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UK REITs
A summary of the regime

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The UK REIT regime

The UK Real Estate Investment Trust ("REIT") regime launched on 1 January 2007 and immediately saw a number of the UK's largest listed property companies convert to REITs. Since then, the regime has continued to evolve, increasing the attractiveness and accessibility of the regime to a wider pool of property investors and providers of capital, including the introduction of institutionally owned REITs.

Key benefits of REIT status

REIT status affords a number of commercial and tax benefits, including:

Access to the global REIT "brand"

REITs are known and understood by both investors and analysts worldwide as tax efficient structures for investment in real estate. There are currently c.40 countries worldwide that have REIT or 'REIT-like' regimes in place.

Attractors of international capital

REITs have a proven track record of attracting international capital. There are significant investment pools and fund allocations specifically designated for investment in REITs. Conversion to REIT status can often unlock new sources of funding.

Effective elimination of latent capital gains

REIT status may reduce or potentially eliminate any discount to net asset value caused by latent capital gains.

REITs often have a competitive advantage on corporate acquisitions, as other non-REIT bidders may have to discount their purchase price for latent capital gains. REITs are therefore able to make commercial decisions in a tax-exempt environment, based on the commercial performance of individual assets.

Enhancement of returns and an attractive vehicle for investing capital from a wide range of sources

REITs may be attractive to investors for the following reasons:

- Attractive for UK and overseas retail and institutional investors.
- Easier access to a tradable property investment compared to purchasing a property directly.
- Enhanced after-tax returns compared to a UK taxable company (see table below).
- Access to parts of the property sector that private investors cannot usually access e.g. shopping centres or industrial property.
- Regular income returns.
- Lower transaction costs, e.g. 0.5% stamp duty on UK shares compared to c.5% stamp duty land tax on direct property.

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

Investor type	After tax return from UK company	After tax return from UK REIT	Enhancement of return
UK pension funds and Sovereign investors	75	100	33.3%
Overseas corporate investor (beneficial tax treaty)	75	85	13.3%
Overseas corporate investor (no beneficial tax treaty)	75	80	6.7%
UK individual basic rate (20%) tax payer	69	80	15.8%
UK individual higher rate (40%) tax payer	51	60	18.5%
UK individual additional rate (45%) tax payer	46	55	18.5%
UK company	75	75	Nil

The table above assumes distributions to investors of underlying property rental business profits of £100 earned by a UK fully taxable company vs. a UK REIT, based on a UK corporation tax rate of 25% (applicable from 1 April 2023), ignoring capital gains and assuming no dividend tax allowance. Some small investors who are holding their shares outside an ISA/SIPP (and have unused annual dividend tax allowance), may enjoy higher after tax returns under the UK corporate structure rather than a REIT. This is because property income distributions (PIDs) from a REIT are not eligible for the annual dividend tax allowance (which is £1k in 2023/24 and £500 in 2024/25).

Requirements to achieve and maintain REIT status

There are a number of conditions that a company (or principal company of a group REIT) needs to satisfy in order to elect to become a REIT and remain within the regime. If these conditions are breached, the penalty can potentially range from automatic expulsion from the regime to additional tax liabilities for the REIT. Some of the key conditions are summarised below, which includes the latest changes to the REIT regime introduced by Finance Act 2024 ("FA24") that received Royal Assent on 22 February 2024.

- **Company conditions:**
  The principal company of the REIT must meet certain 'Company conditions', including:
  - being tax resident only in the UK;
  - not being an open-ended investment company;
  - be 'non-close' (see below);
  - have its ordinary shares admitted to trading on a recognised stock exchange and be listed/traded (see right column);
  - only have one class of ordinary shares (although certain non-voting preference shares are also permitted); and
  - not have any 'non-commercial loans'.
- **Not a close company:**
  The principal company must either:
  - Not be a close company (which means, broadly, it must not be controlled by five or fewer 'participators' taking into account aggregation of the holdings of associated persons, or it must meet the 'quoted company' exception (see right column); or

- Be a close company only because it has as a direct or indirect participator one or more 'institutional investors' as specified in the legislation, which includes: (a) a person acting on behalf of a limited partnership which is a collective investment scheme, a person acting on behalf of a UK co-ownership authorised contractual scheme ('CoACS'), UK or overseas open-ended investment companies, and UK or overseas authorised unit trust schemes (in each case which meet a modified version of the 'Genuine Diversity of Ownership' ('GDO') condition or the non-close condition); (b) UK or overseas life insurance businesses (that meet a modified non-close condition); (c) UK or overseas pension schemes; (d) UK or overseas REITs; (e) UK charities; or (f) sovereign immunity investors.

The 'quoted company' exception:

If at least 35% of the voting power is beneficially held by the 'public' (as defined in the legislation) and those shares have been the subject of dealings on a recognised stock exchange (within the preceding 12 months), the company will not be close.

A three-year grace period exists for new REITs to meet this non-close company condition. If the non-close company condition is not met by the end of the grace period e.g. due to circumstances outside the REITs control, there should in principle be no further penalty other than a loss of REIT status.

- **Shares admitted to trading on a 'recognised stock exchange' and listed/traded:**
  The principal company of the REIT must be 'admitted to trading' on a recognised stock exchange and either:
  - 'listed' on such an exchange; or
  - 'traded' on such an exchange in every accounting period, except the first three (in respect of which there is a grace period).

  However, this requirement may be removed where institutional investors (as defined under the 'not a close company' section covered previously) hold at least 70% of the ordinary share capital in the REIT principal company.

  Both direct and indirect ownership can be taken into account when considering this holding. In this regard:
  - Ownership can be traced through bodies corporate with ordinary share capital (which may be 'deemed' in certain circumstances).
  - Ownership is generally traced through limited partnerships, unless the limited partnership qualifies as an 'institutional investor' for close company purposes (see above), in which case such a limited partnership can be treated as an eligible institutional investor in its own right (and there is no need to trace through it).

Requirements to achieve and maintain REIT status (cont.)

- **Property rental business conditions:** The REIT group must hold a property rental investment business (based on general UK tax principles in relation to property investment vs. trading/dealing) that comprises:
  - at least three properties, of which no single property can exceed 40% of the total value of the properties in the property rental business; or
  - at least one single commercial property worth at least £20m.

  For these purposes, properties that would be regarded as 'owner-occupied' for accounting purposes in the REIT's consolidated accounts do not generally count as property rental business properties. There are also a number of other 'excluded' businesses, including the letting of property held as trading stock, income in connection with certain caravan sites, and rents in respect of the siting of electric-lines, pipelines for oil and gas, wind turbines and mobile telephone masts.

  Each unit or floor that is designed, fitted or equipped for separate rental will generally be regarded as a separate property (e.g. in an office building, shopping centre or residential block).

- **Balance of business condition:** At least 75% of the REIT group's gross assets and at least 75% of the REIT group's accounting profits, on an IFRS accounting basis, must relate to the property rental investment business. Other assets and activities are permitted, but must fall within the balance of the 25% of assets/profits.

  For these purposes, cash balances are included as a 'good' asset for the purposes of the 75% assets test.

  Certain items are excluded from the calculation, including:
  - realised gains and losses on the disposal of property
  - changes in the fair value of hedging derivative contracts (and the value of such contracts)
  - items outside the ordinary course of business of the group
  - non-rental residual business profits arising because of compliance with certain planning obligations in the course of the its property rental business (and the value of such assets).

  In addition, if a group's consolidated accounts for a period show that property rental business profits and assets comprise at least 80% of group totals, a REIT will be assumed to meet the balance of business profits and/or asset conditions and can provide simplified REIT financial statements (see next).

- **REIT financial statements condition:** The principal company must prepare and submit to HMRC certain REIT financial statements within 12 months of each accounting period end.

  These 'REIT financial statements' are separate from the financial accounts and form a part of the annual tax compliance reporting to HMRC in a prescribed format. They must include a reconciliation to audited accounts of the REIT group.

- **3-year development rule:** A REIT can develop properties to hold as part of its property rental investment business. However, whilst not a condition to maintain REIT status, in certain cases the 3-year development rule can remove certain REIT tax exemptions that might otherwise apply (see page 7).

  Where a REIT sells a property within 3 years of practical completion of a significant development (being a development where development costs exceed 30% of the fair market value of the property on the later of entry to the REIT regime, acquisition of the property, or the beginning of the accounting period in which the development commenced), any gain on sale may be taxable (rather than exempt) and REIT entry rebasings may be ignored.

  This 3-year development rule may also apply to sales of shares in property-rich companies holding an underlying property that has been significantly developed.

Requirements to achieve and maintain REIT status (cont.)

- **Distribution condition:**
  The REIT must distribute 90% or more of its tax-exempt income profits (not capital gains), as well as 100% of any property income distributions received from other UK REITs, by the filing date of the company's tax return (usually twelve months after each accounting period end).

  Such 'property income distributions' can be made in a cash or non-cash form (but any withholding tax due will always need to be paid to HMRC in cash – see further on page 7).

- **Financing cost ratio:**
  Whilst not a condition to maintain REIT status, a REIT may suffer a tax charge if it has a profit: financing cost ratio on their UK property rental business of less than 1.25:1.

  For these purposes financing costs related to the property rental business exclude certain amounts in respect of which a deduction is denied for corporation tax purposes, for example under transfer pricing rules. However, the ratio does not exclude deductions denied solely as a result of the UK's corporate interest restriction rules.

- **Holder of Excessive Rights**
  Whilst not a condition to maintain REIT status, the principal company of a REIT may suffer a tax charge if it pays a dividend (in the form of a property income distribution) to, or in respect of, a company that:

  - Is beneficially entitled, directly or indirectly, to 10% or more of the company's dividends; or
  - Is beneficially entitled, directly or indirectly, to 10% or more of the company's share capital; or
  - Controls, directly or indirectly, 10% or more of the voting rights of the company ("Holders of Excessive Rights").

  This charge is not applicable where property income distributions are paid to certain 'excluded holders', which includes:

  - investors entitled to gross payment (i.e. without deduction of withholding tax); or
  - investors that are taxed on distributions from a UK REIT under a relevant double tax treaty ("DTT") at a particular rate (or not taxed at all under that DTT), unless the sole reason for that treatment is the size of the holder's interest in the UK REIT.

Factors to consider when deciding whether to become a REIT

Companies will need to carefully consider a number of factors before deciding whether to become a REIT, such as:

- The impact of REIT conversion on shareholders' after-tax returns.
- The ongoing benefits of REIT status, together with costs of complying with the regime's requirements.
- The requirement for diversity of ownership (subject to the three year grace period and institutional investor rules).
- The requirement for the REIT's shares to be admitted to trading on a recognised stock exchange (subject to the exception where ≥70% of the shares are held by institutional investors).
- Implications of complying with the company, distribution, balance of business and financing cost ratio conditions and tests.
- Whether the company needs to increase operational efficiency in order to provide attractive income yields to investors.
- Whether the company's existing reporting tools provide the outputs that will be required as a REIT (monitoring of conditions, accurate forecasting, accounting information etc.).

Taxation of a UK REIT

A UK REIT needs to carry on a 'property rental business', and meet the various conditions for REIT status. This allows it to benefit from exemptions from UK corporation tax on profits and gains arising from its property rental business.

Property rental business

Profits and gains are **tax-exempt**

- Property rental business profits and gains (on direct disposals of property or on sales of shares in UK property-rich entities[1]) are tax-exempt within the REIT itself.
- Distributions to investors derived from tax-exempt rental profits or gains (referred to as 'property income distributions' or 'PIDs') are generally subject to basic rate withholding tax at 20% except, for example, where paid to a UK pension scheme or UK resident company. Overseas investors may be able to reclaim part (or all) of the withholding tax under a tax treaty or because of sovereign immunity.
- Investors are taxed on the distributions of tax-exempt profits and gains at their normal tax rate on income (as profits of a UK property business, rather than as a normal dividend receipt), with a credit for any tax withheld. However for overseas investors they will be taxed as a dividend under tax treaties.
- To ensure a regular flow of income is subject to tax at the investor level, REITs are required to distribute 90% of their tax-exempt profits. This distribution requirement does not include capital gains which can be retained within the REIT. REITs can satisfy this 90% distribution requirement by issuing shares in lieu of cash dividends or by other non-cash means.

Distributions taxed in the hands of investors as UK property income (generally 20% tax withheld)

Residual business

Profits and gains are subject to **UK corporation tax**

- Any profits and gains which are not derived from property rental activities are part of the residual business and will be subject to UK corporation tax in the normal way. This would include property trading activities, development and asset management fees and capital gains on disposals of shares that do not meet the conditions for the REIT share sale exemption.
- Distributions of profits and gains from the residual business will represent normal company dividends in the hands of investors when distributed.
- The majority of REITs will therefore have both a tax exempt business and a smaller residual taxable business.

Distributions taxed in the hands of investors as normal company dividends (no tax withheld)

[1] The UK REIT tax exemption was extended to apply to disposals of shares in UK property-rich entities (as well as to direct disposals of property) from 6 April 2019, subject to certain conditions.

The REIT journey

A number of steps are needed to launch a REIT and a range of advisers will need to be appointed.

1

REIT feasibility study

A review of the current or proposed business should be undertaken to ascertain whether the various conditions of the REIT regime can be met and maintained.

2

REIT conversion process

Once the decision has been taken to move ahead with REIT launch or conversion, a detailed workplan needs to be agreed. Support will be required from a number of advisers, which may include (depending on the circumstances):

- pre-conversion and restructuring tax advice and HMRC clearances
- tax advice in relation to the ongoing monitoring and managing compliance with the REIT regime conditions and calculation of the minimum distribution requirements
- legal advice
- IPO readiness advice and/or listing process support; accounting support (including reporting accountant, prospectus support and accounting opinions); capital market strategy and capital raising strategy

3

Discussions with HMRC

Liaison with HMRC may be required regarding the proposed REIT structure and the company must give notice in writing to HMRC specifying the date from which the REIT regime is to apply.

4

IPO assistance and capital raising

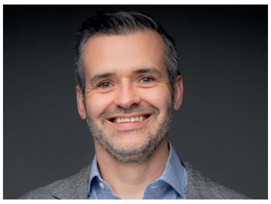
Assistance may be required with listing the REIT entity and completion of any IPO and capital raising process.

5

Launch of the REIT and ongoing management

After launch of the REIT, ongoing advice will be required in relation to monitoring and managing compliance with the REIT regime conditions and filing requirements. Transactions advice may also be needed for e.g. acquisitions and disposals.

Contacts



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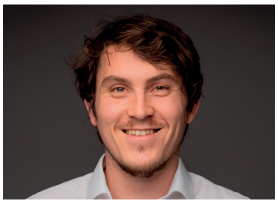

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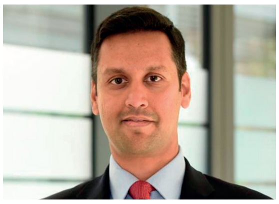

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