

## Foreword

**In this first e-bulletin on commercial property we will be looking at Real Estate Investment Trusts (REIT's) which have come increasingly into public focus following the recent Budget Proposals and latterly the Budget and Finance Bill 2006.**

**Is this the way forward for property investment? – The following article looks at the framework for REITs.**

**Also in this e-bulletin is a quarterly round-up of what is current in commercial property law. If you would like further information in relation to any of the topics covered in this bulletin, please contact Simon Fothergill.**

## Article: UK Real Estate Investment Trusts

### Introduction

The British Property Federation, institutions and the property sector generally, have been lobbying the Government for a number of years to approve collective investment schemes.

The Finance Act 2006 will finally provide the necessary statutory framework and enable Real Estate Investment Trusts to be launched on 1 January 2007.

### What are REIT's

REIT's are a type of collective investment scheme and are common in a number of overseas economies, including the USA.

Generally, they are close-ended companies or trusts that hold, manage and maintain real estate for investment purposes, which is leased to tenants. They tend to have a broad shareholder base and are generally traded on public stock exchanges.

### Rationale

A consultation paper published by the Government alongside the Budget 2004 identified various limitations in the UK property market: -

- Limited secondary trading and liquidity in the property sector.
- Access to commercial property investment is limited for smaller scale investors without significant capital outlay to investors who will then pay tax at their marginal rate.
- Property Companies may be unable to raise optimal amounts of equity and therefore rely more heavily on debt markets.
- There is limited institutional invested participation in the residential property market.

### REIT Structure

The key structural elements of the REIT as set out in the Budget 2006 and to be enacted in the Finance Bill 2006 are as follows: -

- The regime will be open to companies resident in the UK that are publicly listed on a recognised stock exchange.
- There is no maximum restriction on shareholdings (10% was originally mooted) but the Revenue may impose balancing charges on any person who is entitled to 10% or more of distributions or voting rights, to offset any tax benefits retained by the shareholder.
- For tax purposes, the qualifying letting business of the Company is "ring fenced" from the other trading activities of the Company. At least 75% of the Company's assets and profits must relate to the ring fenced, qualifying business.
- The qualifying business of the company must involve at least three properties (a multi-let property would qualify as multiple properties for this purpose) and no one property may represent more than 40% of the qualifying business.
- Companies that meet the REIT eligibility criteria will not pay corporation tax on qualifying property rental income or qualifying chargeable gains that relate to the ring fenced business.

REITs will be required to distribute at least 90% of net taxable qualifying profits.

An entry charge of 2% of the market value of the property assets moving into the ring fence will be imposed on the company when it joins the REIT scheme.

- REITs will be required to withhold basic rate tax on distributions paid to investors on behalf of the Revenue.
- REITs will be subject to an interest cover test on the qualifying part of their business which requires the ratio of profits to borrowings to be 1.25:1.

## Summary

REITs offer a flexible form of property investment and companies will be able to join the new REIT Scheme for accounting periods beginning on or after 1 January 2007.

Only time will tell whether the Government's proposals will offer sufficient incentives for potential institutional and private investors in what may prove to be a hardening market.

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## What's Current?

- Planning – under amendments proposed to the 1995 General Development Order, internal alterations which result in an increase of 200 square metres or more of retail space will in future require planning permission. These amendments are likely to have an impact on larger retailers and their ability to increase floor space in their stores by installing mezzanine floors.
- Land Registry - In June 2006, fourteen prescribed clauses for registered leases will become mandatory. Landlords will need to review their standard form leases to ensure that they comply with the new regulations. Material failure to

comply will lead to leases being rejected by the Land Registry.

- Rent Review (1) – In the case of *Littman & Another v Aspen Oil (Broking Limited) (2005)* a lease granted both parties the right to terminate by giving notice. In the case of the landlord's notice, the lease provided that the tenant must have paid the rent and observed the tenant's covenants up to the date of termination. The tenant served notice, despite outstanding breaches of the tenant's covenants.

The Court held that there was an obvious mistake in the break clause – there was no possible commercial reason for the clause to allow the tenant to defeat the landlord's right to terminate the lease by its own default. A clear error could be remedied by construction, although the Court would have ordered rectification if necessary.

- Rent Review (2) – The recent case of *Fitzroy House Epsworth Street (1) Limited v the Financial Times (2) 2005* also involved a break clause. In this case the tenant was entitled to terminate the lease if it had "materially" complied with its obligations (which included full repair). The tenant served notice and carried out repair works, but the landlord refused to accept the break on the basis of outstanding disrepair.

The Court held that it was necessary to consider whether the outstanding repairs were such to make it reasonable to deny the tenant the right to terminate the lease.

Material compliance is a question of fact and, in considering the adverse affect of any breach, attention must be paid to the legitimate interests that the break clause was designed to protect (for example, the landlord's ability to re-let).

In the circumstances the Court held that there was material compliance and the break was effectively operated.