

UK real estate insights



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Introduction

Welcome to our new quarterly *UK real estate insights*, where we aim to provide industry developments, insights and thought leadership on issues that will affect you. This first issue focuses primarily on tax, and in particular the landmark changes announced in last December's Pre-Budget Report and refined further in April's Budget and the Finance Bill.

The introduction of UK-REITs represents a defining moment for the real estate industry in this country. This will affect real estate companies that are able to convert, those that are not, and the real estate funds industry. It also provides a challenge and an opportunity for operating businesses with major real estate assets. At the same time as the introduction of a tax free property holding vehicle, the Government has

also greatly restricted the ability to indulge in other forms of tax planning. Specific measures include blocking perceived abuses, such as the use of Jersey Property Unit Trusts to avoid stamp duty land tax (SDLT) and the buying of capital losses, as well as the extension of the tax avoidance disclosure (TAD) rules.

In this issue we also look at the findings of *Emerging Trends in Real Estate Europe 2006*, a joint report by PricewaterhouseCoopers LLP (PwC) and the Urban Land Institute (ULI), published in February 2006. We look at the key findings of the report and developments since it was published.

The annual [PricewaterhouseCoopers UK real estate Seminar](#), to be held on Thursday 25 May 2006 at the Institute of Directors on Pall Mall, will present

an opportunity for you to hear the current thinking on these issues and a number of others, as well as network with your peers. Further details of the seminar can be found in the newsletter, [click here](#) to find out more.

There are more links throughout the newsletter which will put you directly in touch with our real estate network. If you have any general queries or feedback on our first issue, or would like to subscribe to future issues or link to this newsletter from your website, then please email the [UK real estate insights team](#).

John Forbes
PricewaterhouseCoopers real estate leader

Approaching the UK-REIT environment

Looking at the considerations for companies

Nobody can have failed to notice that UK-real estate investment trusts (UK-REITs) legislation is on the way. Operating a property business in a corporation tax free environment is clearly attractive, particularly with relaxation of the proposed gearing restrictions and other improvements since the UK-REIT legislation was first published in December 2005. Companies with large real estate holdings are being encouraged to become UK-REITs in order to attract new investment and realise greater value from existing real estate holdings.

This is not only within the real estate industry. Operating businesses with major real estate holdings such as retailers, hotel owners, leisure operators and utilities are the subject of fevered speculation.

There are lots of questions for potential REITs to consider, but how realistic is conversion for real estate companies?

The obvious candidates and investors

The most obvious candidates to become UK-REITs are the existing listed real estate companies quoted on the main market. But how will their investors fare under the new regime?

The Government has announced that pension funds and other similar institutions will be entitled to receive distributions from the gross of UK-REITs, although the regulations to implement this have yet to be published. For these investors, the UK-REIT is clearly a major step forward. For other investors, the position is less clear.

Suppose an existing company makes £100 of net income, pays tax of 30% and distributes the after tax amount: what is the effective rate of tax for the shareholder on the £100 earned?

For shareholders that are UK individuals, the effective rate on the £100 is up to 47.5%. If that company becomes a UK-REIT, the effective rate of tax will fall to 40%. But is this a sufficiently large incentive to convert? Supposing the shares are to be held in an ISA. HM Revenue & Customs (HMRC) has indicated this will be allowed but confirmation that UK-REITs distributions can be received gross by ISAs remains outstanding. For non-resident investors, the withholding tax rate on distributions exceeds the effective tax rate paid by many current fund structures, even though the UK-REIT itself is not subject to tax. Therefore, for non-resident investors, the attractiveness of UK-REITs is still open to debate.

Other than for the very largest quoted companies, limits on single shareholdings are likely to be a major issue. UK-REITs must restrict distributions to people benefiting from 10% or more of the ordinary share capital. If they do not, the

UK-REIT will suffer a tax charge on a proportion of the distributed profits. The rules will allow the company to avoid this predicament if it places restrictions on substantial shareholdings. But how will that affect the value of that shareholding? Will the UK-REIT regime allow this to continue if others abuse it? It may be possible to restructure shareholdings to overcome this difficulty but an upfront tax cost may arise.

For even the most obvious conversion candidates, whether or not to become a REIT is not immediately obvious without first considering the potential questions and carrying out modelling to determine the best option.

Property rich businesses

Well before the announcement of the UK-REIT regime, property rich operating businesses were highly attractive targets for takeover. Private equity funds, in particular, have been salivating over anything that could be split into business [trading] operations (Opco) and the property holding elements (Propco). The arrival of the UK-REIT adds to their options, but also potentially offers a bid defence for their targets.

Approaching the UK-REIT environment (continued)

However, companies holding real estate for use in the business (e.g. hoteliers) may face further obstacles to get assets into a UK-REIT. It will be necessary to demerge the real estate and operating business into separate entities (the properties in a UK-REIT cannot be used for the business' own use), listing the property company separately and leasing back the premises. The tax and commercial hurdles can be overcome, but it takes time and forethought. In particular, due to anti-avoidance legislation, the process of demerger is quite challenging.

Companies will have to ask themselves many questions before embarking on conversion to UK-REIT status. What will be the effect of demerging? Investors may benefit through higher share prices in the demerged UK-REIT and operating companies, but how will the operating business fare once exposed to market rents?

As regards corporate governance, is it appropriate for the same directors to serve on the boards of both the UK-REIT and the operating business? How will conflicts be handled and what impact will it have on operations?

Companies leasing back key sites may wish to have the security of very long leases to protect commercial positions. Under International Financial Reporting Standards (IFRS), the UK-REIT may have to account for these as finance leases. How does this impact on valuations?

The business model

Does a company churn its investments? Consider this on a case by case basis but too many sales may breach the income or assets value tests under the regime. Working through the numbers, carrying out financial modelling and testing the sensitivities may be the key. Crystal ball gazing this may be, but it will focus the mind on the possible outcomes.

What about real estate development? Property investment companies regularly develop assets which they intend to hold. Indeed, property managers who sweat the assets of their business are applauded in the market place. Development is just one of the tools used to increase value. However, under the UK-REIT regime, if a company spends more than 30% of the fair value of a property (measured at the earlier of acquisition or entry into the regime) on



developing an asset which will be sold within three years of completion, then the gain will be taxable. So, if a company receives a high offer on a property after two years of ownership or completion does it sell and pay the tax (no deferred tax having been provided earlier on the basis that the gain would normally be tax exempt) or hope the value holds up for another year?

Some investment companies carry on more mixed businesses. They use the talent within the in-house development team to develop real estate for third parties, selling on or taking a developer's profit share on completion or final letting. This has become more common in recent rising markets. But will this be permitted to continue on the same scale if the group must remain within the confines of the UK-REIT rules?

Approaching the UK-REIT environment (continued)

Being listed – good or bad for REITs?

What about real estate investment companies that are not quoted on a recognised stock market (AIM is not a recognised market for UK-REIT purposes)? Does the company go for a full UK listing? How will senior management and the operation of the business adapt to different regulation? The listing regulations for real estate companies are in the process of change, and therefore for those companies considering listing to benefit from the UK-REIT regime. At the moment it is not clear exactly what the requirements will be.

What about listing elsewhere? Jersey and other offshore territories are already promoting their attractions. Or with the advent of the UK-REIT regime is it time to sell up and reinvest elsewhere or through another structure?

If the decision is to remain outside the UK-REIT regime, how do companies remain competitive? Based on the experience of other countries, REITs raising equity and further to finance expansion has proved relatively easy. Will this be the case for the UK as well?

Creating new investment vehicles

How important is the UK-REIT for fund managers looking to create attractive investment vehicles? The tax treatment depends crucially upon the nature of the investors. In particular, where significant investment from overseas is anticipated, a UK-REIT may not be the best vehicle. The tax inefficiency of the UK company as a way of holding property has led fund managers to create a variety of tax efficient offshore fund vehicles for investment in the UK. The most recent developments in this area have led to the refinement of virtual REIT structures that are potentially more tax efficient than the UK-REIT itself. Some sophisticated modelling is required to test the sensitivity of actual and virtual REIT structures to different investor mixes.

Although the press coverage of the introduction of UK-REITs has provoked considerable interest from overseas investors (and overseas fund of funds), of all the different investors, the non-resident is probably the one for whom the UK-REIT is the least appealing.

Breaching the rules

The Government wishes to adopt a pragmatic approach when it comes to inadvertent breaches of the rules. However, where commercial circumstance causes a breach, the UK-REIT may be taxed.

For example, a major refinancing may result in significant finance costs being taken to the income statement. Conceivably, this could breach the profit to interest cover ratio. A tax charge would arise on the finance costs paid in excess of the amount allowed by the ratio.

Placing too many properties in the UK-REIT into a refurbishment or redevelopment phase at one time – so that rents temporarily fall – could damage the financial ratios needed to stay within the regime.

Where to now?

The Government, with encouragement from the real estate industry, has produced a workable framework for UK-REITs. This has been widely welcomed.

However, even quoted companies should not assume that the UK-REIT is the only way forward or the most appropriate for all commercial circumstances. For others, such as unquoted companies, fund managers or operating businesses long in real estate, the answers are even less obvious.

All the impacts – and not just the tax – must be carefully considered before taking the plunge. There are still alternative tax efficient structures to be considered, the return on investment must be modelled and the accounting and corporate governance effects thought through.

Should a company set up or become a UK-REIT? There are a lot of questions to be considered before companies find the right answer for their business.

For more help on how to evaluate REITs options please contact [Ros Rowe](#) or [Victor Clarendon](#).

A sledgehammer to crack a nut?

Stamp duty land tax after the Budget 2006

The dust has yet to settle fully, but it is clear from the current text of the Finance Bill that there will be winners and losers following the recently announced changes to the stamp duty land tax (SDLT) regime.

Most partnerships should benefit from clarifications and simplifications to the complex partnership-specific SDLT rules (Schedule 15 to Finance Act 2003). Certain trading partnerships will be pleased with a new exemption for transfers of interests in those partnerships. Partnerships will also welcome amendments to prevent potential double charging of SDLT on certain transactions that will bring the actual statutory provisions in line with the outcome intended.

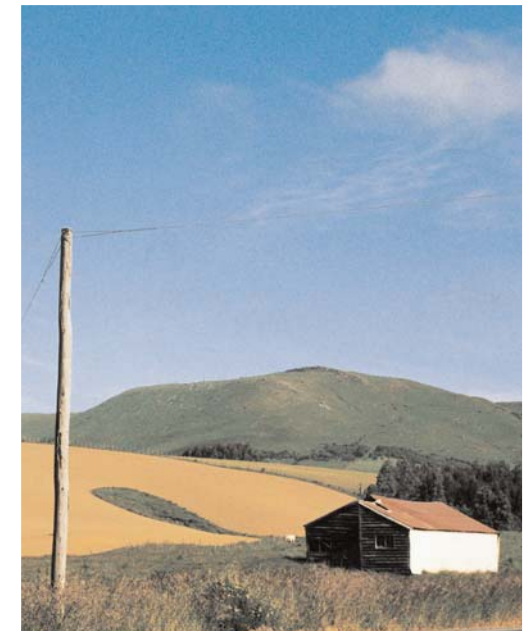
Putting the winners to one side, this year it is those who are less well off who take centre stage. Step forward, but no bows please, property unit trusts.

In one sense, the abolition of seeding relief for unit trusts (s.64A Finance Act 2003) is not unexpected. Indeed, companies might wonder why the relief survived last year's Finance Act given that for some time HMRC has been open about its concerns that seeding relief was being abused. HMRC felt that an increasing volume of high-value, single-asset sales being structured by means of a contribution to an offshore unit trust (relieved from SDLT by s.64A) followed by

a sale of the units in that unit trust (outside the scope of SDLT and, ordinarily, stamp duty reserve tax) had stripped away the commercial credibility of the relief.

However, some may feel that the abolition of seeding relief is using a sledgehammer to crack a nut. Flowing from the Government's high-level policy of encouraging greater collective investment in real estate (in the interests of promoting market liquidity and development financing), the original purpose of the relief was to permit the SDLT-free creation of commercially-managed property unit trusts. Many institutional investors with large property portfolios saw the potential to attract desirable third-party investment into those portfolios without an upfront 4% SDLT charge.

The new REITs regime could be the way forward. REITs may not be suitable for all companies though, as the 2% conversion charge will be on top of any SDLT arising from restructuring a corporate group in circumstances where only a portion of that group will be converted into a REIT.



It remains to be seen how the new SDLT changes, and REITs options, will affect the real estate industry.

For more information on SDLT considerations please contact [Craig Leslie](#).

