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cutting through complexity

The future of the UK REIT regime - who will benefit?

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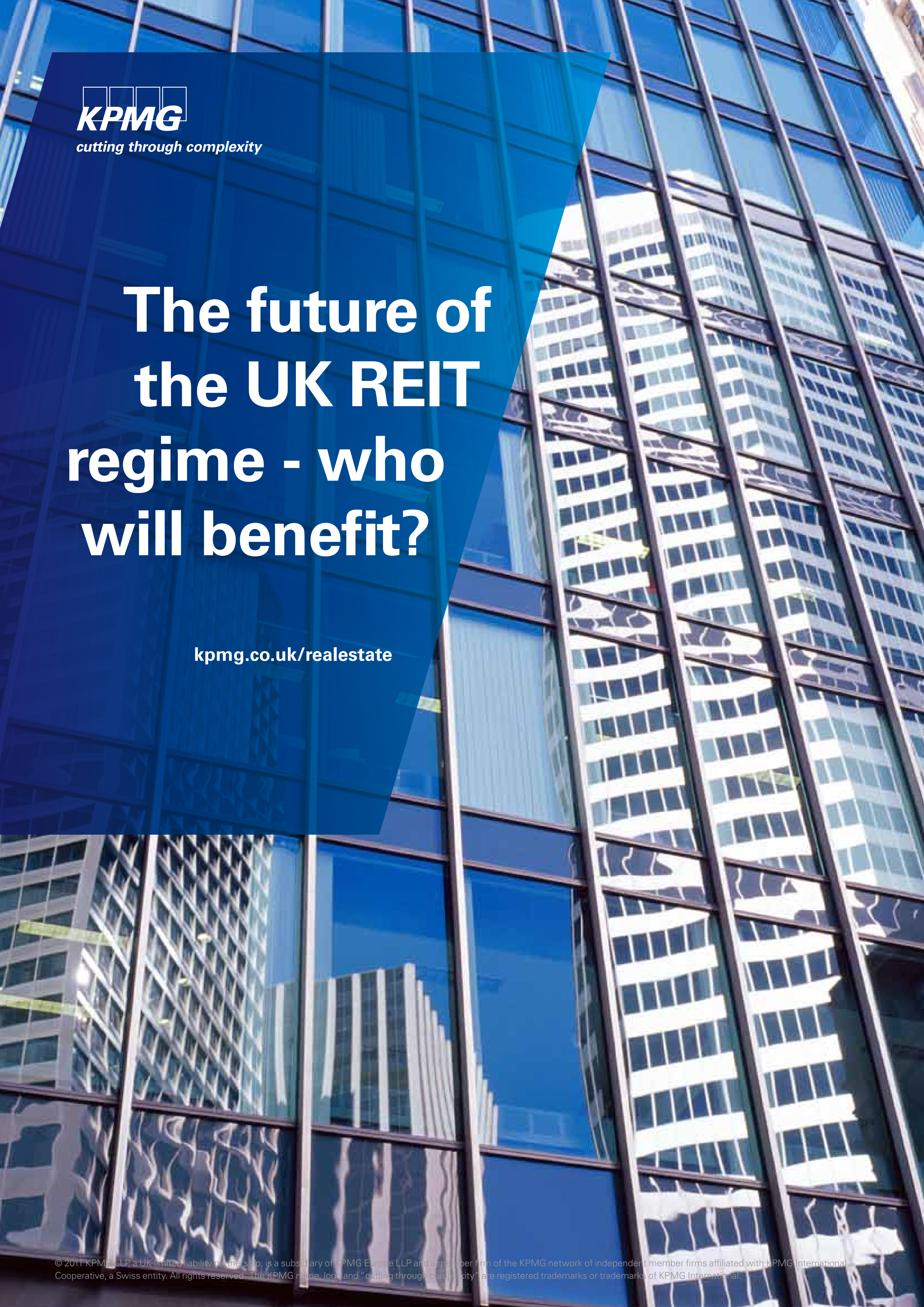
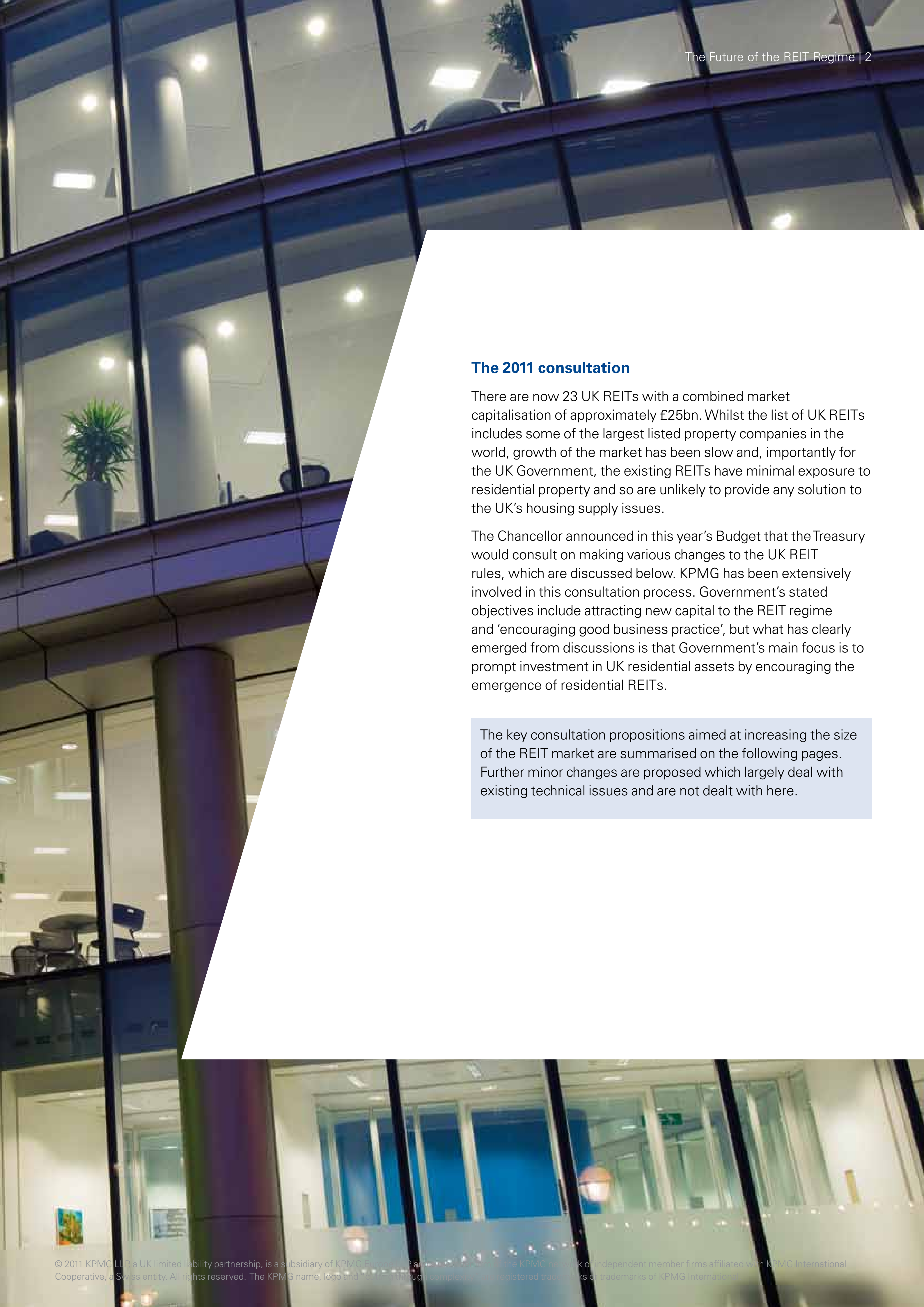


Earlier this year, the UK Government announced a significant consultation on changes to the UK REIT regime. Changes made will have effect from Finance Act 2012, due to become law in late Summer 2012. So what are the proposals under consideration, what changes might be made to the REIT legislation and who may be able to benefit?

What is a UK REIT?

Real Estate Investment Trusts ('REITs') were introduced in the UK on 1 January 2007 after many years of lobbying by the property industry. Despite the name, a REIT is formed as an ordinary company or group, the top company of which is required to be UK tax resident and listed on a stock exchange 'recognised' by Her Majesty's Revenue and Customs.

Provided a company carrying on a 'property rental business' meets the various conditions set out in the REIT rules, it can elect to join the regime. REIT status acts to exempt the profits the company derives from its property rental business from UK corporation tax. In return, a REIT is obliged to pay out at least 90% of its rental profits as a dividend subject to a withholding tax of 20% and taxed on shareholders as rent. The idea of the regime is therefore to move the potential tax from the company to the shareholders.



The 2011 consultation

There are now 23 UK REITs with a combined market capitalisation of approximately £25bn. Whilst the list of UK REITs includes some of the largest listed property companies in the world, growth of the market has been slow and, importantly for the UK Government, the existing REITs have minimal exposure to residential property and so are unlikely to provide any solution to the UK's housing supply issues.

The Chancellor announced in this year's Budget that the Treasury would consult on making various changes to the UK REIT rules, which are discussed below. KPMG has been extensively involved in this consultation process. Government's stated objectives include attracting new capital to the REIT regime and 'encouraging good business practice', but what has clearly emerged from discussions is that Government's main focus is to prompt investment in UK residential assets by encouraging the emergence of residential REITs.

The key consultation propositions aimed at increasing the size of the REIT market are summarised on the following pages. Further minor changes are proposed which largely deal with existing technical issues and are not dealt with here.

Summary of key consultation questions

- Abolition of the 2% entry charge
- Relaxation of the diverse ownership condition for 'institutional' investors
- Allowing REITs to list on AIM and similar foreign exchanges
- Fixed grace period from close company conditions
- Allowing cash to be a 'good' asset for the 75% balance of business asset test

1. Abolition of the entry charge

The headline grabbing Budget announcement for REITs was the abolition of the 2% entry charge. This is currently applied to the market value of all properties held by a group which elects to become a UK REIT, or an existing REIT buying a property owning company. The charge may have been viewed as a fair price for eliminating the latent gains of a large existing property group but it is difficult to justify to investors considering the launch of a REIT where newly acquired properties mean there is little or no latent gain to eliminate. The abolition of the charge will make the regime significantly more attractive.

Issues to be resolved:

Two relatively minor technical points remain to be resolved in relation to the abolition of the entry charge:

- the retention of the ability of existing REITs to reclaim the entry charge already paid in certain limited circumstances; and
- the retention of the tax rebasing of properties on becoming a REIT and on leaving the REIT regime.

It is not clear whether the abolition of the entry charge will have any impact on these provisions, which would be of particular importance where a buyer is looking to acquire a REIT, taking it private.

2. Relaxation of the diverse ownership condition

REITs are required to have a diverse shareholder base. This is currently achieved by prohibiting REITs from being a 'close company' for tax purposes – broadly being controlled by five or fewer persons. The reason for this is that the Treasury have always been concerned that REITs are not used as private investment vehicles, but rather encourage the democratisation of property ownership.

However, the workings of the close company provisions are complex. Additionally, investors such as pension funds and insurance companies, or even widely owned companies, can cause a REIT to be considered a close company for tax purposes where they hold a significant stake, despite the fact that their own ownership is genuinely diverse.

To encourage more investment by institutional investors, Government have therefore proposed the introduction of a 'diverse ownership rule for institutional investors'. This change will make it easier for companies with institutional investors to become REITs.

Issues to be resolved:

This is arguably the most challenging issue under consideration in the consultation and there are some obvious questions. How should 'diverse ownership' be defined? And who should qualify as an 'institutional investor'?

Given the complexity of the existing test, industry (represented in this case by the Property Industry Alliance) have asked for a wider rethink of the diverse ownership condition, replacing the link to the close company test with a more general condition. This has the advantage of potentially simplifying the drafting of the REIT conditions. An alternative approach suggested to Government is to retain the close company restriction for REITs, but to include an exemption to prevent a REIT from being considered to be a close company where it is controlled by one or more 'institutional investors'.

On the question of who should qualify as an 'institutional investor', the property industry are keen to see that the term is defined as widely as possible, including not just pension funds and insurance companies, but also charities, PAIFs, hedge funds, private equity vehicles and listed companies. There is certainly a policy rationale for this – if the intention is to ensure that a REIT is held by a number of people, why should the rules prevent these people from clubbing together in an investment pool above the REIT if there is no loss of tax?

3. Relaxation of the listing requirement

As mentioned above, a REIT is required to be listed on either the main market of the London Stock Exchange, some parts of the PLUS market, or a similar foreign stock exchange recognised by HMRC. This has been viewed as a significant barrier to entry for smaller property businesses because of the costs and regulation involved in such a listing. As such, Government have proposed a relaxation of the listing requirement.

Despite the initial hopes of some in the property industry that such a relaxation may extend to allowing unlisted REITs, the Treasury have indicated that they are only considering allowing listing on AIM and similar foreign (or at least EU) exchanges.

4. Fixed grace period from the close company rules

A particular concern when trying to establish a new REIT has been the need to ensure the REIT is not considered a close company from its first day of trading. This is a factor that is highly dependent on market conditions and somewhat outside the control of the REIT. As such, the Government have proposed a grace period to allow a start-up REIT time to fulfil this condition.

Issues to be resolved:

Such a change does raise several technical questions, which are currently being considered by the Treasury. These are:

- How long should the grace period be? The industry has suggested a minimum period of 3 – 5 years would be necessary.
- What happens at the end of the grace period? Here industry have suggested that HMRC are given the discretion to extend the grace period where the REIT has clearly made efforts to meet the condition but has been thwarted by, for example, market conditions.
- If a REIT cannot meet the diversity of ownership condition following the expiry of the grace period, what should the consequences be? Should all tax benefits obtained during the grace period be retrospectively withdrawn, for example? The industry have put forward a case that there should be no retrospective consequences.

In addition to the above, the property industry have also asked Government to consider a similar grace period for meeting the listing requirement (discussed above), as a further means to allow the 'incubation' of new REITs. This is a fairly common feature of REITs in other jurisdictions but was not a question raised in the consultation by Treasury.

5. Treating cash as a 'good' asset

Under the REIT rules, 75% of a REIT's assets are required to be investment property – this is one half of what is known as the balance of business test. The final proposal aimed at reviving the UK REIT market is to treat cash as a 'good' asset for the purposes of this test – that is, equivalent to investing in property.

This change should also be helpful to newly launched REITs, particularly as it should enable the cash raised on listing to count as a 'good' asset. This would allow breathing space for the REIT to identify and acquire its investments. Although there are currently ways to ensure that a new REIT would only be required to invest 50% of its cash by the end of the first year, and 75% within 3 years, start-up REITs are nonetheless currently exposed to significant risks of being forced to invest against their commercial wishes as these time periods expire.

Issues to be resolved:

The drafting of this amendment is potentially complicated – as a fungible asset it is difficult to track the sources of cash held by a REIT – and the industry therefore hope that HMRC will take the simple route of allowing cash to be a 'good' asset in all circumstances.

KPMG view – What are we likely to see?

Consultation responses were submitted to Government in June and draft legislation is expected to be released in Autumn 2011, which will shed further light on the detail of the government's intended changes.

We fully support the government's initiative in looking again at the REIT regime. Whilst the success of the new rules will depend on the willingness of the Government to listen to representations during the development of the legislation – as well as on a number of market and economic factors that are outwith the REIT rules, we expect that the proposed changes will have a positive impact on the property industry as a whole. Examples of those that may benefit include:

- Existing smaller property companies – the proposed changes should make the REIT regime significantly more attractive to those looking to convert to REIT status as they can now access capital markets via an AIM listing and not suffer an entry charge on conversion.
- Institutional investors – Depending on the outcome of the 'diverse ownership' discussions, institutional investors are likely to be interested in opportunities to take large stakes in REITs or, indeed, find new investment into their existing property portfolios through launching these as a new REIT while retaining significant stakes.
- Housebuilders – may also be encouraged by the changes to the listing requirement and separately announced SDLT changes relevant to the acquisition of multiple residential properties, to consider spinning off unsold properties into a new AIM listed REIT.

- Existing debt providers – similarly, given the exposure of the banks to property, the new REIT regime may offer an opportunity to reduce the banks' exposure by floating property as a REIT. This would include residential property repossessed from owners in default.
- Property rich companies – including hotel and healthcare operators, may now reconsider realising the value of their real estate portfolio via a REIT listing on AIM, which should now be cheaper than previously and therefore more attractive. There are means of structuring transactions such that the original owner retains a significant stake in the REIT. This would also apply to private equity backed property rich groups who may be encouraged to split groups into operating and property businesses structured as a REIT.
- Social housing providers could see an opportunity to put some or all of their portfolios into a REIT structure thereby raising new capital to recycle into further housing provision.
- Offshore funds holding UK property may see an opportunity to move into a tax efficient on-shore structure without an entry cost.
- Residential landlords – Finally, the government will certainly hope that REITs will now offer a new opportunity to potential large-scale landlords of residential property, be that through shared ownership structures or pure market rent.

Contributors

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