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UK REITs: A New Dawn

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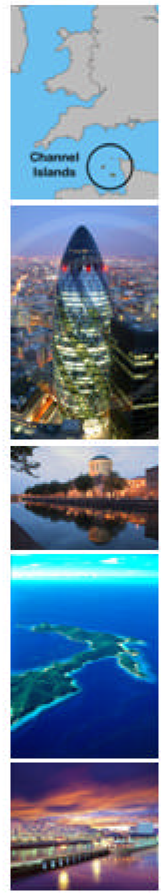

"Holding real estate in a UK REIT enhances shareholder value by approximately 11% for an individual shareholder and over 38% for a pension fund, compared with returns from real estate held through an ordinary UK company"

UK Real Estate Investment Trusts (UK REITs) were introduced by the Finance Act 2006 to give investors a tax-efficient way of getting exposure to commercial property. This special tax regime came into force on 1 January 2007 and, by February 2007, nine of the UK's largest listed property companies had converted to REIT status. These included, amongst others, Land Securities, British Land, Great Portland Estates and Primary Health Properties. Despite the initial impetus, UK REITs have not managed to attract the interest of smaller property companies and housing associations, principally as a result of certain restrictive qualifying rules and a 2% entry/conversion charge.

However, the UK Treasury has recently issued the results of its informal consultation, indicating that it is poised to abolish the conversion charge for companies joining the UK REIT regime and relax the current listing requirements by allowing REITs to be listed or admitted on the PLUS Market or the Alternative Investment Market (AIM). These and other changes to the UK REIT regime outlined below are expected to be included in the Finance Bill 2012.

The REIT model was initially pioneered in the US in 1960 to make large investments in significant income-producing real estate accessible to a wide spectrum of investors, but by 1992 the US REIT market had only achieved a moderate success and was worth a mere $2bn. However, following the simplification and modernisation of the US REIT regime, where limits on expanding portfolios were revoked, investments took off and the size of the US market is now in the region of $390bn.

THE CURRENT UK REIT REGIME

In the UK, a REIT is essentially a UK tax-resident listed company carrying on a "property rental business", within the meaning of section 104 of the UK Finance Act 2006. The UK REIT's rental profits or capital gains arising from its business are not subject to UK corporation tax. Tax is instead payable at the shareholder level.

UK REITs are particularly attractive to exempt bodies such as charities and pension funds, as investment in a UK REIT minimises the tax costs of indirect investment through a corporate vehicle by mirroring the tax treatment of investing into real estate directly or through a tax-transparent vehicle. Holding real estate in a UK REIT enhances shareholder value by approximately 11% for an individual shareholder and over 38% for a pension fund, compared with returns from real estate held through an ordinary UK company.[1]

Qualifying Criteria: In order to qualify for the current UK REIT regime, a company holding real estate must meet the following conditions:

(a) It must be resident for tax purposes in the UK and not resident in any other jurisdiction, having regard to the laws of that other jurisdiction;

(b) It must be a closed-ended investment company such that it would fall outside the definition of "Open-ended investment company" set out in section 236 of the UK Financial Services and Markets Act 2000 (FSMA);

(c) It must have its shares listed on a recognised stock exchange;

(d) It must have a diverse share ownership such that the company is not a 'close' company (broadly, a close company is a company controlled by five or fewer participators);

(e) It must have only one single class of ordinary shares (although non-voting, fixed rate preference shares are allowed in addition to the ordinary shares); and

(f) any loans made to the company must be on terms such that the interest payable is not dependent on the results of the company's business or exceeds a reasonable commercial return. The amount repayable on maturity of any such loan should also not exceed the original principal lent (without taking interest into account).

[1] source: Deloitte 2010

At present, private companies and companies listed or admitted to trading on a non-recognised exchange (such as AIM and PLUS), cannot elect to join the UK REIT regime.

Business Conditions: At least 75% of the UK REIT's assets and gross profits must derive from its property rental business, which must consist of at least three properties, with no single property representing more than 40% of the total value of the properties in the rental business. However, current UK REIT regulations provide for some flexibility including, among other things, allowing a UK REIT's property rental assets to fall below 50% of the UK REIT's total assets in certain circumstances and disregarding breaches of the business conditions test during the first accounting period of the UK REIT, provided that the test is met at the end of the first accounting period.

Properties held by the UK REIT must not include (i) owner-occupied properties owned by the UK REIT or another company being part of its group or (ii) occupation by any company whose shares are stapled to those of the UK REIT.

In addition, the UK REIT must distribute at least 90% of its tax-exempt profits to its shareholders. A UK REIT may also pay discretionary dividends in relation to profits deriving from its non-qualifying activities in accordance with the UK REIT's memorandum and articles of association. In the case of the ordinary dividend, the tax treatment is the same as for the dividend of any other company.

Entry Charge: On entry into the UK REIT regime, a company is levied 2% of the gross market value of the properties involved in the property rental business, which will form part of the company's tax-exempt business going forward. However, under current UK tax rules, a property-holding company joining the UK REIT regime will be able wipe out any contingent capital gains liability that the company may have on its books, which in some cases represent a multiple of the 2% entry charge.

Other charges: Another tax charge may apply if the UK REIT makes a distribution to a person that either:

(a) is beneficially entitled to 10% or more of the UK REIT's shares or dividends; or

(b) controls 10% or more of voting rights.

However, this tax charge can be waived or reduced if the company takes certain appropriate preventative action.

The 10% rule was devised to prevent non-UK shareholders which are resident in a country with a double taxation treaty with the UK from being able to reduce or avoid the tax withholding under the UK REIT regime because of the size of the shareholding. The rule only applies to corporate shareholders. Individuals and non-corporate shareholders are therefore outside the scope of the 10% rule.

THE PROPOSED CHANGES TO THE UK REIT REGIME

On 13 October 2011, the UK Government published the results of the HM Treasury's informal consultation on changes to the UK REIT regime announced in the Budget 2011, which concluded over the summer. The proposed changes to the UK REIT regime that the Government is poised to include in the Finance Bill 2012 are as follows:

(a) **Abolition of the conversion charge for companies joining the UK REIT regime** – This is deemed to be one of the most attractive changes in that it will allow qualifying companies to effectively wipe out contingent capital gains liabilities that they may have on their books upon conversion without incurring any additional charge or penalty.

(b) **Relaxation of the listing requirement to allow listing on non-regulated exchanges** – Allowing UK REITs the ability to choose from a broader range of exchanges (such as AIM and PLUS) where they could list their shares, would lead to increased accessibility to markets for start-up and smaller companies, as well as more flexibility in achieving their corporate objectives with their budget. In addition, this will allow small and medium UK REITs to select an exchange with less onerous rules relating to trading history, and lighter governance and reporting requirements, which, in turn, will result in reduced ongoing costs when compared to a full listing on main markets such as the London and New York stock exchanges.

Private property investment companies will continue to be ineligible for inclusion in the UK REIT regime.

(c) **Introduction of a fixed grace period for meeting the non-close company requirement** – Based on feedback received during the consultation period, the UK Treasury has clarified that a company which registers as a UK REIT will have a three-year grace period in which to meet the requirement to be a non-close company, although with no discretionary extensions allowed. At the end of three-year period, companies which do not meet the non-close company test for legitimate reasons, will be allowed to leave the UK REIT regime without penalties.

In addition, a new UK REIT taking advantage of the non-close company grace period may still be eligible to list on AIM or PLUS, provided they are able to meet the "shares in public hands" requirement of such markets.

(d) **Introduction of "diverse ownership rule" for institutional investors** – This will allow certain types of

institutional investors that are diversely owned to hold shares in a UK REIT without resulting in a breach of the close-company requirement, which is expected to encourage bringing institutional investment into the UK residential property sector.

(e) **Allowing cash to be held in the REIT for the purpose of meeting the balance of business assets test** – This will make it easier for start-up companies wishing to join the UK REIT regime, as well as for existing UK REITs, to raise funds to be spent over time, thus taking full advantage of market opportunities.

(f) **Redefinition of "financing costs" for the interest cover test**.

(g) **Extension of time limit for complying with the distribution requirement** – HM Treasury has agreed to extend the time limit within which the UK REIT is expected to distribute its tax-exempt profits to six months. This addresses industry's concerns that the current three months extension is burdensome for REITs operating on a six-month dividend cycle.

ESTABLISHING A UK REIT USING A JERSEY COMPANY

UK REITs may be established as Jersey companies incorporated under the Companies (Jersey) Law 1991 (the Jersey Company Law), while meeting the requirement for the UK REIT to be resident in the UK for tax purposes. The Jersey Company Law is a modern and flexible statute which has many similarities with the UK counterpart, and English case law is generally persuasive in the Jersey courts.

The key advantages of using a Jersey company are as follows:

- a Jersey company may be incorporated as a limited or unlimited company, with par or no-par value shares, as a guarantee company or as a cell company;
- Jersey allows for companies incorporated or established under the law of other jurisdiction to relocate to Jersey and continue as one of the company types referred to above;
- there is no stamp duty land tax or stamp duty reserve tax payable in Jersey on the issue or transfer of any shares in Jersey company holding UK property, which will be attractive to investors
- there are no statutory limits on a Jersey company's capacity to undertake business transactions; and
- a Jersey company can appoint corporate directors without the requirement to also have an individual director appointed on its board.

Until 2009, Jersey companies owned by non-Jersey residents could make an election for tax 'exempt company' status and, on the payment of a nominal annual fee, be treated as non-resident for Jersey income tax purposes. However, certain jurisdictions (including the UK) took the view that a Jersey tax exempt company was, nevertheless, a Jersey tax resident company by virtue of the company paying the annual fee, which was viewed as a tax. As a consequence, a Jersey tax exempt company, managed and controlled in another jurisdiction, was considered to have dual tax residency.

As a result of amendments made to the Income Tax (Jersey) Law 1961 – which included the introduction of a zero/ten corporate tax regime – a Jersey company is now treated as non-resident for Jersey income tax purposes provided that such company is (a) managed and controlled in another jurisdiction, (b) subject to corporate tax at a rate of 20% or more, and (c) resident for tax purposes in that other jurisdiction. Therefore, a Jersey company managed and controlled in the UK would be treated as being solely tax resident in the UK. This satisfies the qualifying requirement under the UK REIT regime.

LISTING A UK REIT ON THE CHANNEL ISLANDS STOCK EXCHANGE

The Channel Islands Stock Exchange (CISX) is designated by HM Revenues & Customs (HMRS) as a "recognised stock exchange" and is therefore suitable for listing UK REITs under the current regime.

A CISX listing provides a cost-effective alternative to a listing on other recognised stock exchanges. Even after the proposed change to the UK REIT regime which would allow UK REITs to be admitted on non-recognised markets – such as AIM and PLUS – a principal listing on the CISX may be worth considering in order to, for instance, make shares in the UK REIT eligible for inclusion in UK stock & shares individual saving accounts (ISAs).[2]

The CISX commenced operations in October 1998 and has grown rapidly, with over 4,000 securities having been approved since inception, for a total market capitalisation of over US$50 billion. The key advantages of listing a UK REIT on the CISX are as follows:

- a highly responsive and streamlined listing process;
- the CISX is a non EU exchange where EU directives do not apply;
- a pragmatic approach to disclosure requirements while maintaining international standards of issuer regulation;

[2] Under current UK legislation, shares listed or traded on a non-recognised exchange cannot be held in a stocks and shares ISA

- flexibility in the accounting requirements for the purpose of the listing;
- extensive recognitions from both UK and international authorities;[3]
- a fast turnaround for granting listing status which is normally achieved within a few days from submitting the final application for listing; and
- competitive pricing.

Competitive listing and sponsor fees: The listing fees payable to the CISX compare favourably with those payable to other stock exchanges worldwide. The initial listing fee in relation to a UK REIT is currently in the region of £3,500, with an annual fee in the region of £1,650.

In addition to the fees payable to the CISX, fees will also be payable to the UK REIT's listing sponsor. Bedell Channel Islands Limited is a category 1 listing member and can act as listing sponsor on all categories of listings.[4] Listing sponsor fees are dependent on the complexity of the listing, although they are generally extremely competitive when compared with advisory fees in connection with listings on other exchanges and the listing sponsor will not charge a percentage based fee.

There is no requirement for companies listed on the CISX to appoint an independent corporate advisor.

NEXT STEP

The changes in the UK REIT regime outlined in the Government consultation are to be welcomed by institutional investors, lenders and landlords alike. The outcome of the consultation suggests that most, if not all, of the changes announced in the Budget 2011 will be included in the draft Finance Bill 2012, which is expected to be published for technical comments on 6 December 2011. The Government is also considering the introduction of social housing REITs and mortgage REITs, which should hopefully provide an additional boost for the stagnant UK property sector.

For further information in relation to the above, please contact **Amedeo Claris-Delmedico** at info@amedeoclarisdelmedico.com or on +44 (0)20 7367 8330

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Amedeo Claris-Delmedico is a lawyer at Bedell Cristin (part of Bedell Group), a leading offshore-based provider of legal and fiduciary services with a network of offices in key financial centres (www.bedellgroup.com)

[3] For a complete list of international recognition, please visit www.cisx.com

[4] Please contact me for additional information on Bedell Channel Islands Limited and its listing sponsor services