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# KNOW YOUR REIT'S - NON-EXEMPT TAXES

## Introduction

David Vogel FCA has recently joined the Banking Tax and Finance team, advising major UK and overseas clients. David is a senior Chartered Accountant and a well known and respected figure in the property world. Throughout his career he has held senior positions with major UK listed companies, he is also a specialist on the treatment of Real Estate Investment Trusts (REIT's). This is the third and final part in the series looking at taxation of REITS. The two previous articles can be found on our website.

## Background

REITs, as has already been explained in the first two articles of this three articles series, are tax-exempt, listed, property investment companies or groups. REITs were first introduced into the UK on 1 January 2007. REITs are usually exempt from corporation tax on their rental income profits derived from their qualifying property investment businesses, as well as from their capital gains on sales of investment properties. REITs are sometimes liable to corporation tax on income and gains even though these are derived from their normally exempt property investment businesses. In addition, REITs remain subject to, and liable for, value added tax (VAT) and stamp duty land tax in the same way as are normal tax-paying companies. REITs must also deduct PAYE and National Insurance contributions (NICs) from their employees' salaries and remit the funds to HM Revenue & Customs (HMRC), and are themselves liable to pay employers' NICs and remit these funds to HMRC. REITs are also subject to HMRC's penalty regime for inaccurate returns.

## Taxable property investment business income and gains

In order to secure exemption from corporation tax, companies or groups electing for REIT status must, as explained in the first article, satisfy a number of conditions and must also pay an entry charge to HMRC equal to 2% of the market value of their investment properties as at the date of entry into the regime. Subsequently REITs are normally exempt from corporation tax on their rental income derived from their property investment businesses, and on capital gains arising from the sale of their investment properties. Certain income and gains remain liable to corporation tax.

As to income, rent from way leaves, such as for allowing electric lines and oil and gas pipelines on their land, and rent from the siting of mobile phone masts, satellite dishes and wind turbines on their land, remain liable to tax. In addition, dividends from other REITs are taxable, as are interest receipts. Rental income from properties held for re-sale, and profits from the sale of such properties, are also taxable, as REITs are only tax-exempt in respect of their income and gains derived from their property investment businesses.

A gain on the sale of an investment property is only subject to corporation tax where the sale concerned takes place within three years of the completion of the development, the development was completed after entry into the REIT regime and where the cost of the development was more than 30% of the value of the property on the later of the date of its acquisition, and the date that the company became a REIT. In addition, the gain on sale of the shares of a REIT's subsidiary property investment company is liable to corporation tax, even though the sale of an investment property owned by such a subsidiary would be tax-exempt.

## VAT

REITs are subject to the same VAT regime applicable to other non-REIT, fully taxable, property investment companies. As in the case of taxable companies, REITs will seek to arrange their affairs so that they suffer the minimum possible irrecoverable VAT, thereby keeping their costs to a minimum.

VAT recovery will be founded upon the VAT status of a REIT's properties and the REIT's partial exemption position. Under VAT legislation, companies have the right to opt to make their commercial properties subject to VAT; this is known as opting to tax. The option can be applied to selected properties within a portfolio, or to the whole portfolio, as desired. Once opted, however, VAT must be charged on all 'supplies' made by the company in relation to those opted properties. This means that VAT must be charged, for example, on rent and service charge invoices issued to tenants, and subject to the transfer of going concern (TOGC) rules explained below, on sales proceeds when properties are sold. Where, for reasons to be explained, companies decide not to make their properties subject to VAT under the option to tax, supplies in relation to those properties will normally be exempt from VAT. Thus VAT will not be charged on supplies such as rent invoices and sales proceeds in relation to non-opted properties. It should be noted, however, that VAT must always be charged on the sales proceeds of freehold commercial properties sold within three years of completion of their construction.

As regards recovery of VAT incurred, when REITs and non-REIT property investment companies alike incur VAT on their costs, known as input VAT or input tax, in relation to properties, their right to recover such VAT will be determined by the extent to which the input VAT concerned has been used in the making of VATable supplies. This involves directly attributing the input tax concerned to the supplies made in respect of those properties. Thus, where those supplies are subject to VAT, such as when the option to tax in respect of that building has been made, the input VAT on costs may be fully recovered. Where the supplies are not subject to VAT, such as when the option to tax in respect of that building has not been made, none of the input VAT may be recovered. Thus, for example, where input VAT on legal fees is incurred in relation to an opted property, say on drawing up a lease for a new tenant of one of the floors of an office building, that input VAT will be directly attributed to the VATable supplies in respect of that particular building and may, therefore, be fully recovered. Where, however, similar input VAT is incurred specifically in relation to a non-opted property, say legal fees in relation to a letting at a non-opted office building, that input tax will be fully irrecoverable and will, therefore, be a real cost to the business concerned, reducing its profits accordingly. When a non-specific, residual cost is incurred, which cannot be directly attributed to the supplies in respect of any specific building, such as audit fees in respect of the accounts of the property-owning company as a whole, the VAT charged by the audit firm may only be recovered in accordance with the company's partial exemption percentage. Under the standard partial exemption method, which is designed to arrive at the extent to which residual input tax has been used in the making of VATable supplies, the recoverable percentage is expressed by the following formula:

$$\frac{\text{The total value of supplies subject to VAT}}{\text{The total value of supplies subject to and exempt from VAT}} \times 100$$

$$= \text{Recoverable residual input tax percentage}$$

An example will make the standard method of partial exemption clear and demonstrate how much input VAT may be recoverable:

XYZ REIT plc incurred total input VAT in the year ended 31 March 2010 of £20 million. Of this, £15 million was directly attributable to properties which had been opted, £2 million was directly attributable to properties which had not been opted, and £3 million was residual, incurred on general corporate expenses and not specifically referable to any particular properties. XYZ REIT plc had a standard method partial exemption percentage of 85% for the year, as the total value of its supplies in respect of opted properties was 85% of the total value of supplies in respect of opted and non-opted/exempt properties. Recoverable input tax for 2009/10 will, therefore, be £17.55 million, being the whole £15 million of input tax directly attributable to opted properties on which VATable supplies were made, and £2.55 million of the total of £3 million residual input tax on general corporate costs, being 85% of the input VAT incurred in accordance with XYZ REIT plc's standard method partial exemption percentage. Irrecoverable VAT for 2009/10 will be £2.45 million, being the whole £2 million of input VAT incurred in relation to non-opted properties on which exempt supplies were made and £0.45 million of the residual input VAT of £3 million incurred on general corporate costs, being the 15% of such costs which are irrecoverable under the company's partial exemption percentage. The irrecoverable VAT of £2.45 million will be an actual cost of the business, reducing annual profits accordingly.

The obvious question from the above example is, why would XYZ REIT plc not opt to tax all its buildings, as this would thereby increase its input VAT recovery position by enabling greater direct attribution to supplies in relation to opted buildings and thus increase its partial exemption percentage under the formula shown above? The answer to this may lie in the age of some of the properties within its portfolio and the type of tenants in some of the buildings. Supplies in relation to buildings which were constructed before the option to tax became possible in 1989, then known as the election to waive exemption, are exempt from VAT unless those buildings have been specifically opted. If such a building is let to financial tenant, such as a bank, there could be a serious VAT disadvantage to the bank tenant if the landlord opts to tax, as is a landlord's unilateral right, because banks usually have restricted input tax recovery percentages. This is because banks generally make exempt supplies resulting in them having low partial exemption recovery percentages. Thus, the sudden imposition of VAT on rents charged to a bank could effectively increase the bank's cost of occupying the building.

Accordingly it might be possible for the landlord to agree an increased rent with the bank, on the condition that the landlord company does not opt to tax the building.

An example will make clear why a landlord may decide not to opt to tax some of its buildings:

XYZ REIT plc became a REIT on 1 January 2007. XYZ REIT plc owns an unopted office building in the City of London. The development of the building was completed in late 1988 and it was then fully let to ABC Bank plc at an annual rental of £15 million until 2028. When the option to tax was due to be introduced in 1989, the landlord advised the tenant that it intended to opt to tax the office building. If XYZ plc had opted the building, it would have had to charge VAT, at the 15% rate then applicable, on the rent chargeable to the bank tenant. Thus, VAT of £2.25 million would have had to be charged, based on the annual rent of £15 million. ABC Bank plc, being a financial institution, has a restricted VAT partial exemption recovery percentage, say just 10% of input VAT incurred. Thus, if the landlord had opted to tax the building, the tenant's annual rental cost would have effectively increased from £15 million to £17.025 million. This is because VAT of £2.25 million would have become payable in addition to the rent itself, of which the bank could only recover 10%; the irrecoverable 90% of VAT charged would then amount to £2.05 million. In order to avoid this scenario, ABC Bank plc offered to increase its annual rent on condition that XYZ plc did not opt to tax the building. After negotiations were completed, it was agreed that the bank's rent would increase by £1 million per annum to £16 million, on condition that the landlord did not opt to tax the property. This was agreed and documented. Thus, XYZ plc secured additional annual rent of £1 million, and the bank tenant, although liable for that additional annual rent of £1 million, saved potential additional occupation costs of £1.025 million, being the difference between the additional rent now payable of £1 million and the potentially irrecoverable VAT of £2.025 million, being 90% of the £2.25 million of VAT that the landlord proposed to charge. This example shows why some buildings, particularly office buildings in the City of London or other major cities let to financial tenants, such as banks and insurance companies, remain unopted today, some 21 years after the option to tax was first introduced. When such buildings become unoccupied and obsolete, they are likely to be redeveloped. The option to tax will then almost certainly be made in respect of the modern, replacement buildings, otherwise the developers will be unable to recover input VAT on the redevelopment costs, which would make such redevelopments uneconomic.

Although the standard method of partial exemption is often used by property investment companies to determine the extent of their input VAT recovery on non directly attributable costs, other bespoke special methods may also be permitted by HMRC as long as they produce fair and reasonable recovery percentages. An example of a special partial exemption method that a company might seek to apply, and which might possibly be acceptable to HMRC, could be the total floor areas of all let properties subject to VAT, divided by the floor areas of all let properties owned by the company, whether subject to VAT or not, as a percentage. HMRC will decide, on a detailed review of each company's affairs, whether or not the company's proposed special method is fair and reasonable in that company's particular circumstances. A special partial exemption method cannot be used by a company without first obtaining HMRC's approval.

As mentioned earlier, once a property has been opted and is later sold, VAT must normally be charged on the sales proceeds. Thus, for example, if an opted property is sold for £10 million, VAT of £1.75 million, at the current rate of 17.5%, would be chargeable in addition to the sales proceeds. The purchaser would normally be able to recover this input VAT if it had opted the property concerned pre-completion. Where the property sale constitutes the transfer of a business as a TOGC, and all the necessary conditions for this rule to apply are met, the sale is outside the scope of VAT and VAT, therefore, must not be charged by the seller of the property. The TOGC rules, as the name suggests, were originally designed to deal with the sale of an ongoing business which was to continue to be operated by the buyer. HMRC accept that the TOGC rules also apply to the sale of a let or partly-let property, because, in effect, a property rental business is being sold or transferred. The conditions that must be satisfied if the TOGC provisions are to apply include the need for the buyer to opt to tax the property before purchase, the notification of this option to HMRC and informing the seller of this too, the intention of the buyer to continue to operate the property letting business and that an immediate on-sale of the property at completion of the first purchase is not intended. The application of the TOGC rule, which is compulsory where all the conditions are met, offers a reduction in administration and cash management for opted property sales. This is because VAT, normally chargeable on the sale of opted properties, must not be charged by the seller where the TOGC rules apply. No payment of VAT from a buyer is, therefore, required and no remittance of VAT to HMRC will be needed by the seller. As will be explained below regarding stamp duty land tax, TOGCs effectively reduce a buyer's liability to stamp duty land tax.

An example will make the operation of the TOGC provisions clear:

XYZ REIT plc agrees to sell an opted office building in Manchester to EFG Ltd, a property investment company, for £20 million. The office building is substantially let. EFG Ltd intends to continue to let out the property, but hopes to redevelop it once all current leases to tenants expire in several years' time. EFG Ltd opts to tax the building with effect from completion of the purchase and notifies this option to HMRC before completion and informs XYZ REIT plc accordingly. XYZ REIT plc establishes to its satisfaction that all the TOGC conditions will be satisfied on the sale, so must not and does not, charge VAT on the sales proceeds as the sale becomes outside the scope of VAT. The property is sold and purchased for £20 million. XYZ REIT plc does not, therefore, charge VAT of £3.5 million that would, but for the TOGC rules, have been chargeable, and this amount does not, therefore, have to be remitted to HMRC. EFG Ltd does not have to pay £3.5 million of VAT to XYZ REIT plc, or seek recovery of it from HMRC.

When a property is purchased or constructed, or an existing property is altered or extended, at a cost of £250,000 or more plus VAT at the standard rate, currently 17.5%, the provisions of the VAT Capital Goods Scheme (CGS) must be taken into consideration. The purpose of the CGS is to measure the VATable use of a property over ten intervals, usually but not always years, to determine whether or not the initial input tax recovery based the company's partial exemption percentage needs adjustment to reflect actual VATable use over time. Adjustments are made from the second interval onwards to reflect the annual increases or decreases in the company's partial exemption percentage. These increases or decreases then result in VAT payments from, or VAT payments to, HMRC to adjust the initial VAT recovery to reflect the company's VATable use of the property over the ten intervals. A final adjustment will be made on sale of the property during the progress of the ten intervals. If the sale constitutes a TOGC, no CGS adjustment is required by the seller, as the buyer takes over the requirement to make the CGS adjustments over the remainder of the ten intervals which began with the original purchase. As the name of the scheme suggests, the CGS applies to capital/fixed, rather than current assets. Thus, it does not apply to properties purchased or developed for resale.

## Stamp duty land tax (SDLT)

REITs are subject to SDLT in the same way as are tax-paying companies. SDLT is normally payable at 4% on commercial property purchases and therefore, represents a not insignificant cost. Where the property concerned is owned by a UK company, say a subsidiary of another company, and that subsidiary company is available for purchase, a buyer of the company is only liable to pay stamp duty at 0.5%. Not only is there an apparent saving of 3.5% in buying the company owning the property as opposed to buying just the property itself, this saving may well be even greater as the stamp duty payable of 0.5% is only payable on the amount paid for the shares in the owning company. This amount is likely to be lower than the market value of the property because the value of the company will be reduced by any debts owed by the company, e.g. bank loans. Thus, significant stamp duty savings can be enjoyed by buying a company owning a property, rather than buying just the property itself. It should be taken into account that when buying a company the buyer becomes liable for all the company's liabilities and so this should not be done without detailed research. It is normally prudent for a buyer of a company to seek suitable warranties and indemnities to protect the buyer's position. The seller may seek a share of the buyer's SDLT savings for enabling the purchase of the owning company, by offering the owning company for sale, rather than just the property itself. If a UK property is owned by a non-UK company, no stamp duty at all is payable on acquisition of that company. The same situation applies if a property is owned by an overseas tax-resident property unit trust.

At one time many planning ideas were available to legally avoid stamp duty on property acquisitions, but the replacement of the old stamp duty with SDLT in 2003 changed the tax from a tax on documents, which was relatively easy to avoid, to a tax on transactions, which was very difficult to avoid. Also anti-avoidance legislation has made some planning ideas unworkable. Tax accountants and lawyers may still be able to offer some planning ideas to avoid or reduce the SDLT payable, but opportunities to do so are now limited. Avoidance schemes may well require disclosure to HMRC under legislation requiring such disclosures. This can lead to early legislation to close such schemes down.

Although SDLT is normally charged at 4% on property purchases, it is actually charged on the VAT-inclusive amount paid for a property. Using the prior example regarding VAT and TOGCs, where XYZ REIT plc sold an opted office building for £20 million, as the sale constituted a TOGC, no VAT was charged by the seller. SDLT at 4% of £0.8 million would, therefore, have been payable by the buyer EFG Ltd, based on the sales price of £20 million. Had the sale not constituted a TOGC, say because EFG Ltd had not continued to operate the letting business, but had immediately on-sold the property to another buyer, VAT would have been chargeable on the sales proceeds of the opted building. SDLT payable by EFG Ltd would then have been £0.94 million based on the VAT-inclusive price of the property of £23.5 million, i.e. £20 million plus VAT at 17.5% of £3.5 million. Thus, the qualification of a sale as a TOGC is of importance to the buyer, as the buyer's SDLT liability will be less for TOGCs. In the example, EFG Ltd saved £0.14 million because the TOGC rule applied. The liability for SDLT on the VAT-inclusive price remains the case even where the buyer can reclaim the input VAT under the normal rules, so that the true cost of the property is really the net of VAT amount, or £20 million in our example.

## PAYE

REITs must deduct income tax under pay as you earn (PAYE) from salaries paid to their employees, just as must any other company. REITs must similarly deduct NICs on paying salaries to their employees, and must pay employer's NICs. All income tax and NICs collected/paid must be remitted to HMRC. REITs must comply with all the normal reporting requirements to HMRC and meet all deadlines.

## Penalty regime

The penalty regime applicable to returns and documents in respect of all of the above taxes for understatement of liability, false or inflated losses and false or inflated repayment claims, has been changed in recent years. Penalty levels will be mitigated where taxpayers inform HMRC of an inaccuracy, as long as they have no reason to believe that HMRC are either aware of the inaccuracy, or that HMRC are about to discover the inaccuracy. Helping HMRC work out the amount of tax due and giving them full access to records, will also help mitigate penalties.

## Summary

In summary, penalty rates are now as follows:

- For an inaccuracy which occurred even though reasonable care was taken. A penalty of 0% of potential lost revenue.
- For a careless inaccuracy. A penalty of up to 30% of potential lost revenue.
- For a deliberate inaccuracy. A penalty of up to 70% of potential lost revenue.
- For a deliberate inaccuracy and attempted concealment thereof. A penalty of up to 100% of potential lost revenue.



For further advice concerning any of the issues raised in this briefing, please contact David Vogel at [david.vogel@davislangdon.com](mailto:david.vogel@davislangdon.com), or one of our other contacts shown overleaf. Information on other property tax related topics can also be found on our website at <http://bankingtaxfinance.davislangdon.com>.

