CONFIDENTIAL

Promoting More Flexible Investment in Property

Response to HMT & Inland Revenue Consultation Document

By the

Investment Property Forum

British Property Federation

RICS

16 July 2004

BPF BRITISH PROPERTY FEDERATION IPF Investment Property Forum RICS

Table of Contents

page

UK REITs – Summary Recommended Structure 1

Introduction 3

UK REITs - Summary Structure and Investment Criteria 6

Industry Response to Consultation Document Questions 22

The Economic Context

Question A.1 23

Possible Structures for a PIF

Question A.2 27
Question A.3 33
Question A.4 37
Question A 5 45
Question A.6 50
Question A.7 59
Question A.8 63
Question A.9 68

Tax Implications of a PIF

Question A.10 74
Question A.11 82
Question A.12 84
Question A.13 88

Transitional Issues and a Conversion Charge

Question A.14 91

Wider Implications

Question A.15 101
Question A.16 110
Question A.17 115
Question A.18 117
Question A.19 121

Glossary 123

Appendix 1 – Industry Focus Groups and Representatives 125

BPF BRITISH PROPERTY FEDERATION | IPF Investment Property Forum | RICS

UK REITS – Summary Recommended Structure

Principles	• Introduction of a simple structure that will promote the development of healthy, viable commercial and residential real estate businesses which will, in turn, provide the basis for:
	  • Attractive savings and investment products for both retail and institutional investors; and
	  • Internationally competitive, pan-European investment vehicles to the benefit of London generally as a financial centre
	• Objective is to align the post tax returns from indirect real estate investment offered through UK REITs more closely with those obtained from a direct exposure to real estate.
	• Appropriate regulation and governance to protect all investors, particularly those from the retail market.
	• Legislative regime to ensure the maximum operational flexibility.

Legal Entity	• A Corporate rather than Trust or other collective investment scheme structure. • No need for new corporate structure, ensuring minimum amendments to existing UK Company Law and speed of introduction.
Status	• Listed and unlisted with the regulatory regime provided by the UKLA and UK Company Law respectively. • Stamp duty at 0.5% applicable to value of UK REIT share dealings. • Closed-Ended. • Shares in listed UK REITs eligible to be held in ISAs and SIPPs.
Investor Base	• Listed UK REITs, no concentration rules beyond those normally applied by the UKLA requirements. • Unlisted UK REITs, restricted to sophisticated and institutional investors and with no concentration criteria.
Management	• No legislative restrictions, with UK REITS (listed and unlisted) to adopt internal or external management business model of their choice.
Income Distribution	• Ongoing dialogue with HMT / Inland Revenue to assess ratio of gross income to net earnings within UK real estate environment. • In principle agreement to substantial distribution of cashflow earnings (i.e. post expenses and depreciation) at a payout ratio in line with international standards for overseas REITs, subject to the proposed Company Law "override" and IAS definitions. • Eligible income – 75% of gross income must be from active or passive real estate investment and closely related activities • Additionally, 95% of net income must be from similar sources or other passive forms of income. • 5% permissible limit from non-eligible activities.

- Provision for Taxable REIT Subsidiaries (TRSs) subject to maximum exposure income and asset constraints e.g. TRSs cannot comprise more than 20% of UK REIT gross assets.

Capital Distribution

- No obligation to distribute cash gains from UK REITs whether listed or unlisted.
- In both cases, capital distributions to be taxed as capital gains in the hands of investors.

Borrowing Levels

- No legislative restrictions, with UK REITS (listed or unlisted) free to adopt financing structure of their choice.

Development Activity

- No legislative restrictions, with UK REITS (listed or unlisted) free to adopt level of development exposure of their choice.
- Application of existing tax tests to determine difference between gains from investment and trading activity subject to the introduction of "safe harbour" provisions for assets held by a UK REIT for three years.

Property Types

- UK REITs free to invest in land and property in the broadest sense (including infrastructure and PFI projects) with no minimum hold periods.
- Other activities derived from the business of real estate investment to be included, e.g. mortgage REITs, umbrella REITs and/or income derived from the provision of real estate for third party occupation and closely related services.
- All forms of real estate investment activity to be subject to clear arms length contracts between the operating company/tenant and the UK REIT.
- No requirement for sector/geographic diversification within UK REIT portfolios i.e. single sector focused vehicles permissible.
- Cross border investment across EU and elsewhere permitted through UK REIT.

Conversion Charge

- In principle, acceptance of the imposition of a conversion charge, to ensure no overall cost to the Exchequer within the context of the broader debate as to the revenue implications of UK REITs.
- In the absence of a clear assessment of the current net tax take from the UK real estate sector it is difficult to derive an appropriate, and fair, assessment of the scale and mechanism of any such charge.
- Further considerations to be borne in mind:
  - Whatever the mechanism, it will have to reflect the diverse range of investment vehicles active across UK real estate; and
  - The charge will need to be set at a level which encourages vehicles to convert so as to ensure a critical mass develops providing momentum for the process, thereby enabling Government to achieve its overall objectives for the initiative.

1. Introduction

Background

1.1. On 17th March 2004, HM Treasury ("HMT") published a Consultation Document (the "ConDoc") entitled "Promoting more flexible investment in property: a consultation" the objective of which is to "seek views on how a new vehicle for investing in property might be structured in order to meet the Government's objectives to encourage an efficient and flexible property investment market, with fairness for all taxpayers".

1.2. That document launched the government's formal consultation on how the legal and tax structure of a new vehicle might be developed in order to meet the Government's aforementioned objectives, alongside related property investment products. As such, it responds to concerns that barriers in the tax system may be contributing to distortions in the market for property investment resulting in poor liquidity, barriers for small investors entering the market and high debt financing levels. All of which may be hindering progress towards a more stable and efficient real estate market, one which is better able to support the Government's economic objectives.

1.3. This document, submitted on 16th July 2004, represents the joint response to the ConDoc of the three leading property membership organisations in the UK, namely the Investment Property Forum ("IPF"), the British Property Federation ("BPF") and the RICS.

1.4. Between them, these three organisations represent the majority of the UK commercial and residential real estate industry not only by number of individuals (on a multi disciplinary basis) but also in terms of value (including wide representation from both the institutional, as well as, listed real estate sectors). Thus:

- **Investment Property Forum** - Set up in 1988, the IPF is now recognised as one of the leading specialist property industry bodies in the UK. It comprises an influential network of senior professionals all active in the real estate investment market. The membership reflects the strength of the organisation with its diversity of individual (as opposed to corporate) members who now total circa 1500. Members include investment agents, fund managers, bankers, lawyers, researchers, academics, actuaries and other related professionals. The Forum's mission is to improve the awareness, understanding and efficiency of property as an investment for members and others in the wider business community by: undertaking research and special projects; providing education; and, by encouraging discussion and debate.

- **British Property Federation** - The membership of the BPF now comprises a broad range of listed and unlisted institutions, asset managers and investment banks, as well as other organisations which are involved in the property industry such as agents, lawyers, accountants, consultants and project managers. In addition, the membership of the BPF includes an increasing number of institutions and individuals which

invest in the residential property market. The BPF estimates that its members hold property assets and funds under management invested in property with a value equal to approximately £250 billion.

- **The Royal Institution of Chartered Surveyors** – The RICS is regulated by Royal Charter with the objective of promoting the public good. This allows the RICS to comment independently on matters relevant to its profession. The RICS numbers over 100,000 members who work in both the public and private sector and are involved in all aspects of land, property and construction.

1.5. In turn, the three organisations have drawn on the full spectrum of real estate industry participants as well as the associated professionals and stakeholders, as set out in paras 1.9 to 1.11, to ensure that as broad a consensual response as possible has been prepared.

1.6. As such, this response represents a further step in the dialogue on this subject between government and these three organisations acting in unison, and so providing a single representative "voice" for the UK real estate industry. However, the three groups recognise, and have indeed encouraged, that individual organisations and practitioners should respond separately to HMT.

1.7. Throughout the ConDoc, for convenience, the potential new vehicle for the UK was referred to as a "Property Investment Fund (PIF)" though it was noted that the name may change to reflect the final structure and that the Government would welcome alternative suggestions.

1.8. We consider that the concept of a REIT is widely recognised and understood within the real estate and wider investment markets in the UK and overseas, and that there would be little benefit in using the acronym "PIF". We have therefore used the expression "UK REIT" throughout this document.

Preparation and Basis of Response

1.9. As already noted, the comments and thoughts expressed in this document represent the co-ordinated view of the three leading property membership organisations in the UK .

1.10. This perspective has been derived through a REIT Steering Group comprising members of the three organisations noted above, supplemented by a range of industry participants as well as specialist tax and legal advisers. In turn, this Steering Group has drawn on the work of eight Focus Groups convened to elicit views from a range of stakeholders on particular issues raised by the ConDoc i.e. the relative merits of internal versus external management, listed or unlisted etc.

1.11. Appendix 1 sets out the composition of the Steering Group and these Focus Groups together with their constituent members and which highlights the depth and diversity of opinion from across the UK real estate industry which has been drawn together in preparing this response.

1.12. In addition to securing feedback from these specific groups, this response is also based on a range of conversations with stakeholders outside of the UK real estate industry, including many of the organisations represented at the series of HMT Review meetings on the topic convened over the past three months e.g. NAPF, ABI, IMA etc.

1.13. As a result of these meetings, and the issues discussed, there remain a number of areas subject to further research and discussion with HMT post the close of the formal Consultation period on 16th July 2004, and we look forward to continuing our dialogue with HMT in these areas.

Response Document Structure

1.14. Before responding in detail to each of the specific questions raised in the ConDoc, in the next section we have set out in summary form our overall vision for the structure and principal investment criteria that should pertain to UK REITs. The subsequent responses to specific questions can be considered against the context of the whole envisaged vehicle. For ease of reference, the comments on the overall structure follow a broadly similar structure to that within the ConDoc.

UK REITs - Summary Structure and Investment Criteria

2.1 We consider that UK REITs should be relatively conservative vehicles, given the overall objective of aligning the after tax returns from holding property indirectly more closely with those returns obtained from holding the underlying asset directly (e.g. low volatility, relatively high, stable long term cashflows etc).

2.2 The general presumption is that, within the appropriate level of regulation and governance to protect the retail investor, the vehicles should be left as unfettered as possible allowing the markets' pricing mechanism to operate efficiently. Hence, while structural and governance criteria should be clearly prescribed, we believe that the maximum operational freedom (in terms of management structure, gearing and development activity) should be provided for.

2.3 We would emphasise that the most mature and successful markets[1] with tax transparent real estate vehicles (Australia and the US) are, in terms of investment criteria, amongst the least prescribed of the various international jurisdictions providing such vehicles (see ConDoc table 2.1).

2.4 The recommendations in this document, and our general approach to the whole initiative, have been framed by the inter-related requirements of securing the successful launch of UK REITs with sufficient momentum while ensuring the creation of internationally competitive, vibrant businesses capable of success in both the listed and unlisted markets.

2.5 Failure of either objective will, in our opinion, lead to the resumption of the contraction in the listed sector and a further shift by investors into offshore real estate vehicles with all of the consequent tax leakage, loss of government control and associated issues for the retail investor and savings industry so implied. Furthermore, should the UK REIT initiative stall then this may also lead investors into Non-UCITs retail / QIS vehicles, subject to the removal of the current tax disincentive and so long as they, and HMT, are prepared to accept investment into real estate vehicles wholly through open-ended structures.

2.6 The alternative envisages the successful launch of UK REITs to the benefit of the existing real estate markets with the wider prospect of securing the UK's position as the jurisdiction of preference for the overall European real estate fund management industry. The UK has a track record of financial predominance across Europe (e.g. in equities and forex trading) with the recent growth of the hedge fund management industry within London providing a clear precedent of the opportunity, and associated benefits, for the real estate sector.

2.7 Assuming the recommendations set out in this document are followed, and the cost of conversion not too onerous, then it is likely that the introduction of UK REITs, alongside the new schemes promoted in the new Collective Investment Schemes Sourcebook Instrument 2004 ("COLL") will have a profoundly positive impact on the structure of all sectors of the UK commercial and residential real estate markets.

[1] Based on a variety of measures as shown in the Industry Briefing Document for HMT, September 2003

Structural Features

2.8 In considering the most appropriate structural attributes of the UK REIT, as far as practicable and consistent with achieving a relatively rapid and economically successful launch to the initiative, we have sought to ensure that the primary legislation required to introduce UK REITs would be limited to a Finance Bill so that other changes could be dealt with by secondary legislation (i.e. by regulations or statutory instruments issued pursuant to existing legislation).

2.9 **Legal Entity** – We consider that the most appropriate form of legal structure for UK REITs to adopt would be companies formed under the Companies Act 1985 ("CA") rather than unit trusts or other collective investment schemes, for the following reasons:

2.10 Firstly, a trust would take effect as a collective investment scheme for the purpose of the Financial Services and Markets Act 2000 ("FSMA") and, therefore, be subject to the restrictions on promotion contained in FSMA. This would prevent direct marketing to the public (unless the Trust offered investors net asset value redemptions), thereby making it more difficult for the REIT to raise further capital or issue units to vendors in consideration of the transfer of properties.

2.11 Secondly, this would also impose a number of other potential restrictions on dealings by the REIT including circulars, websites, formats of accounts, press releases and statements made at investor meetings. In addition, any trust vehicle would need to be operated by an authorised person. As a consequence, a trust would not be able to operate flexibly in the market in the same way as a property company which could potentially impact adversely on the optimisation of returns for investors.

2.12 Thirdly, there is currently no effective means for dealing with interest(s) in collective investment schemes via CREST. CREST has made submissions to the FSA in connection with CP185 in order to have the regulatory framework changed but these changes have not yet been implemented and it is unlikely that this will occur in the foreseeable future.

2.13 Finally structuring the vehicle as a company will enable UK REITS to lock in to the established framework of company law. This will give investors the benefit of the existing corporate governance regime which applies to UK companies and the protection afforded by director's responsibilities and the Takeover Code.

2.14 **Listed and Unlisted** – Whereas the ConDoc (para 2.8) envisages that a UK REIT should only be listed, we believe that such vehicles should be capable of being listed and unlisted. The UK benefits from both a large, relatively liquid listed real estate sector (61 companies, with £19.7bn aggregate equity market capitalisation) [2] as well as a large and active indirect institutional market

[2] Datastream as at December 2003

operating through a range of vehicle types (207 vehicles with £33.3bn gross asset value)[3].

2.15 We consider that restricting UK REITs to listed entities only would foreclose the opportunity for many of the unlisted vehicles for which there is strong demand from sophisticated and institutional investors. These investors do not necessarily require, nor desire, the liquidity and regulation appropriate for the retail market, but would prefer the ease of operating within an onshore environment.

2.16 Furthermore, many of the current unlisted vehicles may not possess the scale nor structure to warrant listing. Conversion from their current format into unlisted UK REITs would clearly have appeal due to the benefits from access to the onshore capital markets and the ability to list, with relative ease, in future.

2.17 It is important to note that listed Australian Listed Property Trusts ("LPTs") and US REITs represent a minority of all such vehicles in their respective markets, by both size and market capitalisation:

- In Australia, listed property trusts currently account for just 7.6% of all funds by number (irrespective of category) and 41% of total net assets[4]; and
- In the US, there is a dearth of detailed statistics on the unlisted REIT market but, we understand that such vehicles predominate by number (accounting for 82% of all US REIT tax filings in 2001) if not by capital value.

2.18 By allowing both listed and unlisted UK REITs, we believe HMT would:

- Firstly, adopt best practice as shown in the most mature and successful overseas markets;
- Secondly, ensure the development of a pipeline of suitable portfolios with management track records for subsequent listing so as to enhance retail investor choice;
- Thirdly, to ensure the greatest possible chance for the successful launch of UK REITs by embracing the full extent of real estate investment activity; and
- Finally, in so doing, foster and encourage the development of a significant onshore real estate investment market, and in so doing promote the UK as the jurisdiction of preference for the wider European real estate fund management industry, thereby maximising the opportunities for both retail and institutional investors.

---

[3] Oxford Property Consulting, Statistical Summary, December 2003
[4] Property Investment Research, Australian Property Funds Industry Survey 2003

2.19 As such, it is of interest to note the scale of the potential opportunity and the relative advantage the UK already holds within the European real estate fund management industry and which could be built upon:

- As at December 2003, the European (including UK) unlisted real estate market comprised 570 vehicles with a gross asset value ("GAV") of €350bn. This is in addition to the GAV of circa €120bn for the European listed real estate sector[5];
- Of this total, UK indirect unlisted vehicles account for circa €60bn GAV, overwhelmingly structured by way of Limited Partnerships ("LP's") as well as UK and offshore trusts. The proportion held within the latter structures is expected to grow substantially this year with circa £15bn GAV held in onshore LPs expected to transfer offshore so as to avoid the imposition of SDLT on the transfer of interests in partnerships effective from the date of Royal Assent for the current Finance Bill;
- The most popular domicile for these vehicles, by number, is the UK at circa 36% (207 by number); and
- This is matched by the dominance of UK domiciled managers measured by number of vehicles under management (as opposed to GAV where the very large German open-ended funds distort the statistics) at circa 47% (275 by number). In other words, many vehicles based on non-UK domiciled structures are already run by UK based managers.

2.20 **Closed-ended** – The ConDoc (para 2.16) promotes the concept that the UK REIT should be closed-ended as opposed to open-ended irrespective of whether the vehicle is listed or unlisted. We wholly concur with this recommendation and would note that:

- There are already in existence a range of open-ended structures available to the UK retail and institutional investor base, including those now permissible under the New Collective Investment Schemes Sourcebook Instrument 2004 ("COLL") so ensuring a wide range of investor choice with the requisite regulatory controls;
- International experience indicates that closed end vehicles have become the predominate structure of choice over time e.g. US REITs commenced as open-ended structures but the listed sector is now wholly closed-ended; and
- The trend towards sector specific vehicles, driven by investor preference as evident in both the US REIT and Australian LPT markets as well as increasingly within the UK unlisted market, increases the risk of substantial redemption "runs" in an open-ended format. By contrast, closed-ended vehicles merely face price adjustment in the secondary markets. This distinction is of critical importance for an asset class such as real estate, where the underlying direct product is relatively illiquid

[5] OPC Indirect Property Market in Europe, January 2004

2.21 In general, we consider that, so far as is practicable, investors should be provided with the maximum choice allowing them to select between closed-ended versus open-ended and listed versus unlisted vehicles.

2.22 The industry therefore recommends that, in line with the consultation regarding the introduction of UK REITs, a consultation process should be implemented to consider aligning the tax, and possibly regulatory, treatment of APUTs (and OEICs), more closely with that of UK REITs. So doing would ensure a genuine open-ended alternative to UK REITs.

2.23 **Investor Base** – In considering the issue of maximum or minimum concentration limits, as set out in para 2.19 in the ConDoc, for ease of application and subsequent regulatory oversight we recommend that in respect of listed UK REITs, that the UK Listing rules as currently constituted are adopted. Specifically, paras 3.18 to 3.21a in the UK Listing Rules that can be summarised as:

- 25% of the shares have to be in public hands;
- Shares are not deemed to be in public hands if held by a director (or connected party), ESOPS or pension funds of the company or any person holding an interest in 5% or more of the stock; and
- We also recommend that the Controlling Shareholder provisions (paras 3.12 to 3.13 from the same source) apply.

2.24 However, in the context of unlisted UK REITs, where the investor base will comprise a limited number of sophisticated and/or institutional investors, we do not believe it appropriate for concentration criteria to be applied.

2.25 **Management** – The ConDoc (paras 2.3 and 2.22) highlights the fact that international experience indicates that where similar style property investment vehicles have worked well, internally managed structures have historically been more popular.

2.26 It is clear that the bias within overseas listed structures is now towards the internal management business model (comprising the dual roles of self advised and self managed) though this has not always been the case. Thus, as at February 2004, 90% of US REITs by number were internally managed as against 61% at end 1995. However, for the vast majority of US REITs and Australian trusts which are not listed, external management is the accepted business model.

2.27 Accordingly, in line with overseas experience where the management business model tends to be a function of whether the vehicles are listed or not, and where the bias towards internal management structures for listed stocks has varied over time, we recommend that UK REITs should not be constrained in this area but rather should be able to adopt the business model of their choice.

2.28 To our mind, the important issue is to ensure a clear alignment of interest between management and investors. Hence, so long as the vehicles offer investors absolute transparency in terms of costs and information, performance

in line with investment objectives and that the management is capable of being removed by the investors if they do not, the decision should not be determined by regulation. The market may over time, however, show a preference for one structure over another

2.29 **Income Distribution Requirements** - Paras 2.23 to 2.28 in the ConDoc deal with the issue of income distribution and suggest that, again in line with overseas experience, "a requirement to distribute 90% of income (before depreciation) appears to strike a balance between an attractive distribution policy and maintaining sufficient working capital within the vehicle".

2.30 While we agree with the principle that distribution of the majority of the cashflow should a key feature of the UK REIT, we do not consider it appropriate to distribute a substantial element of the gross income pre depreciation (or even pre interest payme nts) as suggested in the ConDoc.

2.31 This is because direct real estate is an asset class that requires regular expenditure to (at least) maintain its value (in terms of the physical fabric and suitability/attraction to tenants) and, if insufficient working capital was retained in the UK REIT for such purposes, then the net result would either be that:

- The portfolio would either effectively become a wasting asset providing degrading accommodation to the occupier base while also adversely impacting any loan to value (LTV) gearing conditions; or

- Regular sales from the portfolio would be required to generate the requisite cash resulting in an eroding asset base; or

- Regular "taps" of the shareholders (i.e. regular small rights issues) would be required just to fund maintenance of the existing portfolio rather for than any particular expansion of the portfolio.

2.32 Accordingly, we consider the more appropriate measure is for a significant proportion of the UK REITs net cashflow earnings to be distributed, post a deprecia tion (or management determined maintenance expenditure) allowance together with other management charges and costs so as to be in line with international standards e.g. 80% plus. Since it will not be practicable to amend existing UK Company Law, we recommend that this requirement be subject to the existing over-riding proviso.

2.33 However, before providing a recommendation as to the appropriate level of distribution and depreciation that should be applied, the complexity of this area both in absolute terms and relative to the operation in other REIT jurisdictions was acknowledged at the HMT / Inland Revenue Property Investment Fund Consultation Meeting 12th May 2004.

2.34 At that meeting it was agreed that a small sub-committee would be formed to research this area in greater depth so as to more fully inform the Consultation Process prior to finalising the recommendations in this area. At the timing of writing, the results from this sub-committee are still awaited.

2.35 **Eligible Income Definition** – A critical element of the decision regarding the appropriate distribution policy clearly revolves around the definition or clarification of what income is to be permissible within the terms of a UK REIT, in terms of qualifying activity, and what element of the whole is eligible for different types of tax treatment.

2.36 In determining the exact nature of the income within a UK REIT subject to the distribution requirements, as is discussed at greater length in our answer to Question A.13, it is critical to take into account the introduction of International Accounting Standards ("IAS") so as to ensure, for example, that the treatment of unrealised gains does not distort the distribution policy.

2.37 In defining the UK REIT income, drawing on best practice from overseas, we would recommend that the following additional key guidelines are applied (the response to Question A.4 provides fuller detail):

2.37.1 Annually, at least 75% of the UK REIT's gross income must be from real estate-related income.

2.37.2 Additionally, 95% of the UK REIT's gross income must be from real estate related sources as noted above, but can also include other passive forms of income such as dividends and interest from non-real estate sources (such as bank deposit interest).

2.37.3 As a result, we recommend that no more than 5% of a REIT's income can be from non-qualifying sources, such as from non-real estate business e.g. marketing/promotional revenue.

2.37.4 We have proposed that the second qualifying proportion should be calculated on a net rather than gross basis as we feel that this is a better reflection of the level of activity within property groups. The ancillary services that property providers undertake are typically provided on a 'pass through' basis (where the services are subcontracted to third party service providers) and/or at a low margin. On this basis, a gross calculation of non-qualifying income could result in undue emphasis being placed on activities which are essentially incidental to the property providers' main business.

2.37.5 We recommend that over and above these limits, that UK REITs are allowed to hold "taxable REIT subsidiaries" ("TRS") so as to be able to conduct business which lies outside the above criteria, subject to the principal qualifications that:

- The value of the gross assets of all of a UK REIT's TRSs cannot comprise more than 20% of the value of the gross assets of the parent; and

- At least 75% of the UK REITs gross assets must consist of real estate assets such as direct property or loans secured on direct property.

2.37.6 Qualifying REIT subsidiaries ("QRS") should be permissible representing income from eligible activities which can be consolidated with the parent UK REIT for the purposes of income and asset testing as well as all other tax purposes. Where the UK REIT owns less than 100% of the QRS, it will be deemed to hold/earn its proportionate share of assets/income.

2.37.7 Trading activity gains should not fall within the eligible income rules and such activity should attract, as now, tax at the basic rate of income tax. Development for long term purposes should, however, be eligible as should the creation of major mixed use schemes/communities where an element of subsequent sales is integral to the business plan.

2.37.8 It will be necessary to provide 'safe harbour' rules such that a development or other asset would be regarded as being held for investment purposes if the asset was retained for at least three years following acquisition or practical completion or if proven intent to develop for investment purposes could be clearly established.

2.38 **Tax Regime General** - In arriving at our view as to the most appropriate tax regime for both capital and income returns, within the UK REIT, we have been guided by the following principles:

- The tax regime for the vehicle (and for investors) should replicate direct investment in real estate as closely as possible;
- If the regime is to replicate direct investment in real estate, taxation should be levied at the investor level;
- To the extent there is any complexity, this should be dealt with at vehicle level; and
- As is referenced throughout the ConDoc, that the new regime should not result in a loss of tax revenue for the Exchequer.

2.39 Against this set of guiding principles, we recommend the following essential features for the tax regime for UK REITs:

- In line with the principle of replicating direct investment in real estate as closely as possible, there should be no tax on rental income or capital gains in the UK REIT itself;
- Distributions of rental income should be subject to withholding tax to minimise complexity for basic rate tax payers (i.e. such tax payers would not be required to submit a Self-Assessment return as a result of receiving a UK REIT distribution because tax would have already been withheld);
- The tax regime should include a mechanism for passing investment incentives like capital allowances onto investors to encourage UK REITS to improve the quality of their property stock. With regard to enhancing investment in the private residential rented sector ("PRS"), we would

highlight the encouragement provided to US REITS investing into affordable housing through the availability of tax credits for investment into this sector;

- Capital distributions should be taxed as capital gains in the hands of investors under the normal rules applicable to particular investors, not as income.

2.40 **Distribution of Capital Gains** – The subject of gains distribution was referred to in the ConDoc in paras 2.29, 2.30 and 3.9 to 3.11 which, rather than setting out an initial preference, sought recommendations in this area.

2.41 On balance, we consider that gains should only be considered on a net portfolio basis (i.e. rather than asset by asset) and that UK REITs should be under no obligation to distribute such gains (again subject to the over-ride that the UK REIT had sufficient distributable profits as a matter of general Company Law) for a variety of reasons:

- Firstly, UK REITs may wish to re-invest proceeds into new assets (development or investment) and the costs and timing constraints of first distributing gains and then seeking to receive them back from investors may prove impractical. The net result would be to stultify active management to the detriment of occupiers (in terms of improving the quality of accommodation), investors (in terms of potential returns) and the Exchequer (in terms of foregone transactional revenue);

- Secondly, again from a UK REIT perspective it may be appropriate given the stage of the market cycle to use disposal proceeds to de-gear i.e. to pay down debt; and

- Finally, from an investors perspective, they may not want a "lumpy" distribution profile nor the problem of managing their capital gains exposure on such an intermittent basis.

2.42 Clearly, there is an issue of deferred capital gains tax take to the Exchequer if gains are held within the UK REIT. However, with there being no reason why UK REITS would wish to hold large, "fallow" cash balances (as it would merely detract from their distribution yield) re-investment into the underlying portfolios should enhance distribution yields which will provide an income tax take offset. Furthermore, this approach does not preclude investors selling shares at the higher NAV and crystallising the gain and, hence, tax.

2.43 **Borrowing Levels** – This topic is addressed in paras 2.31 to 2.32 of the ConDoc and, again without setting any initial quantitative levels, there is a clear presumption that the main capital requirements of the UK REITs should be provided by equity investors and that borrowings would only be needed as a contingency margin – such margin being "achieved by a low nominal percentage limit on the nominal share value or asset value".

2.44 Introduction of gearing restrictions would have several negative impacts which would be likely to restrict the evolution and growth of UK REITs and hence we recommend that there should be no prescription in this area. Rather this issue

should be left to the operation of market efficiency (especially in the context of permitting unlisted REITs where sophisticated and institutional investors may be happy to gauge and accept the risk implied by variable gearing levels).

2.45 Once again, the experience of the Australian and US markets is instructive. Neither impose any gearing limits, yet within the listed arena gearing levels (measured as net debt to gross assets) and interest cover ratios are relatively undemanding – i.e. the public markets have imposed on these vehicles a relatively conservative capital structure. Thus:

- US equity REIT gearing currently stands at 43% (having averaged 44% over the past 5 years) with an interest cover of 3.74[6]; and
- The listed Australian LPTs are currently even more lowly geared at just 35%, averaging 27% over the past five years.

2.46 It is also pertinent to note that the public debt markets are as equally and effectively regulated, and open to public scrutiny, as the public equity markets. Hence, in the same way that equity investors will scrutinise the investment policy and strategy of UK REITs so too will debt investors, together providing efficient market oversight.

Investment Criteria

2.47 **Development Activity** – Referred to in paras 2.35 to 2.37 of the ConDoc, there is a clear dichotomy between the government's keenness "to encourage greater renewal in the property sector and the development of new commercial and residential buildings" yet a requirement to ensure a high level of income and capital distribution (which is inconsistent with high capex on non-incoming producing projects) so as to ensure the sector contributes its fair share of tax.

2.48 We recommend that market forces are left to operate efficiently and that no constraints on development apply, in support of which we would note the following:

2.48.1 Short term deferral of some tax receipts, based upon the enhanced income distribution from new, additional properties in UK REITs may be necessary to ensure that the portfolios continue to grow and provide improved accommodation to occupiers, both commercial and residential. Indeed, the ConDoc in para 2.41 highlights the need for the UK REIT to promote long term investment in property and to maintain over time a high quality of stock;

2.48.2 Neither US REITs nor Australian LPTs have legislative development restrictions (so long as the schemes are retained in the portfolios rather than traded) and as a result, the listed REITs and LPTs do undertake some development activity, though the level is generally relatively muted (in the order of a maximum of circa 5% of asset value per annum) as any

[6] NAREIT Real Estate Chartbook, March 2004

additional exposure tends to adversely impact their share rating through reduced dividends and a higher risk profile;

2.48.3 In terms of ensuring a fair tax take from such activity from listed UK REITs there are few projects where the site assembly and construction phase last much beyond three years (except for the very large regeneration projects) and where again an over emphasis on such activity would adversely impact stock ratings; and

2.48.4 Finally, under the investment criteria for the new COLL vehicles, open-ended retail funds (non-UCITS retail schemes) are allowed to hold up to 50% of gross assets in non-income producing or development properties while the QIS schemes for sophisticated and/or institutional vehicles can hold up to 100% of gross assets in such property. It would therefore appear inconsistent to apply greater constraints on development activity for (less risky) closed-ended vehicles than apply to open-ended structures.

2.49 **Definition of Property** – The ConDoc paras 2.38 through 2.40 suggests a relatively austere definition of property type that might be held within UK REITs.

2.50 In the interests of securing the highest probability of both successful adoption of UK REITs by the real estate industry generally and enhanced contribution to the net tax take from the sector, we recommend that the widest range of property type be eligible. Specifically:

2.50.1 As noted in the ConDoc, the returns underpinning the income distribution from UK REITs should largely stem from the underlying property assets;

2.50.2 There should be no restriction on eligible property types, rather UK REITs should be free to invest in land and property in the broadest sense;

2.50.3 For all forms of real estate held within a UK REIT, it will be necessary to ensure there is a clear arms length contract between the tenants and/or trading company (OpCo) utilising the real estate and the new property owning entity (PropCo or REIT). It is interesting to note that within the listed US REIT universe there are a substantial number (currently for c8.6% of total US equity REIT market capitalisation) which focus on specialist real estate types e.g. lodging. The corollary being that there is clear investor demand for such property types and an acceptance of these being held through such vehicles.

2.50.4 We were surprised that the ConDoc suggested the exclusion of hospital and infrastructure projects from the eligible property definition. Not only do the preceding comments regarding true arms length contracts apply just as fully for these assets but their exclusion would appear to go against

one of the principal economic arguments for the introduction of UK REITs within the Industry's submission last September[7].

2.50.5 As to what proportion of total assets UK REITs should be able to hold in other forms of real estate exposure (e.g. derivatives, CMBS or shares in other UK REITs), so long as the eligible income rules set out in paras 2.37 are met, we see no reason why UK REITs should not solely undertake such investment activity. Thus, in the US there are a number of Mortgage REITs while the provision of "REIT of REITs" in the UK would facilitate both institutional and retail investment.

2.50.6 As to geographic exposure, we consider that a UK REIT should be entitled to hold qualifying assets in any jurisdiction in the world and that the government should therefore not seek to impose restrictions on the ability of a UK REIT to do so. Our rationale for this stance is that:

- Firstly, existing UK legislation governing the most common forms of investment and trading vehicles formed under UK law, does not impose any restrictions on the ability of those vehicles to invest in any jurisdiction in the world. We see no reason why a UK REIT should be treated differently from any of those vehicles in this respect;

- Secondly, if a UK REIT wished to restrict the geographical scope of its activities it would be able to do so by incorporating appropriate language in its constitutional documents or by its board of directors passing an appropriate resolution;

- Thirdly, any restrictions in UK legislation on the ability of a UK REIT to hold qualifying assets overseas (whether in a member state of the European Union or in any other jurisdiction) would amount to a *prima facie* breach of European Union law (see Article 56 of the Treaty establishing the European Community 1957, as amended, which was implemented in UK law by the European Communities Act 1972); and

- Finally, by allowing such a range of geographic activity will provide the opportunity for London to develop as the principal centre for the European real estate fund management industry with all of the associated onshore multiplier effects implied by such a position. Indirect real estate activity is growing substantially and it would be in the UK's general economic interest to establish a pre-eminent position in this field.

2.51 Para 2.44 of the ConDoc, raises the possibility of assisting the provision of residential rented accommodation by requiring a certain (undetermined) percentage of UK REIT assets to be in this sector. We consider that this suggestion is not only impractical but also inappropriate given the evidence from overseas of investor preference for focused vehicles (e.g. in the US

---

[7] IPF/BPF/RICS Industry Briefing Document for HMT, September 2003

diversified equity REITs account for just 11.1% by number and 6.4% of total market capitalisation. In Australia, the corresponding numbers are 11.4% and 30.5%)[8].

2.52 The introduction of UK REITs will widen the opportunities for investment in the PRS and the industry is keen to promote such expansion. Small retail investors, in particular, will want to invest in the sector given their perceived knowledge of the market allied to the benefits of risk diversification (away from highly leveraged Buy-to-Let ("BLT") transactions) and changes to the Self Invested Personal Pensions (SIPPs) rules.

2.53 However, the spectrum of investors will have a multiplicity of reasons for investing into the various elements of the overall asset class and the requirement for all of them to put a proportion of their investments into residential real estate risks forcing many to accept investments that will not meet their preferences and circumstances. Furthermore, it would lead to the creation of vehicles which were supply driven rather than demand led - i.e. imposed rather than desired.

2.54 The absence of a REIT-type structure in the UK is probably the single greatest barrier to more institutional investment in the PRS. Tackling it will promote the flow of funds into the sector, but it will not be the sole catalyst for success, and if Government wants to see UK REITs add to housing supply it will need to continue to drive reform in other areas, for example on the planning regime

Conversion and Trading Charges

2.55 **Conversion Charge** – The whole of section 4 of the ConDoc deals with the "Transitional Issues and a Conversion Charge". Para 4.5 of that document confirms that the Government intends to apply a charge on conversion of property into a new vehicle but consults on the issue of the scale, nature and timing of any charge.

2.56 The ConDoc goes onto state that the purpose of the conversion charge is to ensure there is no loss of revenue to the Exchequer and to ensure fairness for all tax payers (including the real estate sector). While we concur with the general principle of fairness of tax treatment, we are keen to ensure that any conversion charge should play its part in this process as, to our mind, it represents just one element of the tax "debate" rather than a single solution.

2.57 We have not felt capable of making any specific recommendations regarding the level of this charge in this document because it is difficult to ascertain the exact level of net tax receipts following the introduction of a UK REIT from CGT, Corporation Tax and tax on Investment Income offset by:

- Enhanced Stamp Duty Land Tax ("SDLT") receipts as a result of greater trading in the underlying real estate assets (certainly in the run-up to and the early years of the new regime);

[8] NAREIT Statistical Analysis March 2004 & Property Investment Research Property Funds Industry Survey 2003

- Much enhanced Stamp Duty Revenue Tax ("SDRT") receipts from share transactions as a function of a substantial growth in market capitalisation and liquidity in the listed sector as the initiative matures;

- Increased revenue from investors' income tax receipts as a result of the combination of heightened share ownership of the sector and increased levels of distribution (i.e. higher income yields); and

- The differential between the relatively low effective tax rate of the UK listed real estate sector (estimated at 16% for the five years 1998-2002 in last September's Industry submission and which has fallen to nearer 14% in the subsequent two years) versus the 22% basic rate withholding tax on UK REIT income distributions recommended in this document. Clearly, as retail share ownership rises, as envisaged and based on overseas experience, then a considerable amount of new revenue should flow.

2.58 Against this background, and in the interests of ensuring fiscal fairness, we accept the principle of a conversion charge for those existing vehicles electing to adopt REIT status. However, we would note in considering the quantum of this charge and the mechanism of its calculation and imposition that:

- Firstly, if the charge is set too high (and / or the investment criteria for the UK REIT are too restrictive) then few vehicles may convert. In such an event, we anticipate that the contraction of the listed sector would resume with institutional vehicles continuing to move offshore or into open-ended Non-UCITs / QIS schemes (subject to the removal of the tax disincentive);

- Secondly, the salutary experience of the 1996 legislation introducing investment trusts capable of investing in qualifying residential property (so-called HITs). For a variety of reasons, principally to do with tax issues and tight regulatory restrictions, none of these vehicles have ever been launched and which has contributed to the relative lack of institutional investment into the PRS; and

- Finally, it should be recognised that, given, the range of onshore and offshore investment structures used to access UK real estate, a single mechanism or basis for determining the conversion charge may not be appropriate. This is especially the case if one of the objectives of the initiative is to encourage as many vehicles as possible to remain, or migrate back, onshore so as to provide:

  - A level playing field, so far as is practicable, between all vehicles;

  - The maximum possible range of choice for investors; and

  - The opportunity for London to develop as the principal centre for the European real estate fund management business.

2.59 Accordingly, we welcome further dialogue with HMT and the Inland Revenue in this area to identify the most appropriate level for the conversion charge and its mechanism for determination so that, while preserving the principle of tax

fairness (having allowed for the positive transactional and distribution tax receipt offset provided by the new regime) it also ensures a relatively rapid and economically successful launch to the initiative.

2.60 **Stamp Duty** – Paras 3.26 through to 3.29 of the ConDoc reviews the current Stamp Duty land Tax (SDLT) and Stamp Duty Reserve Tax (SDRT) regime.

2.61 We acknowledge the modernisation of the Stamp Duty regime that is intended to be fairer across all types of property transaction and, in principle, concur with the ConDoc in promoting the consistent treatment of SDLT across real estate vehicle types. As such, we do not envisage any special arrangements applying to the transfer of real estate assets involving UK REITs, save for possible revisions in the residential arena to equalise the position between residential UK REITs buying large lot sizes versus the generally smaller lot BtL market.

2.62 Specifically, therefore, we agree that acquisitions and disposals of direct real estate by UK REITs should be subject to SDLT under the normal rules i.e. at the current prevailing scaled rates (subject to the proviso noted above).

2.63 Clearly an argument can be made for also charging SDLT on ‘seeding’ or ‘in specie’ transfers into REITs in exchange for shares or units. However, the extent to which HMT opt to charge this tax, as opposed to SDRT, must be a function of their appetite to see a successful launch to the initiative which maximises momentum and, potentially, the tax take as the lower charge may encourage greater numbers of these transactions.

2.64 With regard to SDRT, we consider that the trading of shares or units in a UK REIT (listed or unlisted) should be subject to the current SDRT of 0.5% of the value of the trade (in overseas markets the norm is for REITs to be treated like normal equities). In the context of considering the overall revenue position to the Exchequer, allied to the need to secure a successful launch to the UK REIT initiative, we would note that imposition of a 4% SDLT charge on REIT units or shares would be a significant barrier to the development of the market.

2.65 Finally, as with other transactions in different sectors of the economy, we do not consider that there should be any transfer tax (SDRT or SDLT) as existing vehicles choose to convert into, merge with or acquire other REITs.