Coming Onshore – are Investors better off when Offshore Property Funds Convert to REIT status?

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Shortly before Christmas last year, the financial press reported that the Guernsey investment company F&C UK Real Estate Investments – F&C for short – was planning to "come onshore" and convert to a UK REIT. This is just the latest of a number of closed ended property funds based in the Channel Islands that have taken this step, Standard Life being another well know name to make the change (or to give it its full name, Standard Life Investments Property Income Trust).

What does it mean to "come onshore" and why are these funds doing it now? In the following article, we shall explain the consequences of converting to a REIT, and in particular ask the question "How does it benefit investors?"

Some background – UK REITs and Channel Island property funds

A REIT – short for "Real Estate Investment Trust" – is a tax efficient vehicle based in the UK, that invests in property. It is aimed at retail as well as institutional investors, and like an investment trust, it is a company whose shares can be bought and sold on a recognised stock market.

Even before REITs first came on the scene in 2007, it was possible to invest in UK property through a Channel Islands based company such as Standard Life or F&C. Although these companies are offshore, they are easily accessible to investors, being quoted on the London Stock Exchange. Indeed, at one time they were so popular that it was not uncommon to see them trading on premiums as high as 20%[1].

Offshore investment companies share the same capital gains tax exemption as does a REIT, simply by virtue of being offshore[2]. However, while a REIT is exempt from tax on its rental profits, offshore property companies are subject to UK income tax at the basic rate of 20%[3]. Furthermore, an offshore landlord's tenants are required to withhold this tax before paying the rent unless the company has successfully applied to receive gross payments[4].

Why should offshore funds convert to REIT status?

This tax difference constitutes a very good reason why offshore funds should convert to REIT status. And indeed, both F&C and Standard Life stated in their respective Letters to Shareholders that that the aim of converting was to improve the tax position. There is an interesting contrast between the companies:

- F&C has been managing its income tax position by setting its interest payments against rental receipts. However, the company recognises that over time, these interest charges will decrease, leaving it with a higher tax exposure[5]:

  "Given the current interest rate environment, it is expected that the deductible intragroup interest will reduce over time and, unless the Group obtains UK-REIT status, the UK income tax payable under these arrangements would increase significantly."

- On the other hand, Standard Life hasn't been paying any income tax at all over the last few years. This is due to the fact that it has carried forward tax losses with which to shelter its income. But once these losses are extinguished, the company will have to start paying income tax[6]:

  "The Group does not currently suffer UK income tax as its net taxable income is set off against brought forward taxable losses. However, once these losses are fully utilised it is expected that the Group will suffer UK income tax on its net taxable income."

And yet it is only recently that companies like F&C and Standard Life have made the decision to come onshore. What's been taking them so long?

The reason for the delay is that until 2012, there was an entry charge for companies joining the REIT regime. This amounted to 2% of the market value of the rental properties in the investment portfolio[7]. This cost, together with the associative expenses of valuing the properties was a major disincentive to convert.

The entry charge was scrapped in 2012[8], and various other rules were relaxed in order to make it easier for a company to secure REIT status. These changes have constituted the trigger for the likes of Standard Life and F&C to come onshore.

What does it mean to come onshore?

In order to convert to REIT status, these Guernsey companies need to ensure that they satisfy the various conditions set out in the legislation, in particular, they need to be tax resident in the UK[9]. And this is in fact, one of the easiest conditions to comply with. No need to set up a separate UK company – the existing Guernsey company is fine as it is. All that is required is to relocate the place where the major decisions affecting the business are made[10].

This would normally be the place where the company's Board of directors holds its meetings, on the basis that it is the Board that is ultimately in charge of the company. Although the fund management team makes the investment decisions and runs the portfolio on a day to day basis, it is the Board that has overall responsibility for setting overall strategy and making policy decisions.

So in order to become UK tax resident, one simply needs to shift the Board meetings from the offshore jurisdiction to the UK. And this is precisely what both Standard Life and F&C have proposed to do[11].

F&C has an additional task to ensure that it keeps within the REIT rules. The institutional investor Friends Life has a stake of 10% or more, and falls within the substantial shareholder rules. These rules impose a tax charge on a REIT, unless the company made reasonable steps to avoid paying a dividend to such a shareholder[12].

What are the main tax differences between a UK REIT and its offshore counterpart?

The table below is a summary of the position comparing a UK REIT with a Guernsey based fund:

	UK REIT	Guernsey Company
Taxation at fund level	Exempt on rental income. Exempt on capital gains on rental properties.	Subject to UK income tax at basic rate (20%). Tenants must deduct basic rate tax from rental payments. Exempt on capital gains.
Withholding tax on shareholder distributions	Individuals – tax deducted at basic rate. Other shareholders paid gross – corporates, pensions, ISAs.	None.
Taxation of distributions Individual shareholders **Basic/higher/additional rates**	Taxed at income tax rates. 20%/40%/45%	Taxed at dividend rates. 0%/25%/30.6%
Taxation of distributions Corporate shareholders	Taxed at corporate tax rate 20% (from April 2015).	Exempt.

To understand why there is a difference, we need to bear in mind the following points.

The idea behind exempting the REIT is to shift the tax burden from the fund level to the investors. Each investor is regarded as running his own private property portfolio and is taxed as if he were receiving the net rents of the property business – which explains why there is no tax credit[13]. This is an important departure from the usual way that corporate distributions are taxed.

A Guernsey based fund investing in UK property pays no local taxes and there are no withholding taxes on corporate distributions[14]. The only tax to worry about at the fund level is UK income tax levied at the current basic rate of 20%. In recent years, UK shareholders receiving a distribution from a Guernsey company have been treated as if they had received a UK dividend – so individuals bear the same effective tax rates and corporate shareholders are exempt[15].

How do the changes affect investors?

This is the key question. Both Standard Life and F&C have stated that by sheltering the company from UK income tax, they hope to free up more profits for distribution to their shareholders. Indeed REITs are under a requirement to distribute at least 90% of their rental profits[16], so on paper, this should benefit investors.

But are they really any better off in terms of how much money they have in their pockets at the end of the day?

In the following scenarios have a REIT and a Guernsey based fund, both earning the same profits before tax, with both companies making the maximum distribution possible.

This is the position for an individual shareholder:

	UK REIT	**Guernsey Company**
Profit before tax	100	100
Tax	0	(20)
Profit available for distribution	100	80
Tax (basic/higher/additional)	(20)/(40)/(45)	(0)/(20)/(24.5)
Basic rate shareholder	80	80
Higher rate shareholder	60	60
Additional rate shareholder	55	55.5

There is very little difference between the two. But at least shareholders aren't worse off as a result of the Guernsey company converting to REIT status.

What about the position of a corporate shareholder, subject to corporation tax? This includes not only normal companies but investment funds such as authorised unit trusts and OEICs:

	UK REIT	**Guernsey Company**
Profit before tax	100	100
Tax	0	(20)
Profit available for distribution	100	80
Corporation Tax	(20)	0
Corporate shareholder	80	80

Again no difference. But at least corporate shareholders aren't worse off either.

Finally, what is the position when the investor is exempt such as a pension fund or an ISA?

	UK REIT	**Guernsey Company**
Profit before tax	100	100
Tax	0	(20)
Profit available for distribution	100	80
Tax	0	0
Exempt shareholder	100	80

Finally, we've hit the jackpot! A clear advantage when investing through a tax wrapper, as one would expect.

So are investors better off?

To answer the question at the beginning of the article: Investors are certainly not worse off, but when the investment is made outside of a tax wrapper, the difference is not significant.

A few years ago, a REIT would have had the clear advantage over a close ended Guernsey fund, even for taxable investors. However, the gap between the two types of fund has narrowed, thanks to the availability of foreign tax credits and lower corporate tax rates.

However, the greatest beneficiaries of converting are those people who invest through a tax wrapper – pensions, ISAs as well as other exempt bodies such as charities and even other REITs and property authorised investment funds.

Will we see more companies coming onshore in future? In tax terms it certainly makes sense. On the other hand, one also needs to look at the bigger picture and ask "What is the overall investment objective of the fund?" Whether the tax rules will support that objective is only one of a number of factors to take into account in deciding what course of action best serves the interest of its investors.

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This article was first published on the website Tax Notes (taxnotes.co.uk) and can be viewed at the following link: http://taxnotes.co.uk/coming-onshore-are-investors-better-off-when-offshore-property-funds-convert-to-reit-status/

A version of this article was also published on the financial website Which Investment Trust at

http://whichinvestmenttrust.com/coming-onshore-investors-better-off-offshore-property-funds-convert-reit-status/

Further links

The articles appearing in the financial press can be found at the following links:

http://www.theaic.co.uk/aic/news/citywire-news/fc-real-estate-trust-to-convert-to-reit

http://www.theaic.co.uk/aic/news/citywire-news/standard-life-property-income-to-convert-into-a-reit

F&C UK Real Estate Investments Limited – the company's website, and its proposals for converting to REIT status can be found at:

http://www.fandc.com/uk/private-investors/investment-trusts/property/fandc-uk-real-estate-investments-ltd/

http://www.fandc.com/documents/fcre-circular/

Standard Life Investments Property Income Trust Limited – the company's website, and its proposals for converting to REIT status can be found at:

http://uk.standardlifeinvestments.com/ifa/funds/investment_trusts/standard_life_property_income_trust_limited.html

http://uk.standardlifeinvestments.com/SLIPIT_REIT_Circular/getLatest.pdf

Two useful sites for information about REITs and Offshore Property Investment Companies – Trustnet (trustnet.com) and the Association of Investment Companies site (theaic.co.uk). These sites are geared towards retail investors, and the companies listed are normally quoted on the London Stock Exchange.

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[1] See financial websites Trustnet or the Association of Investment Companies.
[2] TCGA 1992 s 2(1).
[3] ITTOIA 2005 ss 268, 269(1).
[4] ITA 2007 s 971, Income from Land (Non-Residents) Regulations SI 1995/2902 paragraphs 8(2), 17.
[5] Letter from Chairman to Shareholders dated 25 November 2014, Notice of Extraordinary General Meeting 19 December 2014 at page 7 and 9 onwards.
[6] Letter from Chairman to Shareholders dated 29 October 2014, Notice of General Meeting 20 November 2014 at page 5.
[7] CTA 2010 s 538.
[8] FA 2012 s 2, Schedule 4, paragraph 33(1).
[9] CTA 2010 ss 521(1), 528(1).
[10] The central management and control test – *De Beers Consolidated Mines Ltd v Howe*, 5 TC 213.
[11] F&C Letter to Shareholders page 11; Standard Life Letter to Shareholders page 9.
[12] CTA 2010 ss 551, 552, and see HMRC Guidance on what is reasonable at GREIT02125 to GREIT 02150. Also see the F&C Letter to Shareholders page 11 and proposed changes to the Articles of Association at page 24.
[13] CTA 2010 ss 548(5), (6), 549(2).
[14] For information on how Guernsey companies are taxed, see the States of Guernsey website's section on corporate taxation at http://www.gov.gg/taxforcompanies and also the section on exempt bodies http://www.gov.gg/taxationexemptbodies . The relevant legislation is the Income Tax (Exempt Bodies) (Guernsey) Ordinance 1989, which has been amended on many occasions. Guernsey companies will be exempt from Guernsey taxation if their sources of income profits are outside the jurisdiction as is the case with those companies investing in UK property.

[15] For corporate shareholders, see CTA 2009 Part 9A Chapters 2 and 3. For individuals, see ITTOIA 2005 ss 397A, 397AA, 398(1). The tax credit is available on the basis that the Guernsey company is an offshore collective investment scheme, constituted as a company under TIOPA 2010 ss 355, 356. Both Standard Life and F&C are collectives under the Guernsey Authorised Closed-Ended Collective Investment Schemes Rules 2008.

[16] CTA 2010 ss 530(1)(b), 530(4)(b).