ReedSmith

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UK Real Estate Investment Trusts

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Background and Timeframe

Alongside Budget 2004, the Government published a consultation paper to consider reform to the taxation of the property investment market in the UK. The consultation considered the introduction of Real Estate Investment Trusts (REITs), which are common to many economies around the world with developed property markets (including the USA).

A REIT is basically a company set up with the sole purpose of owning and managing investment property, with property-letting business forming the majority of its activity. A key feature of a REIT is that the tax treatment of property investment held indirectly through the REIT is broadly comparable to that of property held directly. This arrangement prevents property gains from being taxed twice. REITs therefore offer investors an easy, affordable and balanced way of investing in property without having to purchase property directly.

As part of the consultation, the Government set out four key objectives for reform:

- Improving the quality and quantity of finance for investment in commercial and residential property.
- Expanding access to a wider range of savings products on a stable and well-regulated basis.
- Protecting all taxpayers by ensuring a fair level of tax is paid by the property sector.
- Supporting structural change in property markets to reduce costs and improve flexibility and quality for tenants.

The Government received more than 200 responses to the consultation, which closed in July 2004. In March 2005, the Government published a further discussion paper, which takes the responses to the first consultation into account (available at *www.hm-treasury.gov.uk./media/A61/AB/Bud05Reits.pdf*).

The discussion paper recaps the policy rationale for introducing a REIT in the UK and outlines the key structural features and tax treatment envisaged for a UK-REIT. The paper also highlights key areas where further consultation is required before the drafting of legislation can commence.

The Government aims to legislate for a UK-REIT in the Finance Bill 2006. According to the discussion paper, a progress report was expected to be published "later this year," but so far none has been forthcoming. It is therefore unclear whether the Government intends to stick to its timetable for introducing a UK-REIT.

The Structure of a UK-REIT

It is intended that a UK-REIT will take the form of a closed-ended company incorporated under the UK Companies Acts, given the suitability of this type of entity to the illiquid nature of property as an investment asset. There will be a restriction preventing a UK-REIT from being closely held by a small number of shareholders.

The main business activity of a UK-REIT will be the letting of property. However, it will also be able to carry on other activities, such as property development and management. For tax purposes, the property letting business will be ring-fenced, thereby allowing the UK-REIT to have two separate operations, taxed in different ways.

To ensure that the property-letting business forms the majority of its activity, the UK REIT will likely need to meet the following rules:

- At least 75 percent of the UK-REIT's total gross income must derive from ring-fenced activities.
- At least 75 percent of the UK-REIT's gross value of assets must relate to property allocated to the ring-fenced business.
- Only properties generating a significant proportion of Schedule A profits (profits from rental and similar income) are allowed within the ring-fence.
- At least 95 percent of a UK-REIT's net ring-fenced income must be distributed to investors.
- Expenditure and allowances incurred in support of both ring-fenced and non ring-fenced activities must be apportioned on a just and reasonable basis.
- A UK-REIT must hold more than one property with no single property exceeding a defined proportion of the total value of the UK-REIT's property assets.

It is intended that a UK-REIT will be able to invest in any property type, in any location worldwide, subject to meeting the above income and asset rules. It is expected that UK-REITs will be internally managed. However, the Government does not intend to legislate on this issue.

UK-REITs will not have to meet any landlord requirements other than those that apply for all landlords.

There will be no minimum holding period for assets held within a UK-REIT structure.

The Government has not yet decided whether any future UK-REIT regime should be open to all companies or only to those companies listed on a recognised stock exchange. The Government intends to apply a charge on conversion to UK-REIT status to ensure that any reform can be introduced at no overall cost to the UK Exchequer. It is not yet clear how this conversion charge will be calculated. It has been suggested that the conversion charge will not apply to non-residents.

The Tax Treatment of a UK-REIT

The Government's main aim for a UK-REIT is to ensure that the returns from different forms of indirect or direct UK property investment are taxed in broadly the same way. In many REIT jurisdictions, this is achieved be allowing the company to be tax exempt. Rental income and capital gains derived from properties that fall within the allowable definition of the regime are exempt from tax at the company level (the REIT). The REIT distributes most of its income, after operating costs, to investors who are then taxed on this investment income. The result is that investors face broadly the same tax treatment as they would have, had they owned a property directly.

If a tax-exempt model is adopted for the UK-REIT, it will probably be structured as follows:

- ***Taxation at the REIT level***
  - Income included within the ring-fence is exempt from corporation tax.

  - Other income outside the ring-fence remains within the charge to corporation tax.
  - Chargeable gains arising on the sale of property held within the ring-fenced business is exempt from corporation tax.
  - Profits from dealing in or developing property, or from any other activity, remain subject to corporation tax.
  - Losses arising in relation to the ring-fenced activity cannot be off-set against non ring-fenced profits and vice versa.
  - Stamp Duty Land Tax is payable at normal rates on the acquisition of property assets.
- ***Taxation at the investor level***
  - Individual investors: Profits arising from ring-fenced activity are treated as property income chargeable at the taxpayer's marginal income tax rate. Profits arising from non ring-fenced activity are treated as ordinary dividends.
  - Corporate investors: Income from ring-fenced activity is treated as property income and included as part of the ordinary taxable profits. Income from non ring-fenced activity is treated as ordinary dividends.
  - A UK-REIT may choose whether to distribute any gains arising from sale of properties to investors. Any such gains are treated as property income distributions and taxed in the hands of investors at marginal rates.
  - Capital allowances are not available at the investor level as they have already been taken into account at the REIT level.
  - Stamp Duty Reserve Tax is paid on UK share transactions at the normal rate (currently 0.5 percent).

Outstanding Technical Tax Issues

A number of outstanding technical difficulties are associated with the tax-exempt model outlined above, which the Government needs to resolve prior to legislating for a UK-REIT.

The most difficult problem to solve is how to introduce a REIT regime that works within the UK's EU commitments and double tax treaty obligations, without a loss of UK tax revenue. It appears to be impossible to introduce an entirely tax exempt REIT without losing tax revenue from offshore investors and non-resident companies that want to apply for UK-REIT status.

One possible solution considered by the discussion paper is to tax rental profits at the level of the UK-REIT at the rate of 22 percent. Distributions would then be paid to investors with a tax credit of the tax suffered by the REIT. UK investors should then be able to offset this credit against their UK Schedule A liability on distributions from the ring-fenced activity of the REIT. Non-resident investors would receive distributions net of the tax suffered at the REIT level. However, it is likely that this approach of treating rental profits as Schedule A income for UK investors and as dividends for non-resident investors will cause complications.

The Government is also concerned about the issue of borrowing levels in the context of a new UK-REIT market. In particular, it wants to ensure that allowing reasonable levels of borrowing within a UK-REIT market would not reduce the tax collected from investors or result in specific manipulation for tax avoidance purposes. One option might be to limit the amount of borrowing for UK-REITs by reference to the ratio of interest payments to income and/or by reference to the level of debt to equity.

Finally, the Government is currently unsure how a UK-REIT regime could accommodate complex group company structures.

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