



REITS - REAL ESTATE INVESTMENT TRUSTS

How to qualify as a UK-REIT

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The UK-REIT regime

The UK-REIT regime is set out in Part 4 of the Finance Act 2006 (as updated by the Finance Act 2007) and is supplemented by a number of regulations. It is also supported by guidance published by HM Revenue & Customs (HMRC). The regime for UK-REITs has been operational since 1 January 2007 and 18 listed UK property companies, including many of the largest property companies in the industry, have thus far converted to or listed with UK-REIT status. Entry to the regime is by notice to HMRC and does not necessitate a new form of corporate vehicle.

The qualifying conditions

A potential UK-REIT has to carry on a property rental business (a UK property investment business or an overseas property business, for UK tax purposes). It must also fulfil the qualifying conditions (there is no need to fulfil all of the qualifying conditions on entering the UK-REIT regime, see further below). The qualifying conditions fall into three categories:

1 The company conditions

A UK-REIT must be a company and:

- Be solely resident in the UK for tax purposes
- Not be an open-ended investment company
- Have a listing on a recognised stock exchange (this includes the Main Market of the London Stock Exchange, but not AIM)

- Not be a close company
- Have one class of ordinary share, and no other shares (except non-participating fixed-rate preference shares)
- Not be party to any excluded loans (broadly, profit-linked, asset-linked or non-commercial).

2 The tax-exempt business conditions

A UK-REIT must have a property rental business which forms its tax-exempt business. It can also have other taxable businesses, as discussed below. The property rental business carried on by the UK-REIT must:

- Contain at least three single rental properties (these can be commercial or residential, and a property includes each separately-rented unit in a multi-let property)
- Not involve a property representing more than 40 per cent of the total value of the property rental business
- For each accounting period, distribute at least 90 per cent of its property rental business profits by way of dividend (known as a property income dividend or PID).

The PID is required to be made 12 months from the end of each accounting period.

The tax-exempt business may not involve any owner-occupied properties by the UK-REIT or by any other Group UK-REIT company, or occupation by any company whose shares are stapled to those of the UK-REIT.

3 The balance of business conditions

A UK-REIT must pass both of the following balance of business conditions in each accounting period:

- At least 75 per cent of the total profits (before tax and excluding realised and unrealised gains and losses on the disposal of properties and items that are outside the ordinary course of the UK-REIT's business) from the business of a UK-REIT, calculated in accordance with international accounting standards, must arise from its tax-exempt business (the Profit Test)
- The value of the UK-REIT's assets in the tax-exempt business must be at least 75 per cent of the total value of all of its assets, as valued in accordance with international accounting standards (the Asset Test).

Provided they do not exceed 25 per cent of its activities, a UK-REIT can, therefore, undertake activities other than running a property rental business and still pass the balance of business conditions. These activities could be ancillary services associated with the property rental business, or other activities such as property trading or services.

Certain classes of income and profits are expressly excluded from being within the tax-exempt business. These include various income currently not treated as property income, such as receipts from transactions falling within the rent-factoring tax provisions and dividends from other UK-REITs.

Given the exclusion of items that are outside the ordinary course of the UK-REIT's business for the purposes of the Profit Test, a one-off event that enhances the total profits of a UK-REIT should not prejudice the status of that UK-REIT.

Under the Real Estate Investment Trusts (Breach of Conditions) Regulations 2006, in certain circumstances the value of the property rental assets may temporarily drop to 50 per cent without breaching the Asset Test. The Real Estate Investment Trusts (Breach of Conditions) (Amendments) Regulations 2007 relaxed the Asset Test further for new UK-REITs: broadly, a breach of the Asset Test by a UK-REIT during its first accounting period as a UK-REIT will be disregarded, provided that the Asset Test is met at the end of the first accounting period.

Particular companies

Private companies and companies quoted on AIM cannot elect for UK-REIT status by virtue of the recognised stock exchange listing requirement. The UK-REIT is, therefore, a public rather than a private vehicle and it will need to comply with relevant listing requirements, as well as the UK-REIT regime.

In addition, a UK-REIT must be a company and cannot be a trust or some other non-corporate structure. These types of structure may be accommodated, however, within a Group UK-REIT.

As regards the exclusion of owner-occupied properties from the UK-REIT regime, there are clear implications, for example for retailers.

The UK-REIT regime is aimed at property rental companies. It is not aimed at property trading, or property development companies which carry on a trading, rather than an investment, business. A UK-REIT that holds a property and disposes of that property in the course of a trading (rather than investment) activity, will suffer a tax charge; the property will be deemed never to have been within the tax-exempt business.

The operation of the tax-exempt business conditions allows companies to carry out development activities within the tax-exempt business, provided that the development is undertaken with a view to generating future rental income. However, the UK-REIT provisions specifically provide that, where a UK-REIT develops a property held within its tax-exempt business and then disposes of it within three years of completion of the development, the disposal will be treated as falling outside the tax-exempt business. This will be the case if the cost of development exceeds 30 per cent of the fair value of the land and buildings on the later of entry into the UK-REIT regime or acquisition.

In such cases, the proceeds will fall into charge to tax as either a capital or trading receipt. This may be the case even if the original intention was to develop and hold the property. The entry charge (see further below) paid in respect of the redeveloped asset will, however, be refunded.

Group UK-REITs

Groups of companies can qualify as a Group UK-REIT. A Group UK-REIT will be comprised of a principal company and all of its 75 per cent subsidiaries (other than open-ended investment companies and insurance companies). In broad terms, one company is a 75 per cent subsidiary of another if the parent company is the beneficial owner (directly or indirectly) of at least 75 per cent of its ordinary share capital. Each subsidiary must also be an effective 51 per cent subsidiary, adopting the statutory test used to determine a corporate group for chargeable gains purposes.

In a Group UK-REIT, when applying the balance of business conditions, UK and non-UK property rental activities of a UK resident company are included within the Group UK-REIT's tax-exempt business, together with the UK property rental business of a non-UK company. Non-UK activities of non-UK resident companies are treated as within the Group UK-REIT's tax-exempt business for this purpose.

There are some additional requirements for Group UK-REITs, including the rules regarding the submission of prescribed financial statements for the group to HMRC for each accounting period.

Notifying HMRC

A company (or group) that meets the conditions will not automatically become a UK-REIT. The company (or principal company if part of a group) must serve written notice on HMRC before the beginning of the accounting period for which it wants to be treated as a UK-REIT. There is no minimum time-limit for giving this notice.

To enter the regime the UK-REIT need not initially fulfil all of the qualifying conditions: at the point of giving notice it must be UK resident and it cannot be an OEIC. The Finance Act 2007 removed the requirement that a company had to have listed shares at the point of giving notice. Therefore an unlisted vehicle may give notice of entry into the UK-REIT regime and join the regime on the first day on which it is listed.

Entry charge

The entry charge provisions of the UK-REIT regime levy a charge of two per cent of the gross market value of the properties used within its property rental business. The market value is calculated at the date immediately before entry to the UK-REIT regime.

The entry charge will be collected at the same time as corporation tax is payable on the profits of the first accounting period following entry to the UK-REIT regime. If the UK-REIT pays corporation tax by quarterly instalments the entry charge will be collected as instalments, included with each quarterly computation.

Alternatively, companies can elect to spread the entry charge over four years, in instalments of 0.5 per cent, 0.53 per cent, 0.56 per cent and 0.6 per cent (2.19 per cent in aggregate, an effective rate of interest of about six per cent). If a UK-REIT leaves the UK-REIT regime within three years, and this instalment option has been chosen, any remaining instalments are brought into charge immediately.

A company wishing to spread the entry charge over four years must notify HMRC of this decision at the same time as electing to join the UK-REIT regime. This election to spread the cost of the entry charge is generally irrevocable, although the charge itself is refundable in certain very limited circumstances. For instance, where a property previously used in the tax-exempt business is sold in the course of the UK-REIT's trade, that property may be treated as if it was never within the tax-exempt business and the entry charge paid in respect of that property will be refunded.

Group UK-REITs and the entry charge

As regards property acquisitions by a Group UK-REIT, there is no entry charge when a member of the Group UK-REIT purchases a property. As regards company acquisitions, there is no entry charge when a member of a Group UK-REIT acquires another UK-REIT company. However, there will be an entry charge when a member of a Group UK-REIT acquires a company that is not a UK-REIT: this entry charge will arise in respect of the property rental business of the company being acquired.

If a UK-REIT is acquired by a non UK-REIT, then the acquisition will effect a de-listing of the UK-REIT. As a result, it will fail the recognised stock exchange listing requirement and be excluded from the UK-REIT regime from the end of the accounting period preceding the acquisition. The Finance Act 2007 also introduced revisions to permit demergers without fresh entry charges.

Effect of entry

On entering the UK-REIT regime, the company will be deemed to dispose of and re-acquire at market value the properties to be used in its property rental business. Any chargeable gain or loss arising on the deemed disposal will not be brought into account for tax purposes.

Once within the UK-REIT regime, the company will generally retain its UK-REIT status until it issues a valid notice on HMRC to leave the regime (specifying a date of cessation after the date on which the notice is received by HMRC), or until HMRC withdraws the company from the regime (either on notice, or through automatic termination on certain breaches by the company of a Qualifying Condition).

A UK-REIT can give notice to leave the UK-REIT regime at any time. However, where companies elect to leave the UK-REIT regime within 10 years of joining, and dispose of any property that was involved in the tax-exempt business within two years of having left, any uplift in the base cost of the property that occurred under the regime will be disregarded.

This will, potentially, result in a higher capital gain or lower allowable loss than would otherwise be the case. There will be no rebate of the entry charge in such cases.

The 10 per cent rule

The '10 per cent rule' originates from HMRC's desire to avoid a situation whereby a non-UK shareholder (resident in a country with a double-taxation agreement with the UK) receives a dividend from a UK-REIT and, because of the size of shareholding, is able to avoid or substantially reduce the tax withholding under the UK-REIT regime. The 10 per cent rule acts to restrict this possibility.

UK-REIT status will not be lost if a person is beneficially entitled to 10 per cent or more of the UK-REIT's dividends, shares or voting rights (a tax charge will be levied instead if a distribution is made to such a person). However, the rule now applies, by virtue of the regulations, to a person who is defined as 'the holder of excessive rights'. A person for these purposes is then expressly limited to corporate shareholders. Individuals and non-corporate shareholders are therefore entirely outside the rule.

The tax charge that will be levied will apply to the whole of the distribution to that company and not just the excess, unless the UK-REIT has taken 'reasonable steps' to avoid the payment of such a distribution. A potential UK-REIT should examine its Memorandum and Articles of Association so that it can make any changes necessary to establish that it has taken 'reasonable steps' to avoid the payment of a distribution to such a shareholder.

The HMRC guidance clarifies the meaning of 'reasonable steps' to include a provision in the UK-REIT's Memorandum and Articles of Association requiring a shareholder whose shareholding or voting power exceeds the 10 per cent threshold (often referred to as a Substantial Shareholder) to enter into a transaction designed to separate the entitlement to that dividend. This may be achieved by a dividend strip transaction, where the counter-party would not be beneficially entitled to 10 per cent or more of the dividends, or by the establishment of a trust to hold the dividends for a person who is not a Substantial Shareholder – unless or until the shareholder ceased to be a Substantial Shareholder.

Any company considering changing its Memorandum and Articles of Association should consider fully the practicalities of doing so, including any requirement to call an extraordinary general meeting and the need for the necessary shareholder approval.

Shareholders need to be fully informed of the effect of the conversion to UK-REIT on their own tax affairs. As regards any circulars that may be required, the British Property Federation has developed a template circular for companies in their conversion process, as well as a draft article dealing with the 10 per cent rule and close company condition. Both of these have been used by many companies in their conversion process.

Profit: financing-cost ratio

The UK-REIT regime uses a ratio test that compares profits of a UK-REIT's tax-exempt business (before interest costs, capital allowances and losses brought forward from a previous accounting period) with its financing costs, rather than a conventional gearing ratio. This ratio does not limit how much a UK-REIT is able to borrow, but creates a tax charge on the UK-REIT to the extent that it is breached. The profit: financing-cost ratio must not be lower than 1.25. This ratio is applied to a Group UK-REIT on a consolidated basis.

The purpose of the ratio is to prevent a UK-REIT being highly geared, or at least subject to finance costs which reduce the amount of profits available for distribution to shareholders. HMRC is seeking overall tax neutrality for the UK-REIT regime. Reducing the amount of income in the hands of the shareholders would impact on that position. Breach of the 1.25 profit: financing-cost ratio requirement does not result in a loss of UK-REIT status; instead, the company will suffer a tax charge on its excess financing costs. In this way a UK-REIT can still adopt what it considers to be an appropriate level of gearing.

UK-REIT transactions

Where a property within the tax-exempt business is sold, and the proceeds are to be reinvested in assets of the tax-exempt business, those proceeds are treated, for a period of two years, as assets held in connection with the tax-exempt business.

However, any income derived from those proceeds is treated as outside the tax-exempt business and is therefore taxable.

Breaches of the UK-REIT conditions

Broadly, a breach of certain of the Qualifying Company Conditions (those requiring the company to be resident in the UK, not to be an open-ended company, to have only one class of ordinary share in issue and not to be party to any non-commercial loans), will result in automatic expulsion from the regime.

Inadvertent and minor breaches of the other conditions will not usually lead to loss of UK-REIT status (unless the UK-REIT makes persistent breaches). HMRC can also serve notice terminating UK-REIT status where a company has been repeatedly involved in tax avoidance.

Joint ventures

A Group UK-REIT can include a joint venture company carrying on a property rental business with a third party as part of the tax-exempt business to the extent of the UK-REIT's interest. The UK-REIT must have an equity interest of at least 40 per cent.

On electing to include the assets and income of the joint venture company in the business of the UK-REIT, the joint venture company is required to pay a proportionate entry charge equal to two per cent of the value of its assets in the property rental business at the date the election becomes effective. This is the case even if previously the joint venture company was a member of a UK-REIT group and an entry charge was previously paid in respect of the company.

The Real Estate Investment Trusts (Joint Venture Groups) Regulations 2007, enacted in December 2007, extend the joint venture rules to more complex group structures. They are retrospective to January 2007.

Tax-transparent vehicles including offshore unit trusts

If a Group UK-REIT holds property through a tax-transparent vehicle, such as a partnership or a transparent unit trust, its share of the property and income will qualify for the purposes of satisfying the balance of business conditions, provided, in the view of HMRC guidance, that its interest in the partnership or unit trust exceeds 20 per cent. The stipulation of a 20 per cent holding for this purpose is not statutory. Any income from a tax transparent vehicle which is part of the UK-REIT's property rental business is tax exempt.

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