An Introduction to Real Estate Investment Trusts

Introduction – what is a REIT?

A Real Estate Investment Trust – or REIT for short – is a property investment company which pays no tax on the income and capital gains derived from its rental assets. Instead, the tax is effectively transferred to the shareholders, who are treated as if they had invested directly in the underlying properties.

In this introductory article, we shall look at how the tax legislation achieves this result. We shall go on to look at other aspects of the REIT regime in subsequent articles.

But first – why invest in a REIT?

Not everyone can be a property landlord. It takes time, effort and money. For an individual investor who can afford to set aside a smaller sum, it makes sense to invest in a vehicle such as a REIT, where all the hard work is taken care of by those who have the requisite experience of managing a property business.

Technically, a REIT is a company, listed on the London Stock Exchange as well as other junior and overseas markets. It is not regulated by the Financial Conduct Authority, and so it isn't classified as a fund such as an OEIC or a unit trust. However, a REIT shares the same features and purpose of a fund, in that it involves investors pooling their resources so as to provide them collectively with opportunities which might not have been open to them as individuals.

For example, by investing in a REIT or other property vehicle, one can have a stake in many of the office properties in the City of London, or Canary Wharf if it ever comes up for sale. As well as the generalist REITs such as British Land and Hammerson, there are companies that cater to specialist sectors. Local Shopping REIT specialises in shopping centres, while Primary Health Properties owns doctor's surgeries, where the rents are effectively backed by the government[1]. These sectors cannot be easily accessed by the individual investor.

Even larger, sophisticated investors such as pension funds and insurance companies can benefit. A lot of property deals involve such large amounts of money that even these investors find it makes sense to pool their resources rather than go it alone.

A further advantage is that by investing in a single equity stake, an investor is automatically provided with a diversified property portfolio. As a consequence, risk is spread amongst the underlying holdings.

Taxation – what is the purpose of the tax breaks?

Since a REIT is intended to be a proxy for its investors, it is important that it is as tax transparent as possible. In particular, it is important that investment decisions taken at the fund level should not be distorted by tax considerations.

We shall now look at how this is achieved. In the following discourse, one should have a mental picture of the REIT as a landlord, managing its property portfolio, and receiving rental income from its tenants. How is this income and the consequent tax liability passed on to the investors?

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(The statutory references in this article relate to two types of REIT – a single-company REIT and a group REIT. The distinction isn't important for the purposes of this discussion, but we shall look at this in more detail in a subsequent article).

Capital gains exemption

REITs are exempt from capital gains incurred in respect of the assets of the property rental business[2]. The tax is not imputed to the shareholders as would be the case with a partnership – instead, the investors pay CGT only when they sell their shares.

The capital gains exemption is an important tax break shared with other types of investment fund such as investment trusts, unit trusts and OEICs[3]. We have already noted that a fund is a proxy for its shareholders – accordingly, it makes sense that any capital gains accrue in the fund and are realised only when investors actually sell their shares.

There are two further points worth mentioning:

- Firstly, the advantage of an exemption at the fund level is that it enables the managers to focus on the investment case for holding a property. Important decisions, such as the decision to sell, will not be influenced by the fact that the property is standing at a substantial gain;

- Secondly, all the sale proceeds can be reinvested in the business – there is no requirement to distribute capital gains to shareholders as is the case with rental income. Accordingly, the tax saving has the potential to boost investment returns.

However, unlike other fund vehicles, such as investment trusts and authorised investment funds, the exemption doesn't extend to all assets in the portfolio. So shares in other property companies, or holdings in property unit trusts are not covered, even though these vehicles also invest in real estate (we shall see the reason why in a later article).

How is property income taxed?

Rental profits are taxed in the following way:

- At the fund level, the profits are exempt from corporation tax[4]. This includes both rental profits from directly held properties and dividends received from other REITs[5];

- These profits are then distributed to the shareholders. However, unlike a normal dividend, there is no tax credit attached, and corporate shareholders do not benefit from the usual dividend exemption[6]. Instead, each shareholder is treated as having received a net payment of rent, and is taxed accordingly[7].

The overall effect is that each individual shareholder is treated as if he were a landlord running his own individual property portfolio. The REIT is no more than a conduit to channel the profits from its tenants to its investors.

In order to ensure that this transfer of tax liability from the fund to the investors is effective, two further conditions need to be fulfilled:

- Firstly, the profits of the REIT's rental business must be calculated in the same way as the profits of a UK property business[8]. This ensures that when the profits are

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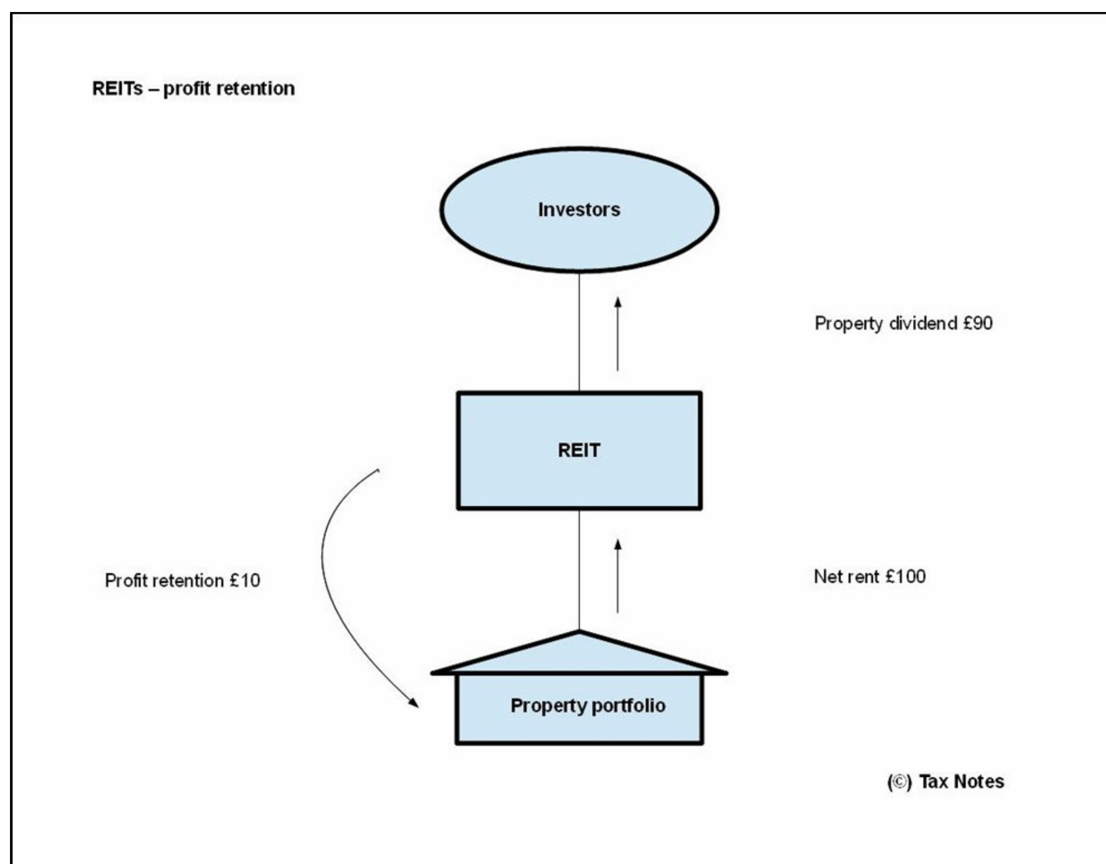
distributed, the shareholders have the benefit of the same tax reliefs that would have been available had they invested directly;

- Secondly, all of the profits should be distributed to the shareholders. This is in fact required in respect of profits from investments in other RIETs[9] – however, for the rest of the rental business, the minimum payout ratio is 90%[10]. Accordingly, the transfer of tax liability from fund to investors isn't perfect if the REIT retains part of its income.

The requirement to distribute a substantial amount of its profits is a condition that REITs share with other investment vehicles. However, for a REIT, this can be a disadvantage if funds are needed to reinvest in the business – most normal companies – even the most mature ones – retain a proportion of their profits for this very purpose.

This is not an issue for investment trusts and authorised funds investing indirectly through equities. These funds do not actually run the underlying property business. It is the companies in which they hold an equity stake that collect the rents, manage and maintain the buildings, and invest in new infrastructure. The companies at the operating level will have already retained part of their profits before paying a dividend to the fund – there is no need for further profit retention when the fund passes on this dividend to its own investors.

This can be illustrated by the following diagrams. In the first example, we see how a REIT distributes its profits from a directly held property.



The second diagram shows the position for an investment trust, holding an equity stake in a property company. We assume that the latter has a 50% payout ratio.

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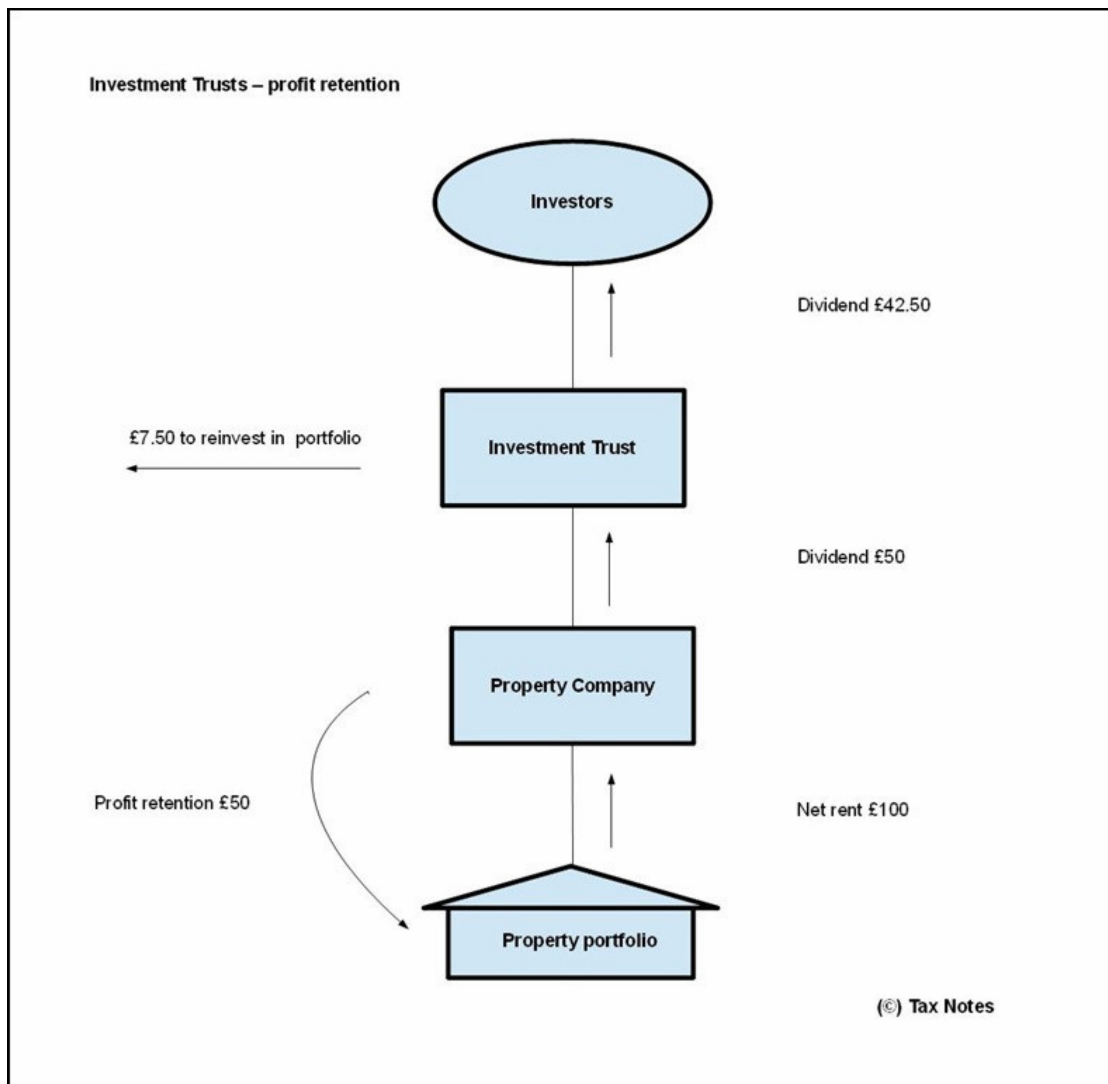

One way in which this issue can be mitigated is for the REIT to pay a stock dividend[11]. This is a recent innovation, enabling cash to stay in the fund – this can be used to maintain existing properties or for new investment opportunities, without having recourse to third party borrowing.

For investors, there are both pros and cons:

- The downside is that investors receiving a stock dividend are taxed on paper receipts rather than cash;

- On the other hand, a stock dividend increases the number of shares held, and therefore increases the dividend yield. Furthermore, studies have shown that a significant proportion of shareholders' return from equities comes from dividend reinvestment[12].

Withholding tax

Unlike a normal dividend, the property rental part of a REIT distribution is subject to withholding tax at the basic rate[13], with a number of exceptions[14]. These include UK corporate investors and tax exempt bodies such as local authorities, registered pension schemes and charities. A REIT can also be held in a tax wrapper such as a PEP, ISA or Child Trust Fund – these also qualify to have the dividend paid gross.

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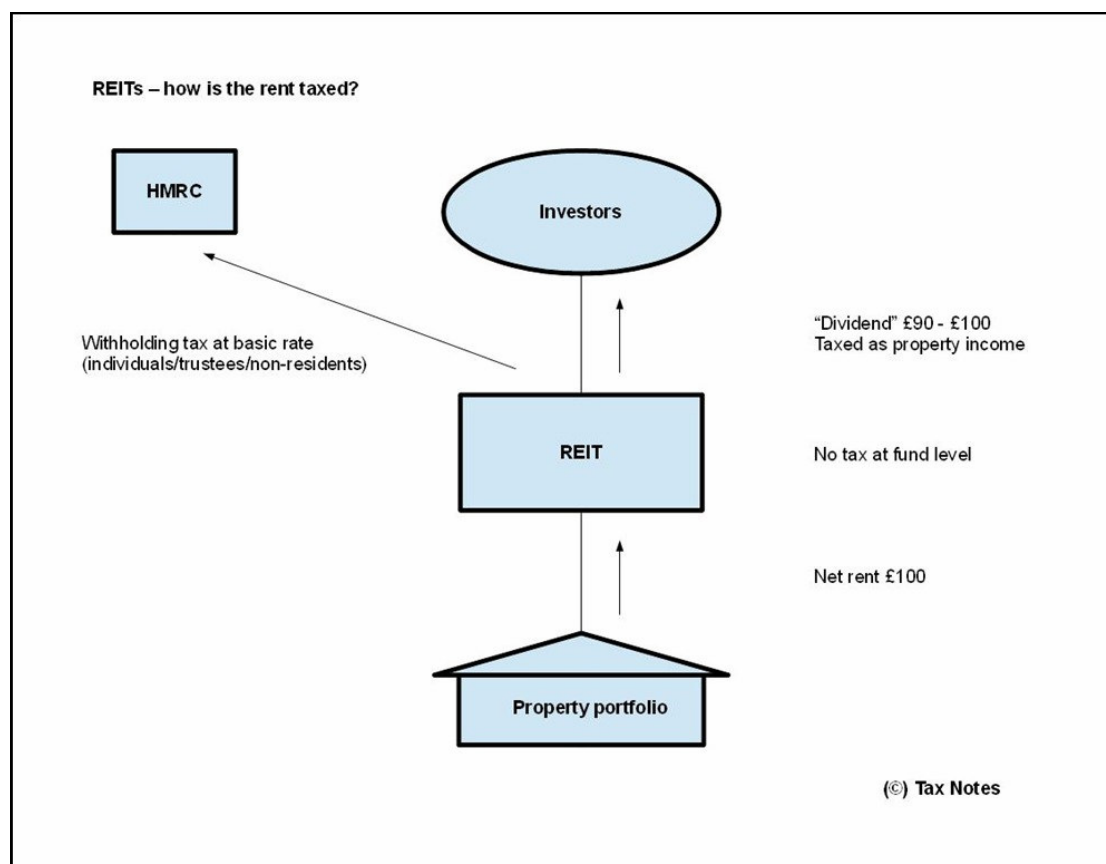
The requirement to withhold tax extends to non-resident shareholders. However, unlike the case for direct property investment, the latter class of investor cannot apply to have their property distributions paid gross under the non-resident landlord scheme[15].

So what does it all look like?



Final points

In the above analysis, we have focused only on the REIT's property rental business, in order to illustrate how the relevant profits are taxed as they flow from the tenants to the fund, and from the fund to the ultimate investors.

In practice however, a REIT may have other sources of property related earnings, and so the dividend payout will consist of a mixture of rental and other income. In these circumstances, the dividend is streamed into its constituent parts[16]. Only the rental part is subject to the rules on withholding and deemed to be property income in the hands of investors – the remainder is treated as a normal dividend.

What types of property asset can a REIT invest in, and do they benefit from the tax exemption? We have already noted that a REIT can hold property and shares in other REITs, but are there any other types of investment that are permitted, and if so, under what conditions?

We shall look at these questions more closely in a subsequent article.

Satwaki Chanda
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This article was first published on the website Tax Notes (taxnotes.co.uk) as the first in a series of article about REITs. It can be viewed at the following link: http://taxnotes.co.uk/an-introduction-to-real-estate-investment-trusts/

[1] A full list of UK REITs can be found at the website of the British Property Federation at http://www.bpf.org.uk/what-reit.
[2] CTA 2010 s 535.
[3] TCGA 1992 s 100.
[4] CTA 2010 s 534.
[5] CTA 2010 ss 549A(1), (5), (7).
[6] CTA 2009 ss 931A, 931B, 931D.
[7] CTA 2010 ss 548(5), (6).
[8] CTA 2010 ss 532(2)(b), 533(2), 599(2).
[9] CTA 2010 ss 530(1)(a), 530(4)(a).
[10] CTA 2010 ss 530(1)(b), 530(4)(b).
[11] CTA 2010 s 530(6A)(b).
[12] See in particular, the Barclays Equity Gilt Study.
[13] Real Estate Investment Trusts (Assessment and Recovery of Tax) Regulations 2006 SI 2006/2867 reg 3(2), 12.
[14] See SI 2006/2867 reg 7 for a full list.
[15] CTA 2010 s 548(7).
[16] CTA 2010 s 550.

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