

UK Real Estate Investment Trusts: a discussion paper

March 2005



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INTRODUCTION AND SUMMARY

1.1 The Government published a consultation paper¹ alongside Budget 2004 to consider reform to the taxation of the property investment market in the UK. A healthy and stable property market is a key element in any successful economy, both to individuals, as a form of housing and long-term security, and in the commercial sector, as a major factor of production. The Government is committed to reforms of the property market where they support the objective of raising productivity in the UK economy.

1.2 The consultation considered the introduction of Property Investment Funds in the UK, equivalent to Real Estate Investment Trusts (REITs), which are common to many economies around the world with developed property markets. Such reform would be of particular benefit to the commercial property market, helping to promote greater liquidity, more efficient investment decisions and wider access to smaller investors. In line with recommendations in Kate Barker's Review of Housing Supply², reform would also aim to address the unresponsive supply of housing through greater institutional investor participation in the residential market.

1.3 As part of the consultation, the Government set out four key objectives for reform, as summarised below:

- Improving the quality and quantity of finance for investment in commercial and residential property;
- Expanding access to a wider range of savings products on a stable and well regulated basis;
- Protecting all taxpayers by ensuring a fair level of tax is paid by the property sector; and
- Supporting structural change in property markets to reduce costs and improve flexibility and quality for tenants.

1.4 The consultation closed in July 2004 and the Government is grateful for the participation of a wide range of industry experts. Consultation responses broadly endorsed the Government's key principles of reform and provided valuable advice on the design for a new property investment vehicle. A summary of these responses is outlined at Annex A of this document. Following the consensus view expressed, the Government has reverted to the industry-favoured term, **UK-REIT** (Real Estate Investment Trust), rather than Property Investment Funds.

1.5 The Government remains committed to the introduction of a UK-REIT subject to meeting the above objectives while imposing no overall cost to the Exchequer. The consultation process has enabled the Government to better define the key features of a UK-REIT model, which allows for market flexibility within a framework of a closed-ended company structure. It has also highlighted three challenging issues around the tax treatment of this model, relating to non-UK resident investors, borrowing and group structures, which the Government will be looking to discuss further with industry.

¹ Promoting more flexible investment in property: a consultation, Budget 2004, HM Treasury and Inland Revenue.

² Review of Housing Supply: Securing our Future Housing Needs (Interim Report) by Kate Barker, December 2003. (www.barkerreview.org.uk)

1.6 The paper is set out as follows:

- **Chapter 2** recaps the policy rationale for introducing a REIT in the UK;
- **Chapter 3** highlights the key structural features that might apply to a REIT in the UK in the context of developing a model broadly along the lines envisaged in consultation responses;
- **Chapter 4** outlines how the tax rules could be adapted to fit this model and then highlights some important and challenging issues, relating to non-UK resident investors, borrowing and group structures. These all pose a significant challenge to meeting the objective of closer alignment between the taxation of direct and indirect property investment. It is these issues that the Government will be looking to discuss with industry; and
- **Chapter 5** invites the industry to work with Government and sets out the next steps, including establishing a working group to take forward discussion with industry representatives.

1.7 In this context the Government will report back on progress later in the year, including the outcome of the working group. Subject to finding a workable solution to the challenging issues raised and meeting the stated objectives, including reform at no overall cost to the Exchequer, the Government aims to legislate for a UK-REIT in Finance Bill 2006.

2

POLICY RATIONALE FOR A UK-REIT

2.1 The consultation paper published alongside Budget 2004, to consider how a Real Estate Investment Trust (REIT) might be developed in the UK, identified the following barriers in the current UK property market:

- There is limited secondary trading and liquidity in the property sector and thus insufficient information to ensure efficient market pricing and capital allocation;
- Access to commercial property investment is limited for smaller scale investors without significant capital outlays, potential risk or tax inefficiency;
- Property companies may be unable to raise optimal amounts of equity and therefore rely more heavily on debt markets, with potential consequences for wider economic and financial stability;
- High levels of owner-occupied property in the corporate sector, in part driven by tax rules, may restrict the full potential for efficient asset management; and
- As highlighted in Kate Barker's Review of Housing Supply there is limited institutional investor participation in the residential property market.

2.2 REITs are common to many economies with a developed property market. Generally they are closed-ended companies or trusts that hold, manage and maintain real estate for investment purposes, which is leased to tenants. They tend to have a broad shareholder base and are often, but not always, traded on a public stock exchange.

2.3 In addition a key feature is that the tax treatment of property investment held indirectly through a REIT is broadly comparable to that of property held directly. This means the combined tax from indirect investment at both vehicle and investor level is broadly equivalent to the tax levied on direct property investment. This ensures that investors are able to make decisions about the appropriate form of property investment based on risk and return profiles, without tax having a disproportionate influence.

2.4 The Government set out four key objectives in the Budget 2004 consultation document as highlighted in Chapter 1. The consultation document then asked a series of open questions about the detailed structure and tax of a potential UK-REIT, pointing to features from other REIT jurisdictions that appear to have worked well in fostering a successful market. Many consultation responses expressed the view that any potential UK-REIT structure should not be overly constrained by legislation (see Annex A for a summary of consultation responses).

2.5 The Government accepts in principle the case for market flexibility, provided it facilitates improvements in the property investment market and can be delivered at no overall cost to the Exchequer. While the Budget 2004 consultation contained a challenging set of objectives, the Government believes that a UK-REIT can lead to improvements in the market by:

- Providing a more liquid complement to the current range of property investment vehicles;
- Allowing smaller scale investors the opportunity to access commercial property returns, currently unavailable without significant capital outlays or tax inefficiency;
- Improving stability in the property investment market by rebalancing some debt with equity among property companies;
- Providing the opportunity for companies to release property assets from corporate balance sheets into professionally managed companies;
- Potentially improving the housing market through greater professionalism in the private and social rented sectors; and
- Alongside wider reforms to the planning system, providing a route into which newly developed rented accommodation can be sold, thereby increasing the willingness of house builders to increase supply.

2.6 However, as highlighted above, the Government's main aim for a UK-REIT is to ensure that the returns from different forms of indirect or direct UK property investment are taxed in broadly the same way.

2.7 The current position for UK residents investing directly in UK property is that they are taxed on rental income at their appropriate marginal rate of income tax, for example 22% for basic rate taxpayers and 40% for higher rate taxpayers. This contrasts with the position for those investing indirectly through UK property companies, where the combined effect of company and investor tax is, for some investors, higher. Rental income derived from UK property held by individuals or companies resident outside the UK also falls within the UK income tax regime, and is again taxed at 22% and collected through the Non-Resident Landlord Scheme.

2.8 The Government is committed to maintaining a regime that collects tax on income derived from UK property, such that the ownership of UK property, in whatever form, continues to contribute a fair share of tax to the UK Exchequer. To support this, the Government intends that any reform be introduced at no overall cost to the Exchequer, by applying a charge on conversion to UK-REIT status. The impact of a conversion charge is considered further in the context of group company issues in paragraph 4.13.

3

KEY STRUCTURAL FEATURES

3.1 In line with the Government's desire to find a model that is workable and achieves improvements to the property investment market, the following chapter sets out a summary of the key structural features, which the Government believes a UK-REIT would require. This draws on the experience of other REIT jurisdictions and takes account of responses to the Budget 2004 consultation.

3.2 This chapter does not provide a detailed description of prospective legislation and any implementation would be subject to a satisfactory resolution of the technical issues outlined later in this paper. Subject to this, the Government would envisage providing a further opportunity to consult on the specific details of any potential draft legislation, along with an update of the Budget 2004 partial regulatory impact assessment, to explore more fully the broader impacts, including compliance costs and benefits.

Legal structure for a UK-REIT

3.3 Many consultation responses endorsed the idea that a UK-REIT should take the form of a closed-ended company, given its suitability to the illiquid nature of property as an investment asset. In the UK context, this would imply a closed-ended company incorporated under UK Companies Acts, and one that is not closely held by a small number of shareholders. The framework for subsidiaries within existing groups of companies is considered in more detail in Chapter 4 on tax issues.

3.4 In parallel to consideration of a UK-REIT, the Government has also been consulting on reforms to the tax treatment of existing open-ended collective investment vehicles in response to changes made by the Financial Services Authority (FSA) to the regulatory framework for such schemes. While consideration of a UK-REIT relates to a company structure, many of the property tax issues also apply in the context of these collective investment vehicles, which provide an alternative opportunity for indirect investment in property. This is also discussed in more detail in Chapter 4.

Investment activity of UK-REIT

3.5 The key principle of a UK-REIT would be to separate, for tax purposes, the ownership and management of property from the activities that take place on that property. This could be achieved by establishing a **ring-fence** around the property letting business of the UK-REIT, drawing on some of the principles applied to oil taxation in the UK. On this basis, the UK-REIT would have two separate operations, taxed in different ways:

- The **ring-fenced property letting business**. While legislation would be needed to define the precise activities that could form part of the ring-fence, they would broadly equate to properties generating a high proportion of UK "Schedule A" profits, and its equivalent for overseas properties;
- The **non ring-fenced business** comprising all other activities that fall outside the ring-fence definition, including income generated from ancillary services associated with the property letting business. Profits, capital gains and subsequent corporation tax liability would be computed and payable on the non ring-fence activities in the normal way.

3.6 In line with REITs in other jurisdictions, it is envisaged that the ‘property letting business’ as described above would be required to form the majority of the UK-REIT’s activity. As such it is likely that a UK-REIT would need to meet the following rules:

- At least 75% of the UK-REIT’s total gross income to derive from ring-fenced activities;
- At least 75% of the UK-REIT’s gross value of assets to relate to property allocated to the ring-fenced business;
- In order to ensure that UK-REITs were focused on property investment activity, it may additionally be necessary to permit only properties generating a significant proportion of Schedule A profits (and its equivalent for overseas properties) to be allowed within the ring-fence;
- A UK-REIT would be required to distribute at least 95% of its net ring-fenced income to investors, calculated by reference to its “Schedule A” profits (and its equivalent for overseas properties) after appropriate deductions and capital allowances. The Government acknowledges that further discussion with industry would be needed to establish how such a distribution requirement would fit with legal restrictions imposed on companies by UK Companies Acts;
- Were a UK-REIT to undertake both ring-fenced and non ring-fenced activity, expenditure and allowances incurred in support of both activities would need to be apportioned on a just and reasonable basis;
- A UK-REIT would be required to hold more than one property with no single property exceeding a defined proportion of the total value of its property assets;
- A UK-REIT would be able to invest in any property type, in any location worldwide, subject to meeting the above income and asset rules; and
- The Government may also need to consider additional rules to ensure the appropriate and intended use of UK-REIT legislation and to protect against any deliberate tax avoidance activity.

Public listing

3.7 The Budget 2004 consultation also considered the issue of whether a UK-REIT regime should only be open to companies that are listed on a public stock exchange. There are a number of arguments in favour of a listing requirement, which were acknowledged in many consultation responses. A public listing would subject companies to the appropriate listing authority rules regarding investor base, disclosure and market scrutiny and would therefore help to ensure suitability for wider retail investor access with arguably a more transparent REIT market.

3.8 In contrast, the view was also expressed that a listing requirement could impose potentially high compliance costs on companies, preventing smaller companies converting to, or establishing themselves as, UK-REITs. This may be of particular significance for the housing market where there may be fewer listed companies currently focused on residential property. Allowing companies to develop initially as unlisted UK-REITs could potentially increase the size and scope of the market.

3.9 The Government has not concluded whether any future UK-REIT regime should be open to all companies or only those companies listed on a recognised stock exchange and will consider the evidence further in light of the detailed structure that emerges, taking into account existing listing rules and following dialogue with industry and the FSA.

Promoting market flexibility

3.10 While rules would be needed to ensure the development of an appropriate UK-REIT market that maintains a fair regime for all taxpayers, the Government is committed to taking a flexible approach and will seek to minimise the necessary constraints placed on UK-REITS. The Government recognises that this approach is critical to the successful development of a UK-REIT market, which would in turn strengthen the UK's position in the context of global property investment. Following further analysis, and taking on board views expressed during the 2004 consultation, the Government would not intend to legislate on the following issues³:

- **Management of the vehicle:** REITs in other markets around the world have tended to be internally managed, although externally managed REITs also exist. In line with this, the Government is of the view that the market should decide the most appropriate management structure for UK-REITs and that they could be established as either internally or externally managed companies. (Budget 2004 consultation, paragraph 2.20, page 18)
- **Property development:** REITs in other markets tend to be largely investment holding companies focused on income distribution. This means that they are often not well suited to significant large-scale property development activity, although they do undertake limited refurbishment and renovation. The Government believes that, in principle, UK-REITs should not be prohibited from undertaking some development activity, consistent with meeting the income and asset tests in relation to ring-fenced and non ring-fenced activity, as described above. This would allow limited development within the non ring-fenced part of the business. (Budget 2004 consultation, paragraph 2.35, page 20)
- **Types of property:** The Budget 2004 consultation discussed the way in which different property sectors (such as industrial, retail, office, residential and leisure sectors) would fit within the objectives for a UK-REIT. This issue links closely to the type of contracts held between landlord and tenants in these sectors and the breakdown of lease contract payments into underlying rental income and other trading profits. The Government's intended approach is not to exclude any specific property sectors from being held within a UK-REIT, provided that the income and asset rules set out above are satisfied, and provided that the activity of a UK-REIT reflects traditional property investments, and is not a proxy for purely financial transactions. UK-REITs would not be constrained to hold a minimum proportion of residential property. (Budget 2004 consultation, paragraphs 2.38 and 2.43, pages 20-21)

³ The text in brackets provides the reference to discussion of the topic in the Budget 2004 consultation document available at www.hm-treasury.gov.uk.

- **Landlord requirements:** The Government has recently consulted on reforms to encourage greater flexibility of lease terms in the property sector. Irrespective of the outcome of that consultation, the Government is content that UK-REITs should be treated in the same way for these purposes as the rest of the property sector, with no additional requirements beyond those that apply for all landlords. (**Budget 2004 consultation, paragraph 2.45, page 21**)
- **Minimum holding period:** In the context of ensuring UK-REITs are not used for the purposes of speculative property trading, the Budget 2004 consultation discussed the merits of a minimum holding period for assets held within a UK-REIT structure. While there is some advantage in such an approach, the Government is of the view that no minimum holding period would be necessary. (**Budget 2004 consultation, paragraph 2.41, page 21**)

4

TAX TREATMENT FOR A UK-REIT

4.1 There are a number of ways in which the goal of closer alignment between the taxation of direct and indirect property investment could be addressed. Many REIT jurisdictions operate by allowing the company to be tax exempt. This means that rental income and capital gains derived from properties that fall within the allowable definition of the regime are exempt from tax at the company level (the REIT). Instead the REIT distributes most of its income, after operating costs, to investors, who are then taxed on this investment income. The result is that investors face broadly the same tax treatment as they would have, had they owned a property directly.

4.2 This chapter considers how a ‘tax exempt’ approach could be applied to the concept of a ring-fence as described in Chapter 3 and then outlines three technical issues which pose a significant challenge to meeting the objective of closer alignment between direct and indirect property investment. Chapter 5 of this paper invites the industry to work with Government to find a structure that delivers these key objectives.

A TAX-EXEMPT APPROACH

4.3 Applying a tax-exempt approach to the concept of a ring-fence would suggest developing a model along the following lines:

Taxation at the vehicle level

- Income included within the ‘ring-fence’, as defined in legislation, would be exempt from corporation tax;
- Other income outside the definition of the ‘ring-fence’ would remain within the charge to corporation tax;
- Chargeable gains arising on the sale of property held for investment purposes within the ring-fenced business would be exempt from corporation tax. Profits from dealing in or developing property, or from any other activity, would remain subject to corporation tax. The normal ‘badges of trade’ would be applied to determine whether or not the purchase and resale of property amounted to trading for tax purposes;
- Any losses arising in relation to the ring-fenced activity would not be able to be used to offset taxable profits in the other business activity of the UK-REIT. Similarly losses in the non ring-fenced activity could not be set against ring-fenced profits; and
- Stamp Duty Land Tax would be payable at normal rates on the acquisition of property assets.

Taxation at the investor level

- Distributions made by a UK-REIT would fall into two categories. Profits arising from ring-fenced activity would be treated as property income in the hands of individual investors, chargeable at the taxpayer's marginal income tax rate. Such distributions would be payable under deduction of income tax, currently 22%, to minimise compliance costs for basic rate taxpayers. Profits arising from activity that falls outside the ring-fence could then be treated as an ordinary dividend in the hands of individual investors;
- Corporate investors would also receive two types of distribution. Income from the ring-fence would be treated as property income and included as part of the ordinary taxable profits. Income outside the scope of the ring-fence could then be treated as ordinary dividends in the hands of a corporate investor;
- The Government is of the view that if a tax-exempt model as outlined above were adopted, it follows that a UK-REIT should be able, but not required, to distribute any gains arising from the sale of properties to investors. Any such gains distributed to investors would be treated as property income distributions and taxed in the hands of investors at marginal rates;
- Capital allowances would not be available at the investor level, which would be consistent with the distribution of net ring-fenced income to investors, after taking account of appropriate deductions and capital allowances at the vehicle level; and
- Stamp Duty Reserve Tax would be paid on UK share transactions at the normal rate, currently 0.5%.

4.4 A UK-REIT developed along the above lines would strike a balance between allowing sufficient flexibility for a market to develop, while ensuring the policy intentions were targeted. There are however a number of outstanding technical issues with this corporate model, outlined below, which pose a significant challenge to meeting the objective of ensuring that a fair share of tax continues to be paid by the owners of, and investors in UK property. The Government recognises that it may need to modify aspects of the tax model described above if it is to meet this challenge.

OUTSTANDING TECHNICAL TAX ISSUES

International tax issues

4.5 The Government intends to ensure that any UK-REIT regime is consistent with obligations under its network of Double Taxation Agreements (DTAs), and under European law. To this end, the Government envisages a regime whereby a company resident outside the UK could have broadly equivalent tax treatment on its property investment activities, provided it met the appropriate requirements applied to UK resident companies. Restricting the regime to only UK resident companies is unlikely to be compatible with the UK's international treaty obligations.

4.6 The key principle of any REIT regime is to achieve closer alignment between the taxation of direct and indirect property investment, which in many REIT jurisdictions is achieved by moving the point of taxation from the company to the investor. However in the context of the framework outlined above, any income distributed by both UK resident and non-UK resident companies would be treated as ordinary company dividends in the hands of non-UK resident investors⁴, rather than as property income⁵. This would cause significant difficulty in meeting the objective of closer alignment between the UK tax treatment of direct and indirect property investment for two reasons:

1. Firstly, in accordance with DTA obligations, the UK would not be able to require a non-UK resident company to withhold UK tax on dividend distributions it makes to its non-UK resident shareholders. Given that the non-resident company would have paid no tax at the vehicle level, the UK Exchequer would not be able to collect any tax on rental income derived from UK property held in this form.
2. Secondly for non-UK resident shareholders in a UK company, the maximum withholding tax that could be applied to a dividend distribution is determined by the appropriate bilateral DTA. For the majority of tax treaties between the UK and other countries this is 15%, which is lower than the current treatment of property investment under the Non-Resident Landlord Scheme, of 22%. In addition, some treaties state that the withholding on dividends is reduced to a lower rate, according to the proportion of shares held in the company.

4.7 The above factors make it difficult to design a UK-REIT structure that taxes non-UK residents investing indirectly in UK property in broadly the same way as if they were to invest directly. Putting in place a regime that complies with international obligations but fails to collect any UK tax from non-resident investors holding UK property (at either the vehicle or investor level) is likely to have a significant impact on the Exchequer and may lead to unintended and undesirable behavioural effects. Furthermore it breaches the UK's right to maintain a fair proportion of tax on UK land and property from all types of investor.

4.8 The Government is interested in industry's views and proposed solutions in relation to the taxation of non-UK resident investors within a UK-REIT regime that would enable the vehicle to be exempt from tax, while also meeting the objectives outlined in Chapter 1. These include closer alignment with the tax treatment of direct property investment and facilitating a more liquid market, with greater access to retail investors.

⁴ This is defined under Article 10 'Dividends' of the OECD model tax convention.

⁵ This is defined under Article 6 'Immoveable property' of the OECD model tax convention.

4.9 One alternative approach that the Government is open to considering is to retain taxation at the company level, but apply a reduced rate of 22% on income that falls within the ring-fenced activity of the UK-REIT. Distributions paid by the UK-REIT to individual investors could then be treated as ordinary dividends. This approach would still leave open the possibility of allowing any gains arising on the sale of ring-fenced investment properties to be exempt from tax at the vehicle level, although further consideration would be needed to decide whether such gains could be distributed to investors. Further consideration may also be needed in relation to other aspects of the tax treatment discussed earlier in this chapter, including the treatment of corporate investors.

Point 1 for discussion

The Government is interested in industry's views and proposed solutions in relation to the taxation of non-UK resident investors within a UK-REIT regime that would deliver the objectives set out in Chapter 1 of this paper. Alongside this the Government is also interested in whether the concept of a ring-fence applied to the property letting business as described in Chapter 3, would work in practice.

Borrowing levels **4.10** The Budget 2004 consultation discussed the issue of borrowing levels in the context of a new UK-REIT market. Borrowing from third party lenders is common practice among property companies and consultation responses generally argued that the market would be able to determine a sensible level of borrowing for UK-REITs. Respondents pointed to evidence showing that average gearing levels in many other REIT jurisdictions were lower than for traditional property companies and that many markets achieved this without legislative restriction.

4.11 As highlighted in Chapter 3, the Government is in favour of allowing the market to operate flexibly. However the level of borrowing within a UK-REIT would have a direct impact on the overall tax position. Higher levels of borrowing within UK-REITs would reduce the amount of income distributed to investors and therefore ultimately the overall level of tax receipts. This would be particularly relevant if the UK-REIT were itself tax-exempt at the vehicle level. Furthermore, artificially increased borrowing could allow companies to channel interest and property income payments separately to different types of investor in order to achieve the most tax efficient position. This would not be consistent with the principle of REITs as property-income distributing vehicles.

4.12 The Government is committed to ensuring that the introduction of UK-REITs does not lead to increased opportunities for tax avoidance and is considering what mechanisms would be needed to ensure tax continues to be collected at the investor level. One option might be to limit the amount of borrowing for UK-REITs by reference to the ratio of interest payments to income, and/or by reference to the level of debt to equity. The Government is open to exploring alternative options to address this issue and will discuss further with both the industry and the FSA before taking any decisions.

Point 2 for discussion

The Government is interested in what solutions the industry can offer to ensure that allowing reasonable levels of borrowing within a UK-REIT market would not reduce the tax collected from investors or result in specific manipulation for tax avoidance purposes. Would requiring a UK-REIT to be listed on a recognised stock exchange minimise this risk?

Group company structures **4.13** The tax-exempt model outlined earlier in this paper relates to a single company structure where the company qualifying to be a UK-REIT is not a member of a wider group. It does not address issues relating to some of the more complex group structures under which many existing property companies operate, where a company that may be suitable for UK-REIT status is not the ultimate parent of the group.

4.14 The inclusion of companies within a group structure into a UK-REIT regime raises a number of issues, in relation to:

- Whether the rules set out for the UK-REIT (e.g. ring-fenced asset and income tests, distribution and borrowing rules) would be applied to a single subsidiary or at group level;
- The timing of tax receipts for Government and the possible delays that may occur between the receipt of rental income by the UK-REIT and the distribution of income into the hands of taxable investors outside the group. Again this is of particular relevance were the UK-REIT to be tax-exempt; and
- The ability for existing group structures to convert to UK-REIT status and the conversion charge payable on assets transferred;

4.15 The most appropriate solutions to address the above points will depend largely on the way in which the other technical issues in this paper, such as the treatment of non-UK resident investors and borrowing, are handled.

Point 3 for discussion

The Government would like to discuss how group company structures could fit within a UK-REIT regime in the context of addressing the other technical issues outlined in this paper.

Collective investment schemes **4.16** In response to changes by the FSA to the regulation of collective investment schemes, the Government has been considering tax changes that might be necessary to support the new regulatory framework. This relates in part to the taxation of property rental income within such schemes, which is currently taxed at the vehicle level at 20%, and the tax treatment of this income when it is paid to investors, currently treated as a dividend.

4.17 The problems highlighted above in relation to the taxation of non-UK resident investors in a UK-REIT would also apply in the context of collective investment schemes. To avoid market distortions that might be created by different treatments of property income, the Government will continue to assess these reforms in parallel and is keen to consider both aspects in further discussions with industry.

5

NEXT STEPS

5.1 This discussion paper sets out the Government's latest thinking on reforms to the taxation of property investment in the UK and describes some of the challenges that are faced in developing a tax-exempt UK-REIT that would deliver against the intended objectives, including closer alignment between direct and indirect property investment, while ensuring no overall cost to the Exchequer.

Working group **5.2** The paper highlights three further technical questions that the Government would like to discuss with industry representatives. In order for work to be progressed quickly, the Treasury and Inland Revenue will establish a small working group of tax specialists representing the property and investment industries to discuss the questions raised. This will provide the primary forum for industry to channel comments to the Government. Interested parties can also send additional comments by 27 May 2005:

- By post to:

Property Tax Team
HM Treasury
1 Horseguards Road
London
SW1A 2HQ

- By email to: UKREIT@hm-treasury.gsi.gov.uk

5.3 The Government remains committed, in principle, to reforming the taxation of property investment to increase liquidity and access for smaller investors, and raise productivity in the UK economy, on the basis that a fair share of tax is contributed by the sector to the UK Exchequer. **In this context the Government will report back on progress later in the year, including the outcome of the working group. Subject to finding a workable solution to the challenging issues raised and meeting the stated objectives, including reform at no overall cost to the Exchequer, the Government aims to legislate for a UK-REIT in Finance Bill 2006.**

Regulatory impact **5.4** The Government published a partial regulatory impact assessment, as an annex to the Budget 2004 consultation document, which is also applicable to this discussion paper and can be found at www.hm-treasury.gov.uk. The Government will publish an updated partial regulatory impact assessment alongside any proposals that follow from the working group discussions described above.

A

SUMMARY OF CONSULTATION RESPONSES

INTRODUCTION

A.1 The 2003 Pre-Budget Report announced that ‘the Government has concluded that reform to the tax treatment of property investment would improve liquidity, transparency and scrutiny, provide access to property for long-term savings, and could expand the private rented sector’. The Pre-Budget Report confirmed that the Government would consult on the appropriate structure for a potential new property investment vehicle.

A.2 HM Treasury and Inland Revenue issued a joint consultation document alongside Budget 2004. The consultation document ‘**Promoting more flexible investment in property**’ (referred to as the ‘consultation’ throughout this summary) invited responses to 19 questions on Property Investment Funds or PIFs (the provisional name for the potential new vehicle used throughout the consultation). These included questions of vehicle structure, tax treatment, the conversion charge, and the wider implications on the property investment market, the UK economy and public finances.

A.3 Following the Budget, the Government held a series of roundtable consultation meetings with the major property industry representative bodies, industry analysts, academics and other interested parties. These were productive and informative sessions ahead of receiving written consultation responses.

A.4 The consultation period closed on 16 July 2004. The Government received almost 200 written responses. Responses were submitted by a wide variety of organisations and individuals, including listed property companies, legal and accountancy advisers, representative bodies and academics. The respondent breakdown, by category, is as follows:

RESPONDENT	PROPORTION (approx)
Property companies, funds, trusts and industry practitioners	43%
Financial institutions, legal and accountancy advisers.	26%
Representative bodies and business associations.	13%
Individuals writing in a private capacity.	10%
Independent organisations, groups and academics.	8%

A.5 Submissions included a joint response on behalf of the property industry prepared by the British Property Federation, the Investment Property Forum and the Royal Institute of Chartered Surveyors and a joint response by the Investment Managers Association and the Association of Property Unit Trusts. The Government is grateful for all the responses received and for the active participation of the various representative groups throughout the consultation process.

A.6 The consultation did not propose any specific vehicle structure or design for consultation but instead posed 19 open questions on a wide range of issues and invited comment and analysis. This summary outlines the general responses received to these questions.

Name A.7 A clear majority of consultation responses preferred the use of the term ‘Real Estate Investment Trust (REIT)’, ‘UK-REIT’ or ‘British-REIT’ to describe any new property investment vehicle. Most responses noted that the term REIT is widely recognised within the industry, and internationally, while the term Property Investment Fund (PIF), used throughout the consultation, could potentially cause some confusion for investors and financial advisors. In line with these views, the term UK-REIT will be used throughout this summary of responses.

POSSIBLE STRUCTURES FOR A UK-REIT

Closed or open ended A.8 The consultation noted the merits of a closed-ended structure for a UK-REIT. This would allow investors to increase or decrease their investment by purchasing or selling shares. The share price (whether trading above, below or at net asset value) would reflect market sentiment, but the REIT managers would not be forced to acquire or divest assets. The consultation noted that REIT vehicles established in other countries tended to be closed-ended.

A.9 There were mixed responses on the suitability of different vehicles for retail property investment. Many respondents endorsed the idea of closed-ended REITs, citing advantages of liquidity in the trading of shares, when publicly listed. They noted the difficulties some open-ended funds had experienced in other countries in relation to large redemption requests. Other respondents pointed out that the existing open-ended UK vehicles are allowed to engage in indirect property investment and that the Financial Services Authority’s (FSA) new sourcebook for Collective Investment Schemes (COLL), introduced from April 2004, allows greater property investment and sets out rules to cope with the issue surrounding redemption of units associated with the illiquid nature of property.

A.10 Overall, most responses suggested that there should be a ‘level playing field’ in the tax treatment of open and closed-ended vehicles (see paragraphs A.46-A.49 below).

Listing A.11 The consultation noted the merits of requiring public listing for the shares in any closed ended vehicle. In the context of the Government’s objective to expand access to a wider range of stable savings products, listing could help to ensure broader access for small investors. The consultation noted that a listed company structure could benefit from greater market scrutiny and, with tax transparent treatment, might trade more closely to net asset value.

A.12 Consultation responses generally noted the potential advantages of listing, and agreed that UK-REITs should be able to list. Many respondents noted that UK-REITs should take a corporate structure, allowing listing. However respondents also noted that there were considerable advantages to allowing unlisted UK-REIT vehicles. These included more closely meeting the requirements of sophisticated and institutional investors, allowing a greater range of smaller funds to convert or be established (which could act as ‘incubators’ for future listed UK-REITs), and allowing potential specialist funds, particularly in the residential sector, which would otherwise fail to attain the scale necessary for listing and UK-REIT status. Respondents also noted the potentially high compliance costs of listing for smaller funds and the relatively high costs of equity finance. Some respondents noted that listed and unlisted UK-REITs could have different requirements, e.g. unlisted UK-REITs could be restricted to the sophisticated or institutional investor.

Management A.13 The consultation noted the prevalence of internal management in other REIT markets – where day-to-day responsibility for managing the REIT’s properties is retained within the fund – and asked whether property management arrangements should be prescribed in legislation.

A.14 There was a general consensus from respondents against the prescription of management arrangements, arguing that the market would determine the most appropriate outcome for specific vehicles. Many stressed that there were significant benefits in allowing a REIT to hire external property managers as it saw fit. These included competition for management talent and the ability to contract specialists for particular property sectors. It was generally argued that a free and open market, where UK-REITs could easily replace unsuitable management, would provide an optimum mix of value for money and professional expertise – whether internal or external.

Borrowing A.15 The consultation noted the range of average borrowing levels across different REIT markets, including those with and without actual borrowing restrictions set out in REIT legislation. The consultation identified high levels of debt financing and subsequent sensitivity to interest rate movements as an aspect of the UK property investment market which could potentially be addressed with the introduction of UK-REITs.

A.16 On the whole, respondents felt that although UK-REITs should be focused on the distribution of rental income, they should also have the ability to borrow. Most felt that the market was best placed to impose constraints on borrowing, and that investors would curb any excessive gearing if it detracted from income distribution. Others argued that a very low borrowing limit would curtail the growth and depth of any UK-REIT market, as companies would be unable to fund acquisitions or refurbishment solely from expensive equity finance at the right time.

A.17 However, a number of responses did endorse the notion of a borrowing limit, or suggested differential treatment, depending upon the REIT’s listing status or investor profile (in order to expose the retail investor to less risk). Some responses noted that there were significant issues to consider regarding the definition of any borrowing limit, with a diverse range of views on the relative merits of a loan-to-asset value measure or an interest cover payments measure.

Distribution requirement A.18 The consultation proposed that a UK-REIT would be required to distribute a high level of rental income to investors, who would then be taxed at their own marginal rates. High distribution requirements (both prescribed in legislation and in practice) are noted as a feature of almost all REITs in other jurisdictions. The consultation discussed some of the factors that would need to be taken into account in setting the distribution requirement within the UK context. These include the need to retain sufficient working capital within the vehicle to meet investment and refurbishment requirements, or to undertake new property acquisitions. Within this context the consultation proposed that a minimum distribution requirement of 90%, before depreciation, might be appropriate.

A.19 Almost all respondents agreed that some form of distribution level should be a requirement for UK-REITs. Many noted the existing distribution requirements set out in the FSA regulations for open-ended funds and stressed that investor demand was likely to ensure that a high proportion of rental income was consistently distributed. Any prescribed distribution requirement may therefore be exceeded.

A.20 Many respondents discussed the consultation's proposal of a 90% distribution requirement (before depreciation) in some detail. A majority of responses argued that this would be an unsuitably high requirement given the need to refresh and refurbish a property portfolio regularly in order to maximise its rental value. A high requirement could therefore create a wasting asset of deteriorating value, offering poor quality to the occupier. Most responses argued that a high distribution should therefore take into account depreciation, capital expenditure, and interest payments before its calculation. Some measure of net distributable income or net cashflow could then be liable for a relatively high percentage requirement.

A.21 Many responses addressed complexities with regard to setting the distribution requirement. In particular, respondents noted the need to comply with Companies Acts requirements (necessary for any UK-REIT vehicle taking a corporate form), which cover permitted distribution levels for accumulated profits.

Development A.22 The consultation acknowledged that the Government was keen to encourage greater renewal in the property sector, whilst ensuring that the sector contributed its fair share of tax. The requirement from investors for a steady income stream discussed above, pointed towards REITs distributing high levels of income, implying minimal development activity.

A.23 Respondents recognised the broad requirement for UK-REITs to focus on rental income, but most felt that any prescribed limitations on development activity were likely to be counter-productive. However, a majority of responses drew a clear distinction between developments undertaken to enhance the long-term rental return within a UK-REIT, and more short-term speculative developments. Respondents generally acknowledged the case for existing corporation tax treatment of the latter. Many argued that the market would ensure that UK-REITs' primary focus would be maximising rental income to distribute, but that UK-REITs would need the flexibility to develop in order to update and improve their asset portfolios. Some responses proposed the use of 'safe harbour' rules in order to exempt new developments from taxation if the UK-REIT continued to hold the assets after a certain number of years. Other responses felt that development activity could be held in separate entities, which did not benefit from tax-transparency, such as 'Taxable REIT Subsidiaries' or 'Stapled' structures as in the US and Australian markets.

- Definitions of property** **A.24** The consultation noted that the rental returns from property held within UK-REITs should reflect the underlying property asset, as opposed to any commercial or other trading activities undertaken by the occupier. This could imply restricting the allowable property within UK-REITs to commercial, industrial, office and residential buildings.
- A.25** Most respondents felt that there should be few, if any, restrictions on allowable property within UK-REITs, arguing that there was considerable scope for beneficial REIT activity in many sectors, including leisure and hospitality. Responses noted that in most cases there were clear arms-length lease contracts between operating-company tenants and the ownership vehicle. Some responses argued that eligible rental income and ineligible operating income could be separated for tax purposes or that taxable subsidiaries could be utilised for a similar purpose.
- A.26** Many responses also argued that there should be no geographical restrictions on the location of property held within a UK-REIT. In other words, UK-REITs should be allowed to own property in Europe or the rest of the world. Some respondents argued that this would support the development of the UK as a base for European and international property investment, as well as promoting diversification by giving the investor access to other property markets.
- Improving the quality of building stock** **A.27** The consultation asked how a UK-REIT could be designed to ensure a better quality of stock and whether a minimum holding period might promote long-term investment in property. Most responses rejected this suggestion. While a minimum holding period might help to entrench an income-focused ‘buy and hold’ approach to property investment, most respondents stressed that artificial constraints on the activity and management of UK-REITs could prove counter-productive. For instance, holding periods could prevent the sale of assets at the optimal point in the property market cycle, adversely affecting investment performance. A minimum holding period could also disadvantage UK-REITs in comparison to other indirect investment options available.
- Private rented sector** **A.28** The consultation noted the Government’s interest in the residential private rented sector (PRS) and the social and affordable housing sectors, and asked whether and how a UK-REIT could deliver high quality residential property across the entire range of rental accommodation.
- A.29** Responses noted that a flexible UK-REIT structure would in theory have the potential to cater to a number of property/occupier markets. Most respondents generally believed that UK-REITs could play a role in the private rented sector, though some noted that the effects of UK-REITs on the overall development of the PRS were likely to be modest. These responses tended to highlight wider policy reforms, such as the implementation of the Barker Review recommendations⁶, as having a greater direct impact in this area.
- A.30** On affordable and social housing, many responses argued that the perception of greater risk, and the nature of potential returns, could prevent the emergence of a significant UK-REIT market in this area.

⁶ Review of Housing Supply - Delivering Stability: Securing our Future Housing Needs, Final Report , Kate Barker, March 2004.

Lease flexibility **A.31** The consultation noted that there is potential for greater flexibility of lease terms in the commercial property market. In May 2004, the Office of the Deputy Prime Minister published a separate consultation on the wider question of commercial property lease reform⁷. The UK-REIT consultation asked whether any potential new vehicle could be structured to encourage greater flexibility for occupiers.

A.32 The majority of responses argued that this issue should be considered as part of the Government's wider consultation on lease flexibility and that a UK-REIT should not have to meet particular requirements in terms of lease specifications. Respondents noted that such specific requirements could disadvantage UK-REITs with regard to other vehicles. In general, responses stressed that a UK-REIT with significant overall flexibility should be able to deliver benefits to corporate occupiers, which could include a greater degree of lease term flexibility, if so desired by occupiers. Some responses argued that UK-REITs, as income-focused structures with active managers, might seek to offer occupiers greater flexibility in return for higher yields.

TAXATION ISSUES

Vehicle level tax **A.33** On the issue of taxation of the UK-REIT itself, the consultation outlined three issues; the treatment of rental income, non-rental income and capital gains. The consultation discussed alternatives for the taxation of rental income, including treating any income distributions made to investors as a deductible expense when calculating taxable profits or using a specific exemption for rental income. The consultation suggested that incidental non-rental income could be taxed at normal rates. The consultation examined options for the treatment of capital gains, including preventing capital gains distribution by the vehicle, so that gains are fully reflected in share prices and are realised and taxed on disposal by investors. Alternatively, the consultation noted that a UK-REIT could be required to distribute a high proportion of gains, which could be treated as income in the hands of the investor.

A.34 Consultation responses on these issues were varied. Most argued that the broad principle for any regime should be to try to replicate direct investment in property as closely as possible. Respondents proposed that there should be no taxation at the vehicle level on rental income or capital gains. Many responses accepted that incidental non-rental income could be liable to tax within the vehicle, though respondents also suggested that a relatively small percentage of the vehicle's tax-free income could come from incidental items or ancillary services. Many responses discussed the strengths and weaknesses of both exemption and deduction; some favoured one approach over the other, or a combination of the two.

⁷ 'Commercial Property Leases: Options for deterring or Outlawing the Use of Upward Only Rent Review Clauses' Consultation document, ODPM, May 2004.

A.35 Responses also discussed a variety of options with regard to the treatment of capital gains. Most responses favoured flexibility over prescription in terms of the distribution of gains. Requirements to distribute realised capital gains were felt to limit a REIT's discretion and ability to reinvest, whilst potentially offering the investor unpredictable and 'lumpy' returns. However, respondents also argued that completely preventing distribution would mean that the investor's regular returns would be less representative of direct property investment and that UK-REITs would only be able to offer capital gain to investors through share buy-backs. Many responses noted that any treatment for capital gains would have to consider the position of tax-exempt investors carefully in order to compete with existing vehicles.

A.36 Many responses argued that reinvested capital gains within the vehicle should not be taxed. Respondents argued that capital gains were likely to be reflected in the vehicle's underlying share price, which would be taxed on the investor's disposal of shares. Respondents also proposed that capital gains distributed to investors should be treated as capital gains, rather than income, for taxation purposes. This would allow individual investors to make full use of their Annual Exempt Amount, for example.

Investor level tax **A.37** The consultation discussed various options for the taxation of the vehicle's distribution to the investor. The consultation noted the broad objective of aligning the treatment of income from direct investment with indirect investment and asked for views on the impact of treating distributions from UK-REITs as (Schedule A) income from property, taxed at the investor's marginal rate.

A.38 Many responses broadly endorsed the idea of treating distributions as Schedule A income for tax purposes. Respondents noted that withholding tax could be imposed so that UK basic-rate taxpayers would not need to submit self-assessment returns.

Stamp Duty **A.39** The consultation discussed the potential treatment of a UK-REIT regime with regard to Stamp Duty Land Tax (SDLT) and Stamp Duty Reserve Tax (SDRT). The consultation made it clear that any UK-REIT structure would need to be consistent with the current SDLT system, and outlined the main issues for consideration, including the purchase and sale of property by a UK-REIT, SDRT on the transaction of UK-REIT shares, and the treatment of 'seeding' or 'in specie' transfers of assets into UK-REITs. The consultation noted that any potential UK-REIT structure could encourage more property to be held in an indirect form, with an impact on the trading of the underlying asset. It noted that any subsequent fall in SDLT receipts would need to be taken into account within the overall assessment of Exchequer impact.

A.40 Most responses agreed that a potential UK-REIT structure should be liable to SDLT within the existing regime, at the prevailing rates. However, some responses argued that there was a case for examining the SDLT treatment of smaller REITs, particularly in the residential sector, in order to promote parity with other forms of property investment. Many responses favoured some kind of 'seeding' or 'in specie' relief for the transfer of assets into a UK-REIT in exchange for shares, or where some existing structures, (such as partnerships) or investors with direct holdings seek to convert. Some respondents argued that if such a relief could not be provided, the costs of SDLT incurred on the transfer of assets into a UK-REIT could be factored into any necessary conversion charge calculation.

A.41 On the question of SDRT, a majority of responses argued that UK-REITs should be liable to the prevailing rate for normal shares of 0.5%. Many responses argued that any rate above this level would be a significant disincentive to most investors, with the effect of curtailing the liquidity of transactions and making the vehicle unattractive. Many respondents also challenged the notion that the establishment of a UK-REIT structure would have a negative overall impact on Stamp Duty receipts.

International Accounting Standards **A.42** The consultation asked what implications the adoption of International Accounting Standards (International Financial Reporting Standards, IFRS) would have for a UK-REIT. Respondents identified a range of technical issues where IFRS could have an impact. In particular, they raised issues around the use of fair value accounting, as distinct from depreciated cost value, and the impact that adopting different accounting policies could have on determining the level of income available for distribution. Detailed points were made on the treatment of unrealised capital gains and losses taken to the profit and loss account; the treatment of rent-free periods and the scope for deducting some items as an expense - thereby reducing the income available for distribution - rather than capitalising them on the balance sheet.

THE CONVERSION CHARGE AND WIDER ISSUES

Conversion charge **A.43** The consultation noted that in order to protect the Exchequer against loss of revenue, if a new vehicle were to be introduced, the Government intends to apply a charge on those companies seeking to convert into UK-REIT status. The consultation highlighted precedents for the application of a conversion charge and identified two possible approaches. One would be to base a charge on the value of the latent capital gain liability ('an exit charge'); another would be to impose a one-off charge based on the value of property assets transferred into a UK-REIT ('an entry charge'). The consultation asked, in the context of no overall cost to the Exchequer, what factors should be taken into account in setting the scale, nature and timing of the conversion charge to a UK-REIT.

A.44 Most responses agreed with the principle of a conversion charge with certain qualifications taken into account. Given the stage of consultation, responses in general did not discuss specific rates or levels, but argued that a charge would have to be carefully set in order to preserve the perceived benefits of conversion from the company's or fund's perspective, and to ensure proportionality between property investment vehicles.

A.45 Most responses briefly discussed the advantages and disadvantages of options for a conversion charge. Many responses noted that while an exit charge might be generally accepted (subject to further detail) amongst UK listed companies, it would fail to take account of the wider spectrum of investment vehicles, including offshore funds. Responses suggested that a conversion charge could be paid over an extended period, as opposed to a one-off payment. Respondents also raised a number of technical issues with regard to the mechanics of conversion from different investment vehicles.

Authorised Investment Funds **A.46** Chapter 5 of the consultation covered the wider implications for reform to the taxation of property investment. In particular, it was noted that the possible introduction of a UK-REIT would need to be considered alongside existing property investment vehicles, such as authorised investment funds. The consultation noted the new regulatory framework for authorised investment funds issued by the Financial Services Authority in April 2004 and the current corporation tax treatment of property rental income within these authorised schemes of 20%. The consultation asked for views on the impact a UK-REIT might have on alternative options for property investment and the implications for the distribution rules of authorised investment funds.

A.47 Further to that the Inland Revenue issued a technical discussion note in July 2004 to consider wider tax reforms for authorised investment funds in response to the FSA's new regulatory framework. This technical note recognised the link between the tax treatment of property rental income within UK-REITs and the authorised funds and stated that the issues would be considered in parallel as part of the UK-REIT consultation.

A.48 The majority of respondents called for parity of treatment across the range of property investment vehicles. This, it was suggested, would lead to greater choice and enable products to be tailored to the different needs of retail and professional investors. Respondents also discussed the potential impact of a UK-REIT on the existing property investment market and suggested that a significant portion of the current UK listed companies could potentially seek to qualify for UK-REIT status. Respondents went on to discuss the experience of other countries introducing such regimes. There was some discussion of the prospect of offshore investment funds and vehicles setting up in the UK in the event of reform.

A.49 There were also comments that a requirement for UK-REITs to distribute a high level of income to investors would be broadly consistent with the treatment of authorised funds. Some noted a slight discrepancy of treatment if UK-REITs were to be required to distribute less than 100% of income, since authorised funds are in practice deemed in their accounts to have distributed all available income to investors.

Wider implications **A.50** The consultation posed a series of further questions on the wider implications of a potential new UK-REIT structure within the context of the current property investment market. It also looked forward to evaluation of any new vehicle and its potential impact in terms of regulation and compliance costs. The consultation asked whether Unauthorised Unit Trusts (UUTs) could contribute to the wider objectives set out, as well as exploring the reasons for the lack of interest in Housing Investment Trusts (HITs).

A.51 A majority of responses felt that UUTs would continue to serve a clear purpose within the property investment market, even with the advent of UK-REITs. Most argued that tax-exempt institutional investors would continue to find the UUT regime attractive. On Housing Investment Trusts, a majority of responses cited overly restrictive legislation as the fundamental disincentive to their take-up. As the consultation itself highlighted, these included low value threshold limits for the acquisition of property. Some responses also argued that legislative constraints were exacerbated by the requirement to list and the subsequent need to meet listing requirements.

A.52 On the question of evaluation, responses offered a variety of options for assessing the growth and development of a UK-REIT market. Many responses focused on measures related to market size (measures of net assets under management or market capitalisation) as a reasonable proxy for size and growth of the market. Transactions of UK-REIT shares were cited as a potential measure of liquidity. Many responses noted that regulatory and compliance issues would be dependent, to a large extent, upon the final details of any proposals. However, responses did stress the overall requirement for a simple and flexible structure that would keep compliance costs to a minimum. Some responses discussed the likely compliance implications of any requirements to list, meeting the specific qualifications for a UK-REIT structure and the potential authorisation of external management.

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