UK REITs

A tax efficient vehicle for real estate investment structures

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A UK Real Estate Investment Trust (REIT) receives the majority of its income as rents from real estate and is exempt from corporation tax on property rental income and gains, provided certain conditions are met.

Tax benefits of a REIT structure

- Exemption from corporation tax (CT) (currently 25%) on property rental income and qualifying gains provided the REIT distributes 90% of its property rental income as a dividend (called a Property Income Distribution “PID”), which, very broadly, is taxable on the recipient as if it was a receipt of rent.
- PIDs are subject to 20% withholding tax (“WHT”) but can be reduced to 15% under most double tax treaties.

For overseas investors this means a saving of 10% as compared with the current UK CT rate of 25%.

What we’re seeing

- The UK Government has recently introduced measures to relax some of the REIT tests, making it easier for certain structures to qualify for REIT status and encouraging the use of REITs. As a result we are seeing increased activity in this space. In particular, we have been working with various types of investors including:

- Overseas REITs
- Pension funds
- Asset managers
- PE houses
- Insurance businesses
- Sovereign immune investors

Why KPMG

KPMG has a team of REIT specialists with extensive experience who can provide a range of services including the following:

- Tax and legal advice for REIT feasibility study
- Tax structuring advice for REIT conversion and set up
- Tax compliance for REITs including tax returns and assistance with REIT financial statements
- Tax modelling services to monitor the various conditions under the REIT regime
- Corporate Finance
- Capital Markets & Investor relations

Key conditions and recent relaxations

A UK REIT needs to meet a number of conditions on an ongoing basis.

Listing

The principal company of the REIT group must have only one class of shares. Historically, the shares were required to be admitted to trading on a 'recognised stock exchange' and either listed or traded. From 1 April 2022, if 'institutional investors' hold at least 70% of the ordinary share capital in the REIT, there is an exemption from the listing condition. This is a very helpful relaxation as the listing condition has historically been considered costly and burdensome.

Institutional investors include collective investment scheme limited partnerships, authorised unit trusts, open-ended investment companies, Co-ownership Authorised Contractual Schemes, long-term insurance businesses, pension schemes, UK charities, overseas equivalents of a UK REIT and sovereign immune persons. Per the proposed changes announced by the Finance Bill 2023-24 ("FB 2023-24"), each of the former four class of investors must also meet the General Diversity of Ownership condition (broadly, marketing the vehicle to a diverse group of investors and not limiting investment to a few specific/ target investors) or the non-close condition, and long-term insurance businesses must meet the non-close condition.

Non-close condition

The principal company must either: (i) not be a close company (i.e. it should not be controlled by five or fewer participators); or (ii) be a close company only because it has, as a participator, one or more 'institutional investors'. FB 2023-24 proposes amendments to this condition to allow tracing through to (ultimate) institutional investor(s) via intermediary holding companies.

Overseas REITs

From 1 April 2022, an overseas entity can qualify as an overseas equivalent of a UK REIT if it is equivalent to a UK REIT itself, regardless of whether or not the overseas REIT regime is equivalent to the UK's REIT regime. A number of overseas REITs were previously unable to meet the definition due to the characteristics of their REIT regime. The relaxation has increased interest from many overseas REITs, as it enables them to qualify as 'institutional investors' and therefore assist UK REITs in meeting the non-close condition and claiming exemption from listing.

Sovereign investors

Investment into UK property via REITs is very tax efficient for sovereign immune investors as they can reclaim all of the withholding tax on PIDs (although they do not qualify as gross recipients). Also, they qualify as 'institutional investors' and their investment assists REITs in meeting the non-close condition and claiming exemption from listing. The 2023 Budget announcement that the rules on UK sovereign immunity will remain unchanged has removed uncertainty ensuring a continued stream of investment into REITs by this class of investors.

Investments in Joint Ventures ("JVs")

Broadly, a REIT group is comprised of a company and all of its direct and indirect 75% subsidiaries in the group that are effective 51% subsidiaries of the principal company. REIT rules allow a JV election to be made where a UK REIT owns at least a 40% interest. The election allows the JV to benefit from a partial exemption from tax on income and gains from the JV's property rental business.

Holders of excessive rights ("HoER")

A HoER is a company or a body corporate which is beneficially entitled (directly or indirectly) to 10% or more of dividends or voting rights or controls the share capital of the principal company of the REIT group. A tax charge is imposed if a distribution is made to a HoER. Accordingly, it is generally necessary to fragment shareholdings of 10% or greater into multiple SPVs. From 1 April 2022, entities that qualify as gross recipients of PIDs are excluded from the definition of HoER. FB 2023-24 has proposed further changes to the definition of HoERs, so that investors taxed at a particular rate (or not at all) on PIDs under the terms of a Double Tax Treaty ("DTT") (where that rate is not dependent on the size of holding) are excluded. As such, overseas investors from certain jurisdictions should not be required to fragment, subject to terms of the relevant DTT. This should provide significant operational cost savings.

Property business

The REIT group must involve at least three properties and no property should represent more than 40% of the total value of the properties involved in the property rental business. The Finance Act 2023 has relaxed this requirement by introducing a "single property rule" such that it can now be met where a REIT owns at least one commercial property worth £20 million or more.

Balance of Business

Broadly, at least 75% of profits and assets of the REIT group must be related to property rental business. Non-rental profits related to compliance with planning obligations are now excluded for the purposes of applying this test.

3 year development rule

Broadly, where property has been significantly developed by the REIT (development costs exceed 30% of the highest of the fair value of the property on entry into the REIT regime, acquisition, or at the beginning of the accounting period in which the development commenced) and is sold within three years of practical completion then the gain is taxable.

Other conditions

A REIT must monitor compliance with an interest cover ratio test (profits to financing cost ratio must be at least 1.25:1) to avoid a penalty. 'Property financing costs' means financing costs referrable to the UK property rental business only. Subject to FB 2023-34 receiving Royal Assent, for accounting periods ending on or after 1 April 2023, amounts in respect of which a deduction is denied for CT purposes are to be excluded from the definition of property financing costs except for amounts disallowed as a result of the application of the Corporate Interest Restriction (CIR) rules.

REITs also need to submit REIT 'Financial Statements' annually to HMRC. From 1 April 2022, there have been relaxations to this requirement to reduce the compliance burden such that if a new 'gateway test' is met, a REIT can submit simplified financial statements instead.

The future – Watch the space!

A number of other areas in the REIT regime may be considered for amendment in the near future to make the REIT regime even more competitive. Some of these were raised by stakeholders when HM Treasury published its consultation/call for input on the UK's funds regime:

- Removing the interest cover test so that REITs only have to consider the corporate interest restriction rules.
- Where a REIT holds overseas property in a UK company and suffers tax in the overseas jurisdiction, WHT should not be applied when paying PIDs to investors.
- Providing clarity on the interaction between the REIT and the Qualified Assets Holding Company ("QAHC") regimes, especially in respect of calculation of PIDs from overseas properties, so that investors can assess whether a REIT structure with investment in a QAHC with underlying properties is viable.
- Seeding relief from Stamp Duty Land Tax (SDLT) to ease transition into the REIT regime.
- Broadening the definition of qualifying assets for REITs to reflect the evolution of the real estate investment industry e.g. property backed debt, operational income from infrastructure assets and renewable energy assets and the technology and other infrastructure needed to enable the transition to net zero.

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