Step change in property investment

REITs are a much needed addition to our investment landscape, providing a tax efficient vehicle for international investment in property, writes Cara O'Hagan head of Commercial Property at Matheson

The recent establishment of a Real Estate Investment Trusts (REITs) regime in Ireland introduces an internationally recognised model for real estate investment that is attractive to institutional investors, private equity and pension funds and gives smaller retail investors access to returns from prime real estate that can otherwise be beyond their reach.

While it remains to be seen what scale of REIT will emerge from the Irish market, and in what context, it is a welcome development at a time when financial institutions control an overwhelming majority of the prime commercial property here and Ireland must continue to attract international investors to our shores to assist with necessary wide scale deleveraging.

A REIT is not in fact a trust but a listed company used to hold rented investment properties, providing a tax efficient investment vehicle for shareholders with broadly similar returns to direct investment in real estate but with greater liquidity.

As against the double layer of taxation associated with investing in property through a private company (with corporation tax payable on company profits and shareholders liable to tax on distributions), if a REIT meets certain criteria it will be exempt from tax on the income and chargeable gains of its property rental business, and all taxes will be payable in the hands of its shareholders.

An Irish REIT must:

- Be incorporated under the Irish Companies Acts and tax resident only in Ireland;
- List its shares on the main market of a recognised stock exchange in an EU Member State;
- Not be a closely-held company except where controlled by certain 'qualifying investors' such as an Irish pension scheme or an Irish regulated fund;
- Have a property rental business comprising at least three properties, which may be within or outside Ireland, and none of which may individually account for more than 40% of the total market value of all of the properties;
- Derive at least 75% of its income and 75% of the market value of its assets from the property rental business; it may carry on other 'residual' business but the income and chargeable gains from that will not benefit from the tax exemption;
- Distribute at least 85% of its property income by dividend to shareholders in each accounting period.

There is a three-year grace period from becoming a REIT within which to comply with the listing requirements, property composition requirement and close company prohibition.

Taxation

REIT dividends will be subject to dividend withholding tax but certain foreign investors may be entitled to claim an exemption from such withholding tax by virtue of Ireland's tax treaty network.

Irish shareholders will pay corporation or income tax on dividends and will typically be liable to capital gains tax on the disposal of their shares. Non-resident shareholders will not pay Irish capital gains tax on such disposal. The transfer of shares in REITs will attract 1% stamp duty.

To discourage the use of REITs for property development, tax will be charged on profits from the sale of any asset developed at a cost exceeding 30% of its pre-development market value and disposed of within three years.

A tax charge will arise if the REIT pays a dividend to a shareholder (other than a qualifying investor) holding 10% or more of the share capital, distribution or voting rights in the REIT, unless reasonable steps have been taken to prevent the distribution to such person.

On the conversion of an existing property company into a REIT, latent gains in its property assets will be subject to Capital Gains Tax at 33%.

Controls and diversification

A REIT must maintain a property financing cost ratio of at least 1.25:1 and the level of debt within the REIT is restricted to no more than 50% of the market value of its assets. These are welcome limits on the exposure to negative equity risk in what was, pre-2008, a highly geared property market and should ensure that income is not wholly allocated to service debt.

REITs promote diversification of risk and asset base, and encourage responsible professional management of both commercial and residential real estate.

International experience suggests that to attract investment a REIT should hold at least €500mn of prime real estate with a recurring stream of rental income from strong tenants, and preferably specialise in a particular property sector (for example, office, retail, residential), so at this scale their use may be less prevalent in the Irish market than in other jurisdictions.

Investment landscape

Many expected the first REITs to emerge from NAMA, but as that agency holds real estate loans and mortgages rather than direct assets (and mortgage REITs do not form part of the new regime), it may not feature prominently in the initial REITs established here.

While they will not be a panacea for the Irish property market REITs are, however, a much needed addition to our investment landscape, providing a tax efficient vehicle for international investment in property. This will no doubt complement existing investment vehicles such as Qualifying Investor Funds (QIFs) which are appropriate for larger, institutional investors and are subject to Central Bank regulation. ■