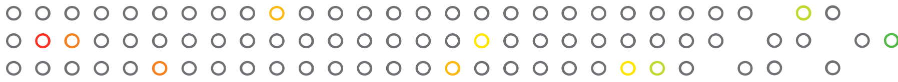

Davis Langdon
Banking Tax & Finance

KNOW YOUR REIT'S: PROFIT DISTRIBUTIONS

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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 second in a three part article series; the first article covered the importance of Capital Allowances to REIT's.

Background

Real Estate Investment Trusts (REITs) are tax-exempt, listed, property investment companies or groups, not liable to corporation tax on their rental income profits or capital gains derived from their qualifying activities. HM Revenue & Customs (HMRC) do nevertheless collect some tax from, and in relation to, REITs.

Firstly, as a consequence of electing to become a REIT, the REIT must pay to HMRC an entry charge equal to 2% of the market value of its investment properties on entry into the regime. Secondly, REITs remain liable to corporation tax on the profits derived from their non property investment businesses, such as on rent received from trading properties and profits from the sale of such properties, as well as being liable to tax on interest received and certain other income and gains. Thirdly, as one of the annual conditions of maintaining REIT status, REITs must distribute to their shareholders, in cash, at least 90% of their annual property rental income profits as Property Income Distributions (PIDs); normally within one year of the end of the accounting period concerned.

As such profits will not have already been subject to tax, the PIDs are fully taxable in shareholders' hands, thus resulting in tax being payable by many shareholders to HMRC. PIDs are taxed in shareholders' hands as property letting income, but distinct from any other such income they receive.

This article will explain how different classes of shareholders are taxed on the receipt of PIDs. REITs are not required to distribute to shareholders their tax-exempt capital gains arising from the sale of investment properties, but they may do so if they so choose.

Calculating mandatory distributable REIT rental income profits

As explained above, REITs must annually distribute at least 90% of their qualifying, tax-exempt rental income profits to shareholders as PIDs and those shareholders will then be liable to tax on those distributions received in accordance with their own particular circumstances. Paradoxically, the profits, of which at least 90% thereof must be distributed, are not the REIT's accounting profits, but rather those accounting profits as adjusted for tax purposes. In other words, although REITs are tax-exempt, they must nevertheless adjust their profits for tax purposes in the same way as fully tax-paying companies do. Instead of then paying tax on the basis of those tax-adjusted profits, they must distribute to shareholders PIDs equal to at least 90% of the tax-adjusted profits. As one of the necessary adjustments, REITs must deduct the maximum amount of Capital Allowances available, being tax deductible allowances on qualifying capital expenditure, even though such allowances do not save tax-exempt REITs any tax. As a consequence of this, Capital Allowances for REITs are known as 'shadow Capital Allowances'.

A simple example will make clear the requirement for REITs to adjust their accounting profits for tax purposes and how doing this affects the level of mandatory PIDs payable to shareholders:

XYZ REIT plc made an accounting profit for 2009 of £50 million. During 2009 it incurred capital expenditure of £30 million on the construction of an office building, on which shadow Capital Allowances of £5.5 million are due for 2009. Enhanced Capital Allowances of £5 million are due at the statutory rate of 100% on expenditure of £5 million on qualifying energy-saving equipment and £0.5 million of Capital Allowances are due, at the statutory rate of 10% on £5 million of capital expenditure, on plant and machinery integral to the office building constructed. Remediation of the contaminated land on which the office block was subsequently built cost £1 million, on which land remediation relief (LRR) at the statutory rate of 150% of actual expenditure is due, i.e. a deduction, therefore, of £1.5 million. XYZ REIT plc also incurred expenditure of £1.0 million in 2009 which is disallowable for tax purposes. Its mandatory distributable profits are calculated as follows:

	£'s millions	**£'s millions**
Accounting Profit for 2009		50.0
Add: Disallowable Expenditure	1.0	
Less: Shadow Capital Allowances	5.5	
Land Remediation Relief (LRR)	1.5	
		(6.0)
Tax Adjusted Profits		44.0
Distributable Profit - £44 million x 90%		**39.6**

Shareholders will be liable to tax on the PIDs received in cash totalling £39.6 million in accordance with their own particular circumstances, as further explained below. As can be seen from the above example, the aggregate of the allowable shadow Capital Allowances and LRR, of £7 million, net of disallowable expenditure of £1 million, reduced the REIT's tax-adjusted profit for 2009 by £6 million, and therefore saved XYZ REIT plc mandatory PIDs payable of a minimum of £5.4 million, being £6 million @ 90%.

This saving will be very valuable to the REIT as it conserves cash for reinvestment in the business and may also help the REIT to fund payment of non-REIT distributions, or ordinary dividends, payable out of taxable REIT income. Ordinary, non PID dividends are taxed more favourably in most shareholders hands than PIDs. The payment of ordinary dividends as well as PIDs makes a REIT a more balanced and attractive shareholding investment. Ordinary dividends carry a non-repayable tax credit and are not taxable in the hands of basic rate taxpayers or UK companies.

As will be appreciated from the above example, every £1 of shadow Capital Allowances and LRR deducted saves at least 90p in PIDs. As LRR is granted at 150% of actual remediation cost, every £1 of qualifying remediation cost actually saves a substantial £1.35 of PIDs, more than the actual remediation expenditure, i.e. (£1 x 150%) x 90% and so is very valuable.

Capital Allowances are only ever granted at a maximum rate of 100%, so every £1 of such qualifying expenditure saves at least 90p in PIDs payable. As Capital Allowances on plant and machinery integral to a building are only granted at the 10% rate, a REIT would have to spend £10 on such plant to secure Capital Allowances of £1, thereby saving at least 90p in PIDs payable.

Taxation of PIDs in different classes of shareholders' hands

PIDs, having been paid out of untaxed income, are potentially fully taxable in shareholders' hands as property letting income. Under the REIT legislation, and as a matter of administration, PIDs are normally paid under deduction of basic rate tax at source, currently 20%, which the REIT must pay over to HMRC on shareholders' behalves. So, for example, if a REIT is to pay an individual shareholder a PID of £1,000, it will deduct £200 and pay that to HMRC on the shareholder's behalf, and will pay the other £800 to the shareholder. As will be explained below, certain classes of shareholder are eligible to receive PIDs gross, without deduction of basic rate tax at source, and if such shareholders certify to the REIT their right to receive PIDs gross, the REIT must pay them the full PID, without deduction, i.e. the full £1,000 in our example. Whether or not tax is deducted by the REIT is purely an administrative matter, it does not affect the question of whether or not the PIDs are taxable in shareholders' hands.

Different classes of shareholders in REITs, and their tax positions, are as follows:

A) Tax-exempt UK shareholders including charities, pension schemes, local authorities, holders of individual savings accounts and child trust funds. In our example, therefore, of a PID payable of £1,000, these tax-exempt shareholders would not be liable to tax on the PIDs received. They are able to certify to the REIT, either in their own right as beneficial owners of REIT shares, or as intermediaries for such shareholders, their eligibility to receive the PIDs gross, without deduction of tax at source. Thus such shareholders would receive the full PID of £1,000 from the REIT and would not be liable to pay any tax thereon.

B) Taxable UK shareholders including individuals liable for basic rate and higher rate tax, and companies. The REIT legislation requires REITs to always deduct basic rate tax from PIDs payable to individual shareholders, irrespective of their particular circumstances. Individual shareholders not liable to tax because their income is below the tax threshold, will be eligible to reclaim from HMRC the tax deducted at source. Thus, in our example, a non tax-paying individual will receive a PID of £800 from the REIT and will reclaim from HMRC the tax deducted at source of £200. Thus such shareholders will receive the full £1,000 PID paid. Individuals liable for basic rate tax, currently 20%, must, in our example, pay basic rate tax on the PID of £1,000. This liability, however, will be satisfied by the deduction of basic rate tax by the REIT, which it then pays over to HMRC on such shareholders' behalves. Thus, in our example, a basic rate taxpayer receives £800 of the £1,000 PID paid and has no further tax to pay. Individuals liable for higher rate tax must pay tax at the 40% or 50% rates applicable, depending on their income levels. Thus, an individual liable to tax at 40% must, on a PID of £1,000, pay a total of £400 in tax. This will be satisfied by the £200 already deducted at source by the REIT and a further payment of £200 payable to HMRC following reporting of the PID received in the individual's self-assessment tax return. An individual liable to the new 50% tax rate, which came into force on 6 April 2010, must pay a total of £500 in tax on the PID of £1,000. This will be satisfied by the £200 already deducted at source and a further payment of £300 to HMRC following reporting of the PID received in the individual's self-assessment tax return. UK companies are liable to corporation tax on PIDs received. A company liable to the main corporation tax rate of 28%, must pay tax of £280 on a PID received of £1,000. REIT legislation permits UK companies to certify to the REIT their right to be paid PIDs gross, albeit that they are liable to tax thereon, so companies will normally pay the full corporation tax due on PIDs received at the same time that they pay their normal corporation tax liability on other income.

C) Taxable foreign shareholders including individuals and companies. Foreign shareholders must pay tax on PIDs received in their countries of residence in accordance with local tax laws. Under REIT legislation PIDs must always deduct basic rate tax on payments of PIDs to foreign shareholders and pay this over to HMRC. If the foreign shareholders are resident in a country that has a tax treaty with the UK, they may typically be able to reclaim back from HMRC 5%, i.e one quarter of the tax deducted by the REIT. Thus with a current deduction rate of 20% by REITs on PIDs paid to foreign shareholders, a foreign resident of a country with a tax treaty with the UK will typically suffer a net UK tax rate of 15% on the PID received. This 15% tax borne will then be available for offset in the foreign jurisdiction against the local tax liability due on the PID received. So, for example, if the foreign tax rate applicable on the PID received was 25%, the foreign shareholder would be liable to pay an additional 10% tax to their domestic taxing authority, i.e. 25% local tax less 15% already borne in the UK. A foreign shareholder resident in a country which does not have a tax treaty with the UK may not claim back the 5% tax from HMRC and so will, therefore, suffer a UK tax rate of 20%. Once again, this tax suffered will be available for offset against the foreign tax liability on the PID received. Thus a further 5% local tax would be due where the foreign tax rate was 25%, i.e. 25% local tax less 20% already borne in the UK. Where the foreign tax liability exceeds the UK rate borne of 15% or 20%, no local tax refund can be claimed as the excess tax represents UK tax and so will not be repaid to the foreign shareholder by the foreign tax authority. So, for example, were the local tax rate in the foreign jurisdiction to be only 10% on PIDs received and the foreign PID shareholder had already borne UK tax of 15% on the PID, although no local tax would be payable, the foreign shareholder would be unable to recover the excess 5% borne from HMRC; thus a tax rate of 15% would have actually been borne.

Summary

To summarise, therefore, tax-exempt REITs must distribute a substantial proportion, a minimum of 90%, of their tax-exempt profits to shareholders. The profits, subject to the 90% distribution requirement, are not the REIT's accounting profits, but those accounting profits as adjusted for tax purposes. Deductions for shadow Capital Allowances and for LRR can significantly reduce accounting profits for tax purposes, thus reducing PIDs payable and thereby saving valuable cash resources for reinvestment in the business, or to help fund payment of ordinary dividends out of a REIT's taxed income. Ordinary dividends can be attractive to some shareholders, such as basic rate taxpayers and UK companies, as such dividends, unlike PIDs, are not taxable in their hands. As explained, shareholders' liability to tax on PIDs is determined by their particular circumstances.

In the Budget of March 2010, the then Chancellor of the Exchequer announced his intention to change the REIT legislation after the General Election to permit REITs to meet their mandatory PID payments in stock, rather than in cash. Shareholders would nevertheless be taxed as presently, as though they had received property letting income in cash. If this measure is ultimately enacted by the new coalition Government, it will enable REITs to conserve valuable cash resources by using stock in lieu of cash to meet PID payments and so would be a welcome change for REITs.

The third, and final article in this series, will review the taxes that otherwise tax-exempt REITs remain liable for, or to administer, including stamp duty land tax, VAT, PAYE and national insurance contributions.

For further advice concerning any of the issues raised in this briefing, please contact David Vogel at 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.

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