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UK Real Estate Investment Trusts

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In December 2005, the UK Government finally announced that it would bring forward legislation for the introduction of Real Estate Investment Trusts in the United Kingdom ('**UK-REITs**'). Draft legislation was published shortly afterwards. That draft legislation has now been overhauled, improved and republished with revised guidance in the Finance Bill 2006 (the '**2006 Draft Clauses**'). The 2006 Draft Clauses will become law later this summer and the REIT regime will apply, on an elective basis, for company accounting periods beginning after 31st December 2006.

Rationale for UK-REITs

The Government hopes that the introduction of UK-REIT legislation will facilitate the setting-up of liquid and publicly-marketed property investment vehicles available to a wide range of investors. In particular, UK-REITs are intended to encourage institutional and professional investment in the private rented sector. The decision to elect UK-REIT status is, however, a complex one, especially if it involves restructuring an existing property group.

Furthermore, it should be noted that UK-REITs will still have to compete in terms of tax-effectiveness with non-UK-resident vehicles for investing in real property (such as 'offshore' companies and unit trusts, usually located in tax havens). Under existing law, such vehicles are normally outside the UK tax charge on capital gains. While their UK rental income is taxed at 22%, there is significant scope for deducting expenses and capital allowances (especially financing costs). Furthermore, there is no UK withholding tax on the distributions of such vehicles. Finally, shares and units in such vehicles can trade free of UK stamp duty/stamp duty reserve tax/stamp duty land tax. Stamp duty/stamp duty reserve tax will, by contrast, apply to transactions in the shares of a UK-REIT, if it is UK-incorporated or its shares are registered in a UK share register.

The 2006 Draft Clauses

The 2006 Draft Clauses set out the framework for the UK-REIT regime, both as it will apply to a single company and as it will apply to corporate groups.

The commentary below deals with both single company UK-REITs and group UK-REITs.

1. **Conditions applying to the legal structure of a UK-REIT**

   (a) The UK-REIT must be a company (a body corporate) that is tax-resident (though not necessarily incorporated) in the United Kingdom. Companies that are dual resident in the UK and another jurisdiction will not qualify. This requirement of UK residence may well contravene EU rules on the

"freedom of establishment" and the "free movement of capital".

(b) The company's shares must be listed on a "recognised stock exchange", as defined. There are many such exchanges, not just in the UK, the USA and the EU but also, for example, in the Channel Islands and Hong Kong. "Listed" does not necessarily signify that the shares must be actively dealt in. However, a London listing on AIM, as opposed to the Official List of the London Stock Exchange, will not be sufficient to meet this test.

(c) The company must be 'closed-ended' for the purposes of UK financial services regulation. In other words, its shares must not be freely repayable out of capital. Therefore, companies such as SICAVs or UK-style "open-ended investment companies" cannot qualify as UK-REITs.

(d) The company must not be a "close" company as defined for UK tax purposes **unless** it is **only** a "close" company by virtue of the ownership of its shares by a venture capital limited partnership. A "close" company is, in essence, one controlled directly/indirectly by five or fewer "participators" or by "participators" who are directors. However, the definition of a "close" company is complex and its application will need to be monitored closely, especially as changes in the ownership/control of a company may mean that it moves in and out of "close" company status.

(e) The company must have only one class of ordinary shares in issue. The only other class of share the company can issue consists of non-participating fixed-rate preference shares. This ability to issue preference shares is a relaxation of the draft rules published in December 2005. Furthermore, it is no longer obligatory for the company to use international accounting standards as the basis for its financial statements. See below for further comments regarding the financial statements of a group UK-REIT.

(f) The company must not be party to a loan which, broadly, provides for profit-linked, asset-linked or non-commercial interest or repayment of the amount lent on non-commercial terms. However, the company is permitted to issue debt instruments that are convertible into ordinary share capital. The ability to issue convertible debt is another relaxation of the December 2005 draft rules.

The company will be required to meet the conditions in (a), (b) and (c) above at the point it issues a notice that it wishes to enter the UK-REIT regime. It must then meet all the conditions ((a) to (f) above) throughout its first accounting period as a UK-REIT and for every accounting period thereafter.

A group UK-REIT must comprise a "principal company" (i.e. the ultimate parent) and all its "75% subsidiaries", as defined for the purposes of UK corporation tax on chargeable gains. The group UK-REIT can comprise both UK-resident and non-UK-resident companies, but the "principal company" must be UK-resident. This residence condition again raises the question of compatibility with EU law: see (a) above. The conditions in (a) to (f) above apply to the principal company only in the context of a group UK-REIT. A group UK-REIT cannot include insurance companies or their subsidiaries, nor can it include open-ended investment companies. Furthermore, the UK parent company of a group UK-REIT must prepare prescribed consolidated financial statements for the members of that group UK-REIT. These statements will identify the group's tax-exempt "property rental business" (as defined in 2(f) below) and the other taxable business of each member of the group UK-REIT. To the extent that a non-member of the group UK-REIT has a minority

interest in a group UK-REIT member, the income and assets of that member which are referable to the minority interest will be treated as attributable to the group UK-REIT member's taxable business, and not to its tax-exempt property rental business.

2. Further qualifying conditions

(a) A UK-REIT must hold at least 3 single properties throughout any accounting period. A property is considered a "single property" if it is designed or, in the case of a property undergoing development, it is intended to be, rented out as a single commercial or residential unit. Ownership by a company of a single "trophy" property (e.g. a hotel) will not satisfy this requirement. However, the intention is that a large shopping centre can be treated as multiple properties for the purposes of this condition.

(b) Throughout any accounting period, the value of a single property should not exceed 40% of the value of all the properties of the "property rental business". Value for these purposes is to be measured as for accounting purposes, using a fair value basis where there is a choice between alternative methods.

(c) The "property rental business" cannot include a property occupied by the UK-REIT itself or by another company whose shares are "stapled" to those of the UK-REIT. Care is therefore needed if UK-REIT shares are to be "stapled" to, say, the shares of a property development company. However, the 2006 Draft Clauses contain no absolute bar on "stapling" UK-REIT shares to those of another vehicle.

In the case of a group UK-REIT, the "3 property" and "40%" rules are applied by reference to the principal company and all UK-REIT members taken together, whether or not they are UK-resident and whether or not the properties are in the UK. The anti-"stapling" rule will exclude from the "property rental business" a property occupied by a member of the group or another company whose shares are "stapled" to those of the principal company of the group UK-REIT.

(d) A UK-REIT must distribute, by way of dividend, at least 90% of the income profits of its "property rental business" on or before the corporation tax self-assessment ('CTSA') filing date for that accounting period, unless it is prohibited from doing so under the company law of the United Kingdom or of any other jurisdiction to be specified in regulations by HMRC. The distribution requirement does not apply to capital gains. The CTSA filing date is normally twelve months after the end of the relevant accounting period. The 90% distribution requirement represents a relaxation of this requirement in the December 2005 draft rules. In relation to group UK-REITs, this 90% test is applied by reference to the income profits of the tax-exempt "property rental business" of all members of the group, as determined by the consolidated financial statements referred to in 1 above. Those profits will include income profits of the worldwide tax-exempt property rental business of UK-resident group members, and income profits of the tax-exempt UK "property rental business" of non-UK-resident group members. The UK-resident parent company of the group must make the requisite distribution, whether or not the necessary profits have been distributed to it by other group members. Furthermore, distributing profits from group members to the UK-resident parent of the group may entail tax leakage e.g. corporation tax and non-UK withholding tax on dividends

distributed to the UK-resident parent company from its non-UK-resident subsidiaries.

(e) The rules establish a tax "ring-fence" around the qualifying "property rental business" of the UK-REIT. That business enjoys the special tax treatment described in 3 below.

(f) "Property rental business" consists of the exploitation of interests in UK or non-UK land, as a source of rent or other non-trading receipts. In other words, it can only include property income which is otherwise currently chargeable under Schedule A or Schedule D Case V. Therefore, active dealing in property (e.g. by a developer) will not qualify as "property rental business". Also excluded are, inter alia, (i) the provision of ancillary services in relation to land; (ii) the incidental letting of property for use in a property development trade; and (iii) income derived from the shares of another UK-REIT. However, distributions from collective investment schemes (such as UK unit trusts and open-ended investment companies) **can** be counted as income of the "property rental business".

(g) The non-ring-fenced business, which does not enjoy special tax treatment, can include income generated from ancillary services associated with the "property rental business" as well as from property development undertaken to generate a trading profit.

(h) At least 75% of the UK-REIT's income must relate to the "property rental business". For these purposes, income is based on profits reported in the company's accounts, net of realised and unrealised capital gains and losses. It is no longer to be based (compare the December 2005 draft rules) on the UK tax rules for computing income. In relation to group UK-REITs, this "income mix" test (and the "asset mix" test in (i below)), must be applied by reference to the income and assets of the group's worldwide "property rental business" (as shown in the consolidated financial statements referred to in 1 above).

(i) On the first day of any accounting period, UK-REIT status requires that the value of the assets used for the purposes of the "property rental business" must be at least 75% of the value of the total assets of the company. For these purposes, the value of an asset is as calculated under international accounting standards but where a choice of valuation method is provided, a fair value basis must be used. In applying the valuation rule, no deduction is made for loans secured against property or otherwise used to fund the business. See (h) above for how this test is applied to a group UK-REIT.

Where cash arises from the disposal of an asset used in the UK-REIT's tax-exempt business, and is not re-invested in an asset of the tax-exempt business at once, it can still count as an asset of that business, but only for a fixed period of 24 months from the date of the disposal, **if** the cash is held on deposit or invested in UK Treasury securities. During this 24-month period, income from the invested cash does not count as income of the UK-REIT's tax-exempt "property rental business".

3. Tax treatment of a UK-REIT

(a) Companies that carry on a "property rental business" and meet the qualifying conditions (i.e. those contained in 1 and 2 above) for the UK-REIT regime to apply will not pay corporation tax on qualifying property rental income or qualifying chargeable gains that relate to the tax-exempt "property rental business". Profits from non-tax-exempt

business will be subject to corporation tax at the normal "mainstream" rate (currently 30%).

(b) A UK-REIT will be subject to an "interest-cover" test in respect of the tax-exempt business, even in relation to funding from unrelated third parties. This test is designed to impose normal "mainstream" corporation tax on the amount (if any) by which the finance costs payable by a UK-REIT in respect of its "property rental business" cause the ratio of profits to finance costs to drop below 1.25:1. This shortfall amount will be charged to tax under Schedule D Case VI as income and no losses, reliefs, excess capital allowances or management expenses will be offsetable against this charge. The test has been relaxed compared to the version in the December 2005 draft clauses and it will be amplified in future regulations but in essence, in each accounting period in which UK-REIT status is claimed, the ratio of profits to finance costs must not be less than 1.25. 'Profits" means the income profits of the "property rental business" (as computed for UK tax purposes) for the relevant accounting period, **before** financing costs and capital allowances; while "finance costs" comprise all the financing costs payable in respect of the "property rental business". They will, in particular, include the financing costs inherent in a finance lease, and not just interest in the narrow sense. Failure to meet this ratio does not result in exclusion from the REIT regime, but will, of course, result in an additional tax charge.

By virtue of The Real Estate Investment Trusts (Breach of Profit: Financing-Cost Ratio) Regulations 2006, which will come into force on 1 January 2007, the amount by which the UK-REIT"'s "finance costs" exceed the ratio of 1.25, shall be chargeable to tax as income of the UK-REIT on which corporation tax is chargeable under Case VI of Schedule D for the accounting period in which the excess occurs. The amount charged to tax under these Regulations may not be set off, in whole or in part, against any loss, deficit, expense or allowance of the UK-REIT. This applies both to single company UK-REITs and group UK-REITs.

When the "interest cover" test is applied to a group UK-REIT, "profits" comprise income profits of each group member from its worldwide property business (in the case of UK-resident members) and from its UK property business (in the case of non-UK-resident members). Again, these profits are computed before financing costs and capital allowances. "Financing costs" are those payable in respect of the worldwide property business of UK-resident group members and the UK property business of non-UK-resident group members.

The objective underlying the "interest cover" test is to restrict the extent to which profits of the tax-exempt "property rental business" can be distributed in a form which avoids UK withholding tax, as compared to dividends. The latter will be subject to withholding tax (see (g) below).

(c) Provisions will be made in regulations to deal with circumstances where a UK-REIT makes a distribution to any person (individual or body corporate) who:

- is beneficially entitled (directly or indirectly) to 10% or more of the dividends of the company; or
- is beneficially entitled (directly or indirectly) to 10% or more of the shares of the company; or

- controls (directly or indirectly) 10% or more of the voting power of the company.

(d) A UK-REIT will not, as was originally intended, be prevented from having persons who are beneficially entitled to 10% or more of its dividends, share capital or voting rights. However, if a UK-REIT does make a distribution to such a person, a tax charge will be levied on the company (in the case of a group UK-REIT, on the UK-resident parent company) in proportion to the interest of any such person. This tax charge results in the UK-REIT being treated as having received an amount of income computed in accordance with section 4 of The Real Estate Investment Trusts (Breach of Condition) Regulations 2006. No such charge will be levied if the company can show that it has taken reasonable steps to avoid paying distributions to such a person e.g. by including in its Memorandum and Articles of Association a rule requiring any shareholder that exceeds the 10% limit to enter into a transaction eliminating beneficial ownership of the dividend, on pain of sanctions such as retention of dividends or a forced sale of the shareholding to the extent that it is 10% or greater. However, the UK-REIT must provide certain information to the Commissioners upon a distribution to such a shareholder, for example the name and address of the shareholder, and the value of the distribution. The rules regarding such substantial shareholdings seem intended to prevent non-"portfolio" shareholdings in REITs being acquired which qualify for lower/zero rates of withholding tax on UK-REIT dividends under the UK's double tax treaties or the EU Parent-Subsidiary Directive. It is far from clear that this kind of restriction can be reconciled with EU rules on free movement of capital.

(e) The tax effects for a company on entering the UK-REIT regime are as follows:

- An "entry charge" will be imposed when an existing company elects to become a UK-REIT. The same applies where a group of companies elects to become a group UK-REIT. Where a company that is already a UK-REIT buys a new property, no special charge beyond normal stamp duty land tax will be levied. If a company that is already a UK-REIT acquires a company that owns a property, the rules applicable to a group UK-REIT apply and an entry charge will be levied in respect of the property owned by the acquired company. In all cases, the entry charge will be 2% of the market value of the property assets that are transferred to the tax-exempt business. This entry charge will be collected in the same way as corporation tax due for the first accounting period for which the company is a UK-REIT or, as the case may be, becomes part of a group UK-REIT.
- In relation to group UK-REITs, to the extent that shares of a group member are owned by non-members of the group, that portion of the market value of each property asset is disregarded when computing the "entry charge".
- As an alternative to paying the entry charge in the first year, a company can elect to spread the charge over four years, but in that case, the instalments are uplifted to compensate for the delay.
- The entry charge cannot be reduced by other losses, expenses or allowances that might otherwise reduce profits brought into charge for tax.

- Any existing assets of the "property rental business" will be deemed to have been sold and re-acquired by the tax-exempt "property rental business" at market value when the company enters the UK-REIT regime. Any gain or loss arising as a consequence will not be brought into charge for corporation tax purposes.
- For capital allowances purposes, assets are deemed to be transferred into the tax-exempt "property rental business" at tax-written-down value.
- Any existing "property rental business" of the UK-REIT will be deemed to have ceased and a new tax-exempt "property rental business" will be deemed to start.

(f) The tax-exempt "property rental business" of the UK-REIT will be treated as a separate company from its non-tax-exempt business for all tax purposes. It will also be treated as separate from any business carried on before or after the UK-REIT regime applies to the company. This has a number of implications:

- Losses of the tax-exempt business may not be set against profits of the non-tax-exempt business of the UK-REIT, or vice-versa.
- A loss of the tax-exempt business cannot be set against profits accruing following cessation of the UK-REIT regime.
- A loss arising in a pre-UK-REIT period may not be set against any profits of the tax-exempt business once the UK-REIT regime takes effect.
- The usual separation for tax purposes of "overseas" property profits and losses from "UK'" property profits and losses does not apply within the tax-exempt "property rental business". Hence, all UK and non-UK profits and losses of that business will be pooled.
- Capital losses for a pre-UK-REIT period can be set against chargeable gains for later periods but only in respect of the taxable part of the UK-REIT's business.
- Simpler rules apply to a group UK-REIT.

(g) Profits and their distribution

- Profits arising from the tax-exempt business are to be calculated using normal income tax principles but there will be certain adjustments to take account of related financing, hedging and depreciation costs.
- A dividend distribution from the tax-exempt profits of a UK-REIT will be taxable in the United Kingdom as income from a UK property business, whether or not the recipient is UK-resident. The recipient's dividend income from a UK-REIT is treated as a separate property business from any other which that person may have. This is to prevent UK-REIT dividends being sheltered with losses from any other such business.
- Shareholders will not be entitled to a "tax credit" on receipt of a distribution from the tax-exempt profits of a UK-REIT but any income tax deducted (see below) is repayable in appropriate circumstances (e.g. to UK-tax-exempts).
- The Government intends that shares in UK-REITs shall be eligible to be held in an Individual Savings Account (ISA), Personal Equity Plan (PEP) or Child Trust Fund (CTF), subject to the existing limits and rules. ISAs, PEPs and CTFs are arrangements for tax-exempt saving by UK-resident individuals. Hence, REIT dividends payable in respect of shares held

under such arrangements will be exempt from UK tax.

- Distributions of profits derived from capital gains that fall to be treated as tax-exempt will also be income, subject to withholding tax. Therefore, the status of such profits as capital gains does **not** flow through to shareholders on a distribution. This is a major drawback because the UK tends to tax capital gains from UK real estate much more lightly than income, especially when they accrue directly to non-UK-residents.
- The UK-REIT will be required to withhold basic rate tax (currently 22%) on the distributions paid to investors. In the case of a group UK-REIT, this obligation will fall on the UK-resident principal company. Further regulations will set out the basis for this withholding tax charge. HMRC seem to accept that, where shareholders in a UK-REIT are treaty-protected, UK dividend withholding tax must normally be limited to the rate for "portfolio" investors mandated in the relevant double tax treaty (typically, 15%). Any excess UK withholding tax over this amount should, at the very least, be recoverable by way of refund.
- By virtue of The Real Estate Investment Trusts (Assessment, Collection and Recovery of Tax) Regulations 2006, a payment of such a distribution must be made *without* deduction of tax if the UK-REIT reasonably believes that the person beneficially entitled to the payment is a person or body which (a) is a company resident in the United Kingdom for corporation tax purposes, and (b) is a company not resident in the United Kingdom that, (i) carries on a trade in the United Kingdom through a permanent establishment, or (ii) is required to bring into account, in computing the chargeable profits, a payment that falls to it be reason of sections 114 and 115 of the 2006 Draft Clauses.

(h) Capital gains

- On a disposal of an asset used for the purposes of the tax-exempt business for not less than 12 months, any capital gain arising will be exempt from corporation tax. However, if a member of a group UK-REIT has third-party minority shareholders, a corresponding part of the capital gains of its tax-exempt business will remain subject to normal "mainstream" corporation tax.
- Where an asset is transferred from the tax-exempt business to the non-tax-exempt business, the transfer will be treated as a disposal of that asset by the tax-exempt business at open market value for the purposes of tax on capital gains. By contrast, this sale and reacquisition will take place at tax-written-down value for the purposes of UK capital allowances.
- Where an asset is transferred from the tax-exempt into the non-tax-exempt business and is then disposed of in a transaction which is trading in nature (e.g. in the course of a speculative development), the entire profit is a taxable trading profit of that non-exempt business. Moreover, the cost to be taken into account in computing this profit is the original acquisition cost of the asset, and not the open market value after the asset is transferred to the non-tax-exempt business.

- If property is developed in order to retain it as an investment property of the "property rental business" but it is then sold within three years of completing the development, it will be treated as never having been an asset of the tax-exempt "property rental business". For this purpose, building work is "development" if the costs exceed 30% of the fair value of the asset at the later of the date when UK-REIT status begins; and the date the asset was acquired by the relevant company.
- Where an asset is transferred from the non-tax-exempt business to the tax-exempt business, the transfer will be treated as a disposal by the non-tax-exempt business at open market value for the purposes of tax on capital gains. The transfer will take place at tax-written-down value for capital allowances purposes, so there will be no recapture of depreciation.

(i) Joint Ventures:

- Regulations will deal with joint ventures in which a UK-REIT may have an interest, but which do not form part of a group for the purposes of tax on capital gains.
- If a UK-REIT owns (or one or more members of a group UK-REIT together own) at least 40% of the ordinary share capital of a joint venture company ("**JVCo**"), an election can be made for the assets and income of JVCo to count towards the tests in 2(h) and (i) above, to the extent of the UK-REIT's interest in JVCo. The tax-exempt income profits of JVCo will be included in the profits of the UK-REIT's tax-exempt business for the purposes of the distribution requirement in 2(d).

4. Joining / Leaving the UK-REIT Regime

(a) A company must give notice to HMRC to elect to join the UK-REIT regime. The notice should state the accounting period from the start of which the company wishes the UK-REIT regime to apply.

(b) The start of the first accounting period under the UK-REIT regime cannot be earlier than 1st January 2007.

(c) The UK-REIT regime will continue to apply until:

- the company issues a valid notice to withdraw from the regime;
- HMRC issues a notice to remove the company from the regime; or
- the company breaches a qualifying condition (i.e. those in 1 above) in such a way that the UK-REIT regime ceases to apply to it.

(d) The UK-REIT must give notice to HMRC where it has breached a qualifying condition. Regulations will be made to deal with the consequences of failure to meet the qualifying conditions of the UK-REIT regime, as well as to prescribe when repeated failure of these and other conditions will result in removal from the regime. The regulations will specify that failure to meet any of the qualifying conditions must be rectified by the end of the next but one accounting period following the failure, in order to remain within the regime. The regulations will allow a UK-REIT four breaches of the qualifying conditions in any ten-year period without the company being removed from the UK-REIT regime.

(e) Where a company leaves the UK-REIT regime within 10 years of joining it and then disposes of an asset of the tax-exempt business within two years, any deemed disposals on entering or exiting the regime, or on transferring the asset out of the tax-exempt business, will be ignored. There will therefore be no "rebasing" of the asset to market value. Hence, the computation of any gain on the disposal will use the **original** cost of the asset to the company. There will be no refund of any part of the entry charge attributable to that property.

(f) Where HMRC remove a company from the UK-REIT regime within 10 years of it joining, they may direct that this removal takes effect at a different time or that the tax exemptions applying to the company are varied. The aim is to deny companies a 'tax advantage' through deliberately breaching a condition of the UK-REIT regime in order to force an early exit.

(g) Where HMRC believe that the UK-REIT has been involved in tax avoidance (i.e. activity at least one of whose "main purposes" is to produce a tax advantage for the UK-REIT or another person, but normally excluding entering into the UK-REIT regime itself), the tax advantage will be cancelled by bringing an additional amount of income into charge under Schedule D Case VI.

(h) When the UK-REIT regime ceases to apply to a company:

- the "property rental business" of the company will be deemed to have ceased and a new "property rental business" will be deemed to start. Therefore, any carried-forward losses of that earlier business will not be available for carry-forward against profits of the new business;
- the assets of the tax-exempt business of the company will be deemed to have been sold and reacquired by the company at market value for the purposes of corporation tax on chargeable gains; and
- for capital allowances purposes, assets are deemed to be transferred from the tax-exempt business at tax-written-down value.

This memorandum is intended only as a general discussion. It should not be regarded as legal advice. The decision to set up a UK-REIT and / or to restructure an existing company or group so that it can achieve UK-REIT status, is a complex one, especially given the ongoing compliance and oversight burden involved in obtaining and maintaining REIT status. We would be pleased to provide additional details or advice about specific situations if desired.

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