UK REAL ESTATE INVESTMENT TRUSTS

An overview of the implications of the Government's draft legislation on UK Real Estate Investment Trusts

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Contents **Page**

Contents	Page
Introduction	3
Principal condition for UK-REIT	6
Investment criteria for UK-REIT	11
Condition for balance of activities of UK-REIT	14
Entry and exit from UK-REIT regime	15
Tax treatment of UK-REIT	19
Conclusion	20

UK Real Estate Investment Trusts

1. Introduction

The Government published draft legislation in relation to the introduction of a UK Real Estate Investment Trust ("UK-REIT") on 14 December 2005. A comparatively short period for consultation to 27 January 2006 has been allowed and HM Revenue & Customs ("HMRC") has confirmed its intention to introduce enabling legislation in the 2006 Finance Act with the UK-REIT regime becoming available in respect of accounting periods commencing on or after 1 January 2007.

1.1 UK Government's position

The UK Government has, historically, been rather reticent at the notion of a UK-REIT. Their ambivalence has stemmed in part from a rather poor perception of the property industry and from a feeling that real estate was really no different from any other commercial enterprise and, as such, should not be afforded any special privileges that might place it in a more tax advantageous position.

Following a concerted and high profile campaign by the property industry and in the wake of the findings of the Barker Report on Housing Supply which recommended that: *"Government should deliver its proposals to promote greater interaction between institutional investors and the residential property market through the introduction of tax transparent property investment vehicles."* HMRC launched a Consultation in 2004. This was followed by a Discussion Paper in 2005 and draft legislation for single company UK-REITs in December 2005.

Whilst the Government have been willing to promote the introduction of a UK-REIT their enthusiasm has been tempered with the need to ensure that no net loss in tax revenues should occur on introduction of the new regime. The mantra preached by HMRC (and repeated in its most recent announcements made) is instructive: *"The Government remains committed to ensuring that the introduction of a UK-REIT results in no overall loss of revenue for the UK Exchequer and will keep this under review"*.

UK Real Estate Investment Trusts

This implies that a key objective for the Government is protecting tax revenues. It is unwilling to allow the development of a UK-REIT framework that would compromise this objective.

In this regard the Government has been aware of the development of the equivalent French REIT regime. The latter has resulted in a significant tax loss to the French tax authorities particularly in relation to investments made by non-residents - HMRC is naturally keen to avoid such experiences.

1.2 Objectives for UK-REIT

Four policy objectives have been identified that it is expected the UK-REIT wil deliver: -

Efficiency in property investment

As a tax-exempt entity the UK-REIT will circumvent any potential distortion caused by tax charges at the entity level.

Investors will be deemed to own a fractional share of the underlying real estate asset(s) and should be able to make their investments whilst incurring relatively low transaction costs.

A UK-REIT will encourage landlords to transfer property assets, particularly those supported by stable income profiles, to the new regime. Furthermore more ‘non-traditional’ classes of real estate asset – including properties held by local authorities could be transferred to UK-REITs.

Expanding access to a wider range of investors

Retail investors have been frustrated by an inability to source appropriate commercial real estate investment opportunities. It is expected that a UK-REIT will alleviate this difficulty.

UK Real Estate Investment Trusts

Ensuring fairness for all taxpayers

Commercial real estate investment opportunities are often only available to investors willing to take significant equity positions. This often precludes participation by investors with lower investment capacities.

In addition, certain commercial real estate investment opportunities are only available through the medium of non-UK entities which may be unacceptable to certain investors.

Improving flexibility for tenants

It is assumed that UK-REITs may promote more flexible lease arrangements for tenants and assist in further cash in-flows to the residential sector.

The Government has high expectations that UK-REITs will facilitate increased institutional investment in residential property.

2. Principal condition for UK-REIT

There are eight principal conditions that a UK-REIT must satisfy in order to receive the benefits of the new regime. Three of these (2.1 to 2.3) must be met before an application is made to HMRC for UK-REIT status. The remaining five conditions (2.4 to 2.8) must be met throughout the accounting periods in which UK-REIT status is claimed.

The eight principal conditions are supplemented by a further series of conditions in relation to asset allocations, distribution policy and interest cover. Turning to the principal conditions:-

2.1 Legal structure

The UK-REIT will need to be established as a corporate entity. It will not be possible to establish the UK-REIT as an Open Ended Investment Company (“OEIC”) within the meaning of Section 236 of the Financial Services and Markets Act 2000.

Comment

It was unsurprising that a closed ended entity would be required. Accordingly, it was inevitable that OEICs would be precluded from the UK-REIT regime.

OEICs were established as listed collective investment schemes and designed to be a more flexible alternative to unit trusts. They have in recent years increased in popularity with a significant number of unit trusts converting to OEICs.

Given the relative popularity of OEICs there is an unanswered question as to whether the UK-REIT provisions should have been extended to include open-ended entities.

2.2 Place of residence

The UK-REIT may be incorporated within the UK or outside the UK. However it must be tax resident in the UK. It will not be possible to have a dual tax resident company as a UK-REIT.

Comment

The UK will by virtue of this clause be able to reserve taxing rights over the UK-REIT. It is hard to divine whether this provision falls within the letter and spirit of EU legislation.

Had the draft legislation prevented EU companies from becoming UK-REITs this would have been in contravention of EU law and subject to successful challenge in the ECJ. The draft legislation does not prohibit EU companies from becoming UK-REITs – it merely places an obligation on them to be UK tax resident.

2.3 Listed status

A UK-REIT must be listed on a "Recognised Stock Exchange". It will not be possible for companies currently listed on AIM to benefit from the UK-REIT regime without securing a full listing.

Comment

The Government listed status will allow wider access and enable a high degree of market scrutiny. There will, of course, be a significant increase in compliance costs in arranging listings on a "Recognised Stock Exchange".

Companies listed on AIM will need to obtain a full listing before they are able to benefit from the UK-REIT regime. This obligation restricts the opportunity for UK-REIT status to large companies. Extending the UK-REIT regime to AIM listed companies would have increased the appeal of the regime but this would have been at the price of a 'light touch' regulatory regime which the Government are unwilling to accept.

The legislation is drafted such that UK incorporated companies will need to be listed on the London Stock Exchange ***before*** *they are able to apply for UK-REIT status. This would seem to be an onerous condition particularly in relation to start-up situations.*

2.4 Shareholding limits

The company must not be a "close company" within the meaning of Section 414 ICTA 1988. It will however be possible for the company to be a "close company " by virtue of having as a participator a limited partnership that is a collective investment scheme within the meaning of Section 235 of the Financial Services and Markets Act 2000.

Comment

Whilst we accept the Government's imperative to afford wide access to the shares of a UK-REIT we believe that a private UK-REIT (albeit one with a reasonably wide share ownership) would have proved attractive to a significant number of shareholders. This opportunity does not seem to be available – either now or in the future.

2.5 Share capital

A UK-REIT must not issue any share capital that does not rank as ordinary share capital. In addition, there must be only one class of ordinary share.

Comment

The requirement for a single class of shares will require management remuneration to be arranged in a manner that is attractive but compliant with the UK-REIT legislation.

The capital structure of property companies is often complex. There are often several different classes of shares with each class afforded distinct rights. Management remuneration is frequently framed such that the latter are issued with a certain class of share on meeting specific performance targets.

2.6 Maximum interest

It will not be possible for one person to directly, or indirectly, control 10% or more of the ordinary share capital or voting rights of the UK-REIT.

Comment

This is a cleverly crafted yet highly controversial provision that will have significant implications for investors and could undermine the attractiveness of the UK-REIT regime. It is also a provision that will from a practical perspective be hard to police and could, potentially at least, leave a majority of shareholders in the UK-REIT exposed to a risk of the UK-REIT failing to meet the qualifying conditions set out in legislation. In essence shareholders are being asked to accept the risk that the actions of a single one of their number could result in an adverse tax result for them all – it is a significant risk.

HMRC have agreed that in those instances where the management of the UK-REIT have done everything in their power to ensure that the 10% shareholding limits were met, a breach of this condition would be regarded as a "minor breach". A "minor breach" would result in an additional liability to tax under Schedule D Case VI but it would not result in a termination of the UK-REIT regime.

Robust control mechanisms will need to be introduced in order to ensure that the 10% shareholding limit is not breached. Furthermore, water-tight shareholders' agreements to prevent a breach.

Whilst the Government claims that the 10% shareholding limit has been inspired by the need to promote wide share ownership, the real reasons for its inclusion would appear to be somewhat different. It is more likely that the 10% limit has been to counteract the benefits that may be obtained by non-residents investing in UK-REITs and at the same time leveraging the benefits of the respective Double Tax Agreement.

2.7 Loan arrangements

The UK-REIT must not be a party to a loan that is not a normal commercial loan within the meaning of paragraph 1(5) of Schedule 18 of ICTA 1988.

Comment

This provision reduces the opportunity to construct more structured financing arrangements with, for example, different tranches of loan each bearing different degrees of commercial risk.

The types of financing arrangements anticipated (and prevented) by the legislation are more commonly associated with more highly geared operations and, in practice, may not prove to be a significantly onerous condition.

2.8 Accounting aspects

It will be necessary to prepare accounts in accordance with International Accounting Standards ("IAS").

Comment

This would not appear to be too onerous a requirement particularly bearing in mind that there is an obligation for UK listed companies to produce accounts using IAS.

3. Investment criteria for UK-REIT

In addition to the principal conditions (outlined in Section 2), a further series of conditions have been introduced relating to the conduct of the qualifying tax-exempt business carried on by the UK-REIT. These are described in further detail below:-

3.1 Investment criteria for qualifying business

The property rental business must comprise at least three properties and these must must be held throughout the relevant accounting period. A 'property' includes any estate, interest or other right.

A 'property' is a 'single property' if it is designed, fitted or equipped for the purpose of being rented, and it is rented or available for rent, as a commercial or residential unit (separate from any other commercial or residential unit).

Comment

The requirement to have a minimum of three properties throughout an accounting period could, depending upon the assets to be acquired, prove an onerous condition to satisfy. This is particularly so if there is a significant 'churn' during an accounting period.

HMRC have confirmed that shopping centres which are multi-let will be regarded as multiple properties. This is a helpful concession that taxpayers will find to be of considerable benefit.

3.2 Value of properties in tax-exempt business

No single property may, throughout an accounting period, represent more than 40% of the total value of the properties in the tax-exempt business carried on by the UK-REIT.

Assets must be valued in accordance with generally accepted accounting practice and where generally accepted accounting practice offers a choice of valuation between cost basis and fair value basis, the cost basis must be used.

Comment

This condition militates against the holding of trophy assets that may skew the portfolio valuation in an unacceptable manner.

Particular care will need to be taken in those situations where there significant 'property churn' takes place in an accounting period.

3.3 Owner occupier test

The tax-exempt business of a UK-REIT must not include any property that in accordance with generally accepted accounting principles be regarded as:-

- 'owner occupied' by the UK-REIT, or
- by another company whose shares were 'stapled' to the shares of the UK-REIT.

HMRC will regard the shares of one company as being stapled to the shares of another if in consequence of the nature of the rights attaching to the shares of the one company it is necessary or advantageous for a person also to have a holding of shares of the other company.

Comment

In preventing the 'stapling' of the shares of a company with the shares in an associated UK-REIT, HMRC have prevented the opportunity for companies to transfer their real estate assets into a dedicated UK-REIT and to carry out a 'PropCo-OpCo' split.

Such a strategy could enable the shares of the two entities to better reflect the value of the consolidated operation. The operating business would be valued on an EBITDA basis whilst the value of the shares in the UK-REIT would be guided by net asset values and the strength of the underlying lease covenants.

It may be possible to have the shares of a company 'paper-clipped' with those of a UK-REIT (i.e. being capable of being traded independently although there being no obligation to do so).

3.4 Distribution

It will be necessary for at least 95% of the profits of the tax-exempt business of a UK-REIT to be distributed by way of dividend either during the specific accounting period or the first six months of the following accounting period.

This provision will, however, be overruled by any specific legislation enforced by the overseas territory in which the UK-REIT is incorporated.

Comment

The level of the distribution is high but broadly in line with that required by a number of other REIT regimes. It will require careful cash flow management on the part of the UK-REIT.

The high distribution requirement will result in the shares of the UK-REIT being characterised as an 'income' stock with the valuations of the shares (and their relative attractiveness) being measured by reference to the dividend yields arising.

4. Condition for balance of activities of UK-REIT

A further set of conditions have been applied to the non tax exempt business of the UK-REIT.

4.1 Income tests

A minimum of 75% of the company's total income in an accounting period must arise from tax-exempt business, i.e. the business that is eligible for UK-REIT purposes. Income for this purpose will be the taxable profits subject to corporation tax as opposed to the accounting profit that might have been easier to establish.

Comment

This condition will need to be met throughout the accounting period in question. The computation of the profits automatically includes a full claim for capital allowances and a full deduction for any financing charges arising.

4.2 Asset value tests

It will be necessary to ensure that at the beginning of an accounting period the value of the assets that relate to the tax-exempt business, i.e. the business that is eligible for UK-REIT purposes, comprises at least 75% of the total value of the assets held.

The assets will be valued by reference to generally accepted accounting practice and where a choice is offered by generally accepted accounting practice between valuation on the basis of cost and fair value, the cost basis must always be used.

Comment

This provision allows the UK-REIT to carry out a significant amount of non tax-exempt business without tainting the tax-exempt business of the UK-REIT. Valuations of the assets will be on a 'gross' basis and will exclude the effect of any financing costs.

Given the findings of the Barker Report in relation to Housing Supply there had been a concern that an obligation would have been placed on the UK-REIT to carry out a minimum amount of property development activity – this does not, fortunately, seem to be the case.

5. Entry and exit from UK-REIT regime

5.1 Entry into the UK-REIT regime

In order for a company to enter the UK-REIT regime it will need to file an application prior to the accounting period in which the company wishes to benefit from the UK-REIT regime. The application must be accompanied by: -

- A statement that the conditions in Sections 2.1 to 2.8 will be satisfied throughout the first accounting period.
- Any information required by HMRC and either specified by regulation or otherwise called for.

Once a company has entered into the UK-REIT regime it will continue to be able to benefit from the provisions ***provided*** that it is able to meet the relevant qualifying criteria.

Comment

The directors will need to have a reasonable measure of confidence that the qualifying conditions will be met before tendering an application to HMRC. This is a significant consideration and not one to be taken lightly.

5.2 Implications on entry into the regime

On entry into the regime the notional tax-exempt business carried out by the company will cease and a deemed disposal of the assets at their market value will take place. No balancing charges or allowances will arise in respect to any capital allowance pools on fixtures and fittings; in addition, it will not be possible to make any elections to 'fix' the value of the tax-depreciable assets transferring to the UK-REIT.

The tax-exempt business of the UK-REIT will be treated separately from the non tax exempt business of the UK-REIT.

It will not be possible to: -

- Carry-forward losses relating to the notional tax business after it receives UK-REIT status.
- Set off any losses incurred in relation to the tax-exempt UK-REIT business against any profits arising in respect of the non tax-exempt UK-REIT business and vice versa.

- Treat any receipts accruing after entry into the UK-REIT regime (but relating to any period prior to UK-REIT status being achieved) as relating to the tax-exempt business.

Comment

The legislation confirms that the Transfer Pricing legislation will apply to the activities of the UK-REIT without the benefit of the exemptions available to small and medium sized enterprises.

5.3 Conversion charge on entry into the regime

The draft legislation is unhelpfully silent on the crucial question of the conversion charge.

HMRC have indicated that the terms of the conversion charge will be disclosed in the 2006 Finance Bill.

Comment

It is rather disappointing that further details regarding this item have not been aired in the draft legislation.

This approach reflects a reluctance on the part of Government to enter into a debate into the relative merits of the alternative strategies for the conversion charge. It is likely that the conversion charge will simply be presented as a 'given' to taxpayers – a 'take it or leave it' option.

5.4 Financing cost ratio

The draft legislation includes a rather controversial provision that, effectively, stipulates the quantum of the debt finance that may be incorporated within the UK-REIT.

The legislation stipulates that the following ratio may not exceed a value of 2.5 in respect of an accounting period: -

$$\frac{P + I}{I}$$

Where P is the amount of the profits of the tax-exempt business computed for tax purposes and I is the amount of the financing costs incurred in that accounting period.

Where the financing cost ratio is breached this will not result in the withdrawal of the UK-REIT regime but will result in an additional charge, the quantum of which will be specified in regulations to be issued by HMRC.

Comment

This provision will reduce the relative attractiveness of the regime.

Whilst the Government have, in the past, expressed reservations as to the quantum of the debt load in a UK-REIT there had been a hope that they would have let this matter be decided by market forces rather than specific legislation.

A significant majority of property investment companies have considerably higher levels of gearing than that which will, seemingly, be allowed in legislation.

5.5 Exit from the UK-REIT regime

In order to exit from the UK-REIT regime three possibilities are open: -

- It will be possible for the UK-REIT to give notice of its intention to exit from the UK-REIT regime. The notice must specify the date on which it wishes to exit from the regime and this must be after the date on which notice is given; or
- HMRC may give notice to the UK-REIT of the disapplication of the UK-REIT regime if it considers that the UK-REIT has, itself, obtained a tax advantage or if a tax advantage has been obtained for another company. Where such a notice is given the UK-REIT will be deemed to have lost its tax-exempt status for the accounting period specified in the notice and in respect of all subsequent accounting periods; or
- Where a substantial breach of the qualifying conditions for UK-REIT status occurs then the benefits of UK-REIT status will be withdrawn.

Comment

HMRC will penalise 'minor or inadvertent' breaches of the UK-REIT provisions with an additional tax charge, rather than an immediate withdrawal from the UK-REIT regime.

5.6 Implications on cessation of the UK-REIT regime

On cessation of the application of the UK-REIT regime, an accounting period of the company will cease and a new accounting period will be deemed to commence.

The assets of the tax-exempt business will be deemed to have been sold and re-acquired by the non UK-REIT company at market value for capital gains purposes. For capital allowances purposes, assets are deemed to transfer at tax written down value and no balancing charge or allowances will arise.

Comment

These are largely uncontroversial provisions; a tax-free uplift should be available for capital gains tax purposes on exit from the regime.

6. Tax treatment of UK-REIT

The tax implications of UK-REIT status to both the company and the investors is set out below: -

6.1 Entry into the UK-REIT regime

Tax treatment of UK-REIT

The UK-REIT will be tax-exempt in relation to its profits arsing from the tax-exempt business. It will, however, be subject to tax at the full corporation tax rate in respect of its non UK-REIT business without the benefit of the small companies' rate of corporation tax, the starting rate or the non-corporate distribution rate.

Comment

It is surprising that UK-REITs will be unable to benefit from the lower rate of taxation.

6.2 Taxation of investors in a UK-REIT

A shareholder in a UK-REIT will, in effect, be deemed to own a fraction of the underlying real estate interests and will be assessed to tax in respect of that part.

The shareholder will be assessed to tax under Schedule A but this will be distinguished from any other Schedule A income received by the shareholder.

The UK-REIT will be obliged to deduct income tax at the basic rate of 22% from the distributions made. Certain categories of shareholder, for instance pension funds, will be entitled to receive their distributions gross without any withholding.

Comment

There is a significant shortcoming for overseas shareholders who will be subject to UK income tax in relation to both income and gains.

6.3 Tax Anti-avoidance

Provisions have been introduced to target companies that leave the UK-REIT regime within ten years or which enter into tax avoidance arrangements.

Comment

The provisions appear wide and will create a fog of uncertainty which will be unwelcome.

7. Conclusion

The publication by HMRC of draft legislation for the UK-REIT and their willingness to enter into a debate in relation to these is welcome news. Some of the provisions do, however, appear a little onerous. Whilst it would have been rather churlish to assume that the UK-REIT legislation would have been drawn up on the basis of a 'one size fits all' the draft legislation appears to have a more narrower application.

Key areas of concern include the fact that: -

- no single shareholder may directly or indirectly control more than 10% of the shares in the UK-REIT,
- the need for a full listing, and
- the introduction of an interest cover ratio.

In addition the above the crucial question of the basis for the conversion charge remains unanswered.

The introduction of a UK-REIT will inevitably change the landscape for UK real estate investment – however it remains to be seen how profound that change will be.

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