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Briefing note

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One Step Closer to UK REIT Reforms

On 6 December 2011, HM Treasury published draft legislation which, when enacted, will change the REIT rules with a view to kick-starting a new wave of UK REITs next year.

The draft legislation follows a consultation exercise by the UK Government, the outcome of which we described in October 2011 - see Client Briefing: "UK REITs – the Government confirms changes will be made".

Key proposed changes reflected in the draft legislation include:

- **Relaxing the listing requirement** - so that a new REIT can be listed on trading platforms such as AIM, Plus and their foreign equivalents.
- **Relaxing the non-close company condition** - the interests of certain institutional investors should not make a company close for REIT purposes.
- **Giving a grace period** - by giving a new REIT a 3-year period to meet the condition that its shares be widely held (known as the 'non-close company' condition).
- **Abolishing the entry charge** - new REITs will not have to pay 2% of the market value of assets at conversion.
- **Treating cash as a good asset** - cash will count as a good asset in applying the REIT asset qualification test (known as the 'balance of business' condition).
- **Relaxation of certain rules relating to the interest cover test** – including relaxing the penalty for non-compliance.

Much of the above was known in October. However, the extent of the relaxation of the non-close company condition was keenly awaited – until yesterday, no information as to who would be regarded as an institutional investor had been given. The possibility of a safe harbour for institutional investors, with the aim of attracting interest in seeding REITs, was seen as key to the UK Government's stated policy objective of increasing real estate investment in the UK. However, the extent of any relaxation had to be balanced against HM Treasury's desire to minimise any risk of these changes allowing private REITs through the back door.

Listing Condition

As trailed in October, the listing condition has been relaxed to allow REITs to be listed on AIM and PLUS markets, and their foreign equivalents.

This is achieved by substituting a requirement that the REIT is "admitted to trading" on a recognised stock exchange. However, providing further evidence of HM Treasury's concerns to prevent private REITs, a new REIT condition has been introduced, breach of which means expulsion from the regime.

This new condition is that shares in the REIT *are actually traded* on the relevant exchange in each accounting period. This means that there needs to be movement in the investor base. There is no grace period here – it applies to REITs from start up, but only for companies electing to be REITs after Royal Assent to Finance Bill 2012.

Non-Close Company Condition – Institutional Investors

The "non-close company" condition means that a company that is controlled (as to 50% or more) by five or fewer "participators" cannot be a REIT. Participator generally means shareholder, but can include other persons with economic/voting interests in a REIT. Therefore a REIT with a few significant shareholders would be at risk of becoming close (and expelled from the regime) if there were a small change in shareholdings. For sponsors (or seed investors) this condition could therefore be problematic.

Under the current REIT rules, the main safe harbour is the "quoted company" exception. This would apply where, notwithstanding that over 50% of the shares of the REIT are held by five or fewer participators, at least 35% of the shares are held by the "public" (as defined for REIT purposes). For a start-up REIT, this 35% requirement could be difficult to meet.

The Consultation therefore proposed that certain types of institutional investor could hold shares in a REIT without causing a breach of the close company requirement. During the consultation, industry participants pressed for a wide range of investors to be regarded as "institutions" for these purposes. The list set out in the draft legislation should not be too disappointing.

Institutional investors are defined (predictably) as including pension schemes and life insurance companies. In addition, certain types of collective investment scheme (authorised unit trusts and OEICs, and equivalent non-UK entities) and persons entitled to sovereign immunity are included. HM Treasury has however reserved the power to amend this definition - presumably to ensure that this relaxation is not abused in order to create private REITs.

The institutional investor exception, together with the 3-year grace period, should provide much greater flexibility for new REITs. By (in effect) switching off the close company condition for three years, and also providing this further "safe harbour" for institutional investors, sponsors can feel more confident about using a REIT to structure real estate investment in the UK.

Some notes of caution however:

- the close company rules are very broad, and even with this 'institutional investor' safe harbour, it will be necessary to monitor ownership of a REIT carefully if there are a small number of significant investors in the REIT to avoid an inadvertent breach (and possible expulsion from the regime).
- no existing REIT can benefit from the institutional investor safe harbour: it is stated to be applicable only to companies electing to be REITs after Royal Assent to Finance Bill 2012 (likely to be post-June 2012).
- finally, any investor with a sizeable holding of more than 10% will still need to consider how it structures its investment given the tax charge that can apply on paying PIDS to certain shareholders with at least 10% of the shares in the REIT (and restrictions generally contained in the Articles of Association of REITs to prevent any one shareholder holding more than 10% of shares in the REIT).

Entry charge

The draft provisions confirm that the entry charge will be abolished for companies entering the REIT regime on or after Royal Assent to the Finance Bill 2012. In addition, the ability to claim repayment of the entry charge where a REIT asset is sold is also to be abolished for such companies. Entry here would includes joining an existing REIT as well as electing for REIT status.

Profits/Financing Costs ratio

Here, in addition to the change announced in October to limit financing costs to interest costs only, HM Treasury has responded to industry lobbying for a limit on the tax charge imposed if there is a breach of the profits/financing costs ratio. The draft legislation provides for a maximum charge of 20% of the REIT's property profits (basically profits before deduction of capital allowances or interest costs) in the relevant period.

This means that, if the ratio is breached, the maximum tax payable by the REIT is the tax that would have been paid on its property profits had there been no REIT exemption in the relevant period.

Cash - the balance of business test

HM Treasury announced in October that cash would be made a good asset for the purposes of the balance of business test. The draft legislation makes this change, and as a corollary, repeals the "old" rule that cash from disposals is good if reinvested within 24 months.

The definition of "cash" is important in terms of how REITs look to manage their funds pending use in the property business.

Cash is defined in the draft legislation as money held on deposit and gilts, but there is a power for HM Treasury to specify other investments or other ways of holding money as cash. Given the various techniques available to manage money, existing REITs will need to focus on what they would like those regulations to allow.

Summary

In the October statement, HM Treasury said that views on the drafting of the detailed provisions to ensure they are "fit for purpose" would be welcomed. The existing REITs will clearly focus on the more housekeeping type provisions, to ensure that they reflect operational needs, and will continue active engagement with HM Revenue and Customs on these changes.

However, and perhaps more importantly given the policy objective behind these changes, anyone interested in the possibility of structuring investment in UK real estate in a tax efficient way should consider the package of measures reflected in these provisions and test their "fitness" for encouraging such investment via a REIT.

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