

Feature

KEY POINTS

- Because the dividend paid by a UK Real Estate Investment Trust ('REIT') is deemed for UK tax purposes to be the *profits* of a UK property business rather than the income, no deductions may be taken against it by an overseas investor.
- While a REIT will not itself suffer tax on its capital gains on its disposals, if the gains are distributed they will fall to be taxed at the basic rate of income tax.
- REITs do not always readily fit snugly into the provisions of the UK's tax treaties.

Author Simon Yates

REIT or wrong? Tax issues for overseas REIT investors

The UK's REIT legislation, enacted in last year's Finance Act, has now been in force for approximately ten months. The REIT regime was quite a long time in planning, and subject to a significant degree of negotiation between the property industry and the government. In the course of the consultation process, a number of potentially awkward wrinkles were ironed out, but some remained.

In particular, the tax position of offshore holders of REIT shares is in many respects somewhat surprising. The position of offshore holders was a key factor in the policy planning for REITs: it was recognised that distributions from REITs would have the character of dividends for double tax treaty purposes whatever they were deemed to be from a UK perspective, and this concern, discussed further below, was an important factor in the 10 per cent shareholding limit.

A VERY BRIEF SUMMARY OF THE REIT REGIME

A company must satisfy a number of conditions in order to secure REIT status. Amongst the most important are that it must be listed, it must not be close, it must meet criteria as to the proportion of its business which is 'property rental business', it cannot borrow over a certain level and it must meet minimum dividend payment criteria. If a company meeting the criteria wishes to become a REIT it may do so by election. It will then pay a one-off entry charge of 2 per cent on the capital value of its property assets, and subsequently is not subject to UK tax on gains and rent deriving from its property rental business.

Dividends paid by REITs are treated for UK tax purposes as the profits of a UK property business. As such overseas shareholders are subject to tax on those dividends at the basic rate of income tax, whilst UK resident shareholders are subject

This article looks at some aspects of the tax treatment of overseas investors in REITs, some of which are advantageous to those investors and some less so.

to tax at their applicable marginal rates of income or corporation tax. REIT dividends are paid to all shareholders net of withholding at the basic rate of income tax.

If a REIT shareholder owning more than 10 per cent of the total share capital of the REIT is paid a dividend, then (effectively) the REIT will suffer a tax charge on the profits out of which that dividend was paid unless it can demonstrate that it has taken reasonable steps to ensure that it had no 10 per cent plus shareholders. Initially the government had hoped simply to prohibit shareholdings of more than 10 per cent being acquired, but it was recognised that in the context of listed companies this would be impossible. As a result, this penal provision on paying a dividend to a shareholder with a greater than 10 per cent interest was introduced.

PARTICULAR ASPECTS OF THE TAXATION OF REIT INVESTMENTS FOR OVERSEAS SHAREHOLDERS

Interest deductions

A dividend paid by a UK REIT is deemed for UK tax purposes to be the *profits* of a UK property business, so making it subject to UK income tax in the hands of an overseas shareholder. Because the dividend is deemed to be profits rather than income, no deductions may be taken against it even in respect of interest where the holder has borrowed from a third party to fund the acquisition of shares. This restriction presumably derives from the policy decision to restrict the level of borrowings available to a REIT. However, it contrasts with the position of a UK-resident corporate REIT shareholder which would be able to use excess loan relationship debits against its deemed profits of a property business.

Capital gains

A non-UK resident investing in UK real property directly (or through a truly transparent investment vehicle such as a partnership) will suffer no UK tax on capital gains made on disposal of that UK land. By contrast, whilst a REIT will not itself suffer tax on such gains, if the gains are distributed they will fall to be taxed at the basic rate of income tax through the mechanism of the withholding tax applied to the REIT's dividends. Whilst this is of little concern to an investor in a jurisdiction which would impose a capital gains tax charge on the sale of directly owned land at a higher rate than the 22 per cent withheld from the dividend (as reduced by any applicable double tax treaty – see over the page), for many investors this will amount to a substantial inefficiency which will be a real disincentive to investing in REITs.

The UK Pre-Budget Report in October introduced an equivalent differential rate between income and capital gains for UK investors. This is likely to lead to REITs distributing gains only in exceptional circumstances.

No non-resident landlords' scheme

Where an overseas person invests directly in UK property, rental income will be paid to him under deduction of basic rate income tax unless he makes an application to be paid gross under the non-resident landlords' scheme. If authority for gross payment is granted, the overseas person will still have to compute and account for UK basic rate income tax on the rent, but is spared the cashflow cost of the withholding tax (and the UK tenants are spared the administrative burden of accounting for the tax). Authority to pay gross will be revoked if the non-resident does not keep its tax affairs up to date.

Biog box

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There is no equivalent to the non-resident landlords' scheme for REIT dividends. Even if the overseas investor satisfies HM Revenue & Customs ('HMRC') that it will meet its UK tax obligations going forward, dividends must still be paid under deduction of basic rate income tax (subject to any relief available under a double tax treaty).

Tax treaties

REITs do not always readily fit snugly into the provisions of the UK's tax treaties. A REIT's status as semi-transparent for tax purposes, whilst still being a company receiving income and paying dividends in legal terms, is not something which was in the contemplation of the draftsmen of all but the most recent tax treaties.

It is acknowledged by HMRC that a distribution paid by a REIT must be regarded as a dividend for the purposes of tax treaties, since as a legal matter that is what it is. The fact that for UK tax purposes it is deemed to represent profits of a UK property business is neither here nor there so far as the overseas resident's fiscal authorities are concerned – the fact is that the receipt is in form a dividend from a UK resident company. (One exception from this general rule is the UK/France treaty, which has a general provision treating investments in real property-owning companies as though they are interests in land).

The 10 per cent shareholding limit was included within the REIT regime largely to prevent REITs being used to enable residents of a large number of overseas jurisdictions to take REIT dividends – and hence effectively UK source rental income – tax free. Most tax treaties provide for complete elimination of withholding tax on dividends paid on a shareholding of more than 10 per cent, whilst permitting a level of withholding (generally 10 per cent or 15 per cent) on dividends on smaller stakes. Some treaties do however provide for a full exemption from withholding, at least in relation to dividends which do not carry a tax credit – most notably those with Cyprus and Finland, along with a number of Caribbean islands and a smattering of African states.

It does not appear that REIT dividends will be 'excluded income' within the

meaning of s 128 Finance Act 1995, with the consequence that the UK will not automatically forego its taxing rights over them to the extent they are paid without deduction of tax. However, the treaty restrictions on taxing dividends would appear to trump any residual entitlement to tax them as property income – as with the withholding analysis, ultimately the fact that the payments are as a matter of law dividends governs the applicability of treaties. In cases where treaty relief is unavailable, withholding will be made at the full rate, so satisfying the offshore holder's tax liability in full.

In many of the UK's tax treaties, the dividend article was drafted in the light of the pre-1999 UK imputation system with advance corporation tax payments. In these treaties, the entitlement to withhold tax from dividends derives in whole or in part from, and is conditional on, UK dividends carrying a tax credit. Whilst the changes wrapped up

UK dividends carry credits or whether the specific dividend in question must carry a credit. By contrast, the UK/Cyprus treaty is explicit in stating that a credit must attach to the particular dividend if withholding is to be imposed, hence the zero rate of withholding available on the payment of REIT dividends to Cyprus.

It would appear that HMRC is taking the interpretation most consistent with the spirit, if not the letter, of the less clear treaties – ie that the lower rate of withholding is all that can be applied unless the specific dividend in question carries a credit. This is apparent from the UK/Belgium treaty, which limits withholding to the rate of 10 per cent where no credit exists, and this is the rate which HMRC states applies in its digest of double taxation treaties. This is reassuring, although alternative constructions of the treaty wording could be taken which would lead to

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with the abolition of advance corporation tax in 1999 reduced the level of the credit attached to a UK dividend to the point where cash refunds to overseas shareholders effectively ceased to be available, technically the credit is still there, so triggering the authority to deduct the maximum amount. However, a REIT dividend carries no tax credit, notwithstanding that tax will have been withheld from it.

It is not entirely clear from the drafting of these treaties whether taxpayers will be able to claim the lower rates of withholding applicable where dividends do not carry UK tax credits. The drafting does not contemplate the possibility that there might be different types of UK dividends, some of which carry credits and some of which do not. As a result, it is in many cases unclear whether it is necessary for all UK dividends to carry tax credits before HMRC may impose the higher withholding levels, whether it is enough that generally speaking

the higher withholding rates being imposed.

CONCLUSION

The REIT regime remains relatively immature and it will only become apparent over time whether it is particularly attractive to overseas investors. The disadvantages discussed above in relation to the taxation of capital gains and the availability of relief for interest payments will in many cases act as a deterrent to investment. However, where investors are resident in treaty jurisdictions then the rate of tax to which their returns are subject may be reduced significantly, in some cases to zero. The availability of zero withholding in some jurisdictions also raises the possibility of international structuring to mitigate the total tax liability borne on REIT-generated profits, although the combination of 'treaty shopping' provisions and the *Indofoods* case may make this more difficult than has previously been the case. ■