

The REIT way or the wrong way

REITS Proposed changes to the existing regime hope to encourage investors to add residential properties to their portfolios. By Laura Nicholson and Vincent Wood

The residential market is a government priority. This has been signalled by proposals to change stamp duty land tax (SDLT) and real estate investment trusts (REITS) in order to encourage investment in residential projects.

SDLT on bulk purchases of residential property has always been charged by reference to the total bulk transaction cost and not the individual values. For example, a purchaser of 10 residential properties at £120,000 each would be charged £60,000 SDLT (5% of £1.2m) compared to £0 SDLT if each property was considered as a separate purchase. The government has announced that it is introducing a new SDLT relief that will deal with this problem and ensure that buyers are not prejudiced by making bulk purchases of residential property.

Alongside the SDLT change is a proposal to introduce welcome changes to REITs, which is expected to motivate institutional and other investors, who might otherwise have been put off by the cost and other issues, to add residential properties into a REIT portfolio.

REIT basics

REITs are collective investments that allow investors to pool their money and jointly invest in property. An investor can buy shares in a REIT to gain exposure to property in its portfolio without having to go through the processes and expense of buying and letting a property. Likewise, selling REIT shares takes less effort than selling a property. Another advantage of REITs is that the investor benefits from exposure to a variety of properties in a portfolio rather than having its eggs all in one building-shaped basket.

Importantly, REITs are tax transparent investments – most of the income generated by the assets will pass to investors without a deduction of corporation tax. The income is taxed as a dividend in the hands of the investor.

The need for increased investment in the private rented sector had been recognised by the previous Labour government, which launched a consultation in February 2010. The consultation acknowledged that banks and building societies had played their part by lending to private individual landlords to encourage investment in the residential sector. However, the consultation found that although institutional investors invariably invested in commercial real estate, they were virtually absent from

the residential housing sector. Institutional investors gave reasons such as reputational and financial risks, a perceived lack of suitable properties and anticipated higher management costs with consequential lower yields that made the sector relatively unattractive.

Before the introduction of REITs in 2007, institutions also pointed to the lack of a tax-transparent investment vehicle as a major impediment to new residential investment; this was a key driver behind the introduction of REITs in January 2007.

By February 2010, most of the UK's major listed property companies had joined the REIT regime. However, only two had residential property in their portfolio, with no REIT being exclusively residential.

The property sector has been lobbying for a slight relaxation of the regime rules to allow further conversions. Remedies for some of these issues were proposed in the 2011 budget. A further informal consultation to look into the specific barriers to both entry and investment for REITs was carried out by the coalition government with a specific focus on the residential housing sector, the compliance requirements and the barriers to entry into the REIT family.

Proposed changes

The proposed new measures are:

- Abolition of the conversion charge for companies joining the REIT regime. This measure is aimed at reducing the significant costs of setting up a REIT. When REITs were introduced, it was understood that the 2% entry charge was effectively the pay-off for their being exempt from paying any corporation tax on both profits and gains from their investment business. The abolition of the 2% entry charge on the market value of the properties held when a REIT enters the regime will be helpful.
- Relaxation of the listing requirement for UK REITs. It is hoped that this will encourage AIM-listed start-ups or unlisted property companies to consider converting to a REIT. Similarly, the ability to list on the AIM, the PLUS or an overseas stock exchange will reduce ongoing running and administration costs. The consideration of this proposal will have to take into account the importance of protecting individual investors under a less demanding listing regime.

- Introduction of a fixed grace period for new REITs to meet the non-close company requirement. This is important because the strict application of the current rule meant that there was a flurry of activity when REITs were introduced with property investment companies converting straight away and almost no significant increases in UK REITs since then. The relaxation of this condition would encourage institutional investors to consider setting up new REITs, and catch the attention of new investors as news of their success spreads. During the period when finance is being raised, it is sometimes not possible to widen the investor base sufficiently quickly to meet the close company requirement at the time that REIT status is sought.

- Introduction of a diverse ownership rule for institutional investors that will allow them to comply with the non-close company rule.

- Allow cash to be a "good asset" for the purpose of the REIT balance of business tests. This is aimed at addressing the practical difficulties that confront businesses in trying to stay within the many restrictions imposed by the complex rules. For instance, REITs may be more influenced as to whether to proceed with a particular asset sale by the fact that they may need to reinvest the cash by the year end to keep within the rules than by commercial considerations.

- Extension of the time limit for complying with the distribution requirement, in particular circumstances involving stock dividends. Currently, REITs are required to distribute at least 90% of their tax-exempt profits to investors within one year of the end of the accounting period. The extension of the time limit for satisfaction of the distribution condition eases a significant administrative burden that new entrants are generally not keen to take on.

- Redefining the "financing costs" for the REIT interest cover test. The current test would benefit from greater certainty.

The results of the latest informal consultation process are expected to be announced when draft rules are published in advance of the Finance Bill 2012.

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