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Real Estate
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UK REITs
A summary of the regime

Overview of the UK REIT regime

A UK REIT is a UK resident listed company, that undertakes a 'property rental business' and has elected to enter the UK REIT regime.

Broadly, a property rental business is one which derives its income from land and generates rental receipts. For the purposes of the REIT regime, a 'property rental business' excludes income and gains derived from owner-occupied buildings.

REITs are exempt from UK corporation tax on rental income and capital gains arising from their property rental business. Any income and gains which are not derived from property rental activities are part of the residual business and will be subject to UK corporation tax. The majority of REITs will therefore, have both a tax exempt business and a smaller residual taxable business.

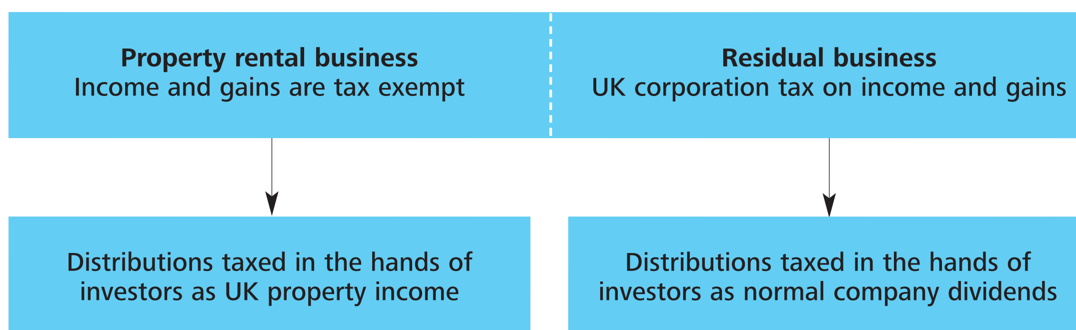
The broad intention of the regime is to replicate the tax treatment of a direct investment in property. To achieve this, rental income and gains are exempt at the REIT level, but are taxed at investor level when they are received by way of dividend.

To ensure income and gains are taxed at investor level, REITs are required to distribute the majority of their tax exempt rental income to shareholders known as Property Income Distributions (PID). Basic rate tax at 20% is generally withheld from the dividend except, for example where it is paid to a pension scheme or UK resident company.

Shareholders are taxed on the PID at their normal tax rate on income, with a credit for the tax withheld. Note that shareholders are also taxed at the income rate when they receive exempt capital gains as dividends. Distributions from the residual business are taxed as normal dividends.

The REIT regime provides a method by which investors can tap into a liquid and publicly available source of property investment.

UK REIT



Conditions

There are a number of conditions that a company needs to satisfy in order to become a REIT and remain within the regime. The conditions are broadly as follows:

Company Conditions

- tax resident in the UK only;
- closed-ended company;
- listed on a recognised stock exchange (excludes AIM);
- not a close company;
- one class of ordinary shares; and
- no 'non-commercial' loans.

Activity conditions

- the REIT must hold at least three properties and, of these, no single property can exceed 40% of the total value of the properties in the property rental business; and

- the REIT must distribute 90% or more of its tax exempt income profits (not gains), by the filing date of the company's tax return (usually twelve months after each accounting period end).

Balance of business conditions

- at least 75% of the REIT's assets must relate to the property rental business; and

- at least 75% of the REIT's accounting profits must relate to the property rental business.

Other considerations

There are other aspects that a REIT needs to consider, including:

- there are restrictions whereby a penalty tax charge is payable by a REIT if it pays a dividend to corporate shareholders who are beneficially entitled to 10% or more of the REITs dividend payments or share capital, or control 10% or more of the voting rights of the REIT;

- REITs are required to maintain a profit:financing cost ratio of greater than 1.25:1, otherwise a tax penalty may arise; and

- properties that are part of the tax exempt business and are redeveloped and sold may fall outside of the exempt activities and into the residual business if the redevelopment costs exceed 30% of the fair value of the property (at the later of entry date or acquisition) and the disposal is within three years of practical completion of the development.

Breach of conditions

If a REIT breaches one or more of the REIT regime conditions, the penalty can range from automatic expulsion from the regime to additional tax liabilities for the REIT.

Multiple minor breaches within a period of ten years can also result in expulsion from the regime. The number of breaches allowed before exit from the regime depends on the type of condition and whether conditions from different sections of the legislation are breached.

Entry and conversion charge

In order to enter the regime the company must give notice in writing to HMRC before the beginning of the period in which the REIT regime is to apply.

On entering the REIT regime a company's rental properties are treated as sold and immediately reacquired at market value. The gains or losses arising on these deemed disposals are ignored for tax purposes. Instead, an entry charge is payable and is calculated as 2% of the market value of the rental properties as at the date of entry.

The entry charge can be paid upfront or it can be settled in four REIT instalment payments over four years. However, if paid in instalments, the conversion charge will increase to 2.19% in total.

Factors to consider when deciding whether to become a REIT

Entering into the REIT regime will impact the whole business of the company. Therefore, companies will need to carefully consider a number of factors before deciding whether to become a REIT.

The factors may include:

- the cost-benefit ratio of the entry charge compared to ongoing benefit of tax exemption;
- the drain on cash resources in complying with the 90% distribution requirement;
- whether the company needs to increase operational efficiency in order to provide attractive income yields to investors; and
- the cost of additional resources required to monitor compliance with the company, activity and balance of business conditions.

Investors and distributions

The REIT regime provides a method by which investors can tap into a liquid and publicly available source of property investment.

REITs may be attractive to investors for the following reasons:

- easier access to property investment compared to purchasing a property directly;
- investment into property through a readily tradable investment asset, as compared to direct investment into property, which is generally illiquid;
- diversity of investments across a range of property assets;
- access to parts of the property sector that private investors have not previously been able to access e.g. shopping centres or industrial property;
- tax is generally only payable at the shareholder level, rather than at both the property company and shareholder levels, giving improved after-tax returns for shareholders;
- regular income returns; and
- lower transaction costs, i.e. 0.5% stamp duty on shares compared to 4% of SDLT on property.

Comparison of after tax returns in investing in a UK company and a REIT

Example – Assumes £100 return before tax

Investor	After tax return from company	After tax return from REIT	Improvement
Basic rate tax payer	72	80	11.1%
Higher rate tax payer (40%)	54	60	11.1%
Pension fund	72	100	38.9%
Overseas (typical treaty country)	72	85	18.1%

Contact

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