

# To REIT or not to REIT, that is the question

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Proposed changes to the REIT rules will mean that this tax free regime for property investment groups will be available to a wider range of investors than large listed companies, as at present.

Currently one of the requirements to be a UK REIT is a full Stock Exchange listing. This means the regime has been feasible only for very large property groups. The Government has announced major changes which mean that beneficial REIT tax treatment will be available for a much wider range of property owners. The changes will be included in Finance Act 2012 and are likely to apply from mid 2012 when the Act becomes law.

## What is a REIT?

A REIT is a normal UK company which has elected for the special UK REIT tax regime to apply to it. To qualify for the regime at least 75% of the group's business must be property investment. If this and other conditions outlined overleaf are met, the REIT's profits from property investment are exempt from corporation tax.

## What about partnerships and offshore trusts. Can these be REITs?

A REIT must be a company, although partnerships, offshore trusts and other non-corporate property vehicles may be able to convert to achieve REIT status. These vehicles may offer some of the benefits of a REIT, but not all. It is therefore worth considering whether conversion is feasible.

## What are the proposed changes?

The two most significant changes proposed are that:

- the regime is extended to companies whose shares are traded on the AIM or PLUS markets (and their non-UK equivalents)
- the 2% conversion charge will be abolished. Previously groups entering the regime had to pay a one off charge equal to 2% of the value of their property assets. This was a significant disincentive to smaller groups and start up situations.



There are also some other technical changes aimed at making it easier to achieve REIT status.

- At present, to qualify as a REIT the company must meet a diversity of ownership test, which is broadly that it is not owned for the benefit of five or fewer persons. This has prevented some groups qualifying as REITs. The rules are relaxed so that:
  - this condition doesn't have to be met in the first three years that the company is a REIT; and
  - certain institutional investors are excluded in deciding if the company is owned by five or fewer persons. These include pension funds, authorised unit trusts and open ended investment companies.
- Currently, substantial holdings of cash can jeopardise the company's REIT status. This has made it difficult for start up REITs or groups in a period of reinvestment. In future, holdings of cash will not jeopardise REIT status.

### Can REITs be used for residential or foreign property?

One of the Government's stated aims in making the proposed changes is to make the regime more attractive for residential property. To date, most REITs have been commercial property investors. The changes will undoubtedly be helpful to residential REITs, although residential groups may sometimes have more difficulty meeting some of the detailed REIT conditions than commercial property investors.

Holdings of non-UK property do not prevent a group becoming a REIT. However, as the non-UK property profits will normally be taxed locally, the REIT regime may offer no overall benefits. For non-UK property, a REIT should give the same tax results as a normal UK company, although could be less attractive than offshore vehicles such as non-UK companies and unit trusts.

### What is the benefit of being a REIT?

A REIT is not taxable on its rental income and gains from qualifying property investments. If the REIT pays dividends to its shareholders out of these profits, the shareholder is taxable on them as if they were property income. For most shareholders this gives a better overall tax result than a normal taxable company. It is especially beneficial for tax exempt shareholders (eg pension funds, charities) who pay no UK tax at all either at the company or shareholder level.

The exemption for gains applies equally to unrealised gains which existed before the company became a REIT. By electing to be a REIT, a property group can extinguish latent tax liabilities on unrealised gains. These gains are taxable if distributed to shareholders, but until that time can be re-invested tax free within the REIT. Previously a REIT had to pay the 2% conversion charge to obtain this benefit, but this should no longer be the case.

Another valuable benefit is where a REIT acquires another property investment group. When the acquired companies join the REIT, their unrealised gains are extinguished in the same way as explained above. This means that a REIT can offer a more competitive price when looking at corporate acquisitions than a non-REIT.

### What are the conditions of being a REIT?

To become a REIT the group must comply with detailed conditions. These conditions can impinge on the group's ability to carry out its business in the way it wants without breaching its REIT status. The most important conditions are:

- 75% of the group's business must be property investment. This can be a problem if the group has other significant activities such as property dealing, development for resale or non-property business
- the REIT must distribute at least 90% of its property investment income (but not gains). Income is taxable income after deducting capital allowances and so this requirement isn't always onerous, but does need to be considered
- the REIT has to have a gearing ratio of more than 1.25:1 of profits to financing costs. If this is not met the REIT's profits can be taxed
- as already noted, a REIT must meet a diversity of ownership test, that broadly it is held for the benefit of more than five persons. In the past this condition has made it difficult for some groups to become REITs. The introduction of the three year grace period and special rule for institutional shareholders, explained above, will make it easier for start up REITs. The extension to AIM listed companies could mean that up to 65% of shares could be held by a single family
- a REIT must have a full listing or be traded on AIM/ PLUS. An AIM listing is easier than a full Stock Exchange listing, but nevertheless involves some cost and complexity.



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### How we can help

**We can help you decide whether the REIT regime would be beneficial for your group, the mechanics of becoming a REIT and ensuring the group continues to meet the conditions to maintain REIT status. If you would like to know more, please contact:**

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