The evolution of the UK REIT regime

Large Corporate OMB

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Jo Cox revisits the basic UK REIT rules and reflects on what the proposed changes to the regime will mean

Key Points

What is the issue?

A real estate investment trust (REIT) is exempt from corporation tax on qualifying rental income and gains on sales of investment properties (and shares in property investment companies) used in its UK property rental business.

What does it mean to me?

To encourage continued investment into the UK property sector using REITs, the latest set of proposed relaxations to the UK REIT rules were published in the draft 2021-22 Finance Bill this summer. This article revisits the basic UK REIT rules and reflects on what the proposed changes mean.

What can I take away?

With the recent and future changes to UK property taxation, and the further announced relaxations demonstrating the government's continued commitment, the UK REIT regime is expected to go from strength to strength.

After launching in 1960 in the US, more than 45 countries now have their own real estate investment trust (REIT) regime, or an equivalent. Across the globe, the level of adoption varies significantly but REITs seem to be more popular where local rules have evolved in keeping with the ever-changing economic environment. In the UK, there are now more than 90 REITs.

In 2019 and 2020, the UK saw some of the most significant changes to the taxation of UK commercial property in decades, with the widening of scope of non-resident capital gains tax to include commercial property, and the migration of corporate non-resident landlords to the more stringent corporation tax regime, including the corporate interest restriction and anti-hybrid rules.

Right now, emerging from the unexpectedly long and societally transformative Covid lockdowns and the UK's withdrawal from the EU at the beginning of the year, the economic environment has certainly changed.

In addition to those changes, the 6% increase to the corporation tax rate from April 2023 looms and many property investors are looking at their forecast internal rates of return afresh.

Since the REIT regime came into effect on 1 January 2007, there have already been a number of significant and helpful changes designed to make it more attractive and accessible. These include:

- the removal of the 2% conversion charge;
- the exemption from tax of gains on indirect property disposals;

- the inclusion of a list of institutional investors who are able to hold large stakes in a REIT (without it falling foul of the non-close condition);
- the recognition of further exchanges for listing; and
- a three year initial relaxation to the non-close company requirement.

For non-UK investors, where there is a double tax treaty with the UK, the effective tax on net rental income and relevant gains is limited to the applicable treaty dividend rate; however, special rules apply where the holding is 10% or more.

To encourage further international capital inflows, and continued local investment into the UK property sector using REITs, the latest set of proposed relaxations to the UK REIT rules were published in the draft 2021-22 Finance Bill this summer.

This article revisits the basic UK REIT rules and reflects on what the proposed changes mean.

Policy objectives

When the government first officially consulted on the topic, the aim was to create a new regime which would raise productivity in the UK economy by stimulating the commercial property market: a key element in any successful economy.

The desire was to promote greater liquidity and more efficient investment decisions and to provide wider access to quality property investment opportunities for smaller investors, which were previously unavailable without significant capital outlays or tax inefficiency.

In addition, it was hoped that UK REITs could play their part in addressing the national housing crisis by providing a route into which newly developed rented accommodation could be sold, thereby increasing the willingness of house builders to increase supply (i.e. today’s high growth ‘Build to Rent’ sector).
However, the government’s main aim for a UK REIT was to ensure that the returns from different forms of indirect or direct UK property investment were taxed in broadly the same way by putting investors in a position where, from a tax perspective, it was as if they held the property directly.

Tax status of a REIT

A REIT is exempt from corporation tax on qualifying rental income and gains on sales of investment properties (and shares in property investment companies) used in its UK property rental business.

On entry into the REIT regime and when REITs acquire companies owning property investments, the assets are rebased to market value. This means that REITs do not need to seek a discount for any latent capital gain inherent in the target company.

Furthermore, when a REIT sells a company owning investment property, there is once again a market value rebasing of the property asset that the new owner benefits from (although this rebasing is subject to a requirement that the property-owning company retains the asset for a period of two years).

Tax is effectively levied at investor level, according to their individual tax status, on their share of rental income which is distributed to them by the REIT as a property income distribution. Distributions of exempt gains are treated in the same way as property income distributions.

Profits on activities of the REIT other than the property rental business, such as interest income or management services (the ‘residual business’), will be subject to corporation tax in the normal way. Profits from property trading activity are also subject to tax in the normal way, as are gains from direct or indirect disposals of property where there has been significant development activity (more than 30% of the value of a property) and the asset is then sold within three years of completion of the development.

Distribution requirement

To ensure that the benefit of the REIT election is passed on to investors, 90% of profits from a REIT’s exempt property rental business must be distributed within 12 months of the end of the accounting period. There is no requirement to distribute exempt gains.

In general, the mechanism of tax collection for certain UK, and all non-UK shareholders, is by the levying of a 20% withholding tax imposed on property income distributions (distributions of exempt income and gains). Payments can be made gross to UK companies, UK pension funds and UK charities.

Distributions out of other income or gains are treated as ordinary dividends which are not subject to any withholding and are not taxed as property income in the hands of the recipient. Special rules apply to determine out of which profits distributions are made. REITs can pay stock dividends (i.e. with the option to issue new shares to shareholders) in lieu of cash dividends, and these are treated as qualifying distributions.

Where a REIT invests in another REIT, 100% of the property income distribution dividends received by the investing REIT must be distributed within 12 months of the end of the accounting period.

Tax status of investors

UK shareholders are treated as receiving property income which is subject to corporation tax or income tax at the investor's marginal tax rate.

Non-UK investors may benefit from a favourable treaty rate (often 15% and in certain cases zero) under their respective double tax treaty, as for tax treaty purposes the property income distribution is treated as a dividend. This compares well against the announced 25% rate of corporation tax which will apply to non-REITs from April 2023.

Sovereign investors who are exempt from UK tax can reclaim the 20% withholding tax to put them into a position equivalent to investing directly in UK real estate.

Other REIT conditions

The key conditions to obtain and maintain REIT status are summarised below:

Property rental business

The REIT must have a property rental business. Certain types of property business do not qualify, such as lettings to group members.

The property rental business must involve at least three properties. Properties are defined by reference to whether they can be let under a separate lease. A single building which can be multi-tenanted, such as a shopping centre, will generally count as more than one property for the purpose of this test.
No single property can exceed 40% of the total value of all properties involved in the property rental business.

Balance of business

The profits arising from the exempt property rental business during the accounting period must represent at least 75% of the company or group's total profits. The value of the assets involved in the exempt property rental business at the beginning of the accounting period must make up at least 75% of the total value of assets held by the company/group.

These tests are carried out by reference to international accounting standards rather than tax legislation which can, on occasion, lead to unintuitive results. REITs are required to prepare and submit three sets of financial statements in relation to the group's activities for each accounting period. These financial statements are fundamental in determining compliance with the balance of business tests, as well as the financing cost ratio test discussed below.

Company requirements

A REIT can be either a single company REIT or a group REIT. The principal company of a group REIT or a single company REIT must be a UK resident company and not dual resident. In principle, non-UK incorporated companies can qualify so long as they are resident in the UK and not elsewhere. A group REIT consists of a parent company and its 75% subsidiaries, regardless of their tax residence, where the ultimate parent has an economic benefit of more than 50% in each subsidiary.

Listing requirement

Currently, REITs must be admitted to trading on a recognised stock exchange and either listed on the London Stock Exchange (or foreign equivalent main market exchange which includes The International Stock Exchange in the Channel Islands) or traded on a recognised stock exchange (including AIM and IPSX).

For new REITs, there is a grace period of three accounting periods (up to three years) in relation to the listed or traded requirements; however, in practice this relaxation is fairly limited in its application.

A proposed relaxation to the listing requirement has been published in the draft Finance Bill this summer and is discussed below.

Non-close requirement

One of the most fundamental principles of a REIT is that its shares are widely held. The REIT must not therefore be a 'close company'; that is, a company which is under the control of five or fewer ‘participators’. The term ‘participators’ covers shareholders, directors or other parties (together with related parties) who can exercise control over the majority of the shares, voting rights, income or assets.

Lenders who are not lending in the ordinary course of business (known as loan creditors) are included when determining who is exercising control.

Investment partnerships which qualify as collective investment schemes can be ‘looked through’ to the individual partners for the purpose of this test.

Shares held by various institutional investors count towards those shares treated as widely held. Institutional investors include pension funds, charities, registered housing providers, sovereign wealth funds, certain insurance companies, managers of UK authorised funds, and other REITs (including both UK and foreign equivalents to a UK REIT).

A REIT is not a close company if at least 35% of its shares are held by members of the public subject to certain further conditions.

If a REIT becomes close, then it loses its REIT status unless it takes corrective action. There is a three-year grace period on being close for new REITs, allowing a new REIT to be set up with cornerstone investors.

Financing requirements

REITs cannot be excessively geared by debt. The REIT must have a profit financing ratio where the profits are at least 1.25x the finance costs. A tax charge is levied on the REIT where there is excess financing (subject to relief under hardship provisions).

The corporate interest restriction rules do apply to REITs, with some special provisions dealing with the fact that REITs can have both an exempt and residual business. As with a non-REIT, they act to limit interest deductions to a percentage of taxable EBITDA (30% or the group ratio), subject to any potential exemption. The rules apply to interest on both related party debt and third party debt and apply in addition to other anti-avoidance rules on interest deductions such as transfer pricing and ‘unallowable purpose’.

Holders of excessive rights

In the event that a corporate shareholder were to hold 10% or more of the REIT, they may be entitled to claim beneficial treaty rates that would undermine the REIT regime by negating HMRC’s ability to collect tax through the withholding tax mechanism. Therefore, the regime has been designed to discourage the REIT from allowing its shareholders to hold 10% or more through a single corporate vehicle. Such a shareholder would be regarded as a holder of excessive rights.

Where the REIT pays a dividend to a holder of excessive rights, a penalty tax charge can arise on the REIT.

Therefore, UK REITs usually have restrictions in their articles of association that seek to prevent distributions from being made to individual corporate shareholders who hold 10% or more of share capital or voting rights and allow a UK REIT to force shareholders to sell stock if they are in danger of breaching the 10% limit.

Joint ventures

Where the REIT owns at least 40% of a corporate joint venture which is not a member of the REIT group, the REIT can make a joint venture election to treat an appropriate share of the joint venture’s property business as being part of the REIT group.

Proposed changes to the rules from April 2022

Listing requirement

The listing requirement was put in place to protect relatively unsophisticated retail investors, by ensuring that REITs are established and overseen by a competent authority.

Since 2012, there are now many REITs owned solely by institutional investors and in that scenario the listing requirement seems to serve little or no purpose. Although the rules are only in draft, the current proposal is that where 99% of a REIT’s shares are held by institutional shareholders, the shares will no longer need to be listed.

Balance of business test

If a REIT’s group accounts for a period show that property rental business profits and assets comprise at least 80% of group totals, it will not have to prepare the additional statements which would be required to meet the full test.

In addition, non-rental profits arising because a REIT has to comply with certain planning obligations will be disregarded for the purposes of the test. This deals with situations where planning consent is conditional on providing affordable housing stock and there is no intention to retain that affordable housing following completion.

Overseas REITs

It is proposed that the definition of an overseas equivalent of a UK REIT within the list of institutional investors is amended so that the specific overseas entity itself, rather than the overseas regime to which it is subject, needs to meet the equivalence test to be considered an institutional investor.

Holders of excessive rights

The ‘holders of excessive rights’ charge will be removed where property income distributions are paid to investors entitled to gross payment. This means that UK companies and certain charities will no longer have to fragment their holdings to less than 10% to avoid the penalty tax charge.

Key message

With the recent and future changes to UK property taxation, and the further announced relaxations to certain requirements demonstrating the government’s continued commitment, the UK REIT regime is expected to go from strength to strength.