

# Information

## Real Estate Investment Trusts (REITs)

### Introduction

Real Estate Investment Trusts (REITs) were introduced on 1 January 2007. The main provisions introducing them are contained in the Finance Act 2006 and subsequent regulations. This has introduced a new way of investing in the UK property market.

### What is a REIT?

A REIT is a company which owns and operates income-producing real estate, either commercial or residential. The pool of money invested via shares in the REIT is then used to buy, develop, manage and sell assets in real estate. Most of the income produced is distributed to shareholders and in return the company is exempt from corporation tax.

For the investor, the appeal is the ability to invest in a portion (no more than 10%) of a managed pool of real estate rather than investing in a single company.

The concept of a REIT is nothing new. Similar ways of investing already exist in many other jurisdictions including the USA, Australia, Hong Kong and France.

### Why has the Government introduced REITs?

The Government wants to ensure a stable property market with long term growth and long term investment instead of a 'boom and bust' cycle. The aim is also to encourage private sector investment in the residential market and give access to more complex property structures to the 'man in the street'.

### What are the benefits to a company?

A company which is a REIT can conduct property rental business as well as 'other' business. However, the income profits and capital gains from the property rental business will be exempt from corporation tax. Profits arising from the 'other' business will be taxed as usual.

There are two main restrictions which will result in a tax charge if breached:

- 1 The income profits must cover any financing related costs at least 1.25 times; and
- 2 A distribution of profits to a corporate shareholder that is beneficially entitled (ie; does not include a fund manager); a) to 10% or more of the REITs shares or dividends or, b) that controls 10% or more of the company's voting rights.

### What are the benefits to the individual investor?

Instead of simply investing in stock in a single company an individual investor can buy a portion (in the UK no more than 10%) of a managed pool of real estate. The profits from the property rental business are then distributed directly to the shareholder by means of a dividend. The pool of distributed income is not reduced by Corporation Tax. However, this dividend, for an individual investor, is then taxed in the usual way.

### How does a company become a REIT?

A single company must satisfy all of the Qualifying Conditions. A group of

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companies will become a REIT if the group's principal company satisfies the 'Company Conditions' and the group satisfies the 'Business Conditions'. REIT status is not given automatically. Written notice must be given to HM Revenue and Customs (HMRC) before the start of the accounting period in which the company wants to be treated as a REIT.

### Qualifying conditions

#### 1 Business Conditions

- 1 Must have a property rental business which qualifies as a 'tax exempt' business:
  - a must involve at least three properties,
  - b no one property can be more than 40% of the total value of the properties of the business,
  - c at least 90% of the income profits must be distributed as a dividend,
  - d no property can be 'owner-occupied'.
- 2 Must receive at least 75% of its total income profits from its property rental business.
- 3 Must, at the start of the accounting period, have 75% of the value of its total assets involved in the property rental business. Usually a company will satisfy this condition at the start of an accounting period. However, a company can join the REIT regime where this condition is not satisfied provided at the start of the next accounting period it satisfies the 75% assets test.

#### 2 Company Conditions

- 1 Must be UK resident.

- 2 Must not be an open ended investment company (basically a company whose size alters depending on how much money is invested).
- 3 Must be listed on a recognised stock exchange at the date it joins the REIT regime (it does not have to be listed at the date at which it gives notice of intention to join the REIT regime).
- 4 Must not be a close company (basically a company controlled by five or less participants).
- 5 Must only issue one class of ordinary shares plus non-voting fixed rate preference shares.
- 6 Must not borrow money on 'non-commercial' terms.

### Tax treatment

The main tax considerations are set out below:

- 1 There is a CGT-free increase in the base cost of properties involved in the tax-exempt business.
- 2 The income profits and capital gains of the REIT are exempt from corporation tax. However, this also means that profits and losses cannot be offset against the REITs non tax-exempt activities.
- 3 There are special rules which apply to the movement of property in and out of the tax-exempt business.
- 4 REITs are still subject to Stamp Duty Land Tax rules in relation to real estate transactions.

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- 5 The sale of REIT shares are subject to the normal stamp duty rules at the rate of 0.5%.
- 6 Where a REIT property is sold in the course of a 'trade' (see below);
  - a the CGT-free increase in the base cost of the property is lost; and
  - b the property is subject to tax.
- 7 A property is sold in the course of a 'trade' if;
  - a the property was developed since being bought by the REIT,
  - b the cost of the development is more than 30% of the value of the property when the company became a REIT or (if later) it bought the property,
  - c the property is sold within three years of it being developed.

### Special rules applicable to joint ventures

A REIT company with a 40% or more interest in a joint venture company which carries on a property rental business can opt to bring their share of the joint venture's profits of the property rental business into the REIT regime. This applies to both single joint venture companies and joint ventures carried on through a group of companies provided that at least one member of the group carries on a property rental business.

The 2% conversion charge still applies. It is calculated by considering the percentage of the company's interest in the joint venture and applying the 2% charge to the same proportion of the market value of the properties held by the company in its property rental business in the REIT.

### Leaving the REIT regime

There are three key ways that REIT status can come to an end.

- 1 By the REIT giving notice to HMRC; or
- 2 By HMRC giving notice to the REIT for persistent breaches of the 'Business Conditions'; or
- 3 Automatically for breach of the 'Company Conditions'.

When a company ceases to be a REIT the assets are considered to have been sold and then immediately bought by the post-REIT business for; a) their market value for CGT purposes and b) their written down value for capital allowances purposes. Where the company leaves the REIT regime less than ten years after joining special rules apply.

### Conclusion

The London Stock Exchange and the Government certainly consider that the development of REITs is set to produce an influx of money into the property sector. However, the current requirement for a listing on the Stock Exchange is certainly a barrier to initial conversion to REIT status.

For more information on Real Estate Investment Trusts please speak to your usual contact.