitted to trading on an HMRC-recognised stock exchange and “actually traded”. Shares in “listed” companies are deemed to be actually traded
• The company must only have one class of ordinary shares, but can have non-voting, restricted preference shares
• The company must not have any loans, interest on which is results or assets-dependent or in excess of a commercial rate
• In a group, specific financial statements must be kept
Note 1. There is a three year period in which to ensure that the “non-close” and “actually traded” requirements are met, plus a relaxation of certain other rules to assist start-ups 2. An “institutional investor” is any of the following: UK authorised unit trust scheme, UK open-ended investment company, charity, life company, pension scheme, sovereign wealth fund, registered provider, general partner of a limited partnership which is a collective investment scheme under FSMA, or REIT (and, in some cases, non-UK equivalents of the above)

Property, balance of business and distribution conditions

- The PRB of the REIT or REIT group must involve at least 3 properties, none of which exceeds 40% of the whole portfolio in value
- At least 75% of the income profits in the accounting period must be from the PRB and at least 75% of the assets of the REIT at the beginning of the relevant accounting period of the REIT must be in PRB assets or in cash
- 90% of PRB income profits, as well as 100% of PRB profits received from other REITs, must be distributed as PID

Other key provisions

- There is a tax charge in the REIT if a dividend is paid to a corporate investor with a 10% or more interest in capital, dividends or voting, unless the REIT has taken reasonable measures to prevent it. This is, in practice, commonly known as the 10% corporate shareholder restriction - see further below
- There is no express restriction on gearing in a REIT. However, there is potential tax in the REIT on profit, to the extent that an "interest cover" ratio (based on property profits to property financing costs) of 1.25:1 is breached - other than in mitigating circumstances, such as severe financial difficulties or unexpected or unforeseen circumstances

Tax position

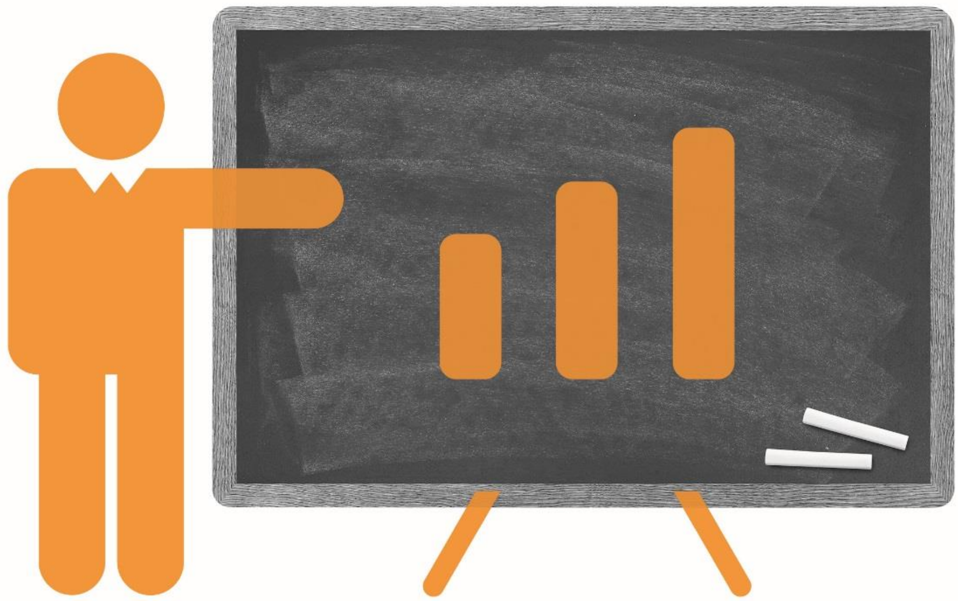
- Income and capital gains of the REIT from its PRB are tax exempt in the REIT, provided that the relevant conditions (as above) are met
- There is, however, a withholding tax at 20% on PID, unless the recipient is a "gross" investor. While capital gains from disposals of assets of the PRB do not need to be distributed, if they are, they are also treated as PID and the potential withholding tax will apply to them also. Refunds of tax withheld are available for non-taxpayers and, for appropriate non-UK investors, treaty reclaims may be made of some or all of the tax withheld
- On acquiring or selling companies into or from the REIT, PRB assets are rebased to market value. Capital allowances carry forward and are used on a tax written down basis
- Other profits and gains of the REIT are taxable and can be distributed as dividends, in the usual way

Modifications to the REIT rules

Since 2012/ 2013, a number of the original REIT rules have been modified to assist, in particular:

Start-ups	REITs investing in other REITs
Larger-scale institutional investment	Joint ventures in the form of REITs with "institutional investors"

Taken together, these have all made the REIT an even more viable and attractive vehicle for investment, for the right business plan and investor.



Particular points to note

- There is no longer any entry charge to join the REIT regime
- While the principal company must be UK tax resident, it does not have to be incorporated in the UK. Subsidiaries do not have to be incorporated or resident in the UK
- The REIT can be either internally managed or managed by an external party
- The REIT can operate as an operating company or as a fund
- It is possible to have a REIT joint venture with suitable investors
- PRB is defined. It includes most, but not all, property-based income. It does not include interest receivable or profits from share disposals
- The REIT can carry on development (though special rules may apply)
- Likewise, the REIT can carry on trading activities, such as sales or management, provided the various REIT tests are not breached (though the REIT tax exemptions would not apply to trading profits)
- The holding of cash does not give issues with the balance of business tests
- It is possible, in practice, for many corporate groups to avoid issues with the 10% corporate shareholder test by disaggregating their holding through subsidiaries. Other measures potentially exist for those for whom disaggregation does not work
- The value of PRB assets in corporate entities acquired and sold is rebased to market value (without any tax charge) on entering or leaving the regime
- There is a choice of exchanges/ markets, both within and outside the UK, on which REIT shares can be traded or listed
- There are specific anti-avoidance conditions and provisions to deal with breaches of the various REIT conditions

The changing tax and market landscape and its impact on REITs

Recent and future developments in the UK tax and regulatory landscape, plus other macro-industry circumstances have only further increased interest in the REIT as an investment vehicle for accessing returns from UK real estate. Some of these factors are set out below (though many of the tax proposals are still in outline form and may change).

Further changes of law and in market sentiment and their potential implications	
Indexation allowance was abolished in computing taxable gains for corporation taxpayers from 1 January 2018	This means that taxable gains could exceed economic profits
CGT will be introduced for non-residents on all UK real estate from April 2019. The proposals to date include: (1) a direct tax charge on disposals of all directly held property (with the abolition of the current exemption for widely held residential property), and (2) a charge on disposals in property-rich vehicles where the investor (and connected parties) has held 25% in the last 5 year period	This is a complete change to the historic position. While the proposals are still out to consultation (and, in particular, HMRC/ HM Treasury do not wish to prejudice tax exempt investors such as pension funds investing in offshore structures), the changes are likely to make UK tax exempt onshore vehicles more attractive where appropriate
From 6 April 2020, corporation tax will be extended to non-resident corporate landlords, including rules around corporate interest and loss carry forward restrictions and more esoteric rules such as those for hybrid mismatches	This will, in practical terms, potentially reduce tax deductions (in line with current rules for UK companies) and correspondingly reduce profits in many offshore structures. In particular, this is likely to impact on structures where interest on shareholder debt has effectively helped reduce the UK tax cost
More generally, there is a growing preference among many UK investors to have a UK vehicle for UK real estate	UK institutional investors, in particular, are increasingly interested in using a UK-based structure, if possible. The REIT is a potential closed-ended option
A preference of some for closed-ended vehicles for more widely held real estate, given the higher illiquidity of real estate to other assets	This issue drives some (but not all) managers and investors to prefer a closed-ended investment vehicle, where appropriate
In the residential sector, there are now increased costs for the buy-to-let market, including higher rates of SDLT, interest restrictions and, for non-domiciled investors, IHT, non-resident CGT and the increased scope of CGT generally from 2019	This may make direct or wholly owned investments in this sector less attractive for some investors and cause them to look at other ways of accessing the sector, such as the REIT
Brexit	This may further increase the attractiveness of local holding structures for property in the UK and other European jurisdictions

So, who is likely to find the REIT attractive?

In considering the optimal choice of structure, various factors need to be considered. These include the target investor base, the suitability of the business model for the relevant regime, regulatory constraints, liquidity, pricing, cost and timing.

Those who may be particularly interested in the REIT as an investment vehicle are likely to be:

- UK propcos and funds with the right business model. Some are already actively reconfiguring their businesses in order to enter the regime
- Non-UK propcos with UK and other "institutional investors" and funds who are concerned about the impact of the new CGT charges and interest restrictions on their returns from other vehicles
- Non-UK pension funds in a suitable treaty jurisdiction for whom investment into UK real estate via a REIT can offer effectively enhanced returns
- Non-UK REITs (ie UK REIT equivalents) looking to invest efficiently in UK assets
- Investors and managers in some offshore property unit trusts (eg JPUTs, GPUTs, IPUTs). While it is understood that HMRC are looking at a fix under the new CGT proposals, so as not to prejudice those with largely UK CGT exempt investors (eg pension funds), it is not yet clear what is going to happen. Many of these are reviewing their options and potentially some may convert to REITs
- Managers considering new funds or propcos seeking to access a wider investor base
- Joint ventures with at least one "institutional investor" with a substantial interest

What next

We are expecting an increased uptake in the use of the REIT for investment into UK real estate and a restructuring of some existing structures to enter the regime.

More on this and some of the practical aspects of becoming a REIT will be considered in the next briefing.

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