REITS: An introduction and a new context after the implementation of AIFMD
Introduction

The Finance Act, 2013 made provision for a new Irish investment product, the Real Estate Investment Trust ("REIT") which was broadly welcomed within the investment community as it could provide investors with a means of investing in real estate through a structure that could provide both income and capital appreciation to investors, like a direct investment in a property would do, while limiting leverage through borrowings with the added benefits of diversification through exposure to a pool of investments and professional asset management.

The Irish government hopes that REITs will provide a new source of capital to the real estate market which could, in turn, reduce dependence on bank financing and because REITs are closed ended, encourage taking a longer term view leading, eventually, to stability of tenure for tenants and better quality buildings.

Investment management professionals in all asset classes, including real estate, are coming to grips with the implications of the European alternative investment funds industry’s ‘big bang’, on 22 July, 2013, when EU Directive 2011/61/EU on Alternative Investment Fund Managers ("AIFMD") is expected to come into force across the EU. One of these implications is that although REITs were not originally designed as a regulated investment product, REITs which are designed for wide distribution will be subject to AIFMD. The EU commission has said, in its guidance on AIFMD:

“The question whether or not a listed real estate investment company is excluded from the scope of the AIFMD depends on whether or not it falls under the definition of an ‘AIF’ in Article 4(1)(a). Real estate companies cannot be excluded as such a priori, each situation needs to be valued on its own merits, based on substance, not on form.”

The purpose if this note is to (i) examine what a REIT is; (ii) look at how REITS can fall to be caught in the AIFMD net; and (iii) compare and contrast REITS and Ireland’s other real estate fund offering, the real estate qualifying investor alternative investment fund ("QIAIF").

Asset Management and Investment Funds Group
Dillon Eustace
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What is a REIT?

A REIT is an Irish company incorporated under Irish company law which meets a number of conditions set out in the Finance Act, 2013 relating to (i) the company itself, (ii) its business (property rental) (iii) its investments, and (iv) its investors.

The REIT itself

The REIT must:

(i) reside, for tax purposes, in Ireland (and not resident elsewhere);

(ii) be incorporated in accordance with Irish company law;

(iii) list its shares on the main market of a recognised stock exchange in a member state of the EU;

(iv) not be a close company (a company controlled by a small number of people) though there are certain exceptions from this requirement where the REIT is under the control of qualifying investors, which includes certain collective investment undertakings.

The Business of the REIT

The REIT must:

(i) derive 75% of its aggregate income from carrying on a property rental business;

(ii) have a minimum rental income to financing costs ratio of 1.25:1; and

(iii) distribute at least 85% of its property income for each accounting period (provided it has sufficient distributable reserves).
Investments of the REIT

The REIT must:

(i) conduct a property rental business consisting of at least three properties,

(ii) invest no more than 40% of the total market value of its properties in a single property;

(iii) not borrow more than 50% of the total market value of its properties.

Investors in the REIT

As above, the REIT must not be a closely held company (a company with 5 or fewer participators as set out in Chapter 1 of Part 13 of the Taxes Consolidation Act, 1997, as amended, (TCA) unless they are “qualifying investors” i.e. Irish authorised funds, Irish insurance companies, Irish tax exempt pension schemes or the National Asset Management Agency of Ireland).

Taxation of the REIT

A REIT must be a company incorporated under Irish company law which makes an election to be taxed under the provisions of the REIT tax regime. Provided the REIT meets the various conditions of the legislation, the REIT will not be liable to corporation tax on income and capital gains arising from its property rental business.

Nevertheless, a REIT will be obliged to operate Dividend Withholding Tax (“DWT”) (i.e. 20% withholding tax) in the normal manner as set out in Chapter 8A of Part 6 of the TCA subject to certain amendments as outlined below.

Taxation of Investors

Irish resident individual investors will be subject to income tax, PRSI and USC in respect of dividends received from a REIT. Irish resident corporate investors will be liable to corporation tax at their appropriate rate. Irish resident investors will be liable to capital gains tax in respect of gains on disposal of their investment in a REIT. Certain Irish resident investors (e.g. pension schemes, insurance companies) will be exempt from DWT.
Non-resident investors will not be liable to Irish capital gains tax in Ireland in respect of gains on disposal of their investment in a REIT as the REIT is a public listed company. However, such investors may be liable to such taxes in their home jurisdictions. In relation to dividends, it is intended that the REIT will apply DWT at the rate of 20% from income distributions to non-residents. Non-residents may be entitled, under their tax treaties, to recover some of this dividend withholding tax from Ireland or otherwise should be able to claim a credit for DWT against taxes in their home jurisdictions.

Transfer Tax

The transfer of shares in a REIT will be subject to stamp duty at 1% on the market value of shares transferred.
Is a REIT an AIF?

Unless a partial or complete exemption is available or the activities in question fall outside the scope of the Directive, the Directive applies to any legal person (an “alternative investment fund manager” or “AIFM”) established in an EU Member State whose regular business is managing one or more “alternative investment funds” or “AIFs”, meaning any collective investment undertaking, including investment compartments thereof, established within or outside the EU:

(i) which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and

(ii) which does not require authorisation pursuant to Article 5 of Directive 2009/65/EC (the UCITS Directive);

A REIT cannot be a UCITS because UCITS cannot invest in real estate but it does generally raise capital from a number of investors (at least 5) and, according to draft Irish Stock Exchange guidelines for REITS, would have to do so on the basis of an investment policy set out in the prospectus being used to obtain its listing. Therefore, most REITs will be AIFs and subject to AIFMD.

It is not yet clear how the Central Bank would deal with REITs as, until now, the Central Bank has not looked at structures such as REITs, established under national legislation where the Central Bank, until AIFMD, had no express role. To date the Central Bank has authorised non-UCITS funds under national legislation and the introduction of legislation implementing AIFMD will put a second layer of authorisation on non-UCITS funds (if they are self-managed) or their managers. From a practical point of view it should be possible for the Central Bank to authorise REIT promoters as AIFMs without imposing any of the QIAIF specific rules of the REIT itself.

Some of the requirements of AIFMD would not be familiar to REIT promoters not used to dealing with a regulated fund management environment. Others, such as the requirements in relation to valuation, might echo the requirements of the Society of Chartered Surveyors in Ireland. The parts of AIFMD which will be of particular concern to a REIT promoter are:

- Operating Conditions
- Organisational Requirements
AIFM Requirements

AIFMD imposes limitations on the activities which an AIFM can carry on, obligations regarding how an AIFM conducts its business, organisational and capital requirements, rules around delegation generally and delegation of investment management functions specifically as well as other obligations in areas such as risk and liquidity management, record keeping, financial control and conflicts of interest.

Valuation

AIFMD requires that appropriate and consistent procedures are put in place by AIFMs so that proper independent valuation of the assets of each AIF that they manage can be performed. The AIFM is responsible for the proper valuation of an AIF’s assets, for the calculation of its NAV and for its publication/dissemination. The fact that the AIFM has appointed an external valuer does not affect the AIFM’s liability towards the AIF and its investors. Accordingly, when establishing AIFs, AIFMs will need to decide whether they will appoint an external valuer, with the requisite professional guarantees, or whether they will perform the function themselves. In either case, the AIFM remains responsible.

Transparency

The Directive deals with transparency in three ways – by imposing requirements as to the annual report of an AIF, required disclosure to investors, and reporting obligations to competent authorities (in Ireland, the Central Bank).
Remuneration Rules

In addition to rules as to how an AIFM must conduct its business, organise itself, report to investors and to regulators, value assets, etc., AIFMD requires AIFMs to implement remuneration policies designed to address what the recitals to AIFMD refer to as “the potentially detrimental effect of poorly designed remuneration structures on the sound management of risk and control of risk-taking behaviour by individuals.”

The remuneration rules do not relate to management or to performance fees charged by an AIFM or investment manager, rather they relate to the remuneration of “identified staff” of the AIFM and, as explained below, of its delegates.

The remuneration rules are principles and must be complied with by AIFMs “in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities”.

Depositary Requirements and Liability

AIFMD requires the appointment of a depositary to carry out specific functions including the monitoring of cash flows and safekeeping of assets as well as general regulatory oversight responsibilities and to impose stringent liability provisions on depositaries.

AIFMs must ensure that, for each AIF it manages, a single depositary has been appointed and that the appointment is formalised in a written contract regulating at least the flow of information necessary to enable the depositary to perform its functions.

Note that, under AIFMD, Member States may also allow an entity such as a notary, lawyer or registrar to be appointed to carry out the depositary function of AIFs which have no redemption rights exercisable for 5 years and which either do not invest in assets that must be “held in custody” or generally invest in issuers or non-listed companies for the purpose of acquiring control (such as private equity, venture capital and real estate funds), provided the entity in question is subject to professional registration or mandatory rules of conduct in respect of the depositary function and can provide sufficient financial and professional guarantees.

For More information on AIFs and AIFMD, please refer to Dillon Eustace’s “Guide to AIFMD”, which can be found here.
REIT v QIAIF: some highlights

Listing on a Stock Exchange

In order to be a REIT, the shares of the REIT must list its shares on the main market of a recognised stock exchange in a member state of the EU. QIAIFs may seek to list their shares on a recognised stock exchange but are not obliged to do so. All listings on the Irish Stock Exchange (“ISE”) must be made through a listing sponsor who will assist the promoter of the entity seeking the listing to meet the ISE’s requirements. REITs must be listed on the main equity market whereas QIAIFs will list as investment funds.

The ISE has drafted a set of Listing Rules specifically for REITs and has aligned these requirements with those of the FCA Listing Rules in the UK so as to facilitate REITs that may seek a dual listing in Ireland and the UK.

Passport

From July 22, 2013, an EU authorised AIFM will have a “passport” to freely market its EU domiciled AIFs to “professional investors” in its own Member State and in other EU Member States, subject to a straightforward notification process. In other words, once the AIFM is authorised in one EU Member State it does not need any further authorisation in any other EU Member State to market its EU AIFs to professional investors in the other Member States.

A “professional investor” is any investor which is considered to be a professional client or may be treated as a professional client on request within the meaning of Annex II of Directive 2004/39/EC. A list of investors categorised as professional investors can be found in Dillon Eustace’s “Guide to AIFMD”, which can be found here.

In addition to the AIFMD “passport”, a REIT will also have to produce a prospectus in accordance with the Prospectus Directive (2003/71/EC) (the “PD”). The PD (and the legislation implementing it in Ireland) applies to the drawing up and the publication of prospectuses when securities are offered to the public and/or admitted to trading on a regulated market in the EU and imposes disclosure requirements over and above those mandated by the Central Bank. The additional burden of compliance with the PD comes with the added benefit that a PD compliant prospectus is a harmonised document which can be used throughout the EU without further amendment.
QIAIFs which do not provide any redemption facility (at the request of the investor) during the life of the QIAIF are subject to the PD (unless they can benefit from any of the exemptions listed below).

- where the offer is made to ‘qualified’ investors meeting certain criteria;
- where the offer is made to fewer than 100 natural or legal persons other than qualified investors;
- where the offer is made to investors who acquire the securities for a total consideration of at least €50,000 per investor or the denomination per unit is at least €50,000;
- where the total consideration of the offer is less than €100,000 calculated over a period of 12 months;
- where shares representing less than 10% of the number of shares of the same class are already admitted to trading on the same regulated market.

Any subsequent resale of securities to which these exemptions apply is however regarded as a separate offer and may require a prospectus unless an exemption applies.

The PD does not apply to QIAIFs which provide even a quite limited opportunity for redemption at the request of investors.

**Liquidity**

Other than when a REIT is at the end of its life and is being wound up, Investors in a REIT may generally only obtain liquidity through the sale of their shares in the secondary market. The only other option is for shareholders to pass a special resolution in relation to the redemption of their shares with a subsequent confirmation from the Irish High Court.

It was hoped that the requirement that shares of a REIT should be listed would facilitate secondary market liquidity. However, it remains to be seen whether a listing in Dublin would be sufficient to create liquidity – it is more likely that a listing in London would provide the desired level of liquidity. This is because investors in London listed investment products are more used to seeing investment products trading at discounts or premiums to their Net Asset Value per share and concepts of discount management through share buyback programs are more established there than they are in Dublin.
QIAIFs can be structured as open-ended, open-ended with limited liquidity, limited liquidity or closed-ended schemes. One would expect, however, that most real estate funds would be established as limited liquidity funds or as closed-ended funds due to the long term nature of an investment in real estate and the lead time in bringing sales of real estate assets to completion.

For highly diversified funds, open-ended with limited liquidity may be considered.

*Open-Ended / Open-Ended with Limited Liquidity*

In summary, an open-ended fund is one which provides redemption facilities for investors (at their request) on at least a quarterly basis. Open-ended with limited liquidity is one which provides redemption facilities at least annually.

*Limited Liquidity*

A limited liquidity fund is one which provides that, at some stage during the life of the fund, there will be an option for investors to request redemption.

*Closed-Ended*

Closed-ended funds are funds which do not provide any capacity for investors to request redemption during the life of the fund.

All closed-ended funds are required to have a finite closed-ended period provided for in the constitutional documentation. There are no restrictions on initial duration for QIAIFs

At the end of the closed-ended period, the fund is required to either:

- wind-up and apply for revocation of authorisation;
- redeem all outstanding units and apply for revocation of authorisation;
- convert into an open-ended fund; or
- obtain investor approval (generally 75% of more of votes cast at a meeting of shareholders in favour) to extend the closed period for a further period.
Investment Scope

REITs must invest in at least three properties with no more than 40% of the total market value invested in a single property.

QIAIFs are not subject to any regulatory investment diversification requirements. QIAIF companies (PLCs) are subject to a statutory requirement to spread investment risk (generally understood to mean at least two but preferably three investments). QIAIF unit trusts can invest in a single investment.

Additionally, QIAIFs may have the flexibility to invest in other types of investments such as government or corporate debt prior to investing in or after divesting from real estate or create hybrid investment policies where the QIAIF can invest in other asset classes as part of its investment policy.

However, the broader scope of the investment universe available to QIAIFs may make finding investment managers for QIAIFs more difficult than for REITs. For example, an Irish manager of a REIT investing in Irish real estate will probably not have to be licenced to use FX or FX derivatives whereas such a licence could be essential for the manager of a real estate QIAIF investing worldwide and having to manage resulting currency exposures.

Leverage

The limit on leveraging a REIT (a REIT can borrow no more than 50% of the total market value of its properties) will be attractive to many investors. There are no mandatory limits for QIAIFs.

Distributions

REITs must distribute 85% of their property income. A QIAIF can either distribute its income or, if its objective is solely capital appreciation, can accumulate its rental income instead of distributing it.

Taxation

Income and Capital Gains Tax

QIAIFs are not subject to Irish tax on income (profits) or gains while REITs are generally not subject to Irish tax on income (profits) or gains.
Withholding Tax

QIAIFs do not have to withhold taxes on distributions to investors provided the investors have made the appropriate tax declaration of non-Irish residence to the QIAIF or the QIAIF has satisfied and availed of certain prescribed equivalent measures.

Except for certain Irish resident investors, who are exempt in line with normal DWT rules, REITs are obliged to deduct 20% dividend withholding tax from all dividends paid by it even if they are non-resident investors (although non-resident investors in REITs may be able to reclaim this amount or claim a tax credit in their home country.

There are no Irish withholding taxes on distributions made to certain categories of Irish investors in QIAIFs (which would include approved pension schemes, charities, other investment funds, etc).

Stamp Duty

Unlike for a REIT, there is no stamp duty or subscription tax payable in Ireland on the issue, transfer, repurchase or redemption of units in a QIAIF.

VAT

Many of the key services provided to QIAIFs (fund administration, investment management, etc.) are exempt from Irish VAT.
Is it better to REITs or not to REITs

Managers of REITs and QIAIFs each fall to be regulated by AIFMD, unless they can avail of an exemption, so the answer to this question depends on the circumstances facing the promoter of the particular structure and really comes down to where the investors are based, how exclusively the product will be focussed on real estate and whether the investment objective is solely to produce income or capital appreciation.

If the target investor group is Irish and the product is intended as part of a diversified portfolio with the product focusing solely on producing real estate income then a REITs may be appropriate. Investors from outside of Ireland will most likely find the tax neutrality of a QIAIF to be more attractive than the treatment of stamp duty and withholding tax for REITs.

The more the product is diversified geographically with requirements in relation to currency management or requires the use of other investment classes the less likely a REIT will be appropriate.
CONTACT US

Our Offices

Dublin
33 Sir John Rogerson’s Quay
Dublin 2
Ireland
Tel: +353 1 667 0022
Fax: +353 1 667 0042

Cayman Islands
Landmark Square
West Bay Road, PO Box 775
Grand Cayman KY1-9006
Cayman Islands
Tel: +1 345 949 0022
Fax: +1 345 945 0042

Hong Kong
604, 6/F, Printing House
6 Duddell Street
Central
Hong Kong
Tel: +852 35210352

New York
245 Park Avenue
39th Floor
New York, NY 10167
United States
Tel: +1 212 792 4166
Fax: +1 212 792 4167

Tokyo
12th Floor,
Yurakucho Itocia Building
2-7-1 Yurakucho, Chiyoda-ku
Tokyo 100-0006, Japan
Tel: +813 6860 4885
Fax: +813 6860 4501

e-mail: enquiries@dilloneustace.ie
website: www.dilloneustace.ie

Contact Points

For more details on how we can help you, to request copies of most recent newsletters, briefings or articles, or simply to be included on our mailing list going forward, please contact any of the team members below.

Trevor Dolan
E-mail: trevor.dolan@dilloneustace.ie
Tel : + 353 1 673 1850
Fax: + 353 1 667 0042

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