

# 2006 Pre-Budget Report



**HM Revenue  
& Customs**

PBRN 03

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## UK REAL ESTATE INVESTMENT TRUSTS

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### Who is likely to be affected?

1. Companies and groups of companies whose main business is property investment and which intend or are considering joining the Real Estate Investment Trust (UK-REIT) regime, and charities that invest in shares of such companies.

### General description of the measure

2. The measure will make changes to the UK-REIT regime that exempts income from and gains made on property from tax, provided the company or group meets certain conditions.
3. The conditions to be met when giving notice and on joining the regime will be relaxed, to make it easier for newly-established companies to become UK-REITs. Other changes will be made to respond to problems that have been identified as companies and HMRC have been working towards implementing the regime.

### Operative date

4. The changes will have effect on and after the start date of the regime, 1 January 2007.

### Current law and proposed revisions

#### Current law

5. The rules for the UK-REIT regime are contained in Part 4 of Finance Act (FA) 2006 and in regulations laid on 1 November 2006.
6. Provided the company or group meets certain conditions and has given notice to join the UK-REIT regime, the profits of its property rental business are exempt from tax. One condition is that 90% of the income of the tax-exempt business is distributed to shareholders within twelve months of the end of the accounting period.

7. Before a company (principal company in the case of a group Real Estate Investment Trust) can give notice to join the regime, the company must not be 'close' (controlled by five or fewer shareholders) and its shares must be listed on a recognised stock exchange. An entry charge of 2 per cent of the market value of their investment properties is chargeable at the date the company or group joins the regime.
8. From the day the company or group becomes a UK-REIT, 75 per cent or more of its assets must be investment property and 75 per cent or more of its income must be rental income (the Balance of Business Conditions). Property that is owned and occupied by the company or group, and rental from it, does not count towards the 75 per cent asset or income test. For the purposes of the Balance of Business Conditions, the measure of income excludes a range of large or unusual items, such as unrealised capital gains.
9. There are limits on the nature and amounts of funding. The company (principal company in the case of a group) must not borrow money on terms that are linked to its profits. Additional tax is payable if the ratio of profits to financing costs falls below 1.25 (the interest cover test).
10. If a UK-REIT de-merges its business into two separate parts, both parts might meet the conditions for being in the regime. One (or possibly both) would not be a UK-REIT for the accounting period in which the de-merger took place and would face fresh entry charges if they subsequently chose to join the regime in their own right. Where one UK-REIT takes over another UK-REIT, the rules that cause these administrative problems and double entry charge are set aside.
11. In the hands of the shareholders, distributions of a UK-REIT's tax-exempt income are treated as income from UK property. The charitable exemption from tax on property income depends on the income arising from an interest in land owned by the charity. Property income distributions paid by a UK-REIT are taxable in the hands of a charity, because the charity derives the income from ownership of shares, and not from an interest in land.
12. There are limits on the nature and amounts of funding. The company (principal company in the case of a group) must not borrow money on terms that are linked to its profits. Additional tax is payable if the ratio of profits to financing costs falls below 1.25 (the interest cover test).
13. Where a UK-REIT carries on a joint venture via a limited company, the activities of the joint venture company can be taken into account in deciding if the UK-REIT meets the regime conditions. To the extent of the UK-REIT's involvement, the joint venture company's property rental business is tax-exempt and an Entry Charge is payable.

#### Proposed revisions

14. The first proposed revision is to make it easier for a newly-established company to become a UK-REIT. This is done by relaxing the conditions

that must be met before giving notice to join the regime and extending the rules for minor breaches of the Balance of Business Conditions for newly-established companies.

15. The company (principal company of a group) will no longer need to have its shares listed on a recognised stock exchange (Company Condition 3 in section 106 FA 2006) on the date they give notice. Instead the company must affirm that it reasonably believes it will meet that condition on the day they actually join the regime, and must meet that condition continuously thereafter to remain in the regime.
16. The consequences of breaching the Balance of Business Conditions are in regulation 7 SI 2006/2864, and the necessary extensions will be made as amendments to these regulations. The extensions will affect newly-established companies that breach the 75 per cent tests during the first accounting period after they join the regime.
17. Where the asset test is failed on the first day in the regime, an additional amount of tax will be charged for that accounting period that equates to 2 per cent of the excess of the market value of investment property at the end of the first accounting period over its market value at the start. If the 75 per cent asset test is not met at the end of the first accounting period, the company or group will be treated as though it never had been in the regime.
18. The other proposed revisions fall into three broad areas:
  - definition of various terms used in the UK-REIT legislation, including
    - ‘owner-occupied’ for the purposes of tax-exempt income and excluded income,
    - ‘profits’ and ‘financing costs’ as used in the interest cover test, measure of profits of the tax-exempt business and the Balance of Business Conditions, and
    - ‘profit-linked loans’ that are prohibited;
  - extension of the UK-REIT take-over rules to de-mergers; and
  - ensuring charities are exempt from tax on distributions from UK-REITs in the same circumstances that are exempt from tax on UK dividends.
19. Currently there are slightly different definitions of ‘owner-occupied’ for the two purposes, in section 107 and Schedule 16 FA 2006 respectively, but both are intended to achieve the same result of excluding owner-occupied property from the tax-exempt ring fence. The proposed revision will remove Tax-exempt business Condition 3 in section 107 (no owner-occupied property) and the associated definitions and amend the definition in Schedule 16 that sets out the kinds of property business that are excluded from the ring fence, to reflect the nuances of the definition that were in section 107.
20. The definition of ‘profits’ for the interest cover test in section 115 FA 2006 is slightly ambiguous about the role of losses brought forward from previous periods. The proposed revision will make clear that these are excluded.

21. In computing the profits of the tax-exempt business, deductions are allowed for 'financing costs' which includes debits and credits from derivative contracts that hedge risk in relation to assets of the property rental business (section 120(3) and (4) FA 2006). The proposed revision will make it clear that this includes derivative contracts that hedge risk in relation to rent and expenses related to an asset, as well as to the asset itself.
22. In the Balance of Business income test in section 108(2) FA 2006, the intention is to exclude 'lumpy' or exceptional items from the measures of profits so that companies do not face exclusion from the regime as the result of a one-off event that skews the outcome. The current range of exclusions in section 108(2)(b) and in regulation 7 SI 2006/2866 can give different results depending on the accounting treatment adopted for some items, such as fair value changes in interest rate swaps. The proposed revision will remove this anomaly.
23. The definition of 'financing costs' used in the top line of the fraction for the interest cover test in section 115(4) FA 2006 differs slightly from the definition for the purposes of computing profits of the tax-exempt business in section 120(3) FA 2006. The proposed revision will bring the section 115 definition into line with the section 120 definition.
24. Where a UK-REIT de-merges in to two parts, both of which meet the conditions for being a UK-REIT, the proposed revision will set aside the rules that result in termination and re-entry, in the same way that the rules in paragraph 33 Schedule 17 FA 2006 do when one UK-REIT takes over another UK-REIT.
25. It is proposed to extend the provisions that apply to joint ventures carried on via a limited company to apply also to those carried on by more complex structures. This will be done by extending the existing Joint Venture Regulations (SI 2006/2866).
26. The final proposed revision will extend the exemption from tax on property income for charities in section 505 of the Income and Corporation Tax Act 1988 to property income distributions received from a UK-REIT.

#### **Further advice**

27. If you have any questions about this change, please contact Rosemary Danielian on 020 7147 2623 or Claire Gough on 020 7147 2548. Information about Pre-Budget Report measures is available on the HM Revenue & Customs website at [www.hmrc.gov.uk](http://www.hmrc.gov.uk)