



Real Estate Investment Trusts and Capital Allowances

Background

The intention of the Real Estate Investment Trust (REIT) regime is to encourage more liquidity in the real estate sector by providing a tax-efficient vehicle for a wider range of investors. The legislation became law in January 2007 and under it companies are categorised according to their stage on the path to REIT conversion. These categories are:

- C (Pre-entry)
- C (Tax-exempt)
- C (Residual)
- C (Post-cessation)

(Where C = company)

REITs and capital allowances

In general, companies that opt to become REITs will not pay tax at the REIT vehicle level. However, this does not mean that capital allowances become irrelevant. On the contrary, companies converting to REIT status will have a number of capital allowances issues to deal with both at conversion and on an ongoing basis.

Capital allowances on conversion

It is well documented that companies wishing to convert to REIT status must pay an entry charge partly to crystallise many years'-worth of capital gains tax. Among other things, the calculation of this entry charge will take account of capital allowances.

In effect, the assets of a property rental business – i.e. C (Pre-entry) – shall be treated for the purposes of corporation tax as ceasing at entry. What this means from a capital allowances perspective is that if a property is owned as an asset in a property rental business before entry, it shall be treated for the purposes of corporation tax as being sold immediately before entry and being reacquired by the tax-exempt REIT immediately after entry.

Ordinarily such a sale and reacquisition could be deemed to give rise to a disposal value for any plant and machinery allowances claimed. Section 1.11 (4) of the REIT legislation specifies the capital allowances rules to be applied in this scenario. In particular, the sale and reacquisition shall not give rise to any allowance or charge and it shall not be possible to carry out a Section 198 or 199 election. This means that companies wishing to convert to REIT status cannot 'strip out' plant and machinery allowances prior to inserting individual properties into the tax-exempt REIT.

It is therefore important to identify capital allowances clearly, both in anticipation of conversion to REIT status and after conversion has taken place as this will affect the entry charge and the ongoing property income distribution.

Ongoing capital allowances

After a company has converted to REIT status – i.e. it becomes C (Tax exempt) and C (Residual) – it is important to have a planned capital allowances shadow-claiming regime in place. This is because in relation to the Property Income Dividend (PID) required to be paid by the REIT, it is assumed according to Section 120 (7) of the legislation that any allowances that a company could claim in respect of the capital allowances legislation shall be made automatically and will be reflected in the calculation of profits. Thus, it is more important than ever to identify clearly any capital allowances available to the REIT. As PIDs are likely to be made on a quarterly basis, the REIT must know with a degree of certainty the capital allowances potentially available to it.

Capital allowances for the investor

The distributions from the C (Tax exempt) REITs will be net of withholding tax that is required to be deducted by the REIT. However, unlike for investors based offshore, for REITs capital allowances will not be available to offset against the withholding tax payable. However, this should be viewed in the overall context of the capital allowances which will be taken into consideration in the calculation of profits of the REIT at the vehicle level.



Real Estate Investment Trusts and Capital Allowances

Conclusions and further action

Any companies listed on a recognised stock exchange intending to convert to REIT status have a number of housekeeping issues to address in relation to capital allowances both pre-entry and on an ongoing basis.

We recommend carrying out a full capital allowances audit both pre- and post- conversion and the systematic introduction of a capital allowances shadow-claiming regime for both property income distribution purposes and also for financial cash flow modelling.

Contact Capitus enquiries@capitus.co.uk for more information.