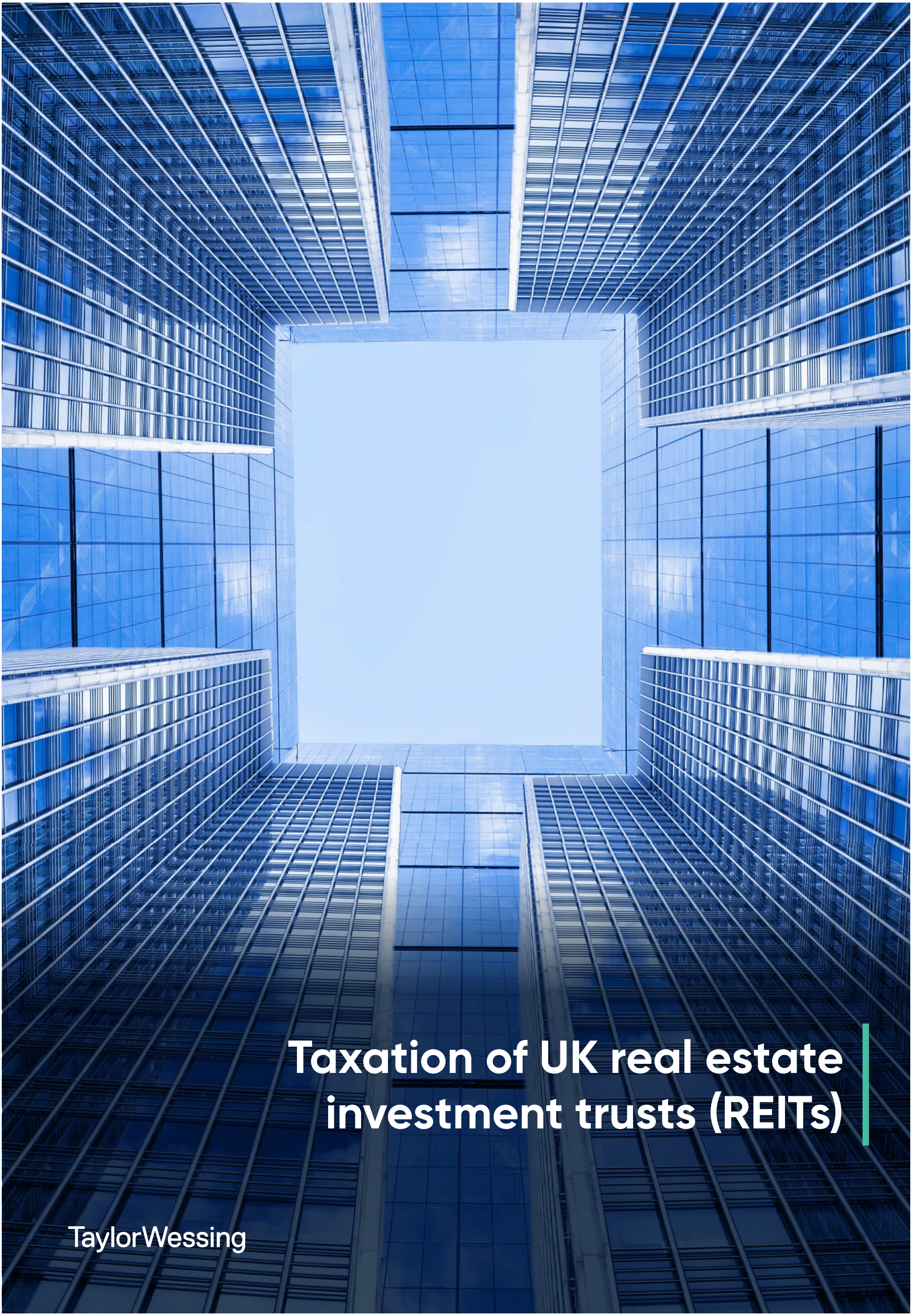

Taxation of UK real estate investment trusts (REITs)

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First introduced in the UK in January 2007, REITs provide a tax-efficient investment vehicle for real estate assets. Where certain qualifying conditions are met, a company or group may elect to join the regime. The income profits and capital gains of the REIT's qualifying property rental business will consequently be tax exempt, with investors subject to tax on distributions from the REIT.

This note provides an overview of entry requirements, qualifying conditions for REIT status, taxation of REITs and their investors, and exiting the regime.

Entry requirements

A company enters the UK REIT regime by giving notice to HMRC specifying the date from which it wishes to join. For corporation tax purposes, an accounting period is treated as ending (and a new one beginning) on entry into the REIT regime. However, this does not affect a company's normal accounting reference date and so due consideration needs to be given to the date on which a company wishes to join the regime.

Qualifying conditions

To qualify as a REIT a company must satisfy various conditions relating to itself and its business. Over recent years, many of these conditions have been relaxed or simplified to enhance the regime and increase its attractiveness to investors.

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Company conditions

The following conditions must be met by the company (or the parent company in the case of a group REIT). A statement should also be included with the joining notice confirming to HMRC that these conditions (other than the non-close company condition) are reasonably expected to be met throughout the first accounting period on entering the regime.

- **Tax residence** - the company must be UK tax resident and not dual resident. In the case of a group REIT, subsidiary companies may be non-UK tax resident.
- **Closed-ended** - the company must not be an open-ended investment company (OEIC, i.e. a company with variable capital).
- **Listing requirement** - either:
  - the company's ordinary shares must be listed or admitted to trading on a recognised stock exchange (which includes the Alternative Investment Market), or
  - from April 2022, at least 70% of the company's ordinary shares must be held by one or more institutional investors (i.e. a 'private' REIT). 'Institutional investors' include pension schemes, insurance companies, co-ownership authorised contractual schemes (CoACS), UK REITs (and overseas equivalents) and sovereign wealth funds.
- **Non-close company** - as the REIT must be diversely owned the company must not be a close company (broadly, controlled by five or fewer 'participators') other than by virtue of having an institutional investor as a

participator. There is a three-year grace period from joining the REIT regime to meet this condition.

As part of an ongoing review of the UK REITs rules, various amendments have been made to the non-close company condition. Notably:

- confirmation that the condition may be satisfied by indirect ownership by institutional investors
- further restrictions on certain institutional investors (i.e. OEICs, unit trusts and limited partnerships) requiring them to be non-close or to satisfy genuine diversity of ownership
- a requirement for long-term insurers to meet the condition.

- **Shares classes** - the company must only have a single class of ordinary shares in issue (although certain non-voting restricted preference shares are also permitted).
- **Prohibited loans** - the company must not be party to certain non-commercial loans (i.e. where the lender is entitled to interest which depends on the results of the company's business or the value of the company's assets, or is in excess of market rates).

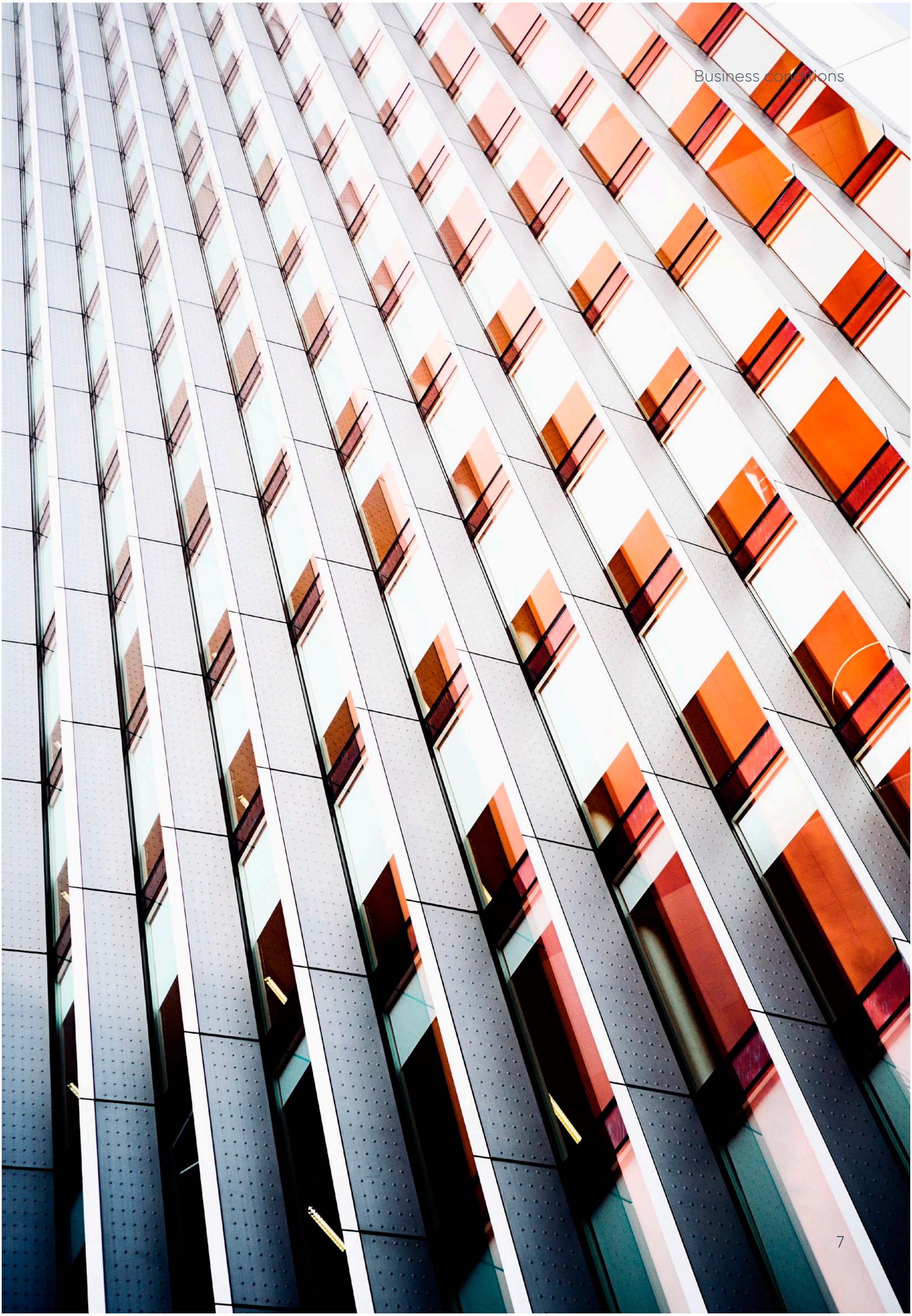
Business conditions

The following conditions must also be met to benefit from REIT status:

- **Property rental business (PRB)** - the company (or group, in the case of a group REIT) must carry on a qualifying PRB meaning it must:
  - hold at least three single properties, none of which represent more than 40% of the total value of the PRB, or
  - from April 2023, hold a single commercial property worth at least £20m.

The tax exempt qualifying PRB may include UK and overseas property, but certain activities (such as the letting of owner-occupied property) and income (such as rent from oil or gas pipelines, mobile phone masts or wind turbines) are excluded. Profits falling within this 'residual' business do not benefit from the tax exemption.

- **Balance of business** - the profits of the PRB must represent at least 75% of the REIT's total profits (being the aggregate of the PRB and residual business profits). In addition, the value of the assets relating to the PRB, plus cash relating to the residual business and shares in another REIT, must represent at least 75% of the total value of the assets held by the REIT.
- **Distribution of profits** - at least 90% of the tax-exempt income from the REIT's PRB (together with all property income distributions (PIDs) paid to it by other REITs) must be distributed to shareholders within 12 months of the accounting year end. A distribution may be made either in cash or as a stock dividend.



Taxation of a REIT

Where the various conditions for REIT status are met, income profits from the REIT's qualifying PRB will be 'ring-fenced' and exempt from UK corporation tax. Gains from the disposal of properties used wholly and exclusively for the PRB, and on the disposal of shares in property rich companies or interests in property rich CoACS, will also be exempt.

Any profits arising from the REIT's residual business (i.e. from activities outside the ring-fence) will be subject to UK corporation tax in the usual way.

Care is needed where a REIT undertakes development activities as this can result in a disposal of the relevant property being treated as part of the REIT's residual business and so subject to tax (i.e. where the costs of development exceed 30% of the value of the property and the REIT sells the property within three years of completion of the development).

A tax charge may arise where the qualifying conditions for REIT status are breached. The following should also be noted:

- **Interest cover** – the REIT will be subject to a tax charge if it is too highly geared; the profits from its PRB must therefore be at least 1.25 times its property financing costs (i.e. costs referable to the UK PRB, but not including non-deductible expenses). HMRC may however waive this tax charge in certain circumstances (for instance, where the REIT is in severe financial difficulties).
- **Maximum shareholding** – a tax charge may also arise where the REIT makes a distribution to a 'holder of excessive rights' (i.e. a

corporate shareholder holding 10% or more of the shares or voting rights in the REIT). However, this tax charge will not be levied:

- where the REIT has taken reasonable steps to avoid paying such a distribution (for instance, by including a protective mechanism in its articles of association)
- from April 2022, where distributions are paid to investors entitled to gross payment, such as UK tax resident companies.

HMRC also accept that the 'holder of excessive rights' rules do not apply to a sovereign wealth fund; it can therefore hold more than 10% of a UK REIT without triggering a tax charge for the REIT.

Taxation of investors

Distributions made by a REIT in respect of income and gains of its tax-exempt PRB (i.e. PIDs) are treated as property income in the hands of investors and subject to UK corporation tax (at 25%) or income tax at the investor's marginal rate (at a maximum of 45%).

PIDs are generally subject to withholding tax at the basic rate of income tax (currently 20%), but certain classes of investor may receive dividends gross (for example, UK resident companies, UK pension schemes and charities). Credit is available for tax withheld at source.

Non-UK resident investors will potentially be subject to UK tax by way of withholding, although the 20% rate may be reduced under a double tax treaty. A sovereign wealth fund is immune from UK direct tax and is therefore entitled to reclaim the full amount of withholding tax irrespective of an applicable treaty.

Distributions from the REIT's residual business are taxed as dividends in the normal way.

A disposal by a UK resident investor of shares in a REIT is subject to the normal capital gains tax (CGT) rules. Non-UK resident investors are liable to non-resident CGT on gains realised on the disposal of shares in a REIT (being an interest in a UK property rich collective investment vehicle). Sovereign wealth funds are however exempt from such tax.

Exiting REIT regime

A REIT may leave the regime by way of:

- Notice to withdraw given by the REIT or HMRC, or
- Automatic termination for breach of certain company conditions.

On leaving the regime a sale and reacquisition of the assets forming part of the REIT's tax-exempt PRB is deemed to take place at market value, but this does not give rise to a chargeable gain (or allowable loss).

Special rules apply where a REIT has been within the regime for less than ten years.

"

Liz Wilson ... is super sharp, technically superb, with clarity of delivery on difficult matters.

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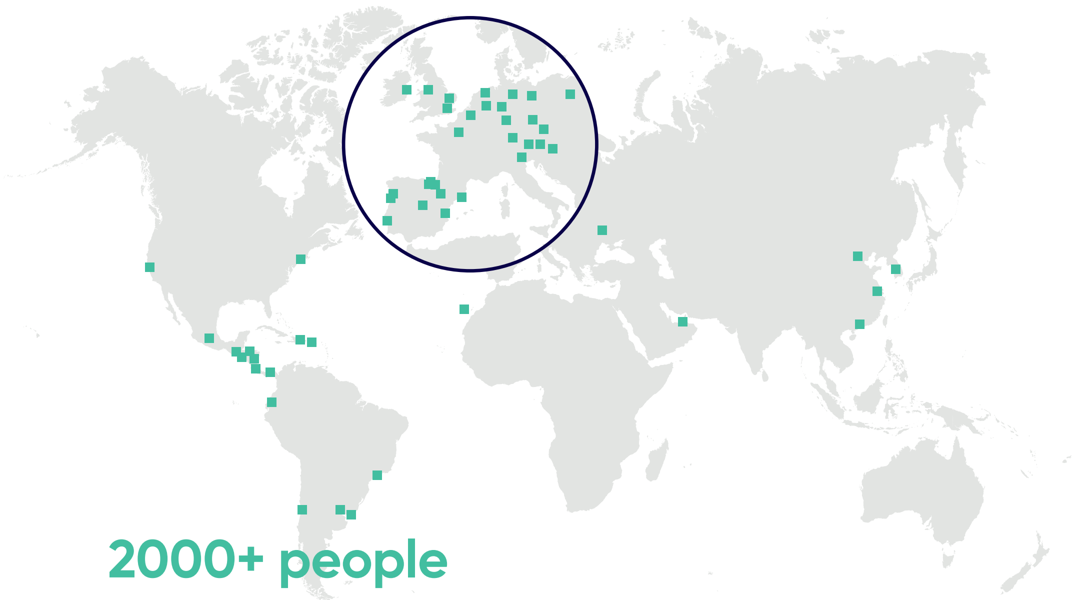

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