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Client briefing
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UK Budget 2011
Encouraging investment in Real Estate

Yesterday the UK Government announced a consultation on the UK REIT regime with a view to kick-starting interest in establishing new REITs. It will concentrate on changing a number of problem areas which have stunted the entry of new REITs into the market to date: the requirements for diversity of ownership and listing, as well as the 2% entry charge.

With a view to encouraging investment in the residential property sector, the Government also announced the introduction of a new stamp duty land tax (transfer tax) relief for the acquisition of more than one dwelling. This, together with REIT changes, could result in the creation of residential portfolios within a REIT wrapper.

The proposed changes to the UK REIT regime, together with this stamp duty relief, may be the regulatory change that means the UK REIT market can follow in the footsteps of the more mature US REIT market.

The UK REIT rules that came into force on 1 January 2007 focussed on the need for a REIT to be a listed entity with a broad investor base. This was reflected in detailed conditions (including, in particular, the "non-close company" condition). This meant in practice that initial take-up was generally limited to existing listed property investment groups, with very limited growth in the UK REIT sector since then.

Over the last couple of years the property industry has been lobbying to seek relaxation of some of the more prescriptive REIT conditions to allow new entrants to join the regime with an overall purpose of encourage growth in the UK real estate sector, both in commercial and residential property. This lobbying was looking to create a second wave of REIT conversions, through facilitating so-called "private REITs".

These efforts appear to have been rewarded by the announcement of this consultation. Its stated purpose is to identify whether changes need to be made to the REIT regime, in terms of both the entry conditions and the on-going compliance obligations. In particular the Government has announced that it is seeking views on the following:

- relaxing the requirement for a UK-REIT to be listed on a recognised stock exchange (with a view to facilitating adoption of the REIT regime by start-up AIM-listed or unlisted property investment companies);

- introducing a fixed grace period for new REITs to meet the "non-close company" condition in order to allow start-up UK-REITs to benefit from the regime whilst they build their reputation and attract investors over time;

- facilitating the setting up of REITs by institutional investors (who would be likely to maintain a seed interest) by introducing a diverse ownership rule for such investors (again, to allow the "non-close company" condition to be met); and

- abolishing the (2%) conversion charge for companies joining the REIT regime.

Key Issues

- **Government announces consultation that could potentially lead to radical changes to the UK REITs regime**
- **Private REITS could be a possibility**
- **New SDLT relief for acquisitions of residential portfolios**

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As well as these potentially radical changes, the consultation will include looking at whether cash can be treated as a "good" asset when applying the REIT balance of business asset test (to give REITs more flexibility in terms of timing their investment decisions) and whether "financing costs" for the REIT interest cover test should be redefined to give more certainty as to what is "in" and what is "out". The interest cover test has been the subject of much discussion in the industry in the recent past given in particular the implications of financial crisis on REITs. In addition, the consultation will consider extending the time limit in which the distribution condition needs to be met in particular circumstances where stock dividends are paid by REITs to reduce the administrative burden for such REITs as well as other (unspecified) technical changes to the rules.

Any legislative changes resulting from the consultation will be included in Finance Act 2012. The fact that the Government seems to be already committing to make legislative change suggests that something will be done – though what exactly will appear on the statute books will depend on the consultation exercise itself.

As mentioned above, in addition to the potential use of the REIT regime to attract residential property investment, the Government also announced the introduction of a new relief for purchasers of residential property who acquires interests in more than one dwelling at the same time. The rate of stamp duty land tax (SDLT) will be determined not by the aggregate consideration but instead by the average consideration subject to a minimum rate of 1%. Currently, the top rate of SDLT (4%) is payable on the aggregate consideration (where it exceeds £500,000) whatever the values of the individual properties. Legislation will be introduced in Finance Act 2011 to make this change.

Both the consultation and the proposed tax changes to SDLT will be well received and welcomed by a real estate industry that has been particularly hard hit by the financial crisis.