Real Estate Investment Trusts (REITs): Tax Policy Rationale

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Introduction

Finance Act 2013 saw the introduction of a substantial new body of legislation into Irish law, providing a tax framework for real estate investment trusts (REITs). The detailed provisions of the legislation were outlined in the article "Finance Act 2013: REITs" by Jim Clery in the previous issue of *Irish Tax Review*, 26/1. The present article provides some details of the policy rationale underlying the introduction of REITs and aims to promote a discussion of how Irish REITs may develop in the future.

Property Market: Structural Issues

The development of new legislation in a time of fiscal consolidation comes with its own specific set of constraints. In the absence of a budgetary surplus, it becomes very clear that the tax "cost" of any new measure (i.e. the amount of any reduction in tax revenue to the Exchequer) must be paid for by raising additional tax revenue from another source. It is therefore important to target new measures at specifically identified issues in a given market, and, where possible, take steps to mitigate any tax cost to the Exchequer.

In the case of the investment property market in Ireland, a number of structural issues of concern were identified.

Double layer of taxation

Before the introduction of REITs, investment in property via corporate vehicles was not generally a tax-efficient option, due to the double layer of taxation that applies to profits earned in a company and then paid out to shareholders in the form of dividends. Corporation tax at the higher, non-trading, rate of 25% is payable by companies on rental profits, and shareholders are liable to income tax at marginal rates on dividends paid from the after-tax profits of the company.

A company may not have any obligation to pay after-tax profits out to shareholders and may instead hold the profits within the

company. This can in itself give rise to further taxation, as rental profits retained in a company can be liable to the close company surcharge, where applicable.

Investors in both commercial and residential property therefore tended either to invest personally, concentrating risk into a small portfolio of assets, or to use other vehicles such as investment funds, which generally were suitable only for high-value investors.

Concentration of risk

This lack of a suitable avenue for collective investment, particularly for the smaller investor, led to structural issues in the property market. According to a report produced by Daft.ie, the average Irish residential landlord owns between 1.6 and 2.1 properties, and less than 1.25% own 10 or more properties.[1]

These figures indicate a significant concentration of risk in one or two buy-to-let properties for the majority of residential landlords. Any significant negative movement in the value of just one property would therefore have the potential to wipe out the value of the investment.

In addition, investment in residential buy-to-let property typically involves a significant level of borrowing by investors, exposing them to a number of risks in a time of financial contraction:

- risk of negative equity, if the property value falls to less than the total amount of borrowings outstanding against it, and
- risk of mortgage arrears from a number of causes, including:
  - a fall in rental values to less than the amount of the repayments due on the borrowings,
  - inability to let the property due to net migration from the area following job losses, and
  - a rise in interest rates, increasing mortgage repayments beyond the rental revenue.

Evidence of the effect of this risk concentration has crystallised in the Irish market: Central Bank figures indicate that 25.2% of mortgages in the buy-to-let sector are in arrears, with 18.9% of these in arrears of over 90 days.[2]

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Finally, the proliferation of small landlords leads to a lack of consistent standards in the residential property market. This creates difficulties for tenants seeking accommodation but also for landlords, who may face difficulties in finding good long-term tenants in a rental sector that has not traditionally been geared toward this market.

Access to capital, and NAMA

Another structural issue of significant relevance to the Irish property market, and indeed to the wider economy, is the restricted availability of investment capital from the banking sector due to the financial crisis.

These difficulties are particularly pronounced in Ireland, and throughout Europe, due to a strong reliance on bank financing over other sources of capital investment. In the US, commercial banks are responsible for an estimated 25%–30% of lending, with the remainder coming from a variety of sources, including capital markets and investors in securitised assets. In contrast, the picture throughout Europe is almost the reverse, with banks accounting for the bulk (*c.* 83%) of corporate financing activity – there is *c.* €8 trillion of corporate debt on European bank balance sheets, and only €1.3 trillion in the bond markets.[3]

Attracting alternative sources of investment capital to the property sector therefore has the potential to provide benefits across a broad spectrum of the Irish economy – by allowing banks to concentrate their available loan financing on other investors such as SMEs and retail customers but also by showing to other sectors the potential for accessing corporate finance from sources other than banks.

In the property sector, attracting new investment capital may be of particular benefit to the commercial property market, as there are indications that certain sectors of the commercial property market are showing strong growth and possibly even a shortage in supply.

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1 "The Daft.ie Rental Report: an Analysis of Recent Trends in the Irish Rental Market 2012 Q3", www.daft.ie/report/Daft-Rental-Report-Q3-2012.pdf.
2 Central Bank of Ireland, "Residential Mortgage Arrears and Repossessions Statistics: December 2012", 31 December 2012.
3 "Filling the Bank-shaped Hole", *Economist*, 15 December 2012.

The Investment Property Databank (IPD) Ireland Q3 2012 Briefing[4] shows that the year-to-date total return for investment-grade property in the category "Office Dublin Docklands" was 6.5%, exceeding even City of London offices, which had a total return in the same period of 5.4%. The total return in the "Office Dublin City" category was not far behind, at 4.3% in the same period. "Total return" encompasses both income return and capital growth.

Finally, no review of structural issues in the Irish property market would be complete without reference to the National Asset Management Agency (NAMA). NAMA has acquired loans (land and development and associated loans) with a nominal value of €74 billion from participating financial institutions, and its objective is to obtain the best achievable financial return for the State on this portfolio over an expected lifetime of up to 10 years.

NAMA, through its debtors and receivers, is directly involved in the management and sale of commercial and residential property assets, interacting with the property market on a number of fronts:

› The holders of the distressed loans may choose or be obliged to dispose of property holdings to reduce or resolve the outstanding debts.

› NAMA may acquire property assets through enforcement proceedings on non-performing loans.

› NAMA may facilitate the completion of certain developments with sound commercial prospects, increasing supply to the property market.

It is in the interests both of NAMA and of other owners of property in the Irish market that property disposals are conducted in a way that does not result in a negative, "fire-sale" effect on general property values.

Potential for REITs to Address these Issues

With these structural issues in mind, what potential does the introduction of REITs to the Irish market have to address them?

Double layer of taxation

REITs are specifically designed to remove the double layer of taxation that otherwise applies to property investment via corporate vehicles. Subject to meeting a number of criteria, including a requirement to distribute annually at least 85% of net rental income to its shareholders, a REIT may qualify for an exemption from tax on qualifying income and gains within the REIT.

The distribution requirement has two drivers. First, it protects tax revenues for the State by ensuring that the majority of rental profits are distributed each year for taxation at the level of the shareholder. Second, it ensures a regular income flow from the REIT to its shareholders, making REIT investments suitable as a long-term investment alternative to traditional pension funds, equity shares and direct property investment.

Risk diversification

By removing this double layer of taxation, REITs provide a framework for collective investment in property assets. Instead of purchasing a single entire property, investors can buy shares in a REIT that holds a diversified property portfolio, thereby spreading risk across a range of different property types, locations and sectors.

Ownership of REIT shares also allows an investor to participate in returns from the property market without the need to manage and maintain a property personally. REITs are typically managed by professional property asset managers, allowing shareholders to benefit from their expertise in the selection and management of assets and allowing tenants to benefit from consistent and professional management standards.

Investing via a REIT can have particular benefits for small investors, allowing them to access returns from investment-grade property that would be beyond their reach as an individual investor. This can also be achieved without recourse to the mortgage borrowings typically associated with property investment. REITs are quoted companies, so the minimum investment could be the price of a single REIT share.

Attraction of capital

REITs originated in the US in the 1960s and are now well-established in the US, Europe, Australia and Asia. Approximately 35 countries worldwide currently have REIT or REIT-like legislation.[5] The REIT model is recognised and understood by large and institutional investors throughout the world and is therefore more attractive to these investors than unique Irish products, which may require considerably more due diligence work on the part of large investors before they feel sufficiently comfortable to invest.

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4 Investment Property Databank, Ireland Q3 2012 Briefing, 26 October 2012.
5 European Public Real Estate Association, "Global REIT Survey 2011", www.epra.com/media/EPRA_REIT_2011_Global.pdf.

REITs meeting the recognised criteria for the format may be listed with international REIT associations – EPRA (the European Public Real Estate Association) in Europe and NAREIT (the National Association of Real Estate Investment Trusts) in the US – which are recognised forums for attracting investors to REIT products.

A REIT vehicle would also provide a mechanism for property specialists to assemble a portfolio of investment property assets and then float that portfolio to retail and institutional investors worldwide.

By providing a suitable investment framework, it is hoped that REITs will help to attract investment capital to the Irish property market, including new foreign sources of capital. This should add to various other initiatives undertaken by NAMA, including joint venture transactions and vendor finance initiatives, to facilitate the disposal of NAMA assets over time at the best possible return to the taxpayer.

New sources of investment capital, particularly if backed by professional property asset management in REITs, also have the potential to finance the completion or development of commercially viable property assets, which may otherwise struggle to find financing from traditional banking sources. This could address shortages of supply occurring in specific sectors, such as the Dublin commercial property market, and provide a basis for responsible property development in the future. REITs are not restricted to investing in any specific asset class or location, and so no tax bias should influence the selection of property assets.

Policy Constraints: Protection of Tax Revenue

After identifying REITs as a potential method to address the structural issues in the property market, the potential cost of introduction had to be considered.

Although REITs are obliged to distribute the majority of rental profits annually for taxation at the level of the shareholder and should therefore maintain a certain continuity of existing Case V tax receipts, a potential loss of tax revenue was identified to the extent that REIT shares were owned by non-resident shareholders.

The REIT framework of a tax exemption on rental income at the corporate level that is tied to a distribution requirement effectively converts Case V rental profits into company dividends, for taxation in the hands of the shareholder.

Under current domestic tax legislation, dividends paid by an Irish company to a shareholder resident in a tax treaty country are specifically exempted from the charge to income tax under s153 of the Taxes Consolidation Act 1997 (TCA 1997*)*, and an exemption from dividend withholding tax (DWT) also applies under s172D TCA 1997. In addition, under s29 TCA 1997, an exemption from capital gains tax (CGT) applies to all non-residents in respect of gains derived from listed shares, even in cases where the shares derive their value from immoveable Irish property.

If a REIT structure were to have been established under existing dividend rules, foreign shareholders resident in treaty countries would therefore have had no liability to Irish tax in respect of dividend streams or capital gains derived from immoveable Irish property.

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This loss would have derived from the displacement of the current taxable owners of the fixed stock of Irish property, and not specifically from the entry of new investors who may not have participated in the Irish market in the absence of a REIT regime.

A secondary exposure to tax loss could have arisen to the extent that REIT shares were held by Irish-resident companies. Under the existing s129 TCA 1997, dividends would have been exempt from tax in the hands of the Irish company as franked investment income (FII), and any subsequent taxation of that income on distribution would have depended on the tax residence of that company's shareholders. There may also have been some potential for REIT dividends to be rolled up tax-free by an Irish company shareholder, but the application of the close company surcharge to FII might have discouraged this practice.

The combination of these potential tax leakages, particularly in view of the fact that a specific objective of introducing REITs was to attract foreign investment capital to the Irish property market, would have made the introduction of REITs impossible in the current fiscal environment.

However, further review of international REIT regimes provided a solution to this problem, which it is hoped will not undermine the international competitiveness of the Irish REITs regime. Most foreign jurisdictions with REIT regimes retain a certain level of taxing rights over their REIT dividends, often in the form of a withholding tax on dividend payments. In fact, when the UK introduced a REIT regime in 2007, a new category of "property income dividend" was specifically created to provide a method for collection of tax from foreign REIT investors.

It was therefore decided that, because REITs are a tax-exempt vehicle and therefore fundamentally different from other Irish corporate entities, the tax treatment of REIT dividends could be separated from that of other dividends from Irish companies. REIT dividends would be specifically carved out from the exemptions in ss129, 153 and 172D TCA 1997, thereby preserving Irish taxing rights on REIT dividends to Irish companies and foreign investors.

This does not wholly eliminate the potential tax leakage, as relief from double taxation may still be available to foreign shareholders under relevant double taxation agreements (treaties vary, but in general source countries retain taxing rights in the range of 5% to 15% on such income), but it mitigates the potential loss to a level that is acceptable within current budgetary constraints, when considered in conjunction with the benefits that REITs may bring to the Irish property market.

A REIT regime may also have the potential to increase certain other tax receipts, which may mitigate this tax leakage. Uptake of a REIT regime in Ireland would result in the transfer of property into newly formed REIT vehicles, generating stamp duty revenue on formation at rates of 2% on commercial property and 1% to 2% on residential property.

In the longer term, the borrowing limits integral to the REIT model, which ensure that rental income is not wholly or even largely offset by interest payments, should result in consistent profitability in the REIT vehicle and consequent taxable income distributions to REIT shareholders. Taxation of these regular income streams should provide a more reliable source of revenue to the State than the highly geared investment structures used to date.

After Finance Act 2013: Where to from Here?

The introduction of a new tax regime is often an incremental process. Finance Act 2013 has established a REIT framework in Irish tax legislation, and development of the REIT regime will be ongoing for some time. The Irish stock exchange is currently developing a listing regime for Irish REITs, and the position of Irish REITs with respect to the EU Alternative Investment Fund Managers Directive is also under review.

The future development of Irish REITs will depend very much on the market response to the products. Ireland has international renown as a centre for the management and administration of investment funds – at the end of 2012, almost €2.2 billion in investment fund assets was under administration in Ireland, and over 40% of the world's alternative investment funds are administered from Ireland.[6]

Building on this knowledge, can Ireland become a hub for the financing and management of tax-efficient cross-border investment in rental property assets? Source-country taxing rights in multiple jurisdictions create difficulties in developing cross-border REITs, but it appears that this problem is not insurmountable – Europe's leading REIT is Unibail-Rodamco SE, a French company with a presence in 12 European countries and a portfolio of assets valued at €29.3 billion in December 2012, generating a mix of both taxable and qualifying exempt income for the company.[7]

The launch of a new tax regime is very much like a maiden flight – a huge amount of work goes into designing a product in the hope that it will take off, and not fade away on the statute books unused and forgotten. Once released, however, it becomes a public property, free to be examined and commented on, and perhaps developed and refined in future Finance Bills.

The views expressed in this article are purely personal and should not, in any way, be attributed to the Irish Department of Finance.

Read more on TaxFind TaxFax 1 Feb 2013 Issue, *FINAK – Finance Act 2013 Explained* and Finance Act 2013 Seminar Paper.

6 Irish Funds Industry Association,"Irish Funds Industry Statistics Factsheet, Dec 2012", www.irishfunds.ie/fs/doc/statistics/stats-factsheet-additional-dec-2012.pdf.
7 Unibail-Rodamco, "Annual and Sustainable Development Report 2012", www.unibail-rodamco.com/W/cms_sites/SITE_16406/ressources16406/pdf1/Unibail-Rodamco_RA_2012_GB.pdf.