UK REITs: a practical overview

Introduction

What is a UK REIT?

A UK real estate investment trust (“REIT”) is, broadly, a closed-ended publicly traded company that provides investors with tax efficient investment exposure to property assets. The UK REIT regime was introduced on 1 January 2007 and is relatively new compared to the longer established regimes of the US and Australia, for example. Amendments to the primary REIT legislation came into force on 17 July 2012, which removed certain barriers to entry and further encouraged investment into UK property.

Some established UK property companies have converted to REIT status, and a number of newly formed REITs have carried out initial public offerings, using the proceeds to acquire property assets. This has acted as an important source of investment for the UK property sector, including recently in sub-sectors such as logistics warehouses and student accommodation.

Key features of a REIT

Tax efficiency: Investment in property assets through a corporate vehicle can be inefficient for certain types of shareholders who will effectively suffer tax twice on the income, first when the corporate investment vehicle pays UK direct tax on its profits and secondly, directly when the shareholder receives a distribution (unless an exemption or tax credit is available). REITs do not pay UK direct taxes on their income and capital gains from their qualifying property rental business, provided certain conditions are satisfied. Shareholders are generally then taxed on the distributions they receive from the REIT as if they were the profits of a property rental business.

Liquidity: All REITs must be admitted to trading on a recognised stock exchange (which now includes AIM and the Specialist Fund Segment of the Main Market) and must not be an open ended investment company (“OEIC”). Investors can exit their investment in a REIT by disposing of their shares in the market, in contrast to an OEIC where units must be redeemed by the fund. In volatile markets, OEICs can face large scale redemptions which the manager will often seek to cap, locking in investors who may otherwise wish to exit. Such redemptions may also need to be funded by the rapid disposal of property assets by the OEIC.

Income yield: REITs are required to distribute at least 90 per cent of profits arising from their qualifying property rental business. REITs whose underlying assets are properties on long term leases to tenants with a strong covenant can deliver secure long-term rental income that is then required to be passed on to shareholders in the form of dividends, coupled with the potential for capital appreciation. In low interest environments, REIT shares can therefore be particularly attractive to yield investors.
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Operation of a REIT

A REIT will operate in most respects as any other UK publicly traded company, but with certain material differences as described below. The following assumes the REIT is subject to the Listing Rules that apply to an issuer with a premium listing.

Internal or external management?

The REIT may either be internally managed, meaning its own officers and employees manage the portfolio of assets owned by the REIT, or externally managed whereby the REIT has no employees, its board is comprised solely of non-executive directors, and the executive function is outsourced to a third party investment management company under the terms of an investment management agreement. Investor preference in the US is for internal management, which increasingly is becoming favoured in Europe, largely due to a perception that external manager interests can deviate from those of the REIT, and that conflicts of interest may arise. In practice, shareholder and manager interests can be aligned by linking the quantum of manager remuneration closely to the performance of the REIT, and even by paying the manager partly in REIT shares. In addition, investors will focus on the term of the manager’s appointment, the circumstances in which it can be terminated and the scrutiny applied by the board of the REIT to manager performance. A formal annual review will typically be carried out by a management engagement committee of the REIT’s board.

An externally managed REIT will normally not qualify for premium listing as a “commercial company” under Chapter 6 of the Listing Rules, due to the requirement for the boards of directors of such companies to have unlimited discretion to make strategic decisions on behalf of the company, and will instead normally be subject to the provisions of Chapter 15 of the Listing Rules applicable to closed-ended investment funds. A chapter 15 REIT will typically be included in more specialised stock market indices, potentially limiting investor coverage.

Externally managed REITs

Particular issues can arise in relation to externally managed REITs as follows:

Service providers: The principal service provider to an externally managed REIT is the investment manager, the terms on which it provides such services normally being contained in an investment management agreement. Typical services will include identification of assets for acquisition or disposal by the REIT and arranging finance, and property management services. An external manager will normally require FCA authorisation as an alternative fund manager within the meaning of the AIFMD.

The manager will be deemed to be a related party of the REIT and as such any material changes to the investment management agreement will need to be made in accordance with Chapter 11 of the Listing Rules.

The REIT and/or the manager will often appoint a depositary to provide AIFMD compliant depositary and custodian services, including monitoring the cash-flow of the REIT and safeguarding certain of its assets. The manager and/or the REIT may also appoint an administrator to carry out the REIT’s day to day administrative functions such as the calculation of the net asset value of the portfolio and maintenance of the REIT’s accounting and statutory records. Other service providers will include registrars, auditors, lawyers and public relations advisers and sometimes an external company secretary.

Certain services provided by the manager under the investment management agreement may be capable of delegation to third parties, such as estate management, for example. However services requiring AIFMD authorisation cannot be delegated without FCA approval.

Independence: The board of directors of the REIT must be able to act independently of the investment manager. Specifically, the chairman of the REIT must be independent from the REIT as must a majority of the board (the chairman may be included within that majority). Directors who are not independent of the investment manager must be subject to annual re-election at the REIT’s annual general meeting. Furthermore, best practice recommended by the UK Corporate Governance Code (“Code”), which has been endorsed by the Association of Investment Companies (“AIC”), requires annual re-election of all directors of FTSE 350 companies.

PDMRs: Questions can arise as to whether the senior executives of an external manager should be considered as persons discharging managerial responsibilities within the meaning of the Market Abuse Regulation (MAR), and therefore subject to the associated restrictions and procedures in relation to dealings in shares of the REIT. To avoid doubt, REITs may choose to designate senior executives of the manager as PDMRs if they are operating as the sole executive function of the REIT, even though they are not directors or executives of the REIT itself.
Key ongoing obligations under Chapter 15 of the Listing Rules:

Published investment policy: A REIT must have a published investment policy setting out its approach to asset allocation, risk diversification and gearing, including maximum exposures. Material changes to the policy may only be made with the approval of a majority of shareholders, and in considering what is a material change the REIT must have regard to the cumulative effect of all of the changes since shareholders last had the opportunity to vote on the policy, or if they have never voted, since the admission to listing. Non-material changes to the investment policy may be made without shareholder approval, although consultation with the FCA prior to any change is advised. Careful consideration should be given as to whether shareholder consent is required if the management fee due to the property manager is amended or increased. If the maximum value of the variation is capped so that the total fee payable to the investment manager in any 12-month period is limited to less than 5 per cent of NAV, then shareholder approval is not required.

Further share issues: Unless authorised by shareholders, a REIT may not issue further shares of the same class as existing shares (including treasury shares) for cash at a price below the net asset value per share of those shares unless they are first issued pro rata to existing shareholders of the same class.

Significant transactions: The obligations of REITs to comply with Listing Rule 10 (Significant transactions) are modified, such that compliance is not required in respect of transactions that are executed in accordance with the scope of its published investment policy. For example a transaction falling within the investment policy that would otherwise be classified as a class 1 transaction would not require the publication of a class 1 circular and shareholder approval.

Periodic financial reporting: A REIT must include in its annual financial report additional disclosures including the following:

- a statement of how investment risk has been spread in accordance with its published investment policy;
- a statement that the continuing appointment of the investment manager on the terms agreed is in the interests of shareholders, together with a statement for this view; and
- a formal valuation of its portfolio by an external valuer.

Corporate Governance

The Code contains the corporate governance provisions applicable to UK listed companies, in particular in relation to financial reporting and accountability, board composition and development, director’s remuneration and relations with shareholders. However REITs that are members of the AIC may follow the abbreviated Corporate Governance Guide for Investment Companies (“AIC Code”), which recognises that externally managed investment companies often have no executive directors, and accordingly many of the provisions of the Code are not relevant. The Financial Reporting Council has endorsed the view of the AIC that by following the AIC Code boards of investment companies should fully meet their obligations in relation to the Code and Listing Rule 9.6.8.

Principal tax implications

A company enters the UK REIT regime by giving notice to HM Revenue & Customs (“HMRC”) specifying the date from which it wishes to join. For corporation tax purposes, an accounting period is treated as ending (and a new one begins) on entry into the REIT regime. However this does not affect a company’s normal accounting reference date and so due consideration needs to be given to the date on which a company wishes to join the regime.

In order to qualify as a UK REIT, the REIT must satisfy certain conditions as set out in the Corporation Tax Act 2010. The joining notice to HMRC must be accompanied by a statement that the company conditions listed below (save for the close company condition) are reasonably expected to be met throughout the first accounting period on joining the regime.

A non-exhaustive summary of the material conditions as follows:
Company conditions
The REIT (or in the case of a group REIT, the principal company) must:
- be UK tax resident and not dual resident;
- be a body corporate and not open ended;
- have its ordinary shares admitted to trading on a recognised stock exchange – the regime previously required the shares to be listed on a recognised stock exchange (i.e. listed on the main market of the London Stock Exchange, which could be a significant barrier to entry) although this was relaxed in 2012 and so now includes, for example, shares traded on AIM;
- not be a close company (broadly meaning controlled by five or fewer persons having a share or interest in the company, including shareholders and certain loan creditors), although there is a three year “grace period” to meet this condition and the condition is further relaxed for certain institutional investors such as pension schemes and insurance companies (meaning a REIT will not cease to qualify simply because it takes a significant investment from such an institutional investor);
- have a single class of ordinary shares (although certain non-voting restricted preference shares are permitted in addition); and
- not be party to certain non-commercial loans.

Property rental business
The REIT must carry on a qualifying property rental business which meets two key conditions (intended to ensure investors are exposed to a diversified portfolio):
- Firstly, the property rental business must include at least three properties.
- Secondly, no single property may represent more than 40 per cent of the aggregate value of the properties within the property rental business.

The tax exempt property rental business may include UK and overseas property, but excludes certain businesses such as the incidental letting of development property, and also excludes certain income such as rent from electric line way-leaves, pipelines, telecom masts and wind turbines.

Profits of a REIT’s property rental business are not subject to corporation tax. Profits not falling within the tax exempt property rental business (the residual business) are generally subject to corporation tax in the usual way.

Distribution of profits
A REIT must distribute at least 90 per cent of the income profits of its property rental business to shareholders annually. A distribution may be made either as a distribution in cash or as a scrip dividend. Such dividends, known as property income dividends, are generally subject to withholding tax at the basic rate of income tax (currently 20 per cent), but certain classes of investor may receive dividends gross (e.g. UK resident companies, charities, UK pension schemes and local authorities). Investors are then taxed on these distributions as if they were UK property income, with credit for any tax withheld at source.

Distributions from the residual business are taxed as dividends in the normal way.

Balance of business
Whilst a REIT can have residual business activities, a significant part of a REIT’s activity must relate to its property rental business.

As such, the profits of the property rental business must represent at least 75 per cent of the REIT’s total profits (being the aggregate of the property rental business and residual business profits). In addition, the value of the assets relating to the property rental business, plus cash relating to the residual business (which includes cash held on deposit and gilts) and shares in another REIT, must represent at least 75 per cent of the total value of the assets held by the REIT.

Some other tax points to consider
- Interest cover ratio – A tax charge will arise if in respect of any accounting period the REIT’s ratio of income profits to financing costs in respect of its property rental business is less than 1.25:1 (although HMRC can waive this charge in certain circumstances, such as where the REIT was in severe financial difficulties).
- The “10 per cent rule” – A REIT may also become subject to a tax charge if it pays a dividend to a company beneficially entitled, directly or indirectly, to 10 per cent or more of the voting rights. This tax charge will not be incurred if the REIT has taken reasonable steps to avoid paying such dividends to such a person, which commonly means including a protective mechanism in the REIT’s articles of association.
- Property development – Care is needed where a REIT carries out development activities as this can result in a disposal of the relevant property being treated as part of the REIT’s residual business and so subject to tax. In particular, if a REIT has acquired and then developed a property, the costs of the development exceed 30 per cent of the value of the asset, and the REIT sells the asset within three years of completion of the development, then the sale of the asset is treated as having been disposed of in the course of the REIT’s residual business rather than its tax exempt property rental business.
Specific issues arising on REIT initial public offerings

Where a REIT is formed to acquire new assets, and where no assets are within its ownership at the time of the IPO, the following issues can arise:

Application for REIT status

The company proposed to be listed cannot enter the REIT regime until it has satisfied all of the REIT conditions. The "company conditions" will normally be satisfied on completion of the IPO, but all of the "property rental business conditions" will not be satisfied until, for example, the REIT deploys the proceeds of the IPO to acquire not less than three property assets, none of which accounts for more than 40 per cent of the total value of the portfolio. However, regulations permit a breach of the "three property asset" and "40 per cent. value" conditions to be disregarded provided, broadly, this does not extend to three or more accounting periods.

Prospectus disclosure

Where the funds raised in the IPO are to be deployed to acquire properties that are contracted to be acquired at the time of publication of the prospectus, full disclosure of those properties (including a valuation report) will be required to be made in the prospectus, which may be commercially undesirable. Furthermore, where more than 20 per cent of the gross assets of the issuer may be exposed to the creditworthiness or solvency of any one counterparty, which may be the case if the issuer at the time of IPO has say a single leasehold asset with a pre-existing tenant under contract, significant disclosure on the counterparty (here, the tenant) is required to be included in the prospectus, which may be impracticable and commercially undesirable. For these reasons it may be concluded that instead of entering into legally binding acquisition contracts, discussions are progressed with vendors to an advanced stage (under exclusivity arrangements) to provide investors in the IPO with assurance that the proceeds of the IPO will be deployed to acquire assets falling within the investment policy as soon as possible following the IPO.

Distributable profits

A REIT must be capable of distributing at least 90 per cent of profits arising from its qualifying property rental business, and therefore must ensure that it has sufficient profits available for distribution to do so. This is unlikely to be the case in the early stages of a newly formed REIT’s life and accordingly it may be advisable to carry out a reduction of share premium arising on subscription of new shares in the IPO to create such profits. It should be possible for the subscriber shareholders to pass the necessary shareholder resolution in advance of the IPO, conditional upon admission, avoiding the need for a public EGM after the date of the IPO.

Specific issues arising on REIT secondary fundraisings

Structure

REITs will often carry out secondary equity fundraisings to fund the acquisition of new property assets, although it is important to obtain and deploy funding quickly so that buying opportunities are not missed, and proceeds are not left unutilised on the company’s balance sheet, creating "cash drag". Secondary fundraisings can be conducted relatively quickly by way of a placing, but in practice they will be limited in size to up to 10 per cent of the company’s issued share capital in any 12 month period. Larger fundraisings will require the publication or a prospectus, which increase the lead time required, and large one off capital raisings require a secure pipeline of investment targets to deploy the proceeds on rapidly, which can be hard to achieve in practice. Accordingly, REITs can publish stand-alone registration documents in respect of a 12 month share issuance programme, with individual fundraisings within that programme requiring the publication of a summary and securities note only, enabling fundraisings to be conducted more flexibly.

Dilution

On secondary fundraisings, issue costs and cash drag can dilute existing shareholders’ share of the net asset value of the Company. A technique traditionally used by non-REIT investment companies to protect existing shareholders is to issue “C shares” on secondary fundraisings, the effect of which being to ring fence these adverse consequences for new investors only. However the requirement for REITs to have a single class of shares only makes the traditional C share route impossible, and while it may be possible to create an equivalent economic effect from a technical perspective, it would be complicated in practice. For the time being, therefore, NAV dilution remains an issue for investors in UK REITs.
How we can help

Our Corporate Real Estate Group of tax, real estate and corporate lawyers specialise in advising international and UK clients on the acquisition and disposal of UK property assets through tax efficient corporate structures.

We combine sophisticated tax structuring with real estate expertise and corporate law know-how to provide a one-stop solution.

Areas of expertise

- All aspects of financing (including Islamic compliant structures) and forward funding
- All aspects of private and listed investment funds, including REITs, IPOs, follow on offerings and corporate governance
- All regulatory aspects of investment funds including AIFMD compliance
- All aspects of debt capital markets work
- Asset management and property management arrangements
- Buying and selling investment properties through the acquisition or disposal of investment vehicles
- Cross-border investments, structuring and reorganisations
- Establishing investment vehicles (such as joint ventures, partnerships, JPUTs, property unit trusts and limited partnerships)
- Mergers and acquisitions of public and private real estate companies
- Planning, environmental and construction related issues
- Property developments
- Tax structuring

Key facts

Partners 100/359 (London/global)
Lawyers 343/935 (London/global)
33 offices in 20 jurisdictions

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