

UK REITs: A New Dawn

In this Briefing we explore the opportunities likely to be presented by the forthcoming changes to the UK Real Estate Investment Trust (REIT) regime and the way in which Jersey companies and the Channels Islands Stock Exchange (CISX) may be used to facilitate REIT structures when the changes come into force.

Executive summary

- Changes to the regime governing REITs are likely to be effected in 2012. These changes will include the abolition of the 2% entry/conversion charge and a relaxation of the listing requirement in order to permit listings on the Alternative Investment Market (AIM) and the PLUS Stock Exchange (PLUS) (in addition to the "recognised stock exchanges" permitted under the current regime, such as the CISX and the main market of the London Stock Exchange (LSE)).
- After the initial take-up of the existing REIT regime by many of the UK's largest property companies, the barriers to entry have proven too high to overcome for all but those largest companies. The changes are likely to encourage a second wave of start-up REITs, REIT investment funds and SME property companies converting to REIT status.
- The abolition of the 2% entry charge may encourage new REITs wishing to enjoy the benefits of REIT status but not necessarily requiring the level of liquidity or wishing to incur the higher costs associated with a listing on, for example, the main market of the LSE or AIM, to utilise the CISX to satisfy the listing requirement.
- New REITs seeking liquidity without the associated cost of a main market listing may seek to list on AIM or PLUS. In these circumstances, a low-cost dual listing on the CISX may provide certain advantages as the CISX is a recognised stock exchange while, for instance, AIM is not.
- Jersey incorporated companies are an increasingly popular choice for London listings and may be used as a vehicle for new REITs regardless of the choice of stock exchange.

REIT overview

REITs were introduced by the UK Finance Act 2006 in order to provide investors with a tax-efficient way of gaining 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. Despite the initial impetus, REITs have not managed to attract the interest of start-ups, SME property companies and housing associations, principally as a result of certain restrictive qualifying rules and the 2% entry/conversion charge.

However, the UK Treasury has recently issued the results of its informal consultation¹, indicating that it is poised to abolish the charge for companies joining the REIT regime and relax the current listing requirements by allowing REITs to be listed or admitted on AIM or PLUS. These and other changes to the 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 investments in large-scale, significant income-producing real estate accessible to a wide spectrum of investors, but by 1992 the US REIT market had only achieved moderate success and was worth a mere US\$2 billion. However, following the simplification and modernisation of the

¹ See: http://www.hm-treasury.gov.uk/consult_reits_feedback.htm

US REIT regime, where limits on expanding portfolios were removed, investments took off and the size of the US market is now in the region of US\$390 billion.²

The current REIT regime

Taxation

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 REIT's rental income and capital gains arising from its qualifying letting business are not subject to UK corporation tax (any non-qualifying business is subject to corporation tax in the usual way). Dividends from the qualifying REIT business are known as property income distributions (PIDs) and UK resident individuals are taxed on PIDs at their applicable marginal rate of income tax, whilst corporates are taxed at the prevailing corporation tax rate. PIDs are subject to withholding tax at the basic rate of income tax (which are set against the investor's total liability to tax on the PID), although there is an exemption from the withholding tax where the investor is subject to corporation tax or is tax exempt.

REITs are particularly attractive to exempt bodies such as charities and pension funds, as investment in a 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 REIT enhances shareholder value by approximately 11% for a UK resident individual shareholder, by up to 18% for a non-UK resident individual shareholder, and by over 38% for a UK pension fund or ISA, compared with returns from real estate held through an ordinary taxable UK company.³

A REIT will be subject to a tax charge if it makes a distribution to a person that is either beneficially entitled to 10% or more of the REIT's shares or dividends or controls 10% or more of voting rights. However, this tax charge can be waived or reduced if the company takes appropriate preventative action.

Qualifying criteria

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

- **Tax residency:** it must be resident for tax purposes in the UK.
- **Closed-ended:** it must be a closed-ended investment company.
- **Listed:** it must have its shares listed on a recognised stock exchange (which includes the CISX and the main market of the LSE, but not AIM).
- **Close company:** 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 shareholders).
- **Share classes:** it must have only one single class of ordinary shares (although non-voting, fixed rate preference shares are permitted in addition to the ordinary shares).
- **Loans:** any loans made to the REIT 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 terms of the loan must not entitle the lender to a profit share.

In addition, the following "business" conditions must be met:

- **Letting business:** it must own at least three properties generating rental income. A single property with at least 3 letting units will be acceptable.
- **Single property value:** no single property must represent more than 40% of the total value of the REIT's qualifying letting business.

² Source: REIT.com <http://www.reit.com/IndustryDataPerformance/MarketCapitalizationofUSREITIndustry.aspx>

³ Source: "Comparison of investor return from a UK Real Estate Investment Trust and a UK taxable company" Deloitte 2010

- **Property occupancy:** the letting business must not include any properties occupied by the REIT or any company whose shares are 'stapled' to those of the REIT.
- **Distributions:** at least 90% of its taxable income from its qualifying letting business must be distributed each year.
- **Gross income:** at least 75% of its gross total income (not capital gains) must be from its qualifying letting business.
- **Gross assets:** the properties forming the qualifying letting business must represent at least 75% of the gross value of the UK REIT's assets.

Entry/conversion charge

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

The proposed changes to the UK REIT regime

On 13 October 2011, the UK Government published the results of HM Treasury's informal consultation on changes to the REIT regime announced in the 2011 Budget. The proposed changes to the UK REIT regime that the Government is poised to include in the Finance Bill 2012 are as follows:⁴

- **Abolition of the 2% entry/conversion charge for companies joining the REIT regime:** this is one of the most attractive changes in that it will allow qualifying companies to effectively wipe out contingent capital gains tax liabilities that they may have on their books upon conversion without incurring any additional charge or penalty.
- **Relaxation of the listing requirement to allow listing on non-regulated exchanges:** allowing REITs the ability to choose from a broader range of exchanges (such as AIM and PLUS) will lead to increased accessibility to the REIT regime for start-up and SME property companies. In addition, this will allow small and medium 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 main market listing in London.
- **Introduction of a fixed grace period for meeting the non-close company requirement:** based on feedback received during the consultation period, HM Treasury has clarified that a company which registers as a REIT will have a three year grace period in which to meet the requirement to be a non-close company, albeit no discretionary extensions will be permitted. At the end of the three year period, companies which do not meet the non-close company test for legitimate reasons, will be allowed to leave the REIT regime without penalties.
- **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 REIT, without being concerned about the REIT breaching the close-company rule on the basis that a single widely held institutional investor is effectively acting on behalf of numerous shareholders. This change may encourage institutional investment into the UK residential property sector.
- **Allowing cash to be held in the REIT for the purpose of meeting the 75:25 balance of business assets test:** this will make it easier for start-up companies wishing to join the REIT regime, for existing REITs to raise funds to be invested over time (50% within the first year and 75% within 3 years) and allow REITs to give proper consideration to the sourcing of appropriate investments using either funds invested in the REIT or through the reinvestment of sale proceeds.
- **Redefinition of "financing costs" for the interest cover test:** at present, gearing levels are limited by an interest coverage test and it is proposed that the current definition of "financing costs" used for the purposes of that definition, which covers a very wide range of debt related expenditure, will be narrowed.
- **Extension of time limit for complying with the distribution requirement:** HM Treasury has agreed to extend the time limit within which the REIT is expected to distribute its tax-exempt profits to six months. This addresses industry's concerns that the current three month extension is burdensome for REITs operating on a six-month dividend cycle.

⁴ See: http://www.hm-treasury.gov.uk/consult_reits_feedback.htm

Establishing a REIT using a Jersey company

The use of a Jersey company as the REIT vehicle may provide certain advantages over its UK equivalent. When considering the choice of jurisdiction the following factors are relevant:

- **Tax residency:** Jersey tax law specifically permits a Jersey incorporated company to be solely tax resident in the UK. Accordingly, the REIT tax residency test can be met.
- **CREST:** CREST settlement is available for shares in a Jersey incorporated company.
- **Stamp duty:** no stamp duty or stamp duty reserve tax is payable on the transfer of shares in a Jersey company provided the share register is maintained offshore.
- **Jersey company law:** Jersey company law is based on UK company law but with additional flexibility, particularly regarding dividend payments and maintenance of capital provisions. Dividends may be paid from any source (other than a capital redemption reserve or nominal capital account) on satisfaction of a cash-flow solvency test and there is no requirement for payment to be made out of distributable profits. In addition, there are no statutory pre-emption rights or financial assistance rules.
- **Takeover Panel:** the City Code on Takeovers and Mergers will apply to a Jersey incorporated REIT on the basis that its central management and control will be in the UK in any event in order to satisfy the tax residency test.
- **Jersey tax:** a Jersey incorporated REIT would not be subject to Jersey income tax.
- **Corporate vehicles:** in addition to standard companies, Jersey law also provides for protected and incorporated cell companies. A cell company structure may be attractive for a REIT seeking to ring fence assets and liabilities attributable to different properties or to provide different sets of investors with exposure to different types of property within a single platform.

Listing a REIT on the Channel Islands Stock Exchange

As indicated in the executive summary section above, the abolition of the entry/conversion charge may encourage new REITs wishing to enjoy the benefits of REIT status but not necessarily requiring the level of liquidity or wishing to incur the costs associated with a listing in London, to utilise the CISX to satisfy the listing requirement. The CISX is designated by HM Revenue & Customs as a "recognised stock exchange" and is therefore suitable for listing REITs under the current regime and will continue to be suitable under the new regime.

A parallel listing on the CISX may also be considered by REIT entrants seeking a London listing on AIM after the listing rules are relaxed in order to, for example, ensure that shares in the relevant REIT are eligible for UK stocks and shares ISAs. At present, shares traded on AIM are not eligible for inclusion within an ISA wrapper.

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 benefits of the CISX in the context of a REIT listing and more generally are as follows:

- **Investment fund listing rules:** new REITs can utilise Chapter VII of the CISX Listing Rules applicable to investment funds and the CISX has the discretion to waive the requirement for historic audited accounts.
- **Speed:** the CISX offers a highly responsive and streamlined listing process.
- **Non-EU:** the CISX operates outside the EU and therefore EU directives do not apply.
- **Pragmatic:** the CISX takes a pragmatic approach to disclosure requirements while maintaining international standards of issuer regulation.
- **Flexible:** the CISX is flexible in its accounting requirements and will not require the adoption of international accounting standards or international financial reporting standards, provided that an appropriate accounting standard is used.

- **Recognised:** the CISX is formally recognised by numerous UK and international authorities;⁵
- **Listing costs:** the CISX offers a very competitive pricing structure.
- **No corporate advisor:** there is no requirement for companies listed on the CISX to appoint an independent corporate advisor.

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 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 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. Listing sponsor fees are dependent on the complexity of the listing, although they are generally significantly lower than advisory fees in connection with listings on other exchanges and the listing sponsor will not charge a percentage based fee.

Next steps

The outcome of the HM Treasury consultation suggests that most, if not all, of the changes outlined above will be included in the draft Finance Bill 2012, which is expected to be published for technical comments on 6 December 2011. The UK Government is also considering the introduction of social housing REITs and mortgage REITs, which should provide an additional boost for the UK property sector.

For further information in relation to the above, please contact:

Bruce Scott

T +44 (0)20 7367 8309
bruce.scott@bedellgroup.com

Martin Paul

T +44 (0)1534 814864
martin.paul@bedellgroup.com

Amedeo Claris-Delmedico

T +44 (0)20 7367 8330
amedeo.claris@bedellgroup.com

Simon Hopwood

T +44 (0)1534 814706
simon.hopwood@bedellgroup.com

November 2011
AMD/BRS

⁵ For a complete list of international recognition, please visit: www.cisx.com