

REITs - Finance Bill 2012

How we see it

This package of changes is a significant step forward for the UK REIT regime and a number of the changes will be welcomed by investors and existing REITs.

Unfortunately, as a package of changes intended to boost investment in the UK property sector and specifically the UK residential rental sector they do appear to fall short of what many in the UK property industry had been hoping for.

As a result, there is a risk that the changes will not have a dramatic impact on the size and number of REITs investing in residential property in the UK.

The removal of the conversion charge and the increased flexibility in relation to the listing requirements will undoubtedly be advantageous.

For tax exempt institutions, REITs will probably be one of the most tax efficient methods of investing in a rental portfolio. This may not be the case for individual investors and many overseas investors.

The changes are likely to be of limited interest to many of the UK's largest property owners such as private individuals, and some overseas investors.

The opportunity for the UK Government to create the most flexible and accessible European REIT regime appears to have been missed as a result of the detail of these changes.

The changes to the REIT regime first announced in February's budget speech were set out in detail yesterday with the publication of draft legislation to be included within Finance Bill 2012. The broad outline of the changes has been discussed for some time and captured the attention of the UK real estate market with over 50 responses to HM Treasury's consultation over the summer. A sense of anticipation had grown over recent months that the changes could mark the start a period of expansion and growth of the UK REIT regime and boost the ability of investors to access the UK property market in a tax efficient manner.

So what are the key changes?

1. As expected, the **2% conversion charge** is to be abolished with effect from summer 2012. This is the largest single change to take place since the introduction of the regime 5 years ago and is an important step forward, meaning that investment vehicles with existing property portfolios will find the cost of conversion dramatically reduced. We expect this change alone to lead to a number of REIT conversions in the next 12-18 months.
2. Certain Institutional investors such as Pension funds, insurance providers, sovereign immune investors, Authorised Unit Trusts and Open Ended Investment Companies will be able to hold controlling interests in the shares of a REIT without causing the REIT to fail the Close company test. This change has been made to encourage these investor groups to invest more widely in UK property and residential property in particular. The impact of this change is discussed further below.
3. Also, the government will welcome REITs that are **traded on AIM and other** markets as well as the main London stock exchange in the UK. This should help some smaller property investment groups to take advantage of the regime but the REIT shares will need to be traded to some degree.
4. Shares in newly established REITs will not have to be widely held for the first three years following conversion. The prime intention behind this change is to attract larger levels of investment into residential property and in particular to encourage private and individual investors to transfer residential property portfolios into REIT vehicles. This will be a useful incentive for some businesses, and may provide opportunities for property portfolios controlled by large corporate investors to be converted into REITs.
5. In addition, a number of rule changes, including simplification of the so-called '**profits: financing ratio**', and of the balance of business asset test will provide existing and new REITs with a more straightforward and forgiving set of rules in which to operate.

Institutional investment

In February 2012, the government announced that it would seek to change the REIT rules to encourage increased levels of investment in the UK property sector with a particular focus on encouraging institutional investment in the private rented sector.

HMT stated that investment by certain investment vehicles that represent a diverse ownership were currently restricted from holding major shares in REITs, and this restricted the level of investment in the sector.

As part of its consultation process, HMT requested respondents to help define the terms 'institutional investor' and 'diverse ownership', and most commentators and respondents agreed that these terms should be defined as widely as possible, so as to encourage as many investor groups as possible to invest in the UK property industry via REITs.

The draft legislation proposes a white-list of largely regulated 'institutional investors' such as pension fund managers, insurance businesses, AUT's and OEICs, as well as investors with sovereign immunity. Interestingly there is no specific requirement for these to be diversely held. There is provision for additional investor types to be added to the list through secondary legislation. It is perhaps disappointing that HMT have sought to exclude diversely held companies and private equity funds. Nevertheless, the changes should encourage increased levels of investment into the UK REIT regime, and enable retail investors to invest in property currently held by the above investor groups.

What is missing?

At the heart of the original announcements in February 2011 was a desire to see increased levels of investment in the UK residential sector, and to encourage increased development of UK homes. It remains to be seen if these measures will actually have a material impact on the attractiveness of residential investment to the wider investment community.

It is disappointing to see that a number of barriers to entry have not been addressed at this point. The following changes could be relatively easily made to existing legislation without any net loss of tax to the Treasury and, in our view, would significantly strengthen the appeal of the REIT regime to investors:

- ▶ The uncertainty surrounding the taxation treatment of residential property disposals, is currently a barrier to many residential property investors from accessing the REIT regime.
- ▶ The absence of capital allowances for residential property means that the distribution requirements would be unsustainable for many potential residential REITs.
- ▶ Individuals and overseas investors in REITs suffer higher rates of taxation on property gains than they would if directly investing in UK property.
- ▶ VAT on residential letting and management fees is detrimental to the ability of a REIT to undertake build-to-rent investment.
- ▶ REITs are unable to hold shares in other REITs in a tax efficient manner. This prevents REITs from raising additional investment based on specific sub-portfolios of property, which can be used to invest in new projects.
- ▶ Significant occupiers of property (such as retailers, and leisure providers), are still unable to establish a REIT vehicle as a way of holding property, such that they can attract additional investment based on a stable rental return.

What does this mean for the future of the UK REIT regime?

The changes announced will encourage some new investors to adopt the REIT regime as a vehicle for holding UK real estate, but its use is likely to be restricted to those that invest either solely or predominantly in the UK and therefore may exclude many overseas investors that may have otherwise sought to base their European or even global operations from the UK.

However, the UK REIT regime will remain a useful investment structure for tax efficient investment in UK property, alongside more traditional structures.

The Government have provided a window for interested parties to provide technical comments on the draft legislation, however, this is unlikely to result in material changes to the application of the rules.

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