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UK REITs and Private Equity Real Estate Funds: Structuring Considerations

Since changes in law in 2022, private UK real estate investment trusts (REITs) have become more popular as a holding vehicle for private equity real estate (PERE) managers investing in UK real estate and the UK's new qualifying asset holding company (QAHC) has gained traction for investments in non-UK real estate and debt investments.

This GT Advisory provides a brief overview of the UK REIT regime before exploring why private UK REITs have become so popular and some of the key considerations for PERE managers looking at using UK REITs.

Key Features of the UK REIT Regime

- 1. Tax Exemption:** A UK REIT is exempt from corporation tax on its property rental business (PRB) profits and on gains from direct and indirect disposals of properties used in its PRB; it remains subject to corporation tax (at 25%) on anything else (referred to as its “residual” profits).
- 2. UK withholding tax on PIDs:** The quid pro quo of the UK REIT's tax exemption is that all profits and gains that have benefited from its tax exemption are subject to UK withholding tax when distributed to investors (unless they have “gross payment” status). These distributions are referred to as property income distributions (PIDs). Currently, the withholding tax rate on PIDs is

20%, but it is due to rise to 22% from April 2027. There is no UK withholding tax on distribution of residual profits.

- 3. Removal of latent capital gains tax:** On corporate real estate deals, it is common in the UK market for buyers to factor any deferred tax liabilities for “latent gains” into pricing for PropCos – i.e. the tax which a target PropCo would suffer if it sold its UK properties. UK REITs can remove such ‘latent gains’, which may be beneficial for pricing.
- 4. Distribution rules:** A UK REIT is required to distribute at least 90% of its PRB profits for each accounting period annually, before the relevant UK corporation tax return deadline. Priority rules also dictate the order in which the UK REIT distributes its profits and gains.
- 5. Qualifying conditions:** A company needs to satisfy various conditions to qualify as a UK REIT. Some conditions are structural and relate to the UK REIT’s ownership and structure. Other conditions are more operational — for example, the annual distribution requirement and conditions around the proportion of assets and profits which are required to be PRB-related.
- 6. Other important rules:** The UK REIT regime also contains various rules which are not qualifying conditions for being in the UK REIT regime, but which may have adverse tax consequences. This includes “holders of excessive rights” rules, the “three-year development rule,” and a REIT-specific limit on debt financing (in addition to the UK’s various tax rules on interest deductibility).

UK REITs’ Popularity as a Holding Vehicle for UK Real Estate

In 2022, the UK government amended REIT legislation to allow for unlisted private REITs owned by qualifying widely held funds (and by other vehicles that have enough “good” investors). These changes opened UK REITs as an option for PERE managers structuring UK investments. Prior to the changes, UK law required all UK REITs to be admitted to trading on a recognised stock exchange (and subsequently listed or traded) and prevented them from being closely held, save for some exceptions in practice for sovereigns.

The key attraction of a UK REIT is tax efficiency. A UK REIT effectively converts what would be UK corporation tax leakage within the structure (at 25%) into UK withholding tax on PIDs (currently, at 20%). That arbitrage may be enhanced further by the fact that some non-UK investors are eligible to reclaim some (or in some cases, all) of the UK withholding tax to get to an effective UK tax rate of 0-15%.

UK REITs’ attractiveness compared to traditional, taxable holding structures (e.g. Luxembourg holding companies) was also boosted by two changes in law that came into effect in the years following the expansion of the UK REIT regime:

- **UK corporation tax rate increase:** From 1 April 2023, the UK corporation tax rate increased to 25% (from 19%). This created the arbitrage between the UK withholding tax and corporation tax rates mentioned above. Previously, the withholding tax rate (20%) was higher than the UK corporation tax rate (19%).
- **UK-Luxembourg tax treaty changes:** Changes to the UK-Luxembourg tax treaty that came into effect in 2024 granted the UK taxing rights over “indirect” disposals of UK land. Prior to those changes, a Luxembourg holding company was effectively exempt from UK non-resident capital gains

tax on indirect disposals of UK real estate via share sales, which meant that a Luxembourg holding structure could potentially deliver better net-of-UK tax returns than a UK REIT structure.

Impact on Investor Returns

For a tax-transparent fund investing via a UK REIT, its underlying investors may be able to reclaim the UK withholding tax on PIDs. In effect, this means that investors are taxed on their share of returns from underlying UK REIT investments based on their own tax status. In that sense, a UK REIT can be thought of as quasi tax transparent from an investor's perspective.

If the PERE fund has investors entitled to gross payment of PIDs (e.g. UK companies and many types of UK pension schemes), the private UK REIT is able to pay their pro rata share of PIDs without withholding tax, provided certain conditions are met.

The impact on an investor's returns will, therefore, depend on their tax status and (where eligible) whether they submit withholding tax reclaims:

- **Sovereigns:** Investors with sovereign immunity from UK direct tax are entitled to reclaim all of the UK withholding tax on PIDs, providing an effective UK tax rate of 0% on their returns. (Note that the investor needs to have HMRC confirmation of its sovereign immunity.)
- **Non-UK pension schemes:** Overseas pension schemes without sovereign immunity may still be able to reclaim all of the UK withholding tax under a UK tax treaty, or at least a greater proportion than taxable investors. This depends on whether the dividend article of the relevant UK tax treaty has a special provision for pension schemes and, if so, the relevant tax rate. Where there is a special rate for pension schemes, typically the effective UK tax rate is either 0% (e.g. Canada, Netherlands, Spain, Switzerland, and the United States) or 10% (e.g. Germany).
- **Non-UK resident taxable investors:** If entitled to benefits of a UK double tax treaty, non-UK taxable investors can often achieve an effective UK tax rate of 15%. For investors without relevant treaty benefits (or those who do not submit a reclaim), the UK tax should be limited to the withholding tax (save for some niche cases).
- **UK registered pension schemes:** Like sovereigns, many UK pension schemes are entitled to reclaim all the UK withholding tax on PIDs if their share was not paid gross.
- **UK resident corporate:** UK tax resident companies are subject to tax on PIDs at 25%, with credit for any UK withholding tax suffered on their PID returns (i.e. assuming their share of PIDs was not paid gross).
- **UK resident individual investors:** UK tax resident individuals are subject to income tax on PIDs as if they were PRB profits and will be taxed at rates of up to 45% (with credit for any UK withholding tax on their returns), rather than the lower dividend tax rates.
- **UK and non-UK carried interest holders:** Under the draft legislation for the UK's new carried interest tax regime, it appears that the "exclusive charge" provisions would mean that carried interest comprised of PIDs is taxed at about 34.1% if it is "qualifying" carried interest (rather than up to 45% for UK resident individual investors) but at about 47% if it is non-qualifying carried interest.

The overall economic impact for investors of the PERE fund investing via a UK REIT versus a taxable structure may also be influenced by whether the withholding tax is deemed distributed to investors for the purposes of the fund waterfall, which is common for withholding taxes. Where withholding tax on PIDs will be deemed distributed, the acceleration through the waterfall sometimes means that the comparison

is not as simple as the investor swapping 25% corporation tax leakage within the structure for its effective withholding tax rate on PIDs.

What Types of Investment May Be Suitable for a UK REIT?

UK Real Estate

UK REITs are most often used for UK investments in core/core-plus assets that are expected to generate a significant amount of income, albeit the majority of returns might still be expected to come from gains on exit.

Value-add and opportunistic investments tend to be less suited to private UK REITs for a combination of reasons. Most prominently, the UK REIT exemption and latent gain rebasing do not apply to properties being held as trading stock (e.g. in a property development trade) or those held as investments but sold within three years of completion of development where (broadly) works costs exceed 30% of the value of the property. This is referred to as the “three-year development rule” and can catch a broader range of investment strategies than might be expected (e.g. forward fundings). Commercial drivers for PERE funds mean that such properties may be sold within three years of completion of works, which may be a barrier to using a UK REIT.

Operational real estate investments also tend not to be well-suited for UK REITs, though this is fact dependent.

Non-UK Real Estate

Private UK REITs typically do not hold non-UK real estate.

The UK REIT regime does not provide an exemption from non-UK taxes, so there is no specific tax benefit to holding non-UK real estate in a UK REIT versus other common holding structures (and there may be some disadvantages).

Instead, pan-European PERE funds that do use UK REITs for UK investments often have one or more sister holding companies for non-UK investments and any UK investments not suited to a UK REIT. This might be a single master holding company for all non-UK/non-UK REIT investments – for example, a Luxembourg company or a UK QAHG – but might also include jurisdiction-specific tax-advantaged investment vehicles, such as an Italian real estate investment fund or a Spanish SOCIMI.

What Conditions Do a PERE Fund and Its Investors Need to Meet?

A private UK REIT must be at least 70% owned by certain “good” categories of investors – referred to as “institutional investors.” This is a specific legislative definition and will not necessarily catch all investors that would normally be considered “institutional” in a commercial sense.

For the purposes of the UK REIT regime, a fund itself can qualify as an “institutional investor” if it meets either the “genuine diversity of ownership” (GDO) condition or a “strict” “non-close” condition. As a rough guide:

- A widely *marketed* fund may meet the GDO condition if it includes certain prescribed statements in its fund documents, even if the fund ends up with a relatively small number of investors.
- A fund or other vehicle that is widely *held* may meet the non-close condition.

The UK REIT itself is also required to meet a “non-close” condition. For these purposes, the non-close condition is more generous than the “strict” version for qualifying as an institutional investor and can be met if the UK REIT is closely held — but only because of ownership by institutional investors.

In practice, a private UK REIT may meet the non-close condition if it is wholly owned by a fund that meets the GDO condition. Where that is not the case, the UK REIT may still be able to meet the non-close condition, provided that the underlying investor base is sufficiently broad or comprised of a sufficient proportion of institutional investors.

Generally, for both the ownership test and the non-close condition, it may be simpler for the fund vehicle to meet the GDO condition, as that path avoids the need to look through to the underlying investors. By contrast, the non-close condition requires ongoing monitoring of the investor base.

In addition to these structural conditions relating directly to the PERE fund itself or its investors there are other conditions which must be met to qualify as a UK REIT – for example, the “principal company” of a UK REIT group (i.e. the TopCo) is required to be UK tax resident; the UK REIT must meet the ‘property rental business’ and ‘balance of business’ conditions; etc.

Other Considerations

Investing through a UK REIT presents a number of additional considerations compared to traditional taxable holding structures. Some important examples include:

- **Holders of Excessive Rights rules:** A UK REIT may be subject to a penalty tax charge if it pays a PID to a “holder of excessive rights” (HoER), unless the HoER is an “excluded holder.” Broadly, a HoER is a company or body corporate that holds (directly or indirectly) 10% of the economics or voting power in the UK REIT. As a result, PERE managers will need to identify potential HoERs (and whether any HoERs qualify as “excluded holders”). It may prove beneficial for the manager to have powers under the fund documentation to seek mitigate the risk of penalty tax charges under these rules.
- **Property: financing-cost ratio:** The UK REIT regime includes a restriction on debt financing via a form of interest cover test. This requires property profits to be at least 1.25x the associated financing costs — otherwise there may be a penalty tax charge in the UK REIT. This is a specific legislative test and does not map directly onto interest cover tests in real estate financing facilities, so it is possible to meet the interest coverage ratio test in financing documents but still breach the property: financing-cost ratio.
- **Attribution of distributions:** The UK REIT regime requires that any distribution made by a UK REIT be attributed to one of six categories, four of which are PIDs and two are non-PIDs. A distribution from the UK REIT will be subject to UK withholding tax to the extent it is attributed to PIDs (save where the recipient has gross payment status). Distributions must be made in a specific order of priority, though there is some flexibility in when residual business profits are distributed. In broad terms, the rules require income profits to be distributed before capital gains, and for profits and gains that have benefitted from the REIT’s tax exemption to be distributed before those that have not. This structure may create unexpected practical difficulties where there are commercial agreements that seek to “stream” certain categories of returns to particular investors.
- **Operating partner joint ventures:** Structuring UK investments through a private UK REIT creates additional considerations for operating partner joint ventures. Key considerations include whether the REIT benefits will be streamed away from the (taxable) operating partner and how any promote arrangements will be structured to minimise risks of diluting REIT benefits.

Conclusion

PERE managers considering UK REITs should consider weighing the tax advantages of a UK REIT structure against the potential for at least some increase in running costs and operational complexity, as well as factoring in how their particular investor base impacts that assessment.

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