Guidance Note - Investment

The REIT choice

As of 1 January 2007, investors will be able to invest in shares in UK Real Estate Investment Trusts (REITs). In reality it will take existing property companies some time to convert to a REIT so that initially the market will be small, but rapid growth is expected.

So who should be interested and why?

After many years of lobbying and following the recommendations of the 2004 Barker Report on the supply of housing, the Government has finally legislated for UK REITs. The UK property industry felt they were at a disadvantage since many other countries such as the US and France had their own version of REITs. Additionally, UK listed property companies have traditionally traded at a substantial discount to net assets.

This was at least partly due to the double tax layer – the company would have to pay corporation tax on its rental income and on gains arising on the sale of its property. Only the net amount would be available to pay dividends to shareholders which would then be taxed in their hands.

The structure of UK REITs has been well trailed. The key areas, which have been honed following a considerable amount of consultation, are as follows:

- UK REITs will be established as UK resident quoted companies with special rules. They cannot be close companies or OEICs and their share capital can only be issued in the form of ordinary or non-participating fixed rate preference shares.

- Existing quoted companies and groups that carry on a qualifying property rental business can elect to be a UK REIT from 1 January 2007.

- The conditions for a qualifying property rental business are that:
  - at least 75% of the company's assets must be property investments
  - at least 75% of the company's income must derive from rental
  - gearing must be greater than 1.25. This ratio is calculated by dividing profits after adding back the interest charge, by the interest charge.

- The conversion charge which is payable to HMRC has been set at 2% of the value of the company's investment properties.

Components of a UK REIT

The business of a UK REIT will be divided into a tax-exempt qualifying part and a non-qualifying part. The tax-exempt part will not pay corporation tax.

90% of the profits from the tax-exempt part must be distributed each year normally within 12 months of the end of the accounting period. These distributions will be paid net of basic rate tax.The recipient will treat them as Schedule A (rental) income.

Corporation tax will be payable on the profits of the non-qualifying part and distributions will be treated as normal dividends.

Various further conditions apply to the tax-exempt business.

- The company must own at least three single properties.
- No single property must have a value exceeding 40% of all the properties in the tax-exempt business.
- No property can be occupied by the UK-REIT or its associates.
- The company must derive 75% of its income from the tax-exempt business.
- The value of the assets in the tax-exempt part must be at least 75% of the value of the assets in the whole.

Market for UK REITS

REITs will appeal to individuals who want to invest in property without the complications of owning it themselves. They will be able to select REITs that specialise in different types of property and location, including foreign property so that REITs may reduce the attraction of investing via LLPs.

REITs may be of particular interest to non-taxpayers such as pension schemes and individuals who do not pay tax as, unlike the tax credit attaching to UK dividends, the tax deducted at source can be repaid.

Additionally, discretionary trusts receiving dividends suffer a high marginal tax rate if they wish to distribute all their income since the dividend tax credit does not form part of the tax that is needed to 'frank' payments to beneficiaries. This problem will not arise with REITs as the tax deducted at source will be available to 'frank' income distributions to beneficiaries.

Many of the larger quoted UK property investment companies have already signalled their intention to convert to REITs.

Owners of private property investment companies with high inherent gains on their properties may also be interested in REITs since the 2% conversion charge is relatively benign and property companies could amalgamate and float, with the original shareholders taking shares in the REIT.

The big opportunities

- REITs will appeal to individuals who want to invest in property without the complications of owning it themselves.
- REITs may be of particular interest to non-taxpayers such as pension schemes and individuals who do not pay tax.
- A more tax efficient investment for discretionary trusts as the tax deducted at source will be available to 'frank' income distributions to beneficiaries.
- Could prove to be a much more cost effective and flexible way to access the property asset class.

If you would like to arrange a free no obligation meeting to discuss REITS please contact John Lang Director Tower Hill Associates Limited on 020 8891 6375.

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