Real Estate Investment Trusts ('REITs')

Standard Note: SN/BT/4045
Last updated: 31 May 2006
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In the 2003 Budget the Government announced that it was to examine the options for enhancing the property investment market.[1] Formal consultation on the creation of a tax transparent property investment trust began in March 2004;[2] a follow-up discussion paper on the introduction of "Real Estate Investment Trusts" (REITs) was published alongside *Budget 2005*.[3] At this time the Government stated that "subject to finding a workable solution that meets 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."[4] Finally, in his Budget speech on 22 March 2006 the Chancellor Gordon Brown confirmed that "to attract more capital into house building, we are now legislating to introduce for Britain the real estate investment trusts that are so successful in the USA."[5] Companies and groups may elect to join the REIT regime from 1 January 2007.[6] Provisions to this effect are included in the *Finance (no.2) Bill 2006* – specifically clauses 103-146.

This note gives some background to these developments.

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A. Consultation on property investment funds (2003-04)

In Budget 2003 the Government announced that it was to consider "measures" to encourage the development of the commercial property market; for some time before this, many in this sector had been lobbying for the introduction of a new form of investment trust to support the private residential housing market[7]; an extract from the Budget report is given below:

[1] HC 500 April 2003 para 3.13
[2] HM Treasury & Inland Revenue, *Promoting more flexible investment in property: a consultation*, March 2004. Available at: http://www.hm-treasury.gov.uk/budget/budget_04/associated_documents/bud_bud04_adproperty.cfm
[3] HM Treasury & Inland Revenue, *UK Real Estate Investment Trusts: a discussion paper*, March 2005 At: http://www.hm-treasury.gov.uk/media/A61/AB/Bud05Reits.pdf
[4] HC 372 March 2005 para 3.118
[5] HC Deb 22 March 2006 c 293
[6] HM Revenue & Customs Budget Note BN03, 22 March 2006
[7] for example, "Tax incentive plan for property investment", *Financial Times*, 22 June 1999; "Tax wish-list for investors", *Financial Times*, 17 March 2000.

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> Tax distortions can be a further source of structural problems in the commercial property market. [Budget 2003] outlines a series of reforms to stamp duty to tackle avoidance and reduce distortions to commercial decision-making [paras 5.86-92]. Tax reforms may also have a role to play in enhancing the property investment market. The Government will discuss with the industry the appropriate tax treatment of new property derivative products. Consultation on corporation tax reform also provides an opportunity to consider the tax treatment of commercial property. The Government also wishes to explore with the industry the evidence for further measures to improve the efficiency and flexibility of the commercial property market.[8]

In a story just after the Budget, Norma Cohen, who then wrote on the property market for the *Financial Times*, noted that other European countries – France, Holland and Belgium - had recently introduced this type of trust – inspired by the success of real estate investment trusts in the US. However, in her view a more compelling argument for the UK might be the popularity of 'listed property trusts' (LPTs) in Australia among elderly people who needed to invest for their retirement: "the low volatility and relatively high payouts of LPTs have satisfied the needs of many pensioners." Ms Cohen quoted an Australian expert on this area as saying, "we have found that there are a lot of advantages for mums and dads who are looking after their retirement," going on to observe, "such arguments may hold far more sway with [the Chancellor] and his advisers than any discussion of cheap capital for development."[9] A second story in the paper noted that from the investors point of view, a unit trust model had definite attractions:

> The Treasury is thought to favour the creation of US-style real estate investment trusts (reits) which are widely seen as successful and have been replicated in France and Germany. The model is broadly similar to unit trusts: investors have to pay tax on income and capital gains from the trust, but the trust does not have to pay tax on the income it distributes, which must be a high proportion of its net cash flow …
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> While the precise details of Brown's announcement are unclear, the reform could mark the first chance for private investors to get diversified exposure through funds to residential property. They have largely been confined to buying their own homes or acquiring investment properties which they rent out. Other ways to get exposure include buying shares in house builders or estate agents. But for many investors, a chance to spread risk within residential property would be a first.[10]

At the time of the 2003 Budget, the Government commissioned Kate Barker – a member of the Monetary Policy Committee – to conduct a review of issues affecting housing supply in the UK, "in particular to look at the role of competition, capacity and finance of the house-building industry, and possible fiscal instruments, and the interaction of these factors with the planning system and sustainable development objectives."[11] Ms Barker's interim report was published in December 2003; in this she noted that the level of institutional investment in residential property was relatively low in the UK, and there was a case for introducing a new investment vehicle to encourage its growth:

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[8] HC 500 April 2003 para 3.131

[9] "Budget hints at tax reforms", *Financial Times*, 11 April 2003

[10] "A helping hand for investors", *Financial Times*, 6 December 2003

[11] HC 500 April 2003 para 2.77

7.32 Despite the strong performance of property compared with other assets in recent years direct institutional investment in residential property is very low in the UK. The rental market mostly comprises a large socially rented sector, provided by local authorities and Registered Social Landlords, and a smaller private rented sector run by often part-time and predominantly small-scale landlords.

7.33 In other countries institutional investors play a larger role in private rental housing, with social housing and owner occupation contributing smaller proportions of the total tenure mix (see Annex A for a more detailed breakdown of tenure type across countries). Institutional investors in other countries typically invest money in property through specifically tax-transparent property investment vehicles, for example Real Estate Investment Trusts (REITs) in the USA.

7.34 Governments in the UK have attempted to encourage such institutional investment in property in the past. For example:

- in 1996 legislation was introduced permitting the establishment of Housing Investment Trusts (HITs), which, among other features, had a reduced tax liability compared with normal property companies; and
- the Business Expansion Scheme (BES) of the 1980s represented an earlier attempt to interest venture capital investors into property.

However, like development taxes, these were not a success: BES was widely seen as a costly deadweight loss to the Exchequer that achieved few of its original aims; and to date no HITs have been created.

7.35 Several submissions to the Review have indicated a continued desire on the part of institutional investors to increase their exposure to property and highlighted the difficulties of doing so, including those difficulties related to the tax treatment of property investment companies. These submissions have argued that changes to the tax system would encourage greater institutional investment in property which might have positive benefits for housing supply:

- the quality of private rented stock may improve through greater investment in the physical fabric of dwellings, which would extend the usable life of the properties, and thus increase housing supply overall. Such quality improvements might also generate increased demand for the tenure type;
- given a guaranteed institutional buyer, housebuilders may be more willing to increase supply of the specific type of housing units desired by investors; and
- long-term investment may promote greater stability in the market, as institutional investors are typically less reliant on debt financing, and thus less vulnerable to interest rate changes than small individual private landlords, as well as being subject to greater market scrutiny.

7.36 Given the benefits that may result from greater institutional investment, and the role REITs play in other countries' housing economies, there may be merit in the Government looking at ways to promote greater interaction between institutional investors and the residential property market.[12]

Ms Barker's interim report was published alongside the Pre Budget Report; in this the Government confirmed that it formally consult on a REIT-type vehicle:

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[12] Kate Barker, *Review of Housing Supply: securing our future housing needs – Interim report: analysis*, December 2003 pp 119-120

> Following Budget 2003, and in line with the interim conclusions of the Barker Review, the Government has also concluded that a tax transparent property investment trust would improve liquidity, transparency and scrutiny, provide access to property for long-term savings, and could expand the private rented sector. Evidence from other countries suggests that these vehicles have worked particularly well where they are publicly listed, internally managed, closed-end companies, with a requirement for high distributions. In order to protect the Exchequer against loss of revenue, the Government also intends to apply a charge on conversion of property into a new vehicle. A consultation document, which will consider the most appropriate structure, alongside related property investment products, will be issued at Budget 2004.[13]

The industry welcomed the announcement,[14] as did Ms Barker in her final report published in March 2004; on this issue she recommended that "Government should deliver its proposals to promote greater interaction between institutional investors and the residential property market, through the introduction of tax transparent property investment vehicles":

> 6.10 The Interim Report noted[15] the limited role played by institutional investment funds in the residential property market in the UK. The Review noted further, that increased investment through a new bespoke vehicle (such as the Real Estate Investment Trusts, which operate in the US) has a number of possible attractions:
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> - Such vehicles could commission new build. This would directly increase the supply of new properties, if the supply of planning permissions also rises. However, if housebuilders were simply selling to property investment funds, rather than to individual purchasers, this would not, in itself, make an appreciable contribution to improving housing supply.
> - Such vehicles have clear incentives, as well as the financial strength, to maintain their properties. This could lead to higher quality and a more professional private rental market, improving its attractiveness, and thereby helping to create a better balance of housing tenures.
> - Long-term investment may promote greater stability in the market, as such vehicles would have greater access to equity finance, are therefore typically less reliant on debt financing and so less vulnerable to interest rate changes as well as being subject to greater market scrutiny.
> - There is potential for institutional investment to play a greater role in managing subsidised housing.
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> 6.11 The Review's Interim Report recommended that Government consider the introduction of a tax transparent property vehicle. It is therefore welcome that the Government has since announced its intention to consult on this proposal at Budget 2004.[16]

Prior to the Budget, the *Financial Times* noted that expectation was running high: "in anticipation of the change, property company shares have risen 21 per cent in the six months since [the PBR]":

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[13] Cm 6042 December 2003 para 3.111

[14] "Property industry welcomes tax-transparent vehicle", *Financial Times*, 11 December 2003; "The REIT characteristics?", *Tax Journal*, 9 February 2004

[15] pp. 69-70, Barker Review Interim Report (2003).

[16] *Housing Supply: Delivering Stability: Securing our Future Housing Needs - Final Report: Recommendations*, March 2004 p 106, p 105

> The UK-listed property sector - which has been shrinking as many businesses have gone private because high discounts to underlying assets prevented them from raising capital - could become one of robust high-yielding publicly-traded companies. That is because tax-transparent property investment vehicles distribute nearly all their taxable income to investors. In return, they are exempt from capital gains and tax at the corporate level. Investors pay tax on the dividends and capital growth at their own marginal tax rates, avoiding the double taxation that falls on investors in UK property companies.[17]

The Treasury published a consultation paper on a UK version of REITs – a 'Property Investment Fund' (PIF) - alongside the Budget. In this it underlined the intention was "not to reduce the tax contribution made by the property investment market, but to reform the means by which it is made and therefore deliver a more efficient market", so that it was envisaged that a conversion charge would apply for existing investments being converted into a PIF.[18] The document gave more detail as to the ways in which the Government felt the market was operating inefficiently:

- lack of choice for small investors – who tend to access property in higher risk ways, such as buy-to-let investments or direct ownership, and therefore cannot diversify their portfolio to reduce risk;
- poor liquidity – which is a reflection of the nature of property itself as an asset. The commercial property market is dominated by large investors and pricing and investment decisions are largely determined by individual transactions among a small number of players;
- potential for more efficient use of property – a high proportion of commercial property in the UK is owner-occupied, and this tends to be used less intensively than property in the investment market. More indirect investment may allow increased efficiency through economies of scale;
- high levels of debt financing – which increase the sector's sensitivity to interest rate changes, coupled with lower transparency and scrutiny in the private sector, may lead to instability in the wider economy;
- tax distortions – as investors are taxed differently depending on how they invest in property, it is not easy to compare performance of different investment choices. This may result in investors undertaking more risky, less suitable investments than if it were possible to make a simple and direct comparison; and
- variable standards of provision in the private rented sector – with the lowest quality housing stock and management at the bottom end of the market. Improvements and expansion to this sector could enhance efficiency and flexibility in the housing market.[19]

As the document went on to explain, the policy aims underpinning this initiative would mean that a PIF would have particular rules regarding the distribution of its profits:

> The broad principle is to consider a savings and investment vehicle that would provide a liquid market in property investment that is widely accessible by the private investor. Such a vehicle would need to fit alongside existing savings opportunities,

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[17] "Tax at the heart of property change", *Financial Times*, 10 March 2004

[18] HM Treasury/Inland Revenue, *Promoting more flexible investment in property: a consultation*, March 2004 para 1.4. At: http://www.hm-treasury.gov.uk/budget/budget_04/associated_documents/bud_bud04_adproperty.cfm

[19] *Promoting more flexible investment in property*, March 2004 para 1.15

> and should be designed to enable investors to have clarity in the tax treatment of alternative vehicles. One option for achieving this might be to construct a new bespoke vehicle with a tax treatment more closely aligned to the tax arrangements in place for direct investment in property. As such, a PIF might be designed in a way that it pays no corporation tax. Instead the PIF would be required to distribute a high level of income to investors, and tax would be collected from individual investors on the returns they receive from the PIF.
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> The requirement to distribute a high level of income emphasises the crucial distinction between an investment vehicle that provides returns to investors from managing and leasing property, and a normal trading company that would need to reinvest a significant proportion of profits and so naturally falls within the normal corporation tax rules.
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> Property is unique in comparison with other assets since it is both a factor of production, and an investment opportunity in its own right. This does not apply to other sectors and assets where, for example, plant and machinery on their own do not represent individual investment opportunities. Their main value is the part they play in the production process. A PIF structure with a high income distribution requirement might therefore not suit a company seeking to develop new property itself, but would provide a vehicle in to which newly developed property could be sold and managed, providing a product for individuals to invest in.[20]

Responses were invited up to 16 July 2004.

Commentators noted that although the Treasury had not specified the form a PIF should take, the consultation paper had observed that those funds in other countries that were working well were "closed-ended, publicly listed and internally managed, with a requirement to distribute a high level of income and capital to investors."[21] ('Close ended' structures allow investors to withdraw their investment by selling shares in the vehicle – so this decision does not require the company to sell its assets. This would have attractions for any REIT structure since property, particularly commercial property, cannot be acquired or disposed of quickly.[22])

One important difference from the Barker report was that the Government foresaw PIF investment to be in both residential *and* commercial property – not just the former; one commentator noted that this was something strongly supported by the industry, although went on to conclude that "since the Government seems to fear any potential loss of revenue, there is a real danger that the tax rules will be so complicated that PIFs are strangled at birth."[23] The *Financial Times* noted that the getting the design details right would be hard: "if Whitehall is too generous, the property industry … will take them to the cleaners … if the criteria is too stringent, take-up will be too low." The paper highlighted three particular issues: first, the size of a conversion charge; secondly, the threshold for the minimum level

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20 *Promoting more flexible investment in property*, March 2004 paras 1.17-1.21

21 *Promoting more flexible investment in property*, March 2004 p 38. See, "Property funds aim to promote housebuilding", *Financial Times*, 18 March 2004; "Property & the Budget", *Tax Journal*, 29 March 2004.aras

22 for more details see, *Promoting more flexible investment in property*, March 2004 paras 2.15-7

23 "Property investment funds", *Tax Journal*, 24 May 2004. On this theme see, "Property funds are a delicate balancing act", *Financial Times*, 24 July 2004

distributions to PIF shareholders, and third, the possibility of a gearing threshold (to prevent companies with over heavy borrowings converting to PIF status).[24]

In the Pre-Budget Report in December 2004, the Government announced that it was "continuing to explore whether the introduction of a REIT in the UK, as envisaged in many consultation responses, would meet the objectives set out alongside Budget 2004 ... While the Government will not legislate in 2005, it will report back with a discussion paper by Budget 2005, for further dialogue with industry representatives."[25] There was some impact on share prices for property companies on the announcement, but the *Financial Times* quoted Phil Nicklin, tax partner at Deloitte and a member of the industry steering group on Reits, as saying that the timing was not a surprise to those who had been discussing the issue with government. "People who had an inside track and saw this becoming more and more complex knew that to expect government to invent a commercial framework for this and a tax framework by March was ridiculous."[26] Liz Peace, chief executive of the British Property Federation, was quoted as saying that the Government *were* listening to the industry: "They will discuss further their ideas with us and are not rushing through something that is poorly thought through."[27]

B. Further consultation on REITs (2005-06)

In the 2005 Budget the Government published a second consultation paper, with an aim to introducing legislation in the Finance Bill in 2006:

> The Government is committed in principle to reforming the taxation of property investment. The consultation has enabled the Government to better define the key features of a potential UK-REIT model that allows for market flexibility. These features are set out in the discussion paper. The paper also raises some challenging issues in designing the tax treatment for a model that meets both the needs of the UK property investment market and the Government's objectives for a UK-REIT. The Government will therefore engage in further dialogue with industry representatives. Subject to finding a workable solution that meets 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.[28]

The paper includes a summary of the responses to the initial consultation; apparently responses "broadly endorsed the Government's key principles of reform", and following the consensus view the Government decided to use the term REIT rather than PIF as originally proposed: "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

24 "Theoretically everyone wins but it is in the detail that PIFs will stand or fall", *Financial Times*, 12 July 2004
25 Cm 6408 December 2004 paras 3.126-7
26 "Property shares falter after Reits decision put off", *Financial Times*, 3 December 2004
27 "Say 'reets' and wait for Brown's Reits issue", *Financial Times*, 4 December 2004
28 HC 372 March 2005 para 3.118

advisors."[29] On the taxation of REITs the paper proposed that a 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.[30]

Any REIT would have to have at least 75% of its income and assets relate to its ring-fenced property business, and distribute at least 95% of its net ring-fenced income to investors. Those rules aside, the paper argued that minimising the necessary constraints placed on REITs would be "critical to the successful development of a UK-REIT market", and as a consequence, it would not legislate on a series of issues: for example, determining whether a REIT was internally or externally managed, requiring a REIT to hold a minimum proportion of residential property or setting a minimum holding period for assets held in a REIT.[31]

The *Financial Times* quoted Phil Nicklin again, from the industry's REITs steering group, saying, "This is terrific … Their approach is very welcome; they seem to be producing a very flexible vehicle." It went on to note that "questions remain over how companies will be taxed when they convert. This could either be a levy on outstanding capital gains tax or on total assets, or a hybrid of the two. A windfall of more than £1bn could be raised, analysts have suggested."[32] The consultation paper did not examine how a conversion charge might be calculated, arguing that the most appropriate solution to this would depend on other technical issues, such as the tax treatment of overseas companies listed as REITs and limits on REITs borrowing. On the latter, the Government asked for views on how "reasonable levels of borrowing" could be allowed in a REIT market, without reducing the tax collected from investors or promoting specific manipulation for tax avoidance purposes.[33]

One practitioner writing in the *Tax Journal* commented, "the Treasury and Inland Revenue have clearly listened to the responses to the earlier consultation and the proposals are now for a reasonably flexible vehicle, which is likely to be attractive both to the industry and to investors."[34] The *Financial Times*' property correspondent, Jim Pickard, argued that if successful, "the REIT universe is likely to look very different to the existing listed property sector":

> First, companies such as British Land, Hammerson and Land Securities, are likely to be joined by an array of newcomers. These may be private companies or property

[29] HM Treasury / Inland Revenue, *UK Real Estate Investment Trusts: a discussion paper*, March 2005 para 1.4, para A.7
[30] *UK Real Estate Investment Trusts*, March 2005 para 3.5
[31] *UK Real Estate Investment Trusts*, March 2005 para 3.10
[32] "UK-REITs win approval from property industry", *Financial Times*, 17 March 2005
[33] *UK Real Estate Investment Trusts*, March 2005 para 4.15, 4.12
[34] "Property", *Tax Journal*, 28 March 2005

> funds which are keen to become Reits. They may be retailers, such as Marks and Spencer or Tesco, choosing to float off some of their property portfolio directly to the public. Second, do not expect companies to remain in their existing form. Instead of one Land Securities Reit, for example, there may be separate ones for its different asset classes; London offices, shopping centres and retail parks.
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> Existing Reits in the US tend to be highly focused on distinct sectors, whether retail parks, apartments, east coast offices or - at the most extreme - jails. In theory, investors will be able to buy a slice of just one shopping centre, although ministers have indicated this is unlikely, or they will be able to put together their own portfolio of Reits. Eventually, there may be ways of buying into the UK Reits index, says [Andrew Hynard, head of capital markets at Jones Lang LaSalle], just as investors can buy securities which track the stock market or baskets of shares within it.[35]

In a second article, Mr Pickard saw the treatment of overseas investors as the largest potential stumbling block to achieving this kind of success:

> It is the question of how to deal with overseas investors that is causing civil servants and accountants to reach for the aspirin. The dilemma is not unique to the UK: the German finance ministry is facing a similar problem ahead of trying to launch G-Reits next January. When the French set up their own version of Reits in 2003 - called SIICs - they took the Gallic shrug approach; foreign investors in SIICs do not pay tax on this source of income. But it seems highly unlikely that Gordon Brown would be quite so laissez-faire … On the one hand, the government does not want to restrict its new system to just UK companies. But it is determined that there should be no tax leakage. It admits in the paper, "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." As a result, the Treasury would collect no tax whatsoever from UK property held in an overseas-based Reit.
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> It is a similar story for overseas investors in a UK-based Reit. Although those investors can be tapped for tax through Double Taxation Agreements (DTAs) with other countries, there are limits to this. The government cannot levy a withholding tax on these investors above the usual bilateral agreements - anything from 15 per cent to 0 per cent. This is much less than the current 22 per cent tax burden on rental income from directly-held property. "This would breach the UK's right to maintain a fair proportion of tax on UK land and property from all types of investor," says the discussion paper. Given the industry's penchant for tax avoidance - billions of pounds of UK commercial property is now held offshore - it is clear why civil servants are worried.
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> One suggestion in the Budget discussion paper was that maybe a 22 per cent tax could be levied at the Reit level. This would neutralise the foreign investor issue at a stroke. But UK pension funds, which pay no such tax, would be penalised. They could be given tax credits, but this would be politically sensitive - given how the Inland Revenue deals with shares. Labour removed the dividend tax credit for pension funds in 1997 in one of the most controversial fiscal decisions of its government.[36]

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[35] "A brand new investment world", *Financial Times*, 4 June 2005

[36] "Opinion: Time needed to get property trusts right", *Financial Times*, 11 April 2005

Despite concerns from the industry that the Government might delay the launch of REITs beyond 2006,[37] confirmation came in the Pre-Budget Report in December:

> 3.131 The Government will bring forward draft legislation for inclusion in the 2006 Finance Bill. Details of the tax proposals will be published before the end of 2005 and will include the following key features:
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> - the regime will be open to property companies resident in the UK, that are publicly listed on a Recognised Stock Exchange as defined for tax purposes;
> - companies or groups that meet the UK-REIT eligibility criteria as set out in legislation will not pay corporation tax on qualifying property rental income or chargeable gains; and
> - a requirement to distribute at least 95 per cent of net taxable profits on rental income to investors, who will then pay tax at their marginal rate.
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> 3.132 The Government is committed to taking a flexible approach in developing a UK-REIT while ensuring a fair and appropriate regime for all taxpayers, and believes this model strikes the right balance. The Government remains committed to ensuring that the introduction of a UK-REIT results in no overall loss of revenue for the Exchequer and will continue to keep this under review. The rate and mechanism for the conversion charge applying to companies joining the regime will therefore be announced at Budget 2006. The Government continues to consider in parallel the taxation position for authorised investment funds investing in property.[38]

One commentator noted that the announcement "has been widely welcomed, as it was not certain that the Government had accepted the case for REITs."[39] Draft legislation was published at the time gave more details, pertinent to the important questions of REIT borrowing and investment by overseas investors. (A second draft was issued at the end of January 2006.) First, a REIT would be subject to an "interest-cover test" on the ring-fenced part of its business; if a business' financing costs exceeded a given ratio with respect to profits, they would be subject to an additional tax charge, rather than exclusion from the REIT regime.[40] Second, a REIT would withhold basic are tax on the distribution paid to investors on behalf of the tax authorities.[41] Despite its general enthusiasm for the scheme, the industry raised concerns about two issues: the exact level of the "interest cover test"; and a rule preventing any shareholder owning more than 10% of any REIT.[42] In addition one practitioner writing in *Taxation* noted that "the continuing lack of detail over the form of the conversion charge, an item that will significantly contribute to the overall success of a UK-REIT, is rather disappointing."[43]

Nevertheless in February 2006 Jeff Schwartz, chief executive with ProLogis, the third largest REIT in the United States, gave an interview arguing that these criticisms were unwarranted:

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37 "Treasury fears 'could delay real estate trusts by a year'", *Times*, 10 June 2005

38 Cm 6701 December 2005 p 71

39 "Focus on property", *Tax Journal*, 12 December 2005

40 The proposed test required that the ratio of profits plus financing costs to financing costs is 2.5 or higher – roughly equivalent to 40 per cent loan to value.

41 HM Revenue & Customs, *UK Real Estate Investment Trusts*, 14 December 2005; "Real estate trusts set to boost savings", Financial Times, 15 December 2005.

42 "Changes sought to real estate trusts", *Financial Times*, 4 January 2006

43 "REIT on!", *Taxation*, 19 January 2006

UK analysts and executives say the Treasury's proposals, set out in draft legislation last year, are unworkable because of borrowing restrictions on Reits and a rule that will prevent any shareholder owning more than 10 per cent of any Reit. But Mr Schwartz said Reits had put up with similar restrictions worldwide with few untoward effects. The 10 per cent rule already existed in the corporate charter of many US Reits, including ProLogis. Under federal law, no five shareholders could own more than 50 per cent of any such company.

He dismissed the argument that without large shareholders, Reit managers would lack the incentive to perform well. "You could argue the opposite; that a single large shareholder can become complacent. Large institutional ownership may not be appropriate for Reits given that they are aimed at retail investors."

Mr Schwartz said the Treasury's proposed limit on borrowings, that interest payments must be covered at least 2.5 times by income, which analysts say typically equates to 40 per cent gearing, was not too tight. "Most Reits in the US are about 40 to 45 per cent geared, so it is not terribly dissimilar. If you look at Singapore Reits, which need special permission from the government to go above 30 per cent, they haven't anything over 40 per cent but they have been a success."

Another proposed restriction on Reits, criticised by some in the property industry, is that 75 per cent of their business must be ring-fenced. Any property developed within that ring-fenced proportion must be held for at least three years. But Mr Schwartz said ministers were right to create such restrictions, given that Reits would be aimed at small investors. "A private equity group like Blackstone can borrow 90 per cent, do more development and have a different risk/reward approach but that is not the place for public markets."[44]

C. Budget 2006

In the Budget report the Government announced that REITs would be launched on 1 January 2007; it also gave details of the conversion charge, and certain changes regarding the rule on distributions and the interest cover charge:

3.118 Following consultation on draft legislation released in December 2005, the Government is able to announce the following significant changes:

- to provide greater flexibility for companies to operate within the regime, a reduction in the required distribution rate to 90 per cent of net profits;
- in line with industry's response, a reduction of the interest cover test to 1.25 on a pre-capital allowances basis; and
- to enable companies to operate the 10 per cent shareholding limit effectively without preventing normal market activity, HMRC will set out in guidance mechanisms through which companies can operate the limit through their Articles of Association, in accordance with the listing rules of the Financial Services Authority.

3.119 To meet the Government's objectives for UK-REIT legislation to be introduced at no overall cost to the Exchequer, a conversion charge will be levied on companies

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[44] "Property chief says Reits will overcome cynicism", *Financial Times*, 8 February 2006. Similar comments were made by others in the UK industry: "Property companies accused of hijacking Reit debate", *Financial Times*, 13 February 2006.

> electing to join the new regime at a rate of 2 per cent of the gross market value of investment properties. The Government believes that this package of measures, along with a number of further technical amendments, will enable the successful launch of Real Estate Investment Trusts from 1 January 2007 and lead to a better functioning and more efficient UK property investment market.[45]

Further details were given in a press notice – including the calculation of the conversion charge (***emphasis added***):

> **Current law and proposed revisions**
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> 5. Where a company owns property, it is chargeable to corporation tax at 30%, on the net rents received (section 15 Income and Corporation Tax Act 1988 (ICTA)) and under section 1 Taxation of Capital Gains Act 1992 on any gains made when property is sold. When a company distributes these profits to investors, they are treated as normal dividends for tax purposes, as set out in Part VI of ICTA and Chapter 3 Part 4 Income Tax (Trading and Other Income) Act 2005 (ITTOIA).
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> 6. For many investors, there is no further tax to pay on the dividends. This is because UK companies are in general exempt from tax on UK dividends (section 208 ICTA), and for individuals, the tax credit attached to the dividend meets the liability to tax for all but higher rate taxpayers (section 397 ITTOIA). Higher rate taxpayers pay additional tax of 25% on the dividend. The tax credit cannot be paid to investors whose liability to UK tax is less than the tax credit.
>
> 7. For companies or groups that meet the necessary conditions for the regime, the measure will allow them to elect for special rules to apply to their property business and to their distributions. Those that elect will be known as UK-REITs (Real Estate Investment Trusts).
>
> 8. For UK-REITs, their qualifying rental income and gains on disposals of investment properties will be exempt from corporation tax. Profits and gains on any other activities carried on by the UK-REIT will be subject to corporation tax in the normal way.
>
> 9. Distributions paid out by a UK-REIT, so far as they are paid out of tax-exempt property income or gains, will be treated as UK property income. They will be chargeable to tax under Schedule A (section 15 ICTA) (for corporation tax) or section 268 ITTOIA (for income tax) and paid out to investors under deduction of basic rate income tax (22%). Dividends paid out of other profits will be treated as normal dividends for UK tax purposes. The detail of the administrative arrangements for accounting for tax deducted from payments will be included in regulations.
>
> 10. The conditions that have to be met to come within the UK-REIT regime cover:
>
> - the company (or the parent company in the case of a group),
> - the business carried on, and
> - a requirement to distribute at least 90% of the tax-exempt profits each year.
>
> 11. The conditions the company must meet include the following:
>
> - it must be UK resident for tax purposes,
> - its shares must be listed on a recognised stock exchange, and

[45] HC 968 March 2006 pp 70-71

- no one investor may be beneficially entitled to 10% or more of distributions or control directly or indirectly 10% or more of the share capital or voting rights.

12. The conditions that relate to the business are that:
- 75% or more of its assets must be investment property,
- 75% or more of its income must be rental income, and
- the ratio of taxable rental profits before interest and capital allowances to interest on loans to fund the tax-exempt business must be more than 1.25:1.

13. Companies or groups wanting to become UK-REITs will pay an entry charge of 2% of the market value of their investment properties at the date the company or group joins the regime. This charge will be collected at the same time as any corporation tax that is due for the first accounting period the regime applies to them. Companies or groups will be able to spread the charge over four years, in instalments of 0.5%, 0.53%, 0.56% and 0.6% if they prefer.

14. The legislation relating to "housing investment trusts" (sections 508A and 508B ICTA) is being repealed at the same time.[46]

It is estimated REITs will raise £35 million in 2006-07, £155 million in 2007-08, and £130 million in 2008-09.[47] HMRC published a final regulatory impact assessment alongside the Budget; this sets out the expected benefits of REITs as follows:

> 2.29 Small investors (retail and smaller institutions) would have greater access to property through a diversified savings portfolio, without being subject to the potential risks, large capital outlays or tax inefficiency, which they currently face when choosing to invest in property.
>
> 2.30 Information obtained from an Investment Management Association survey[48] on the asset allocation of retail investors (as well as pension and insurance funds) found that in 2004 investment in property accounted for 2.4% of the portfolio of retail investors, compared with 4.5% for pension funds and 9.7% for insurance funds. Assuming that larger institutions have a greater proportion of their investments in property because it is more accessible to them, we might assume that the proportion for retail investors could increase to similar levels once they have access to shares in UK-REITs;
>
> 2.31 Business would be expected to benefit from an improved supply of good quality, well maintained, competitively priced accommodation, as a more efficient utilisation of financing sources allows for greater investment. Owner occupying businesses might find that the opportunity of releasing property assets to professional building managers would allow them efficiency gains from specialisation in their core business;
>
> 2.32 The UK economy would be expected to benefit through greater efficiency in the allocation of investment resources and a rebalancing of debt and equity in the financing of property companies. The privatisation of 12 listed companies, perhaps

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46 HM Revenue & Customs Budget Note BN03, 22 March 2006

47 HC 968 March 2006 p 188

partly driven by tax regulations, caused the listed sector to decrease by as much as 25% between 1999 and 2003 – we would expect this trend towards delisting to be halted under a UK-REIT regime, with companies' behaviour being driven by economic fundamentals and not tax regulations; and

2.33 The private rented sector would be expected to benefit from improved management through the involvement of large institutions in the form of UK-REITs, and developers would be expected to bring forward more housing supply to the private rented sector with UK-REITs there to act as willing purchasers.[49]

The industry gave a positive response to the amendments announced in the Budget:

> Shares leapt in most of the listed property companies after the Treasury made it easier for them to convert into real estate investment trusts, a type of tax-efficient property vehicle that will be introduced next January … Shares in the leading property companies, which have already outpaced the wider stock market in the past two years, reached new highs on the back of the positive news. Land Securities, the largest group, gained 13 per cent to £20.80, British Land was up 12 per cent to £13.00 and Hammerson rose 9 per cent to £13.00 …
>
> Many property companies had criticised the draft legislation, published in two batches in December and January, as "unworkable". That opinion is likely to be reversed in the next few days as executives work through the new details of the proposed legislation. Stephen Hester, chief executive of British Land, and Francis Salway, chief executive of Land Securities, both said they would look favourably on the new rules, which seemed broadly positive. Clare Hartnell, head of property at Grant Thornton, said: "They have actually listened for once on Reits, they have done what they can, to be fair, to make Reits workable."[50]

Writing in the *Tax Journal*, one practitioner wrote, "all these changes are helpful and mean that the regime is likely to be more attractive in many respects for listed companies and their shareholders." On the two questions of the conversion charge and gearing, he commented:

> The entry charge will be based on 2% of the gross asset value of properties going into the regime. This is at the lower end of many estimates and would potentially make the regime affordable for a larger number of existing companies. The use of gross asset value is a somewhat blunt instrument but it has the merit of simplicity and transparency and is generally to be welcomed. The limit on gearing originally proposed in December is to be doubled. The limit will now be an interest ratio of 1.25:1, which equates to a loan to value of some 70-80% for most companies … Nearly all listed property companies would currently meet this test.[51]

In a *Financial Times* survey on REITs published on 5 April, the paper's property correspondent wrote, "it is still possible that some of the small print in the Finance Bill could deter companies from converting, but the overall mood in the industry has switched from one of pessimism [prior to the Budget] to outright joy."[52]

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[48] http://www.investmentuk.org/news/surveys/default.asp

[49] *Regulatory impact assessment - 2: Real estate investment trusts*, March 2006 p 5. At: http://www.hmrc.gov.uk/ria/ria-reits.pdf

[50] "Industry greets changes to rules for Reits as fair", *Financial Times*, 23 March 2005

[51] "Property", *Tax Journal*, 3 April 2006. See also, "A Reit good thing", *Tax Journal*, 3 April 2006.

[52] "Potential obstacles to success removed", *Financial Times*, 5 April 2006

There does not appear to have been any substantive comment or debate in the House on REITs until after the Government presented its final proposals in Budget 2006. The issue was raised just once during the second reading debate on the *Finance (no.2) Bill 2006*, when Sir George Young made two strong criticisms: first, that it had taken far too long to introduce REITs, and that second, that the focus on investment in *residential* property – highlighted in the Barker report – had been lost:

> The first question that I want to ask the Government is: why has this modest reform taken so long? When we left office some 10 years ago, most of the spadework for REITs had been done. We consulted the Council of Mortgage Lenders, the British Property Federation and the City and the response was positive. There was all-party support for that sensible fiscal reform. There were models for it in other parts of the world. Indeed, this country had pioneered investment trusts and a REIT is, in effect, an investment trust for property. The transplant should have been straightforward and yet it will be nearly 10 years—1 January 2007—before we get the first REIT …
>
> The second issue that I want to raise about REITs is more fundamental … The original thinking behind REITs was to promote investment in residential property. I remember because I was Housing Minister at the time the debate got under way in the mid-1990s. What we wanted was a vehicle to enable institutions and private investors to invest in property for rent, in the same way in which they could invest in shares through an investment trust. At that stage, the vehicle was not called a REIT; it was called a HIT—a housing investment trust.
>
> HITs were envisaged as the last stage of a series of reforms to promote the increased supply of good quality rented housing. We introduced assured shortholds to put tenancies on a viable basis. Once we had that underpinning the private rented sector, there was going to be a new fiscal framework to get serious, respectable, long-term institutional funds into property for rent. If quoted companies invested in rented property, that would bring institutional funds into a market that needed—and still needs—more supply, and private investors could buy shares in those companies. Also, institutions that find it difficult to get exposure to residential property in their portfolio would be able to do that through REITs.
>
> The clauses contain the necessary changes to introduce that measure and I welcome that—it avoids double taxation. However, something has happened in the intervening period that I find very worrying. Instead of housing investment trusts, they are now real estate investment trusts. … The emphasis is very much on commercial property and the original idea, if not abandoned, is certainly no longer centre stage. There was never an equivalent argument for REITs for commercial property, compared with residential property. If one wants to invest in commercial property, there are listed property companies and one can do that with great ease. There is no shortage of institutional capital to invest in shops and offices, whereas in many parts of the country, as I said, we need more good quality new accommodation for rent.[53]

Provisions to introduce REITs are set out in clauses 103-146 of the *Finance (no.2) Bill 2006*. The House debated one of these clauses in the Committee of the Whole House on 3 May 2006: clause 106 – which sets out the conditions for giving notice to join the REIT regime,

[53] HC Deb 24 April 2006 cc 421-2. In concluding the debate on second reading, the Paymaster General, Dawn Primarolo, did not discuss REITs in any detail.

and the conditions a company must fulfil to join and remain within it.[54] The explanatory notes to the Bill comment that these conditions "are designed to restrict the regime to publicly listed companies with their equity and debt finance arranged in such a way as to ensure that tax-exempt profits are paid out to shareholders as income taxable under Schedule A."[55]

Speaking for the Conservatives Mark Francois said the Opposition welcomed the principle of REITs – "having pressed the Government to adopt such a structure for several years"[56] – but asked if the Government might consider extending the REIT regime to property investment companies listed on the alternative investment market (or AIM as it is commonly known). The British Property Federation had argued that limiting REITs to listed companies would make it much more difficult for new REIT companies to form. He also asked why 'close companies' could not become REITs (broadly speaking, companies controlled by five or fewer people). Mr Francois also proposed an amendment requiring the Government to produce a report to Parliament on the regime – first in March 2007, and then on an annual basis.[57] Speaking for the Liberal Democrats, Julia Goldsworthy supported the last of these measures – in light of the fact that many existing companies appeared keen to convert to REITs, but opposed an extension of REITs to AIM-listed companies because they represented a "higher risk investment."[58]

Speaking on this occasion Sir George Young reiterated his concerns raised on second reading about "the elephantine gestation period" for REITs and the focus on investment in commercial property. He also asked for the Minister's views on "to what extent the proposal is a new badge on something that is already happening or an opportunity for fresh investment that would otherwise not have taken place."[59]

In response the Economic Secretary to the Treasury, Ivan Lewis, said, "At this stage the introduction of a UK REIT is intended to improve the situation for existing companies, but as a consequence of doing that we expect new companies to emerge in the marketplace. We believe that there will be a dual effect." On Sir George's concern about the balance between residential and commercial property the Minister observed that the predecessor to REITs, housing investment trusts, had been specifically focused on low cost residential property but not adopted in practice. He went on to say that even though commercial property was "a very important part of this new development" he did "not necessarily accept that there is undue emphasis [on it.]"[60] The Minister set out three reasons why the Government opposed extending REITs to AIM-listed companies:

> First, it is obviously a new regime and in the Government's opinion, the first companies in that regime should be listed only on exchanges that are regulated, which gives some assurances to investors, particularly small investors, that their investments come with full—and full is the important word—regulatory protection. Only regulated markets are admitted to the list of recognised stock exchanges maintained by Her Majesty's Revenue and Customs.

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[54] HC Deb 3 May 2006 cc 1024-1050
[55] Bill 161-EN (Clause 106)
[56] HC Deb 3 May 2006 c 1024
[57] HC Deb 3 May 2006 c 1030
[58] HC Deb 3 May 2006 c 1031
[59] HC Deb 3 May 2006 c 1032
[60] HC Deb 3 May 2006 cc 1040-1

> Secondly, the term "recognised stock exchange" is a fundamental concept used in our tax legislation. For example, only those shares listed on an RSE can qualify for inclusion in an ISA and the RSE definition is also important in areas such as stamp duty, venture capital trusts and the enterprise investment scheme.
>
> Thirdly, and crucially—to deal with a point that hon. Members did not raise—it would not be possible to allow companies with shares listed on AIM to be eligible for the regime without also extending the same position to companies listed on similar markets in the European Union. The behavioural effects of such an extension are difficult to quantify in terms of the long-term cost to the Exchequer. Again, the risk for small investors would be greater than if the regime were restricted to companies listed on an RSE.[61]

He also opposed the withdrawal of the close company test, on the grounds of preventing tax avoidance

> The absence of [this condition] would allow any one person to control a UK REIT and divert many of the benefits of tax exemption conferred by the regime. In particular, a large group of companies could set up its own private UK REIT and obtain entirely unintended tax benefits in relation to the group's property holdings. That would be a clear subversion of the intention of the legislation, which is that the tax benefits of the regime should be available only when that kind of owner-occupied property is released into the investment market. The listing requirement, while undertaking a useful function in encouraging wider ownership, would not be sufficient on its own to prevent that kind of abuse. Companies may argue that they do not always know when they are closed, but the test is commonly understood and should not trouble a truly widely held vehicle. Indeed, that condition attracted little adverse comment in any of the public consultations in recent months.[62]

On the question of an annual REIT report, the Minister said:

> The FTSE real estate index currently includes 35 companies, which have a combined market capitalisation of approximately £28 billion. At a recent industry conference, it was stated that most of those companies will choose to enter the UK REIT regime in January next year or at some point after that, depending on their particular circumstances. In addition, the expectation was that some currently unlisted companies would choose to list in order to join the regime and that some companies would be formed from scratch for the purpose of joining. There would be very little value in having a specific Government report on an issue which will be widely known, which will be in the public domain and on which we will have the opportunity to report, perhaps in the pre-Budget report or the Budget.[63]

Finally, the Minister confirmed that it was the Government's intention that the draft regulations underpinning the REIT regime would be ready "by the time the clauses are debated in Committee."[64]

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[61] HC Deb 3 May 2006 c 1044
[62] HC Deb 3 May 2006 c 1045
[63] HC Deb 3 May 2006 cc 1045-6
[64] HC Deb 3 May 2006 c 1040