REIT spells a new way to invest in property

Real Estate Investment Trusts have created wider access to property investment in the United States and may soon be available in Britain. Cristina Arumi *and* Jonathan Ivinson, *Tax Partners of the international law firm Hogan & Hartson, explain how they work.*

Mark Twain said: "Buy land – They don't make it anymore". But investing in land and property has often been the preserve of the already rich.

Two things have changed this recently. The first is the rise of the 'buy to let' phenomenon, fueled by easier access to commercial mortgages. The second is a new concept, the Real Estate Investment Trust or REIT as it is commonly known.

REITs are a way ordinary investors can place money into a special vehicle created to make major property or land purchases and which work in a similar way to Unit Trusts in relation to equity holdings.

They are tax friendly, in that tax is only levied at the investor level, not both at the entity level and at the investor level. In the 2003 pre-budget report, the Chancellor announced a public consultation on the introduction of a REIT-type vehicle in the UK, which would likely be known as the "PIF" or "Property Investment Fund."

The decision was greeted enthusiastically by stock-market quoted property companies in particular. It is widely believed that the lack of tax transparency is one of the main reasons why quoted property companies trade at a discount on stock exchanges compared to the values of companies in other industry sectors.

The first REIT regime was introduced in the United States in 1960. The vehicle was designed to facilitate investments in large-scale income-producing real estate by smaller investors.

The US model was simple, enabling small investors to acquire equity interests in vehicles holding large-scale commercial property in the same way that they invested in other industry sectors, by buying shares in publicly-traded mutual funds.

In order to ensure that the US REIT is widely-held, it must have at least one hundred shareholders, no five or fewer individual shareholders can own more than 50% of the equity value of the REIT shares and the REIT must be managed by one or more trustees or directors.

At least 75% of the gross income of the vehicle must come from real estate related sources and at least 95% of the REIT's gross income must come from real estate related and other passive income sources. At least 90% of taxable income must be distributed annually.

This income is then taxed in the hands of the investors as dividends, or in the case of capital gains realized by the REIT from the sale of property and distributed to investors, as capital gains favourable rates).

Currently, investors in UK quoted property companies suffer double taxation as investors pay tax on dividend income while the company pays corporation tax and capital gains.

The significance of a REIT is that it is tax transparent, meaning that there is no liability for tax on income or capital gains (provided the REIT operates within the appropriate rules) with investors paying tax on their dividends and any capital profits arising from the sale of their share investment.

The US REITs sector has boomed in the last decade. The market currently has more than 200 companies with a total market value of $310 billion. A US REIT achieves tax transparency by allowing companies to deduct dividends paid to investors and requiring that the vast majority of income be paid out to investors on a current basis, which can limit a REITs ability to reinvest its profits.

So, although income is exempt at the REIT level, the bulk of the income earned by a REIT will be passed on almost immediately to the investors to be taxed in their hands.

The vehicle also is subject to numerous restrictions relating to the nature of the activities which may be undertaken by the REIT, although in the US, a REIT is allowed to conduct a limited amount of non-qualified activities, such as development and dealing activities, through taxable subsidiaries.

The main purpose of the restrictions is to make the REIT a conduit for rental income, limiting the other active business activities of the REIT, thereby creating a distinction between the tax transparent "passive" REITs and "active" companies that pay tax at the company level.

It is likely that the UK will introduce similar restrictions on the assets and activities of the UK REIT-type vehicle, as well as a minimum distribution rule.

The Government believes that the introduction of REITs will represent a major boost for the private rental housing market, encouraging widespread access to the buy-to-let market in particular. In the context of declining house prices in the UK, they will be hoping that REITs will play a part in a swift recovery.

Cristina Arumi and Jonathan Ivinson
Hogan & Hartson