Analysis

# Where next for UK REITs?

## Speed read

**UK REITs have become the premier UK property investment vehicle. More changes to the REIT regime have been introduced as part of the government's ongoing UK funds regime review. The changes will reduce barriers to entry to the regime and redevelopment of older property. Other potential changes being considered as part of the funds review, particularly the removal of barriers to investment in non-UK property and extending the definition of qualifying activities, should further enhance the regime's attractiveness and could support compliance with the government's net zero commitment.**

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### Where are we now?

Since its introduction in 2007, one of the strengths and attractions of the UK real estate investment trust (REIT) regime has been its stability. Prior to 2022, the only substantive changes to the regime since its inception had been the major reforms enacted in FA 2012 and the extension of the REIT exemption from UK corporation tax to include gains arising from disposals of 'UK property rich' vehicles (CTA 2010 s 535A) in FA 2019, which was introduced as a corollary to the wider changes to the taxation of gains arising from UK property in April 2019.

At Budget 2020, the government announced that it would carry out a review of the UK funds regime. Consultation with stakeholders was launched on 26 January 2021 with the publishing of *Review of the UK funds regime: a call for input* and a summary of responses was published by HM Treasury on 10 February 2022. Although the wide-ranging review sought input on various UK fund regimes, REITs formed a significant part of this as it was recognised that more could be done to enhance the attractiveness of the regime.

In part, this came from strong representations made during the separate contemporaneous consultation on the introduction of the qualifying asset holding company (QAHC) regime, namely that certain issues associated with the REIT regime were acting as barriers to entry and adding undue complexity.

Measures to address the areas deemed of highest priority in those QAHC consultation representations were taken forward and ultimately fast-tracked into FA 2022 Sch 3, as the relaxations to the REIT regime that took effect from April 2022. The most significant of these was the removal of the requirement at CTA 2010 s 528(3) for REIT shares to be listed where institutional investors hold at least 70% of the ordinary share capital in the REIT.

### The Finance (No. 2) Bill 2023 changes

The UK funds regime review sought views on other possible changes to the REIT regime. The February 2022 summary of responses outlined the representations made and specified that some would again be prioritised with the intention of their being implemented in 2023, while others would be considered over a more protracted timescale.

Part 2 of Sch 4 of the draft Finance (No. 2) Bill 2022/23, published on 23 March 2023, brings forward three further changes to the REIT regime:

- REITs will no longer be required to own at least three properties if they hold a single commercial property worth at least £20m (para 3).
- The three-year development rule in CTA 2010 s 556 will be amended so that it applies where the cost of the development exceeds 30% of the fair value of the property at the later of entry to the REIT regime, acquisition or the beginning of the accounting period in which the development commenced, rather than just the later of entry and acquisition as currently (para 4).
- The Real Estate Investment Trusts (Assessment and Recovery of Tax) Regulations, SI 2006/2867, reg 7 will be amended to allow REITs to make property income distributions (PIDs) to partnerships without deduction of withholding tax where partners in the partnership would themselves be entitled to gross payment of PIDs if they held an interest in the REIT directly (para 5).

The change to the three-year development rule takes effect in relation to disposals made from 1 April 2023. The other changes will take effect from the date of royal assent of the Bill.

These changes will:

- enable large single asset commercial property investment companies (for example, those invested in single-tenant warehouses) to enter the REIT regime;
- limit the number of instances in which the three-year development rule applies and remove a barrier to redevelopment of older property (which should support green retrofitting required to reduce greenhouse gas emissions) by taking into account increases in property values since acquisition or entry to the REIT regime; and
- remove a disincentive for some funds to invest in UK REITs.

### Other 2023 changes

With the increase in the main rate of corporation tax to 25% from 1 April 2023, previously enacted in FA 2021, there is now a material arbitrage between the 25% main rate of corporation tax and the withholding tax rate payable on PIDs (of a default 20% but lower for non-residents entitled to reclaim UK withholding tax charged on PIDs under the terms of an applicable double tax treaty or nil for those investors entitled to gross payment).

Meanwhile, the announcement at the Spring Budget on 15 March 2023 that the proposals in the 2022 consultation on sovereign immunity from direct taxation would not be taken forward was also significant for REITs. The consultation had proposed *inter alia* that sovereign immunity from all UK direct taxation (including distributions from a REIT) would be removed and replaced with a limited sovereign exemption from UK tax for UK-source interest income. If introduced, the proposals would likely have had a profound effect on the REIT market: sovereign persons would have been disincentivised from investing in UK REITs because, for the first time, they would become liable to UK tax on rental profits and gains, whether investing directly or indirectly, and liable to UK withholding tax on REIT PIDs (subject to the application of double tax treaties).

Furthermore, there was uncertainty whether sovereigns would remain within the definition of 'institutional investor'

at CTA 2010 s 528(4A). Several UK REITs have relied on sovereign investment to meet the close company condition and, since April 2022, to enter the REIT regime without a listing; their REIT status may have been jeopardised if sovereign institutional investor status were withdrawn.

Similarly, when making investment decisions some REIT investors have relied upon sovereign persons being a 'qualifying institutional investor' (QII) (within the definition at TCGA 1992 Sch 7A para 30A) in the knowledge that this will mean that a future sale of REIT shares should qualify for the substantial shareholdings exemption (SSE) (in whole or part), and there was uncertainty as to whether or not sovereign persons would retain QII status.

Although there was a period of uncertainty during the consultation, the announcement that the proposals will not be taken forward was welcomed.

Taken together, the various 2023 changes and announcements retain and further enhance the attractiveness of the REIT regime.

### Where next?

The other main areas identified in the February 2022 summary of responses as for consideration were:

- incentivising investment in non-UK property by REITs by:
  - improving the interaction of the QAHC and REIT regimes;
  - exempting overseas property rental business profits and gains arising to UK REITs from UK tax and treated as ordinary dividends rather than PIDs when distributed, where the overseas property profits and gains are taxed in the applicable overseas jurisdiction; and
  - extending the UK branch profits exemption to the income and gains arising from a non-UK property rental business;
- incentivising investment in other asset classes by broadening the definition of qualifying assets to include assets such as property-backed debt, infrastructure, renewable energy and technology and other infrastructure needed to enable the transition to net zero;
- introducing a seeding relief from SDLT;
- reforming the operation of the capital allowances regime for REITs;
- refining the proportional basis on which the s535A exemption applies; and
- removing the requirement for larger REITs to be subject to both the corporate interest restriction in TIOPA 2010 Sch 7A Part 10 and the REIT interest cover test in CTA 2010 s 543.

To the extent any or all of these are taken forward, they would, to a greater or lesser extent, enhance the attractiveness of the REIT regime and alleviate some of the current practical issues associated with REITs.

Removing the obligation on REITs to track capital allowances in annual financial statements filings and comply with both the corporate interest restriction and the REIT interest cover test should be straightforward changes that would reduce the compliance burden on REITs, whilst the introduction of a SDLT seeding relief would bring UK REITs in line with property authorised investment funds (PAIFs) and authorised contractual schemes (CoACS).

Meanwhile, broadening the s 535A exemption to ensure small sundry balances held by companies solely engaged in UK property rental activities do not give rise to tax liabilities on a sale should remove corporation tax as a consideration for REITs when deciding whether to sell property directly or indirectly. Currently, the exemption is proportionately reduced to the extent that the entity disposed holds assets that are not related to its property rental business. This can result in corporation tax liabilities accruing to REITs even in cases where all the disposed company's activities are in fact part of its property rental business.

However, the other two potential changes would be perhaps the most significant introduced since the regime's inception and are worth considering further:

#### 1. Incentivising investment in non-UK property by REITs

The REIT regime was established to facilitate investment in UK property, but there is recognition that the regime would be more internationally competitive if barriers to investment in non-UK property were removed.

A fundamental tenet of the UK REIT regime since inception has been that the tax point for property investment is moved from the vehicle in which funds are pooled (i.e. the REIT) to the investor. However, profits and gains from investment in overseas property are typically taxed in the applicable overseas jurisdiction, meaning the current approach of applying UK withholding tax to the distribution of such profits and gains by the REIT to its investors results in double taxation.

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Amending the treatment of distributions of overseas profits and gains from PID (on which UK withholding tax is currently payable, unless the recipient qualifies for gross payment) to ordinary dividend (on which withholding tax is not payable) would remove this second layer of taxation that acts as a barrier to a REIT investing in overseas property.

Furthermore, whilst s 535A exempts from UK tax disposals of shares in UK property rich entities, there is no equivalent provision for sales of entities that are non-UK property rich – albeit the SSE could apply if a REIT is controlled at least 25% by QIIs. Consequently, UK REITs keen to invest in overseas property have typically established an intermediate holding company in a jurisdiction such as Luxembourg which does have an exemption from tax on such disposals.

Since April 2022, it has been possible to overcome this issue by investing in overseas property via a QAHC. Disposals by QAHCs of overseas land and shares that do not derive at least 75% of their value from UK land are exempt from UK corporation tax under FA 2022 Sch 2 Part 9. UK REITs are 'Category A' investors for QAHC purposes, meaning it is possible to have a QAHC within a REIT group. However, the use of QAHCs by REITs may not be appropriate in all circumstances, and the disposal of the QAHC itself (or any other non-QAHC non-UK property rich company) by a REIT remains chargeable to corporation tax.

Accordingly, an extension of the s 535A exemption, or the introduction of an equivalent provision for disposals of entities that are not UK property rich, would remove a major deterrent to investment in overseas property.

However, the interaction of any extension of the exemption with other taxing provisions would need to be considered. For example, since April 2019 disposals by non-resident investors of interests in UK property rich vehicles such as REITs have been liable to UK tax, but if a REIT started to hold greater than 25% non-UK property assets it would cease to be UK property rich for the purposes of TCGA 1992 Sch 5AAA Part 1 para 3. In such circumstances a disposal of the REIT's shares

would not be subject to UK tax and thus run contrary to the principles adopted in 2019.

### 2. Incentivising investment in other asset classes by broadening the definition of qualifying assets

Broadening the definition of qualifying assets would undoubtedly enhance the REIT regime's attractiveness and, depending on the categories of assets ultimately included, bring it in line with certain other overseas REIT regimes such as Belgium and the US which have a wider range of qualifying asset classes.

There have been calls for a number of years from some sections of the UK infrastructure arena for a dedicated REIT equivalent vehicle through which investors could pool investment into the sector, particularly following the withdrawal of political support for private finance initiative projects. Extending the REIT regime to infrastructure by expanding the definition of qualifying assets would perhaps be the simplest way of implementing this.

However, as most infrastructure (including renewables) concessions and developers are treated for UK tax purposes as trading entities rather than property businesses, there are significant questions over how extending the definition of REIT qualifying activities to infrastructure could work in practice given that the exemption from corporation tax on profits and gains in CTA 2010 Part 12 Chapter 3 has applied only to property rental business within CTA 2009 ss 205–206 (subject to specified REIT exclusions in CTA 2010 ss 604–605, including rent from the siting of wind turbines) since the regime's introduction.

Extending the exemption to trading companies would represent a significant reform and care would need to be taken to ensure that any extension is appropriately targeted. It may be possible to borrow, with appropriate modifications, the legislation in TIOPA 2010 Part 10 Chapter 8 that applies to the corporate interest restriction exemption for 'public infrastructure'.

Alternatively, there is precedent for modification to the regime to allow targeted activities being treated as property rental business for REIT purposes even though the same activities may be treated as trading activities for companies not within the REIT regime: FA 2009 introduced what is now CTA 2010 s 519(2), which specifically overrides CTA 2009 s 42(2) such that receipts and expenses derived by REITs from tied premises should be treated as part of property rental business rather than part of a trade as normal. This change enabled tenanted pub businesses to become UK REITs.

The property rental/trading borderline has long been a source of contention. It often forms the basis of non-statutory clearance applications made by prospective REITs seeking to confirm that their activities will fall on the right side of the borderline for REIT qualification purposes, as well as existing REITs that may be looking to extend the scope of existing activities or acquire businesses invested in other activities.

HMRC's guidance in its *Investment Funds Manual* (at IFM24035) demonstrates how tight the borderline can be by citing the example of a car park, which can be treated as either depending on the circumstances. For instance, if fees are charged to shoppers for a car park attached to a shopping centre and the same company owns and operates both the car park and the shopping centre, the car park income should be property business income. However, if one company owns a shopping centre and the adjacent car park is operated by another group company, car park income receivable by the operator may be trading income, depending on who uses the car park, what fees are charged and what level of services is provided.

Similar considerations apply to emerging real estate trends. Increasingly, owners of UK real estate are investing in improvements to their properties to make them more energy efficient and reduce greenhouse gas emissions, particularly owners of offices that are now required by law to ensure that their buildings are energy performance certificate (EPC) category C or above by 2028. Questions therefore arise as to which side of the property/trading borderline solar photovoltaic (PV) panels or electric vehicle charging infrastructure installed in office blocks fall.

Where solar panels are let as part of a wider lease of premises to tenants then the solar panels should be treated as part of the property rental business. Where the energy generated by solar PV panels is used to power the applicable building that is let to one or more tenants, the solar PV panels should form part of the property rental business. However, where excess electricity is sold by the landlord to the grid, or the solar PV panels are used solely to generate electricity that is sold to the grid (or another third-party purchaser), such income is likely to be regarded as trading income.

A further example concerns a REIT group that develops or acquires a solar farm (or other renewable energy generation facility) in order that the electricity generated may be used solely to power its property portfolio (that is let to third party tenants). If the solar farm has been installed to supply energy in property let to tenants, then intuitively it would be expected that the farm should form part of the property rental business. However, if, again, excess electricity were sold to the grid, this may be treated as residual income.

Addressing remaining barriers and potentially extending the scope of qualifying activities would likely cement the regime's position as the pre-eminent UK property investment vehicle

It would be relatively simple for legislation to be introduced to provide that income derived by REITs from renewables not provided for in leases may be treated as ancillary to the property rental business and hence a qualifying activity for REIT purposes. However, to incentivise larger scale investment in renewables by REITs, a more fundamental change to the definition of qualifying assets would be required, such as to extend the qualifying activities definition to electricity generation as a whole. That would appear problematic at a time when the largest renewable energy generation companies are liable to the 45% electricity generator levy (which will apply between 1 January 2023 and 31 March 2028 once Finance (No. 2) Bill 2022/23 is enacted).

### Conclusion

The UK REIT regime has increased in popularity as barriers to entry have been removed. Legislative changes taking effect in 2023 further enhance the regime's attractiveness. Addressing remaining barriers and potentially extending the scope of qualifying activities would likely cement the regime's position as the pre-eminent UK property investment vehicle and could support adherence to the UK's 2050 net zero commitment. ■

- Spring Budget 2023: report (16.3.23)
- REITs: relaxation of the listing condition (P Nicklin, 7.1.22)
- Taxation of REITs: ringing in the changes (P Nicklin, 2.9.21)




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