



REITS - REAL ESTATE INVESTMENT TRUSTS

Key tax-related issues

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Providing an alternative to offshore structures, the REIT regime came into effect on 1st January 2007. The objective of the regime is to provide an attractive, tax-efficient, UK vehicle for operating a property rental business – irrespective of whether the business involves UK or non-UK property.

To summarise, UK-REITs ensure tax transparency by exempting from tax all property income and capital gains at the company level, while taxing as property income any distributions made to shareholders, which must represent at least 90 per cent of the income (as adjusted for tax purposes).

Capital gains need not be distributed but if they are, their tax treatment is the same as for income distributions. There are various charges and penalties that arise for breach of scheme rules.

This article outlines the key tax-related issues and is intended to highlight the effect of the legislation, regulations and draft guidance material published. Changes may be made to the guidance and further regulations may be laid, so this article should be read with this in mind.

Considerable guidance material is available on the HM Revenue and Customs (HMRC) website at www.hmrc.gov.uk/manuals/greitmanual.

Benefits and key features of UK-REITs

Benefits

From a tax-related perspective, the UK-REIT regime presents two major benefits:

1. The profits arising from a tax-exempt business are not chargeable to UK corporation tax; and

2. The shareholders are taxed as though they had received any distribution out of the exempt business as property income.

Key features

The regime is for listed companies only (on a recognised stock exchange – this does not include AIM) and is at the choice of the company.

- Once a company enters the regime, it will remain within the regime until it ceases to be so as a result of a termination event. This will either be when it decides to cease to be within the regime or it is excluded from the scheme by HMRC.
- Companies/groups wishing to enter the regime must pay an entry charge, at two per cent, on the gross value of its property rental business assets.
- Profits and gains from a qualifying property rental business are not subject to UK tax.
- Profits from any other business will be subject to corporation tax at the full company's rate (currently 30 per cent).
- To the extent that dividends paid by the REIT derive from the tax-exempt profits and gains, they are taxable in the hands of the recipient as property income, rather than as dividends.
- On the cessation of the regime, generally (but see consequence of an early exit, below) there is a deemed disposal and reacquisition of the assets at market value, other than for capital allowances purposes.
- If the scheme rules are breached, there are various provisions allowing for a charge to tax to be imposed by HMRC.

- These charges limit the benefit of the scheme to what would have been available if the various conditions had been met. They do not generally operate as a penalty mechanism.
- If HMRC considers that a company has tried to obtain a tax advantage under these provisions for itself, or another person, they may, by notice to the company, counteract the advantage and assess the company to an additional amount of corporation tax, and impose a tax penalty.

Group

The regime is available to groups.

A group of companies may elect for REIT status. The REIT provisions then, subject to some modifications, apply to the group of companies as they do to a single company. Groups within the REIT regime are referred to here as REIT groups.

If a company within the REIT regime becomes a member of a REIT group or if a member of a REIT group becomes a member of another REIT group, the provisions that would apply on entry into the regime will not have effect.

The exemption from tax applies to the property rental business of UK resident members of the group and the UK property rental business of non-UK resident members.

Entering the regime

The commencement date for the company or group must be specified by written notice (containing such information as is prescribed) to HMRC before the beginning of that period. In relation to group UK-REITs (see Nabarro LLP's article "How to qualify as a UK-REIT" for more detail on group UK-REITs), notice to enter the regime must be given by the group's principal company.

Effects of entry

Having entered the regime, the following major tax consequences will take effect:

- The company's qualifying property rental business is treated as ceasing. An accounting period ends and another begins for the new, tax-exempt business. The cessation of an accounting period before, and the beginning of a new accounting period on entry, applies to each UK-resident member. Any rental business losses connected with the pre-entry property rental business lapse.

- Except for capital allowance purposes, the assets involved in the property rental business are treated as having been sold and immediately reacquired at their market value. Any gains arising as a result are not chargeable gains. However, there is an entry charge (see below).
- The deemed disposal and re-acquisition of assets takes effect in relation to each UK resident group member. On any subsequent disposal (apart from one following an early exit from the regime) the deemed market value on reacquisition is to be used as its base cost
- The tax-exempt business is treated as acquiring the assets for capital allowances at their written-down value (as though the pre-entry business had not ceased).
- In relation to certain group reliefs, the tax-exempt businesses of the group members are treated as a separate group distinct from the pre-entry businesses, the non-tax exempt businesses and the post-cessation businesses of those companies.

Entry charge

On entering the regime, a company is charged on a notional amount of income which is treated as arising in respect of its non tax-exempt business.

This charge is, in effect, the price of having the assets rebased to market value. The notional income is two per cent of the aggregate market value of the assets treated as transferred to the tax-exempt business, grossed up by the rate of tax. The effect of the grossing-up is to give an effective tax rate of two per cent.

No loss, deficit, expense or allowance can be offset against the notional income or tax charge.

In applying the entry charge, these rules apply to each member of the group. Where a company joins a REIT group, the entry charge applies to a company on joining a group as if it were entering the REIT regime.

Spreading the entry charge

A company can elect, irrevocably, to spread this notional income over four years. The aggregate amount is then increased (to 2.19 per cent), reflecting the cashflow advantage of spreading the tax liability.

Tax on this notional income is payable along with any tax for the residual non-exempt business. If the company ceases to be a REIT before the third anniversary of entry, any remaining installments immediately become chargeable.

First	0.50 per cent
Second	0.53 per cent
Third	0.56 per cent
Fourth	0.60 per cent

Qualifying conditions

Companies must adhere to a number of qualifying conditions (see Nabarro LLP's article "How to qualify as a UK-REIT" for more detail). In some cases, failure to do so can give rise to a tax charge, or removal from the REIT regime (unless non-adherence is rectified within a specified period). A system that monitors compliance with the conditions should therefore be put in place by management. The most important tax-related conditions are listed below:

Listed status

The company must be quoted on a recognised stock exchange and, in principal no shareholder should own more than 10 per cent (see below for consequences).

Residence

The company must be resident in the UK only, either by virtue of its place of incorporation or because its central management and control is in the UK. A non-UK incorporated company can be a REIT provided it is not tax resident outside the UK.

Close company status

The company must not be a 'close company'. A close company is one that is broadly under the control of the directors or five or fewer shareholders. The definition of a close company here is wider than it is for some other tax purposes. It will generally not be close if it is controlled by more than five persons or more than 35 per cent of its shares are in public hands.

Business

To qualify as a tax-exempt business, a property rental business (which, in technical terms, is defined for tax purposes according to the scope of the income arising), must meet all the following three conditions:

- it must involve at least three properties. There is no clear definition of a property for these purposes. However, a property is treated as a single property if it is rented or available for rent as a unit separate from any other such unit
- no single property is to have a value of more than 40 per cent of the total value of all the properties involved in the property rental business
- none of the properties involved should be categorised as owner-occupied in accordance with generally accepted accounting practice (see International Accounting Standard, IAS 40).

In addition, certain types of property rental business are non-qualifying, in particular those relating to the rental of oil and gas pipelines, mobile telephone masts etc. Property dealing, or any other form of trading activity, is also excluded.

Distribution

The company must distribute a sum equivalent to 90 per cent of the tax-exempt rental profits (not capital gains), as adjusted for tax purposes (and so net of capital allowances), arising in an accounting period. The distribution must be made on or before the filing date (normally 12 months after the end of the accounting period) for the company's tax return. This condition does not apply to the extent it would be unlawful to make a distribution.

Where part of a distribution has been withheld to avoid or reduce a tax charge that arises on making a distribution to investors with a shareholding of 10 per cent or more, it will nevertheless count as having been made. For this purpose, a tax charge may be imposed, by Treasury regulation, if it makes a distribution to or in respect of a company (not individual) who is beneficially entitled (directly or indirectly) to 10 per cent or more of the company's share capital or dividends, or who controls 10 per cent or more of its voting rights. The purpose of this charge is to discourage single shareholdings above the 10 per cent level.

Limitations on non-exempt business

The profits (before deduction of tax), as defined, arising from a company's non-exempt business in the accounting period must not exceed 25 per cent of the aggregate of the total profits and the value of the assets involved in the non-exempt business at the beginning of the accounting period must not exceed 25 per cent of the total value of assets held.

Where a company disposes of an asset and holds the proceeds in 'cash', the proceeds will count as an asset of the tax-exempt business for the purpose of the 25 per cent rule above for a period of 24 months from the date of the disposal.

Where the asset disposed of was used only partly for the tax-exempt business, an apportionment is to be made. Any income derived directly or indirectly from those proceeds whilst awaiting reinvestment is, however, treated as income from the non-exempt business.

Debt financing

In order to regulate the level of deductions for debt finance that underpin the calculation of profits and distributions on which the tax is calculated, a charge may be imposed where, for an accounting period, the company has a very high level of gearing (over 80 per cent). A charge is imposed by HMRC if the aggregate of the profits from the tax-exempt property business (before the offset of capital allowances), plus the finance costs in respect of that business divided by those finance costs, is less than 1.25.

Calculation of profits

There are detailed rules to ensure that only income and gains of a property rental business attract tax privileges. The tax-exempt business is effectively ring-fenced by being treated as a separate business of a separate company.

- A loss incurred in the tax-exempt business cannot be offset against profits of any non-tax exempt business and vice versa
- These ring-fencing provisions apply to the various parts of a REIT group in the same way as they do to the various parts of a REIT company. Accordingly, the no gain/no loss provision on the transfer of assets within a group does not apply to disposals by or to a company within the REIT regime and the following reliefs are also subject to similar restrictions:
 - actual or notional transfers
 - reallocation of rolled-over gains
 - group relief for losses
 - loan relationships
 - derivative contracts, and
 - intangible fixed assets.

- There are a number of specific rules that will need to be noted. In particular:
 - any capital allowances available will automatically be taken into account in the calculation of profits of the tax-exempt business without the requirement for a claim
 - the exemption from the transfer pricing rules for small- and medium-sized enterprises does not apply to the company's exempt or non-tax exempt business
 - receipts accruing after entry relating to the pre-entry business cannot be treated as receipts of the tax-exempt business.

Capital gains

A gain arising on the disposal of an asset used wholly and exclusively for the purpose of a tax-exempt business is not a capital gain for tax purposes.

Where an asset has been used partly for a tax-exempt business during one or more periods aggregating to at least one year, the gain is not chargeable to the extent that it can reasonably be attributed to the tax-exempt business.

Parallel rules apply to REIT groups.

Movement of assets out of ring-fence

When an asset moves out of the ring-fence, there is a deemed disposal and reacquisition for a consideration equal to the market value of the asset. On any subsequent disposal of the asset, the deemed consideration is to be used as its base cost (unless on early entry from the scheme, or if disposed of in the course of a trade).

Movement of assets into ring-fence

There is a disposal and reacquisition at market value.

Distributions

Tax liability of the shareholder

Distributions made from the REIT tax-exempt profits (including any gains) are taxable on the shareholder (whether or not UK resident) as property rental income. This continues to be the case even after the company has left the REIT regime.

This treatment does not apply to certain company shareholders resident in a country which has a tax treaty with the UK, and which treats such distributions as normal distributions. In consequence, the regime rules enable a charge to be made on the REIT where distributions are made to company shareholders having a large interest (10 per cent or more).

In the case of certain traders where distributions would normally be taxable under Schedule D Case I, such as financial traders and members of Lloyd's, the REIT distribution will continue to be taxable under those rules.

Deduction of tax

The basic taxing mechanism is that distributions which count as property income under the REIT rules are subject to deduction of tax at source. A non-resident shareholder is not, however, subject to taxation as a non-resident landlord in respect of the distributions. Rules for the assessment, collection and recovery of tax are prescribed by Treasury regulations which:

- require the company to deduct income tax at source at the basic rate and specify classes of shareholder to whom distributions can be made gross
- contain detailed provisions for the calculation and payment of tax, claims and appeals, payment of interest, notices and returns, etc.
- apply to distributions deriving from the profits of a tax-exempt business after a company has left the REIT regime.

Attribution of distributions

Whereas distributions derived from the tax-exempt business are subject to deduction of tax at source, distributions derived from any non-exempt business are paid gross. Rules are therefore required to identify the distributions as derived from the exempt and non-exempt businesses.

The distributions are to be attributed in the following order:

- payments made to meet the 90 per cent distribution requirement
- distributions deriving from activities chargeable to tax on income (as the company determines)
- distributions of profits of the company's property rental business (up to the amount of such profits not yet identified as having been distributed)
- distributions of gains arising from the tax-exempt business
- other distributions.

Leaving the regime

Termination by notice

A REIT can give notice in writing to HMRC specifying a date from which the REIT regime is to cease to apply to the company or group.

HMRC may give written notification to a REIT that the regime is to cease to apply to it if:

- the company has relied on the minor or inadvertent breach provisions on a 'specified' number of occasions in a 'specified' period
- the company has been given a specified number of notices in relation to the cancellation of a tax advantage in a specified period; or
- HMRC considers that the breach of the company conditions or tax-exempt business conditions, or an attempt by the company to obtain a tax advantage, is so great that it no longer qualifies for REIT status. Such a notice must state the reason for the termination and may be the subject of an appeal. The regime will then cease to apply (subject to the early exit provisions) at the end of the accounting period before that in which the event occurs (or the last event occurs) which caused HMRC to give the notice.

Automatic termination

If certain company conditions above (see Nabarro LLP's article "How to qualify as a UK-REIT" for more detail) are not satisfied in an accounting period, the REIT regime is treated as ceasing to apply to the company at the end of the previous accounting period. A company which gave notice of entry must notify HMRC as soon as is reasonably practicable if any of those conditions cease to be satisfied.

Effects of cessation

Consequences that mirror those on entry apply so that:

- the company's tax-exempt business is treated as ceasing to exist immediately before the cessation; an accounting period of the non-tax exempt business ends on cessation and a new accounting period of the company begins
- the assets involved in the tax-exempt business immediately before cessation are treated for corporation tax purposes as sold and reacquired at their market value. The effect of this is that on any subsequent disposal (apart from one following an early exit) the deemed consideration is to be used as its base cost
- for capital allowances purposes, the post-cessation business is treated as acquiring the assets as though the tax-exempt business had not ceased.

These provisions apply in relation to each UK resident group member.

Effects of early exit

It is intended that companies will be within the regime for a significant period of time. If the company leaves the REIT regime having been within the regime for a continuous period of less than 10 years then:

- if the company disposes of an asset that was part of the tax-exempt regime within a period of two years beginning with the date of cessation, any deemed disposals that applied to that asset on entry to the regime, on transfer out of the ring-fence, or on exit from the regime, are ignored in calculating the gain on the disposal
- HMRC may, on an early exit, alter the time the company is treated as leaving the REIT regime and may also disapply or alter the effect of the provisions which exempt the profits and gains of the REIT's property rental business from corporation tax.

Administration

Penalties will apply for failure to comply with the requirement:

- to provide a notice of a minor or inadvertent breach, or with any requirements imposed by regulations in relation to such breaches
- imposed by regulations in connection with deduction of income tax from distributions
- to provide notice of a breach of company conditions in relation to automatic termination; and
- to meet the company conditions and for the principal company to send in financial statements as part of those conditions.

An initial penalty of up to £300 will apply and, if the failure continues after this penalty has been imposed, a further penalty of up to £60 per day can be imposed for each day the failure continues.

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