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## Section 15 and Schedule 3: real estate investment trusts

A special tax regime for real estate investment trusts (REITs) was originally enacted in the Finance Act 2006 with the intention of encouraging investment in UK real estate.[1] The broad effect of the regime is that, in so far as the REIT carries on a property business, it is effectively a form of tax-transparent property investment vehicle in that tax on the REIT's property business income and gains is payable by its investors, and not by the REIT.[2] Given the benefits of such treatment, a REIT must meet a number of conditions set out in the legislation (now in Part 12 of the Corporation Tax Act 2010 (CTA 2010)), including a requirement to distribute at least 90 per cent of its property business profits arising in each accounting period.

In the 15 years in which the REIT regime has been in effect, a number of changes have been made to these conditions with a view to enhancing the regime's attractiveness.[3] Of these changes, perhaps the most significant to date were those made by the Finance Act 2012 (FA 2012) which resulted in the abolition of the so-called entry charge and a relaxation of the non-close condition (Condition D) in section 528(4) CTA 2010 (allowing a REIT to be closely-held by certain specified categories of institutional investor).[4]

Given that the government sees REITs as a fund-type vehicle, it is not surprising that REITs have featured in the recent flurry of consultation activity connected with the government's current

[1] John Challoner, "Real estate investment trusts" [2006] B.T.R. 20.

[2] The REIT itself benefits from an exemption from corporation tax on profits and gains arising from its property business; shareholders are taxed on distributions of such (exempt) profits and gains as if they were profits of a property business carried on by that shareholder (CTA 2010 ss.534, 535 and 548).

[3] Many of these have been commented on in previous years' *British Tax Reveiw* Finance Act notes (e.g. on Finance Act 2007, Finance Act 2009, Finance Act 2012 and Finance Act 2013).

[4] Finance Act 2012 (FA 2012) Sch.4. The abolition of the entry charge was provided for in FA 2012 Sch.4 para.33 and the close company relaxation in para.4.

review of the UK's funds regime (which was announced at Spring Budget 2020).[5] The first stage consultation on the tax treatment of asset holding companies (AHCs) in alternative fund structures published on 11 March 2020 asked for views on changes to the REIT rules that would enhance the UK's attractiveness to funds.[6] The second stage consultation on AHCs, published in December 2020, devoted an entire chapter to the REIT regime,[7] asking for comments on a (limited) number of specific proposals intended to reduce administrative and costs burdens for existing REITs whilst, at the same time, holding out the prospect of further reforms as part of the government's Wider Funds Review.

The amendments to the REIT regime contained in Schedule 3 to the Finance Act 2022 (FA 2022) are therefore limited to the specific proposals set out in the second stage consultation on AHCs. Their focus is on simplifying some of the compliance obligations to which REITs are subject under the regime. Conceptually, the changes are relatively easy to understand, but the same cannot be said for the legislation that enacts them: this is mainly because the changes require a lot of small (but detailed) amendments to existing provisions. As a result, trying to read the FA 2022 changes into the existing REIT rules can feel like doing a jigsaw without the benefit of the picture on the box: it is only when you see the changes actually incorporated in Part 12 CTA 2010 that you can hope to make sense of them.

In terms of whether other changes to the REIT regime are likely in the near future, shortly before Royal Assent to FA 2022, the government confirmed that it would establish "a new work-stream as part of the UK funds regime review" to evaluate the case for further reform.[8] Although it has not yet committed to a specific timeline for this new work-stream, it does seem that, 15 years after the REIT regime first came into being,[9] the government is embarking on another "continuing process…of enhancements to the REIT regime".[10]

The changes made by FA 2022 affect the listing condition, the definition of institutional investor for the purposes of the non-close condition, the condition that the REIT delivers to HMRC certain financial statements each year, the balance of business conditions and the holder of excessive rights rules.

[5] HM Treasury, *Red Book, Budget 2020. Delivering on our promises to the British People* (TSO, 2020), HC Paper No.121, para.2.208, *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/871799/Budget_2020_Web_Accessible_Complete.pdf* [Accessed 15 September 2022].
[6] HM Treasury, *Tax treatment of asset holding companies in alternative fund structures: consultation* (TSO, 2020), para.3.23, *https://www.gov.uk/government/consultations/tax-treatment-of-asset-holding-companies-in-alternative-fund-structures* [Accessed 15 September 2022].
[7] *HM Treasury, The Tax Treatment of Asset Holding Companies in Alternative Fund Structures—Government response and second stage consultation* (TSO, 2020), Ch.5, *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/947430/201211_AHC_consultation_2_Final_document.pdf* [Accessed 15 September 2022].
[8] HM Treasury, *Review of the UK funds regime: a call for input—Summary of responses* (TSO, 2022), para.2.56, *https://www.gov.uk/government/publications/review-of-the-uk-funds-regime-a-call-for-input* [Accessed 15 September 2022].
[9] Finance Act 2006 s.145(1).
[10] In his Finance Act note on Finance Act 2013, Michael Hardwick referenced there having been "a continuing process over recent years to enhance the real estate investment trusts (REIT) regime" (Michael Hardwick, "Section 39 and Schedule 19: real estate investment trusts: UK REITs which invest in other UK REITS" [2013] B.T.R. 422). History appears to be repeating.

**Relaxation of the listing condition: the alternative Condition C—Schedule 3 paragraph 2**

When the REIT regime was introduced, the government's key objectives included creating a vehicle that would provide smaller scale retail investors with access to returns from commercial property.[11] Requiring a REIT to be listed was seen as a way of helping ensure broader access for small investors as well as providing a market place for REIT shares.[12]

But, since 2012, a REIT that is "closely-held" by one or more institutional investors can qualify for the regime (assuming the other conditions are met).[13] As a result, it became possible to set up REITs that operated as a joint venture between a small number of institutional investors—and even captive REITs (that is, with one investor only). But as there was no corresponding change to the listing condition (Condition C), a closely-held REIT still had to list its shares to benefit from the regime, resulting in both cost and compliance burdens.

Ten years on from the changes to the non-close condition that allowed institutionally-owned REITs, the government has accepted that, in some cases, the listing condition "has no obvious benefit" and can be removed.[14] Initially the government considered that this was the case only where the REIT was wholly owned (or almost wholly owned) by qualifying institutional investors (which meant that at least 99 per cent of the REIT must be owned by institutional investors).[15] By the time the Finance Bill was published in November 2021, however, that ownership threshold had been reduced to 70 per cent[16] (coincidentally—but perhaps deliberate—the same threshold used in the ownership condition for qualifying asset holding companies).[17] As a result, to paraphrase (broadly—and borrowing from other tax provisions), a REIT that is "wholly or mainly" owned by institutional investors should not have to list—and in practice this should allow most (if not all) existing institutionally-owned REITs to benefit from the change.

The amendments made by paragraph 2 of Schedule 3 FA 2022 do not, however, remove the listing condition as such. Instead, the amendments create an alternative Condition C (a new section 528(3)(b) CTA 2010). Under this alternative Condition C, a REIT with the relevant percentage of institutional investors will meet Condition C without having to list its shares. The REIT can still choose to list—in which case it will meet both the original Condition C (that is, being listed—now section 528(3)(a) CTA 2010) and the new alternative Condition C (that is, at least 70 per cent owned by institutional investors).

[11] HM Treasury and HMRC, *UK Real Estate Investment Trusts: a discussion paper* (TSO, 2005), *https://webarchive.nationalarchives.gov.uk/ukgwa/20060213233445/http://www.hm-treasury.gov.uk/budget/budget_05/other_documents/bud_bud05_odreits.cfm* [Accessed 15 September 2022].

[12] HM Treasury and HMRC, *UK Real Estate Investment Trusts: a discussion paper* (2005); and also see HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response to second stage consultation* (TSO, 2021), para.3.26, *https://www.gov.uk/government/consultations/taxation-of-asset-holding-companies-in-alternative-fund-structures-second-stage-consultation* [Accessed 15 September 2022].

[13] CTA 2010 ss.528(4), (4A).

[14] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response to second stage consultation* (2021), para.3.79.

[15] Finance (No.2) Bill 2021–2022 Sch.1 (Real Estate Investment Trusts: amendments) cl.2(a) (20 July 2021), *https://www.gov.uk/government/publications/real-estate-investment-trusts-amendments* [Accessed 15 September 2022).

[16] Ownership for these purposes means ownership of the REIT's ordinary share capital (if the REIT is a group REIT, this means ownership of the ordinary share capital of the principal company of the group REIT).

[17] FA 2022 Sch.3 para.3(1). Although the ownership condition refers to a 30% threshold, this applies to non-category A investors. Therefore, the threshold for category A investors is at least 70%.

If a REIT decides not to list, but then finds that its level of institutional ownership falls below the 70 per cent threshold, the legislation deems the alternative Condition C to continue to be met for a 12-month period. This grace period is designed "to avoid creating a cliff-edge where REIT status could be terminated immediately following a change of ownership"[18] and gives the REIT time to arrange a listing to be able to meet the original Condition C.

The ability to satisfy the so-called listing condition without being listed means that one further change was needed and so paragraph 2(1) of Schedule 3 FA 2022 effectively disapplies section 528A CTA 2010 for as long as the REIT meets (or is deemed to meet) Condition C on the basis of ownership by institutional investors (necessary as, without a listing, section 528A CTA 2010 could not be met).[19]

The changes to the listing condition apply for accounting periods of a REIT that begin on or after 1 April 2022.[20]

**Definition of institutional investor—Schedule 3 paragraph 2**

The list of institutional investors in section 528(4A) CTA 2010 was enacted in FA 2012 in connection with the relaxation of the non-close condition (Condition D).[21] The normal close company rules apply in determining whether Condition D is met, as a result of which an institutional investor must be a direct participator in the REIT for their ownership to be taken into account.

Although the alternative Condition C uses the same list of institutional investors as Condition D, the government has chosen not to follow the same approach in terms of limiting ownership to direct participation. Instead the government has borrowed from Schedule 5AAA to the Taxation of Chargeable Gains Act 1992 (TCGA), allowing account to be taken of both direct and indirect ownership by institutional investors (and indeed a hybrid of the two) for the purposes of Condition C.[22]

Further, the FA 2022 changes also provide clarity as to how to work out ownership interests where the investor in the REIT is a partnership. The general rule is that the transparency of the partnership is respected (and so you look through the partnership to the partners themselves)—but there is a significant exception to this general rule where the partnership: (a) is an investor within section 528(4A)(c) CTA 2010 (that is, a limited partnership that is a collective investment scheme); and (b) meets the genuine diversity of ownership (GDO) test.[23] For these purposes, again borrowing from Schedule 5AAA TCGA, the GDO test has been modified so that it is capable of applying (sensibly) to a closed-ended fund.[24]

Therefore, where an investor within section 528(4A)(d) CTA 2010 satisfies this modified GDO test, there is no look-through: instead it (and not its partners) is regarded as an institutional

[18] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response to second stage consultation* (2021), para.3.80.
[19] FA 2022 Sch.3 para.2(1), Sch.3 enacting the new CTA 2010 s.527(3A).
[20] FA 2022 Sch.3 para.6.
[21] CTA 2010 s.528(4A).
[22] CTA 2010 s.528ZA as enacted by FA 2022 Sch.3 para.2(3).
[23] FA 2022 Sch.3 para.2(3) inserting CTA 2010 s.528ZA(7).
[24] FA 2022 Sch.3 para.2(3) inserting CTA 2010 s.528ZB(2)–(5) (cf. TCGA Sch.5AAA paras 46(4) and 46A).

investor when applying the alternative Condition C (even if all its partners are not themselves institutional investors).[25]

The summary of responses to the second stage consultation on AHCs indicates that some respondents had argued for an equivalent look-through to apply to the non-close condition so that indirect participation could be taken into account.[26] Although the government's answer to that was "no", it was more of a "no for now" than an outright rejection—this is because the possibility of changes to the non-close condition has been held over for consideration as part of the Wider Funds Review.[27] But now a look-through has been allowed for the listing condition, it seems difficult to see why a similar change cannot be made to the non-close condition. However, for the moment, further change to the non-close condition does not seem likely to happen any time soon.[28]

Although the changes described above only apply for the purposes of the alternative Condition C, paragraph 2 of Schedule 3 FA 2022 includes one change to the definition of institutional investor that will apply for both the alternative Condition C and the non-close condition. The definition of "overseas REIT equivalent" in section 528(4A)(j) CTA 2010 has been amended by removing the requirement that the overseas REIT's local law must mirror the UK REIT regime if the overseas REIT is to qualify as an institutional investor.[29] Going forward, HMRC have said that the test of overseas REIT equivalence for these purposes is intended to be more closely aligned to the OECD definition of a REIT.

These changes also come into effect in relation to accounting periods of a REIT beginning on or after 1 April 2022.

### Financial statements—Schedule 3 paragraph 3

A REIT is required to provide HMRC with certain financial statements for each of its accounting periods. These statements enable HMRC to assess compliance with various REIT conditions (primarily the balance of business condition).[30] The content of these statements is prescribed by legislation.[31]

Until FA 2022, these financial statements had to set out information for the group overall and also for individual members of the group (which, for the larger REITs, could easily number more than 100 companies). The effect of the changes made by paragraph 3(2) of Schedule 3 FA 2022 is that, where it is seen as obvious that a REIT will satisfy the balance of business condition, the

[25] FA 2022 Sch.3 para.2(3) inserting CTA 2010 ss.528ZA(7) and 528ZB(1).
[26] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response to second stage consultation* (2021), para.3.82.
[27] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response to second stage consultation* (2021), para.3.84.
[28] HM Treasury, *Review of the UK funds regime: a call for input—Summary of responses* (TSO, 2022), para.2.57, *https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/1053909/Final_UK_Funds_Regime_Review_-_Call_for_Input_Summary_of_Responses.pdf* [Accessed 15 September 2022].
[29] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response to second stage consultation* (TSO, 2021), para.3.85.
[30] CTA 2010 ss.527(2)(e) and HMRC, Internal Manual, *Investment Funds Manual* (27 July 2022), IFM22300, "Real Estate Investment Trust: Group conditions and rules: Financial statements: basics: CTA2010/S532 - S533".
[31] CTA 2010 ss.532 and 533, and the Real Estate Investment Trusts (Financial Statements of Group Real Estate Investment Trusts) Regulations 2006 (SI 2006/2865).

requirement to provide financial information for individual members will fall away.[32] After all, if it is so obvious, do HMRC really need the granularity of detail provided by member level information?

The legislation is, of course, slightly more sophisticated than this suggests. Reflecting the fact that there are actually two balance of business conditions (one for profits and one for assets), the new rules apply separately to profits of a REIT and its assets. This means that a REIT may find itself still having to provide information at individual member level about profits whilst able to report asset values at group level only (or vice versa). But in either case, the same approach applies to determine whether it is so obvious that a REIT meets the relevant balance of business condition that HMRC do not need member level information. Basically the REIT needs to work out whether or not it would meet the relevant balance of business condition using its group statement only, substituting 80 per cent for the 75 per cent required by the actual balance of business conditions.[33] HMRC describe this as a gateway—that is, if, using 80 per cent, a REIT would meet the balance of business condition for either profits or assets (or both), then it passes through the gateway to the other side, where it is rewarded with simplified (and so less costly) reporting obligations.

If the REIT does not pass through the gateway, its position is the same as it was before these changes—that is, providing member level information within its financial statements.[34]

For many REITs, of all the changes made in FA 2022, this is likely to be of most benefit in practical terms, particularly given the links to the (actual) balance of business condition (as discussed next). However, for now, it is a benefit deferred as the gateway only applies to accounting periods that begin on or after 1 April 2022.[35]

**The balance of business condition—Schedule 3 paragraph 4**

As referenced above, the REIT balance of business condition is actually two conditions—one relating to profits, and the other to assets. The conditions are designed to ensure that the main activity of the company is property investment.

The second stage AHC consultation asked for views on a single technical change to the (income) balance of business condition involving the exclusion of profits resulting from compliance with planning obligations entered into in accordance with section 106 of the Town and Country Planning Act 1990.

But as a result of consultation on the draft Finance (No.2) Bill legislation the changes made to the balance of business condition by paragraphs 3 and 4 of Schedule 3 FA 2022 go beyond this one change.

First, the same so-called gateway that applies to the financial statements requirement also applies to the actual balance of business conditions.[36] So if a REIT passes through the 80 per

[32] CTA 2010 s.533(1)(a) as amended by FA 2022 Sch.3 para.3(2)(a)(i).
[33] FA 2022 Sch.3 para.3(2)(c) inserting CTA 2010 s.533(1B) (profits) and s.533(1G) (assets).
[34] FA 2022 Sch.3 para.3(2)(c) inserting CTA 2010 ss.533(1B) and (1C) (profits) and ss.533(1D), (1F) and (1)(G) (assets).
[35] FA 2022 Sch.3 para.6(1).
[36] FA 2022 Sch.3 para.3(2)(c) inserting CTA 2010 ss.533(1E) and (1I).

cent gateway in section 533 CTA 2010 for profits and/or assets and only has to provide group level statements, it is deemed to have met the related balance of business condition.

Although this seemed implicit from the government's response to the second stage consultation on AHCs, there was uncertainty as the draft Finance Bill legislation published in July 2021 limited the application of the gateway to delivery of financial statements. It clearly made no sense if, having passed the gateway using a (notional 80 per cent) balance of business condition, the REIT nevertheless had to apply the actual (75 per cent) balance of business condition using individual member information. By the time the Finance Bill was published in November 2021, the legislation had been amended so the gateway applied to the balance of business conditions in section 531 CTA 2010 as well (with the 5 per cent headroom provided by the gateway, using consolidated figures, presumably seen by HMRC as sufficient reassurance that the REIT could be expected to meet the (actual) 75 per cent balance of business conditions in practice).

Secondly, the opportunity has been taken to level up (as it were) the profits and asset balance of business conditions, so that where profits from a particular activity are excluded when applying the profits condition, assets relating to that same activity are excluded under the assets condition. So, for example, the exclusion of profits resulting from compliance with planning obligations in the new section 531(4)(d) CTA 2010 is now matched by an exclusion for assets held for such purposes.[37]

Finally, there are a few tidying changes—this is because, given the obvious links between the balance of business conditions and the contents of the financial statements that a REIT is required to file, changes to one set of provisions have knock-on effects for the other.[38]

These changes take effect for accounting periods beginning on or after 1 April 2022.[39]

## Holder of excessive rights—Schedule 3 paragraph 5

The final change made by FA 2022 relates to the holder of excessive rights rules in sections 551–553 CTA 2010, which are intended to discourage investors from holding interests of 10 per cent or more in a REIT. This is because, although certain dividends (property income dividends or PIDs) paid by a REIT are treated as property income for UK tax purposes,[40] they are still dividends for treaty purposes. Under many treaties, a holding in a company of 10 per cent or more allows an investor to benefit from reduced dividend withholding tax rates—and the holder of excessive rights rules are directed at ensuring those reduced rates cannot apply so that withholding tax is charged at the full basic rate (currently 20 per cent).[41]

Paragraph 5 of Schedule 3 FA 2022 amends the definition of holder of excessive rights to exclude those investors who are entitled to receive PIDs free of withholding: after all, if withholding is in any event 0 per cent, treaty relief is irrelevant. In practice, this means only a limited number of categories of investor can benefit—basically, UK resident companies, local

[37] CTA 2010 s.531(7A).
[38] Note that items excluded when applying the balance of business condition still need to be reported in the financial statements though (CTA 2010 s.533(1) as amended by FA 2022 Sch.3 para.3(2)).
[39] FA 2022 Sch.3 para.6.
[40] CTA 2010 s.548.
[41] Income Tax Act 2007 s.983. If a reduced treaty withholding rate applies, the holder of excessive rights rules impose a corporation tax charge on the REIT (CTA 2010 ss.551–552).

authorities, charities and some UK pension schemes.[42] This amendment takes effect on 1 April 2022.

For other investors, it is possible in practice to avoid the application of these rules by fragmenting their holding between different entities—an inconvenience, but preferable to the tax charge that would otherwise be imposed on the REIT under section 551 CTA 2010. Those other investors include sovereign immune investors. Some stakeholders had suggested that these too should be excluded from the holder of excessive rights rules given that their immunity meant that they could in any event reclaim the tax withheld from a PID. In fact, HMRC's own guidance on the holders of excessive rights rules says "the policy objective…does not apply to sovereign immune entities and they should not come within the HoER rules".[43] However the government said no, on the basis that immunity could be "an area of uncertainty".[44] A year on, this comment seems very prescient: that uncertainty now includes the prospect of sovereign entities no longer having immunity from UK direct taxes.[45] If the proposals in the consultation on removing sovereign immunity are taken forward, treaty entitlement could become very relevant for those sovereign entities that are no longer immune.

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[42] Real Estate Investment Trusts (Assessment and Recovery of Tax) Regulations 2006 (SI 2006/2867) reg.7.
[43] HMRC, Internal Manual, *Investment Funds Manual* (27 July 2022), IFM22105, "Real Estate Investment Trust: Conditions and Tests: maximum shareholding: definitions".
[44] HM Treasury, *The Tax Treatment of Asset Holding Companies in Alternative Fund Structures: Government response to second stage consultation* (2021), para.3.90.
[45] HM Treasury and HMRC, *Sovereign immunity from direct taxation: Consultation on policy design* (TSO, 2022), *https://www.gov.uk/government/consultations/sovereign-immunity-from-direct-taxation-consultation-on-policy-design* [Accessed 15 September 2022].
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