



Changes to REIT Regime: The re-invention of REITs

Background

Real Estate Investment Trusts ("REITs") were introduced in the UK on 1 January 2007. A REIT is a company or group, the top company of which is required to be UK tax resident and listed on a stock exchange "recognised" by the Revenue. Provided a company carrying on a "property rental business" meets the conditions set out in the REIT rules, it can elect to join the regime. The profits a REIT derives from its property rental business are exempt from UK corporation tax. In return, a REIT is obliged to pay out at least 90% of its rental profits as a dividend subject to a withholding tax of 20% and taxed on shareholders as rent. This treatment moves the burden of tax from the company to the shareholders.

In this year's Budget, the Chancellor announced that the Treasury would consult on making various changes to the REIT rules. The overall aim is to increase the number of REITs and also expand the exposure of REITs to the residential property market.

Recent developments

The results of the consultation were released on 4 October. It is likely that some changes will be included in the draft legislation to be published on 6 December 2011 for inclusion in next year's Finance Bill.

Here is a summary of the main proposed changes:

- (a) The change which has attracted the most headlines is the proposed abolition of the 2% entry charge. This is currently applied to the market value of all properties held by a group which elects to become a REIT, or to all properties owned by a company bought by an existing REIT. It is this entry charge which limits the number of entities which can viably become REITs. The charge may have been viewed as a fair price for eliminating the latent gains of a large existing property group but it is difficult to justify to investors considering the launch of a REIT where newly acquired properties mean there is little or no latent gain to eliminate.
- (b) The proposed changes include the introduction of a diverse ownership rule for institutional investors which will exempt them from the close company rule. This will reflect the fact that a REIT could be considered a close company

for tax purposes where an institutional investor holds a significant stake, despite the fact that the investment fund, through which the institutional investor holds the stake, could itself be held by a diverse ownership.

- (c) A relaxation of the listing requirement to allow REITs to list on AIM and PLUS markets and their foreign equivalents. This does not go as far as the property industry initially hoped in allowing unlisted REITs, but should still encourage more companies to become REITs.
- (d) The introduction of a grace period of 3 years for meeting the non-close company requirement. This allows a REIT to start as a close company and then obtain more investors once it is established.
- (e) Cash arising from the disposal of an asset or from a rights issue will be able to be treated as a "good" asset. This will allow breathing space for a REIT to identify and acquire its investments. Also, financing costs for the interest cover test will be re-defined so that the reduction in exemption from corporation tax (that might arise because of the level of interest paid) will be based on a measure of excessive borrowing rather than on the total finance costs incurred on the borrowing.
- (f) In certain circumstances the time limit for complying with the distribution requirement will be extended from 3 to 6 months where the distribution is met by share capital rather than cash.

Possible consequences

Our view is that these proposed changes will make the REIT regime more attractive to a variety of organisations. Benefits from the changes may include:

- (a) Making the REIT regime more attractive to smaller property companies.
- (b) Making it more likely that institutional investors will take large stakes in REITs or find new investment into their existing portfolios through launching these as new REITs while retaining significant stakes.
- (c) Encouraging house builders to consider spinning off unsold properties into AIM listed REITs.

- (d) Encouraging property-rich companies such as hotel and healthcare operators to consider realising the value of their real estate portfolio via a REIT listing on AIM.
- (e) Encouraging off-shore funds holding UK property to move into a tax efficient on-shore structure without an entry cost.
- (f) It is possible that banks will take the opportunity to reduce their exposure by floating property as a REIT. This could include residential property repossessed from owners in default.
- (g) Large scale landlords of residential property may list as REITs.
- (h) Social housing providers may consider putting some or all of their portfolios into a REIT structure.

It is worth noting that many countries' competing REIT regimes have some or all of these characteristics already, so these changes should make UK REITs more attractive to the international market and encourage foreign investment into the UK.

If you would like to discuss any of these issues further, please contact Rick Read or Nigel Popplewell:



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