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What REITs mean for you

Construction briefing

May 2007

REITs became a reality this month, and they are about to become a force in the property development world. But what do they mean for the firms that work with them?

Real estate investment trusts, or REITs, finally came into effect on 1 January. Their aim is to provide a more favourable tax regime for anybody operating a property rental business.

The system means gains on sales of rental-producing property assets will be tax free. It also means that tax on property rental income will occur only at shareholder level, after the distribution of profit. By contrast, the old regime had tax hits both at company level, on income, and at shareholder level, on dividends.

Choosing to become a REIT is not for the small fry. Only companies listed or intending to list on the stock exchange or another recognised exchange (not the alternative investment market) can take advantage of the REIT regime.

In the future, therefore, REITs are likely to be regarded as blue-chip property-based shares. Demand for REITs should then sustain demand for investment property.

If you follow that logic, it should mean more development, and more work for the construction industry. So here's what firms need to know about REITs.

HOW WILL THEY AFFECT SCHEMES ALREADY ON THE BOOKS?

They should have no affect on any scheme with a company that converts to REIT status, as existing contractual rights and obligations will remain. Elsewhere, cash-rich REITs will be keen to acquire more assets, which will include property that has been newly built or redeveloped by companies without REIT status.

WILL THIS MEAN JUST GIVING THE PURCHASER COLLATERAL WARRANTIES OR THIRD-PARTY RIGHTS?

As a minimum. A developer might also want to disclose details of any agreement between the developer and the REIT to contractors and consultants, as well as imposing contractual obligations on them not to cause the developer to be in breach of that agreement with the REIT.

This type of "third-party agreement" clause may widen the liability of contractors and consultants from that arising from defective design or workmanship to loss that the developer would suffer by being in breach of an agreement with the REIT.



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HOW WILL REITS DEVELOP?

There are constraints on the nature and extent of the development a REIT can undertake, but expect them to be substantial developers. Any development should be with a view to generating rental income. Further, no more than 25% of a REIT's business can be outside property rental, both in terms of profit and the value of assets.

WHAT CHECKS SHOULD BE DONE IF A REIT IS THE DEVELOPER?

REITs are likely to have good balance sheets and you can check this against publicly available information.

You should also check which entity owns the land. A REIT may structure its business so certain companies within a group undertake or manage development, separate from its property rental business. If the client is not the owner of the land, collateral warranties or third-party rights should be required in favour of the owner. There may also be intra-group agreements as to how the development is to be undertaken. If so, expect more third-party agreements. That may affect the nature and extent of risk, and therefore pricing.

WHAT IF I GET INTO A DISPUTE WITH A REIT?

Unlike private companies, REITs are less able to hide their dirty linen. The regulations for listed companies, including REITs, mean that information regarding material disputes may need to be disclosed to the market. This may be found in annual reports and accounts or other regulatory announcements.

So for instance, a REIT defending or bringing any claim may disclose contingent liabilities or assets respectively. By reviewing market-disclosed information, this may give hints as to the perceived merits of the claim or defence.

As a dispute progresses, any changes in the disclosed information may be a barometer as to how the dispute is perceived to be progressing.

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