EXPLANATORY MEMORANDUM TO

THE REAL ESTATE INVESTMENT TRUST (AMENDMENTS TO THE CORPORATION TAX ACT 2010 AND CONSEQUENTIAL AMENDMENTS) REGULATIONS 2014

2014 No. 518

1. This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs (HMRC) on behalf of the Treasury and is laid before the House of Commons by Command of Her Majesty.

2. Purpose of the instrument

2.1 This instrument amends Part 12 of the Corporation Tax Act 2010 ("CTA 2010") and makes consequential amendments to the Authorised Investment Funds (Tax) Regulations 2006 in relation to Real Estate Investment Trusts ("REITs").

2.2 Section 528(4A) of CTA 2010 sets out classes of institutional investor that can invest in REITs without causing the REIT to violate the non-close company rule. These Regulations amend that list to include UK REITs and their foreign equivalents as 'institutional investors'.

2.3 Certain items have to be taken into account in calculating the ratio of REITs' profits to their financing costs. Where the ratio is breached a charge to tax arises. These items are listed in section 544(5) of CTA 2010 and these Regulations amend that list to include amounts in relation to hedging the risks of borrowing.

2.4 The Authorised Investment Funds (Tax) Regulations 2006 ("the AIF Regulations") make reference to REITs. These Regulations make consequential amendments to the AIFs Regulations to reflect changes to the REITs legislation.

3. Matters of special interest to the Select Committee on Statutory Instruments

3.1 None

4. Legislative Context

4.1 Regulations are made by the Treasury under section 528(4B) and section 544(6) CTA 2010 and it is the first use of those powers.

4.2 One of the conditions for a company to qualify as a REIT is that it is not a close company or is a close company only because it has an institutional investor as a participator (section 528(4) CTA 2010).

4.3 Section 528(4A) lists persons who are "institutional investors".

4.4 Subsection (4B) provides that the Treasury may by regulations amend the definition of "institutional investor" by inserting, omitting or amending the list in subsection (4A).

4.5 Section 543(1) and (2) CTA 2010 set out the calculation PP/PFC (where PP is property profits for the accounting period and PFC are the property financing costs for the accounting period) and state that where the result of this calculation is less than 1.25 the excess is charged to corporation tax.

4.6 Section 544 gives the meaning of "property financing costs". The costs are those incurred by a REIT group or company in respect of the property rental business and mean "the cost of debt finance".

4.7 Subsection (5) lists the items that are included as the costs of debt finance.

4.8 Subsection (6) provides that the Treasury may by regulations amend the list by inserting, omitting or amending the description.

4.9 These Regulations also amend the Authorised Investment Funds (Tax) Regulations 2006.

4.10 Regulation 69E describes the property investment business condition and regulation 69F explains what a property investment business is.

4.11 Part 1 of the Schedule to the Statutory Instrument contains a list of abbreviations of Acts

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Exchequer Secretary to the Treasury, David Gauke, has made the following statement regarding Human Rights:

"In my view the provisions of the Real Estate Investment Trust (Amendments to the Corporation Tax Act 2010 and Consequential Amendments) Regulations 2014 are compatible with the Convention rights".

7. Policy background

7.1 REITs are a tax advantaged vehicles introduced to encourage investment in the real estate sector.

Institutional investors

7.2 The Finance Act 2012 made changes to the regime to encourage investment in REITs by institutional investors. Prior to this, investment by an institutional investor could cause a REIT to violate the requirement that a REIT was not a close company. The change was achieved by listing those institutional investors that would not cause the requirement to be breached. The primary legislation included power for changes to be made by regulations to the list of institutional investors. REITs themselves were not included in the initial list of institutional investors.

7.3 The Government announced at Budget 2013 that it was to undertake an informal consultation on reforms to the REIT regime to assess the potential appetite for including REITs as 'institutional investors' and the potential tax risk of such a measure. The consultation on the measure took place in the spring of 2013. The consultation attracted 13 responses.

7.4 Including a UK REIT and its non-UK equivalent in the list of institutional investors will provide three benefits to the REIT sector: facilitating joint venture REITs; enabling specialism by REIT investors; and promoting transfer of international expertise. By attracting more international and institutional capital into the UK the measure is expected to result in a more competitive and efficient UK real estate and REIT sector.

Property financing costs

7.5 The REITs legislation restricts the amount of borrowing a REIT can undertake. The profits of the property rental business are compared with the amount of financing costs incurred in earning those profits. Prior to Finance Act 2012 some of the items listed as financing costs went beyond the aim of restricting borrowing. Changes were made in the Finance Act 2012 to the list of items that could be taken into account in calculating the cost of debt finance to remedy this. A power was introduced to allow for further changes to be made as required. The change now being made builds on the work done in 2012 and takes into account items relating to derivative contracts. Derivative contracts are not interest and are not captured in the Finance Act 2012 list but are financing costs of a similar type to those in that revised list.

Authorised Investment Funds (AIFs) Regulations

7.6 Property Authorised Investment Funds (PAIFs) are authorised funds which invest in property and which share many of the same characteristics of REITs. The changes made in these Regulations do not have any policy effect and only serve to update the AIFs Regulations.

8. Consultation outcome

8.1 The informal consultation - *Including Real Estate Investment Trusts (REITs) as "institutional investors"* - was launched on 20 March 2013 and closed on 14 June 2013. The Government received a total of 13 written responses from Stakeholders representing existing UK and foreign REITs, tax advisors and UK and foreign property industry associations. The respondents broadly welcomed the proposed change.

8.2 Having analysed the responses to the consultation and assessed the potential implications for tax receipts and the wider impact on the REIT regime, the Government considers that the measure will provide benefit to the REIT sector in terms of facilitating joint ventures and providing UK REITs access to more financing opportunities and has therefore decided to include REITs within the definition of "institutional investor". By attracting more international and institutional capital into the UK the measure is expected to result in a more competitive and efficient UK real estate and REIT sector.

8.3 The Regulations were published in draft for consultation and five responses were received. The legislation was welcomed by the industry and the Regulations have been amended to address comments in relation to commencement and effect so that existing REITs can benefit from the new provisions. Stakeholders also requested more detail in relation to the meaning of "equivalent of a UK REIT", this will be provided in guidance.

9. Guidance

9.1 The changes to the institutional investors (including guidance on the meaning of "equivalent of a UK REIT") and property financing costs lists will be included in HMRC's manual on REITS – *Guidance on Real Estate Investment Trusts* and the consequential changes to the AIFs regulations will be included in the *Company Taxation Manual.*

10. Impact

10.1 The Instrument is expected to have negligible impact on business, charities and voluntary bodies.

10.2 The impact on the public sector is expected to be negligible.

10.3 A Tax Information and Impact Note covering this instrument will be published on the HMRC website at http://www.hmrc.gov.uk/thelibrary/tiins.htm

11. Regulating small business

11.1 The legislation does not apply to small business.

12. Monitoring & review

12.1 The change will be kept under review through communication with affected taxpayer groups.

13. Contact

Allana Sheil at the HMRC Tel: 03000 586059 or email: Allana.Sheil@hmrc.gsi.gov.uk can answer any queries regarding the instrument.