What do they invest in? Part Two – Investing in other REITs

27 June 2015

In an interview with Taxlinked[1], the author of this article mentioned the fact that REITs could invest in other REITs as well as in the traditional bricks and mortar that one associates with property funds. In this article we shall have a closer look at what this statement actually means.

In particular we shall find out that while it is possible to have a REIT holding shares in other REITs, this cannot be the sole investment – there needs to be a minimum level of bricks and mortar for this to be possible. Furthermore, while distributions from other REITs are tax free, the exemption does not extend to capital gains.

What do we mean by: "Is it possible to invest in other REITs?"

Actually it has always been possible to invest in other REITs. Recall that a REIT must satisfy a balance of the business test whereby[2]:

- At least 75% of the company's total profits must be derived from its property rental business; and

- At least 75% of the total value of the assets must relate to the property rental business.

That leaves 25% of the REIT's business which can be made up of non-rental activities. This can include property development, property management, and holding shares in other property companies.

The key question is: "Does holding shares in other REITs fall on the right side of the line?" This is what we mean when we ask: "Can a REIT invest in other REITs?" The short answer is "Once it was not possible, but now it is."

In other words, it was possible to invest, but with the proviso that holding REIT shares didn't constitute property rental activities. Consequently, the amount of REIT investments that could be held in the portfolio was limited by the 25% ceiling on non-rental activities. Now the position has changed. REITs can invest in other REITs quite freely, without being constrained by this 25% limit.

Are REIT shares part of the property rental business? What is the common sense position?

A REIT's exemption from corporation tax relates to its property rental business. In particular:

- The profits of the property rental business are not charged to corporation tax (the income exemption)[3]; and

- Gains on the disposal of assets used "for the purpose of the property rental business" are exempt (the capital gains exemption)[4].

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The key phrase is "property rental business". The meaning of this phrase is crucial – it means either a UK property business or overseas property business within the context of the relevant statutory provisions which charge property income to corporation tax[5].

In particular, a property rental business is described as being "every business which the company carries on", whether in the UK or overseas, for "generating income from land"[6], including every transaction entered into for that purpose. And "generating income from land"[7] means:

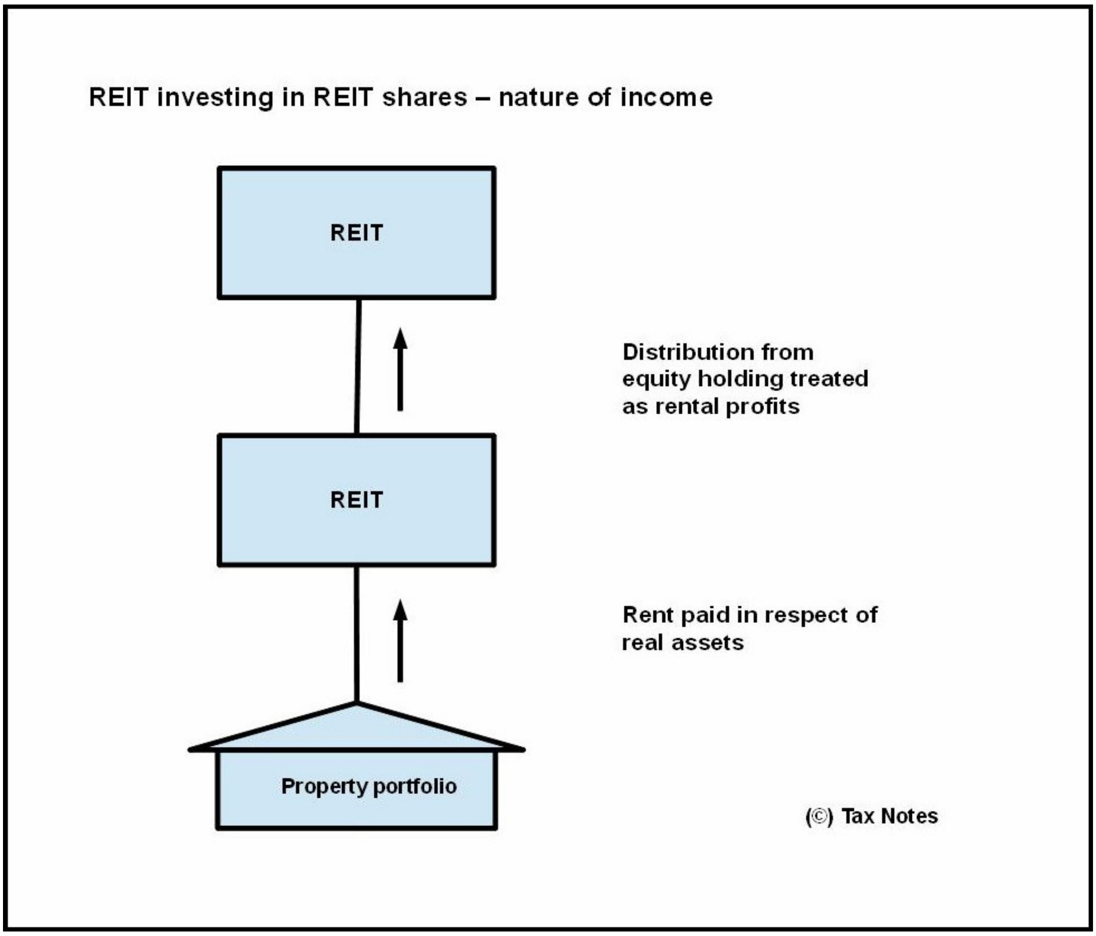
> "exploiting an estate, interest or right in or over land as a source of rents or other receipts."

It is clear from this definition that investments in other REITs cannot, on the face of it constitute part of the property rental business. A REIT is a company, and holdings in a REIT constitute equities not real estate assets. The fact that the underlying business is property is irrelevant, because a company is an opaque vehicle – one cannot look through and disregard the corporate structure.

So in order for the tax benefits to extend to investments held in other REITs, there needs to be special deeming provisions in the legislation to ensure that this is the case.

What was the position on REIT distributions before 2013?

It is for this reason – the fact that holdings in REITs constitute equity and not property – that REITs fell on the wrong side of the line before the rules were changed in 2013. In particular, there was a specific provision in the legislation stating that dividends received from another REIT were not to be treated as the profits of a property rental business[8].



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This deeming provision was necessary to remove REIT holdings from the 75% side of the line. For although REIT shares don't constitute real property, the income generated does constitute property income. This is on the basis that REIT distributions paid out of rental income are specifically treated as profits from a UK property business[9]. (We assume in the rest of this article that such distributions are made out of rental income only. To the extent that distributions are paid out of the profits of the non-rental part of the business, they are treated as normal dividends[10]).

What is the current position on REIT distributions?

The income exemption now includes distributions received from other REITs. The words of the amending legislation specifically state that such a distribution is treated as profits of the property rental business and therefore they come under the income exemption[11]. Such amounts are known as UK REIT investment profits.

Because REIT distributions are now considered to be property rental profits, they automatically fall on the right side of the line for the profits condition in the balance of the business test[12]. They also fall on the right side of the line for the assets condition – we shall consider this more closely when discussing the capital gains exemption.

Is there a capital gains exemption on selling REIT shares?

The key question to ask is whether shares in other REITs constitute assets used for the purpose of the property rental business. Given the earlier comment that REIT shares constitute equity, the common sense answer is "No." If it is the case that REIT shares benefit from the exemption, there needs to be an appropriate deeming provision in the legislation.

But there is no such deeming provision. In the legislation a reference to assets used in the business of a company includes a reference to assets[13]:

- Which were acquired for the purpose of that business and which are not being used in another business;
- Which are available for use in that business; or
- Which are in any other way held in respect of, or associated or connected with, that business.

But the legislation sheds no further light on the question whether equities in property companies could be assets of the REIT's own property business.

Further support that the legislation does not turn REIT shares into bricks and mortar, can be found in the amended balance of the business test as it applies to assets:

- The original test simply stated that the value of the assets relating to the property rental business had to be at least 75% of the total;
- Cash was then added in 2012; and
- Finally shares in REITs in 2013.

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However, it isn't accurate to say that the last two items are deemed to constitute property for the purpose of the new assets test. In fact it isn't even accurate to say that 75% of the assets must relate to the property rental business. This is what the legislation actually says[14]:

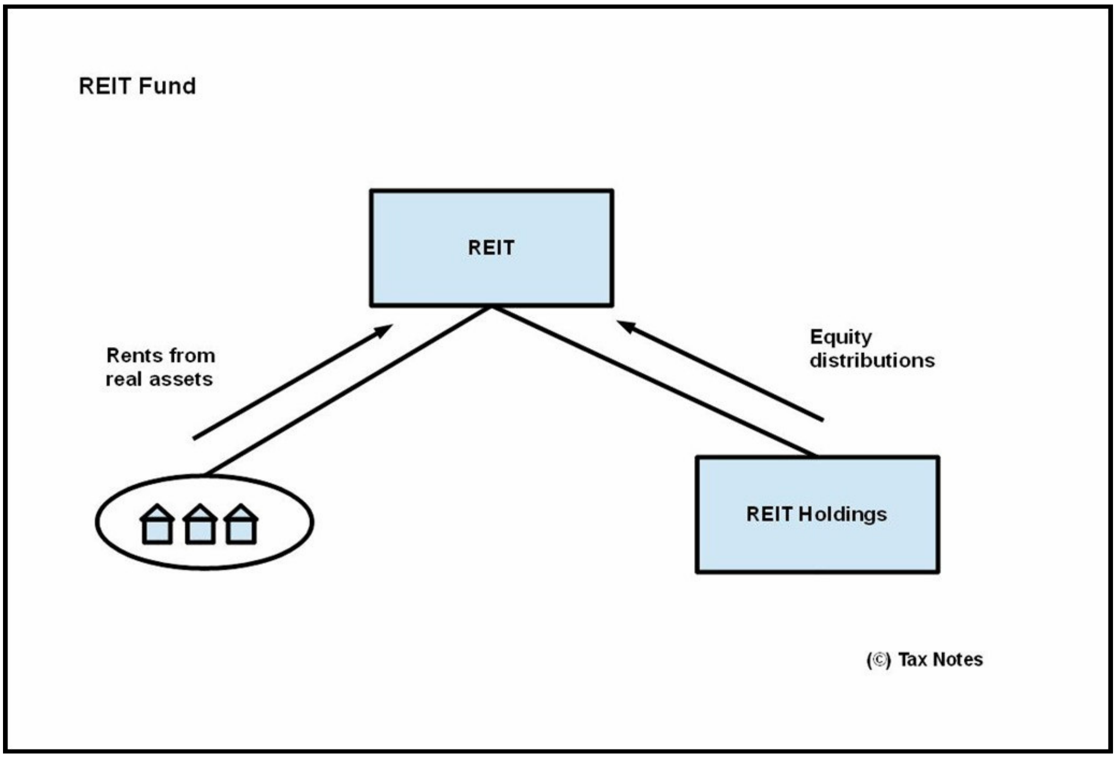
> "…the sum of:
>
> (a) the value of the assets relating to property rental business and
>
> (b) the value of the assets relating to residual business so far as consisting of cash or relevant UK REIT shares
>
> is at least 75% of the total value of assets held…"

Note how the legislation groups cash and REIT shares separately from the property rental business. Note also how the REIT shares are specifically said to be part of the "residual business" – that is, the non-rental business. This clearly means that the REIT shares cannot constitute assets of the property rental business and so cannot qualify for the capital gains exemption.

So why are REIT shares included in the 75% asset condition if there is no capital gains exemption? No doubt the reason lies in the fact that the income exemption was to encourage more investment in other REITs. This would be constrained if the asset values of the REIT holdings had to be kept within the 25% limit applicable to the non-rental business.

REIT Funds – can a REIT invest solely in other REITs?

The answer is "No." A REIT must have at least three properties in the rental business[15], and we have just seen that shares in other REITs do not constitute real assets. Furthermore, there is no deeming provision which turns equities into real property.



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A comparison with Property Authorised Investment Funds

A Property Authorised Fund – or PAIF for short – is the open ended equivalent of a REIT. PAIFs were introduced in 2008[16] and from Day One, they have enjoyed a tax exemption on REIT dividends. The exemption of a PAIF is in fact wider than that of a REIT[17]:

- A REIT is exempt in respect of its property rental business;
- A PAIF is exempt in respect of its property investment business. This is wider than the concept of a property rental business, as it also includes investments in REITs, both the UK version and foreign equivalents.

There is a further tax advantage for PAIFs. PAIFs are exempt from capital gains on all their investments. This includes REIT shares, as well as assets that are strictly not part of the property portfolio. This isn't because of a deliberate policy to favour PAIFs over REITs. The exemption is a consequence of the PAIF's status as an open ended investment company ("OEIC")[18].

A word of caution however. Just because a PAIF appears to have more favorable tax treatment than a REIT, doesn't mean that it is the better investment vehicle.

Cast your minds back to the credit crunch in 2008, when investors were heading for the exits.

If the fund is open ended, the Manager has an obligation to redeem units should investors wish to sell. If there is insufficient cash, they may be forced to sell the underlying investments – assets that are illiquid and whose value may have decreased substantially. Not a pretty sight.

REITs on the other hand, are close ended companies, and the only way investors can bail out is by selling their shares – while this may depress the price, the underlying property portfolio is left intact.

Conclusion

While a REIT can invest in other REITs, a pure REIT Fund is not possible – there needs to be at least three proper bricks and mortar holdings in the portfolio. Furthermore, while income distributions from REIT holdings are now treated as exempt property income, capital gains remain taxable.

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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/reits-investing-in-other-reits/

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1 See https://taxlinked.net/taxlinked/spotlights/investment-funds-reits-uk-property-investments
2 CTA 2010 ss 527(2)(b), 527(3)(b), 531(1), 531(5).
3 CTA 2010 ss 534(1), (2).
4 CTA 2010 s 535.
5 CTA 2010 s 519(1).
6 CTA 2010 s 519(1), CTA 2009 ss 205, 206.
7 CTA 2009 s 207(1).

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[8] CTA 2010 s 605(2) Class 7.
[9] CTA 2010 s 548(5).
[10] CTA 2010 s 550.
[11] CTA 2010 ss 549A(1), (5), (7), 605(1A).
[12] CTA 2010 s 531(1).
[13] CTA 2010 s 608(2).
[14] CTA 2010 s 531(5).
[15] CTA 2010 s 529(1).
[16] The Authorised Investment Funds (Tax) (Amendment) Regulations SI 2008/705 paragraph 5.
[17]The Authorised Investment Funds (Tax) Regulations SI 2009/964 ("AIF Regulations") reg 69C(3), 69F, 69Y(1)..
[18] TCGA 1992 s 100, the AIF Regulations, reg 100

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