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CLARITY MATTERS

## Corporate Real Estate briefing

### UK Real Estate Investment Trusts

The Government published on 16 March 2005 a discussion paper on UK REITs, along with a summary of responses to the Budget 2004 consultation.



#### **GOVERNMENT DISCUSSION PAPER**

The Government aims to legislate for UK-REITs in the Finance Bill 2006.

However, the Government is committed to maintaining a regime that collects tax on income derived from UK property. This means the ownership of UK property, in whatever form, is to continue to contribute a fair share of tax to the UK Exchequer. To support this, the Government intends that UK REITs be

introduced at no overall cost to the Exchequer, by applying a charge on conversion to UK-REIT status.

#### **POSITIVE PROGRESS**

The discussion paper represents positive progress towards UK-REITs and specifically:

- The question of internal versus external management should be left to the market;
- Some development should be allowed;
- A broad range of property types should be eligible for inclusion;

- There should be no minimum proportion of residential property;
- There should be no special requirements placed on landlords regarding lease flexibility;
- There should be no minimum holding period for assets held within a UK-REIT structure (except perhaps in relation to assets being developed).

#### **THE KEY ISSUES**

The consultation process highlighted three “challenging” issues around the tax treatment of a UK-REIT:

- Non-resident investors;
- Borrowing; and
- Group structures.

Importantly, details of any conversion charge and how to convert are awaited.

# The Government's intended approach is not to exclude any specific property sectors from being held within a UK-REIT, provided that the income and asset rules set out above are satisfied, and provided that the activity of a UK-REIT reflects traditional property investments, and is not a proxy for purely financial transactions.

## THE INDUSTRY RESPONSE

The British Property Federation, Investment Property Forum and RICS published its response on 27 May 2005 ("Response") to the discussion paper. The Response notes that there is a real danger the outstanding issues could cause a delay to the projected timetable, or indeed that the adoption of over complex, or commercially unviable or unattractive solutions, could limit the take up of REITs in the UK. In addition, if the new REIT structure is to have any chance of attracting back on shore those vehicles that are currently established in offshore tax havens, it will have to offer a simple structure with tax arrangements that are equal to, if not better, than these vehicles currently enjoy.

## STRUCTURE

The discussion paper considers the key features of a closed ended company structure as the model for a UK-REIT.

### Investment activity

The key principle of a UK-REIT would be to separate, for tax purposes, the ownership and management of property from the activities that take place on that property. This could be achieved by establishing a ring-fence around the property letting business of the UK-REIT.

### The ring-fenced business

The ring-fence, would broadly relate to properties generating a high proportion of UK "Schedule A" profits, and its equivalent for overseas properties.

It is envisaged that the 'property letting business' would be required to form the majority of the UK-REIT's activity. As such it is likely that a UK-REIT would need to meet the following rules:

- At least 75% of the UK-REIT's total gross income to derive from ring-fenced activities;

- At least 75% of the UK-REIT's gross value of assets to relate to property allocated to the ring-fenced business;
- A UK-REIT would be required to distribute at least 95% of its net ring-fenced income to investors, calculated by reference to its "Schedule A" profits (and its equivalent for overseas properties) after appropriate deductions and capital allowances;
- A UK-REIT would be required to hold more than one property with no single property exceeding a defined proportion of the total value of its property assets. The Response has questioned why single assets such as a shopping centre should not be permitted as these have tenants in different businesses and provide a good spread of risk and adequate protection for investors;
- A UK-REIT would be able to invest in any property type, in any location worldwide, subject to meeting the above income and asset rules.

### **Management of the vehicle**

The Government is of the view that the market should decide the most appropriate management structure for UK-REITs and that they could be established as either internally or externally managed companies.

### **Property development**

The Government believes that, in principle, UK-REITs should not be prohibited from undertaking some development activity, consistent with meeting the income and asset tests in relation to ring-fenced and non ring-fenced activity, as described above. The Response also suggests that a UK-Reit should be permitted to carry out development for investment within the ring-fenced business.

### **The non ring-fenced business**

This would comprise the activities outside the ring-fenced business such as income from ancillary services associated with the property letting business. Tax would be payable in respect of these activities in the normal way.

### **Types of property**

The Government's intended approach is not to exclude any specific property sectors from being held within a UK-REIT, provided that the income and asset rules set out above are satisfied, and provided that the activity of a UK-REIT reflects traditional property investments, and is not a proxy for purely financial transactions. UK-REITs would not be constrained to hold a minimum proportion of residential property.

### **Landlord requirements**

The Government is content that UK-REITs should be treated in the same way for these purposes as the rest of the property sector.

### **Minimum holding period**

The Government is of the view that no minimum holding period would be necessary.

### **Public listing**

The Government has not concluded whether any future UK-REIT regime should be open to all companies or only those companies listed on a recognised stock exchange. The Response identifies the need for a supply of unquoted REITs to ensure long term success of the REIT market.

### **TAX TREATMENT**

Applying a tax-exempt approach to the concept of the ring-fenced business is suggested for developing a model along the following lines:

#### **Vehicle Level**

- Income included within the 'ring-fence', as defined in legislation, would be exempt from corporation tax;
- Other income outside the definition of the 'ring-fence' would remain within the charge to corporation tax;
- Chargeable gains arising on the sale of property held for investment purposes within the ring-fenced business would be exempt from corporation tax;

- Profits from dealing in or developing property or from any other activity outside the ring fence, would remain subject to corporation tax. The Response suggests that development activity for investment should be permitted within the ring fenced business;
- Any losses arising in relation to the ring-fenced activity would not be able to be used to offset taxable profits in the other business activity of the UK-REIT. Similarly losses in the non ring-fenced activity could not be set against ring-fenced profits.

#### **Taxation at investor level**

- Distributions made by a UK-REIT would fall into two categories. Profits arising from ring-fenced activity would be treated as property income in the hands of individual investors, chargeable at the taxpayer's marginal income tax rate. Such distributions would be payable under deduction of income tax. Profits arising from activity that fall outside the ring-fence could then be treated as an ordinary

dividend in the hands of individual investors;

- Corporate investors would also receive two types of distribution. Income from the ring-fence would be treated as property income and included as part of the ordinary taxable profits. Income outside the scope of the ring-fence could then be treated as ordinary dividends in the hands of a corporate investor;
- The Government is of the view that if a tax-exempt model as outlined above were adopted, it follows that a UK-REIT should be able, but not required, to distribute any gains arising from the sale of properties to investors. Any such gains distributed to investors would be treated as property income distributions and taxed in the hands of investors at marginal rates;
- Capital allowances would not be available at the investor level;
- Stamp Duty Reserve Tax would be paid on UK share transactions at the normal rate, currently 0.5%.

## **TECHNICAL TAX ISSUES**

### **International tax issues**

Putting in place a regime that complies with international obligations but fails to collect any UK tax from non-resident investors holding UK property (at either the vehicle or investor level) is likely to have a significant impact on the Exchequer.

The Government is interested in industry's views and proposed solutions in relation to the taxation of non-UK resident investors within a UK-REIT regime.

One alternative approach that the Government is open to considering is to retain taxation at the company level, but apply a reduced rate of 22% on income that falls within the ring-fenced activity of the UK-REIT.

The Discussion Paper focused initially on a tax exempt approach.

The Response identifies the big issue to address as the tax treatment of a UK-REIT and particularly with regard to overseas investors. It not only

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considers an exempt company but also alternatives, being a taxable company solution and an internal trust structure.

The industry recommends that the Government should follow the most straightforward and internationally recognised model for REITs and adopt the exempt company structure. The Response proposes that a suitable UK-REIT model would result in more general property activity and distributions should ease the Government's concerns that the Exchequer will lose out.

The Response also discusses the possibility of amending by agreement Double Tax Agreements to reduce the Government's concerns regarding the position of overseas investors.

The Response generally considers that a partially exempt company (under which a small amount of withholding tax would be imposed on income distributions) would compare very badly with international models which use the exempt company model and

would be unlikely to be the vehicle of choice for either companies or investors.

#### **A 22% taxable company**

The Response also explains that a UK-REIT that pays tax at 22% would be roundly dismissed by the industry as it would fail to replicate direct ownership and would be likely to increase taxation costs thereby encouraging companies to convert to a REIT.

#### **The Internal Trust Structure**

The Response also discusses a trust structure. This would involve a trust in respect of the rental income in favour of the investors to place them in the position that they receive property income rather than dividend income. There are considerable industry concerns that the additional complexity would render it unappealing to investors and to converting companies that would need to adjust their current structures, and that it would prove inflexible.

#### **Capital allowances**

The Response also highlights that clarification is required on how investors can access capital allowances specifically where distributions exceed taxable income.

#### **Gearing**

The Response strongly advocates that listed companies should not be subject to a gearing restriction on the basis and that the market will decide what is appropriate and that may change from time to time.

The Response also proposes that unlisted REITs should be able to borrow in a way that does not inhibit their development but nevertheless protects against tax avoidance where the amount of loans and shares can be set between related parties. The Response recommends, therefore, that where there is borrowing between connected parties, a provision be introduced to protect Exchequer receipts such as by treating excessive interest (ie outside industry norms) as a distribution by the UK-REIT.



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### Group company structures

The inclusion of companies within a group structure into a UK-REIT regime raises a number of issues, in relation to:

- Whether the rules set out for the UK-REIT would be applied to a single subsidiary or at group level;
- The possible delays that may occur between the receipt of rental income by the UK-REIT and the distribution of income into the hands of taxable investors outside the group;
- The ability for existing group structures to convert to UK-REIT status and the conversion charge payable on assets transferred.

The Government would like to discuss how group company structures could fit within a UK-REIT regime.

### Collective investment schemes

The problems highlighted above in relation to the taxation of non-UK resident investors in a UK-REIT would also apply in the context of collective investment schemes.

### Conversion to UK REIT status

The Government has not announced the tax charge it will make on companies or collective investment schemes converting to a UK REIT. This is obviously crucial to any decisions to convert.

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