

Providing more flexible investment in property

IMA's Key Recommendations

(see Attachment 4 for details)

- **Make simple amendments to the existing regime for authorised unit trusts and open-ended investment companies investing in property:**
 - Tax income in the hands of the investor under Schedule A (and not at the fund level), but for Basic Rate Tax payers at their Lower rate of 20% in order to maintain parity with the current tax position. Also, income tax at the Lower Basic Rate to be withheld on distribution (ensuring Basic Rate Taxpayers fall outside the self-assessment regime), except for investors who are exempt and/or otherwise eligible to receive gross income. The treatment of capital allowances to be as for REITs (see below).
 - Amend the ISA Regulations to provide that authorised funds invested in property are eligible investments and to allow the income distributed to be exempt from withholding tax.
- **Draw up new Listing Rules for corporate, close-ended REITs**, using the requirements in the revised CIS rules – for retail and qualifying investor funds – as a template.
- **Draw up a new tax regime for listed REITs** with the following characteristics:
 - Investment limits and restrictions, and other regulatory requirements, to be captured in the UKLA's Listing Rules, not in tax legislation.
 - No tax on capital gains within the REIT.
 - No requirement to distribute capital gains. The investor to be taxed within the Capital Gains Tax regime on disposal of shares.
 - The REIT to be subject to tax, but with deduction for distributions (see recommendation below regarding the offsetting of capital allowances to minimise residual tax sticking in the vehicle), thereby remaining favourable and fair across all investors, while avoiding Treaty issues etc.
 - We recognise that a minimum income distribution requirement of around 90% is common in other REIT markets, but the basis must be income net of expenses. (We would also note that, in comparison, open-ended funds are required to distribute 100% of net income.)
 - Income distributed to investors to be taxed as Schedule A income, but for Basic Rate Tax payers at their Lower rate of 20%. Also, income tax at the Lower Basic Rate to be withheld on distribution (ensuring Basic Rate

Taxpayers fall outside the self-assessment regime), except for investors who are exempt and/or otherwise eligible to receive gross income.

- REIT shares to be confirmed as eligible for ISA investment.
 - Capital allowances to be either (a) offset against any residual taxable income within the REIT and/or in the calculation of withholding tax, or (b) fully passed through to investors as a tax credit.
 - The REIT to pay SDLT at up to 4% on purchase of UK property, but no SDLT charge on seedings, mergers and in specie transfers.
 - A charge to be payable by existing vehicles which do not have an exemption from tax on capital gains when converting to the new REIT structure. *(Note: the methodology for calculating that charge is outside IMA's remit. But we would urge that it be clear, simple and fair, for both existing and potential shareholders).* No charge can be justified for other vehicles or for the establishment of *de novo* REITs.
- **Leave unamended the current regime for Unauthorised Unit Trusts**, but consideration to be given to the removal of the unnecessary and cumbersome income tax payment/reclaim process, which gives rise to additional administrative costs (for pension funds, charities, management companies and the Revenue) without any gain to the Exchequer.
- **Amend the requirement for Life Funds to calculate annual deemed disposals for investment in authorised unit trusts and OEICs (CIS)**, to mirror the position of direct investment in property. Also, there are issues for property funds as regards the **FSA requirements on "permitted links"** for insurance companies, which need urgently to be addressed.
- **Consideration to be given to removing the double stamp** (ie stamp duty/SDRT on acquisitions of shares/units by investors, in addition to SDLT on acquisitions of property assets by the vehicle), by exempting acquisitions of shares in the new companies, CIS and UUTs from the 0.5% charge. At the very least, the treatment of exempt investors (ie pension funds and charities) should be considered.

NOTE:

Separately, the IMA is in the process of drawing up detailed proposals for a future simplified tax regime for savings products, which will address, *inter alia*, the question of mandatory income distribution. Our proposals in response to this specific consultation are in the light of the existing tax regimes for property investment vehicles, with the aim of eliminating or significantly reducing existing tax distortions. As part of the wider review of the taxation of savings products, we shall include property investment vehicles, both open and close-ended.

Property Investment Vehicles

A comparison of the current tax regimes and their effect

Attached are three tables summarising: the current tax profile of different types of property investment vehicle; the taxation of income received by different types of investors; and the taxation of capital gains received by different types of investors.

This depiction shows immediately and graphically the distortions to investor choice of the current tax regimes, and therefore why neither open nor close-ended onshore vehicles have to date been particularly attractive to investors. In particular:

- **Direct investment in property and investment in offshore investment vehicles are attractive options**, as: there is no loss of tax in the vehicle; the benefits of capital allowances are passed on in full to investors; and no stamp duty or SDRT (over and above SDLT of 4% on acquisition of the underlying asset(s)) is payable on acquisitions of holdings in the vehicle.
- Direct investment, however, does not provide appropriate diversification other than for very large portfolios; it requires the investor to be or engage an expert in the property market; and the investor has to have the ability (or engage a service provider) to maintain the properties.
- Investment in offshore vehicles is not (readily) accessible by most individual investors or small corporates, due to the restrictions on the sale of offshore funds.
- From a pure tax perspective, Property Investment Trusts or Property Companies are less attractive for individual or exempt (ie pension funds and charities) investors, due to the higher rate of taxation (30%) suffered within the vehicles. They are largely owned by institutional investors within their equity portfolios. The tax position is implicitly factored into the price (ie in the discount to NAV).
- **Life funds prefer to invest in offshore vehicles** that do not give rise to an annual deemed disposal of capital gains.
- **CIS (Authorised Unit Trusts and OEICs) are currently unattractive to pension funds**, as they cannot reclaim the 20% tax lost in the vehicle, leaving smaller DC schemes in particular without access to a suitable pooled vehicle (as they may not have sufficient cash flow to invest direct or via a limited partnership or unauthorised unit trust, and they have to operate within a restrictive regulatory environment preventing investment in a number of unauthorised schemes).

- Despite these considerable handicaps, interest from other investor bases has led over the past five years to a rise in funds under management in authorised property funds from £250mn to £1.2bn.
- Unauthorised Unit Trusts are significant investment vehicles, both in number and size. They can be open or close-ended, but are confined to exempt investors (pension funds and charities). In other asset classes such as equities and bonds, the size of total investment by UK pension funds is very considerable, enabling economies of scale that make UUTs attractive for providers and investors alike. But given that property funds need to be of a large minimum size (relative to other asset classes) to be viable and that UUTs are not open to institutional investors other than pension funds and charities, **a number of property UUTs have moved offshore in recent years.** Offshore vehicles allow assets of pension funds, life funds and corporates to be co-mingled without prejudicing the exempt investor. Moreover, for pension funds, they do not require the cumbersome and administratively costly income tax payment/reclaim process.
- Another vehicle that has been attractive to institutional and sophisticated investors is the Limited Partnership. Until recently, its tax profile was similar to that shown in the attached tables for offshore Baker Trusts. But proposed changes to the application of SDLT would result in investors in these vehicles effectively being hit twice in certain circumstances, which has caused an exodus of funds offshore. The recent report by the Lords Economic Affairs Committee criticised this measure.

These facts overwhelmingly support the Government's belief that "tax reform could help to address many of the inefficiencies that currently impact on the property investment market" (paragraph 1.16).

But they also illustrate starkly that, when designing the new tax regime for REITs and contemplating other amendments to the tax regime, if the results are in anyway less attractive than direct investment or offshore vehicles it is questionable whether the Government's policy objectives will be achieved. However, neither is that a reason for the Government to seek directly to reduce the attractiveness of offshore funds. They are making property investment more accessible, within the confines they operate, and are run professionally by many leading fund management houses. The key to achieving the Government's objectives is to allow the UK to compete for business on at least a level playing field.

Table 1 - Current tax profile of different types of property investment

Vehicle type	Tax on Income	Treatment of Capital Allowances	Min. income distribution requirement	Tax on Capital Gains	SDLT on UK property	VAT charged & reclaimable by vehicle	SDRT/SD on dealings in units/shares
Direct	NIL	CAs available to investors (=22, 30 or 40% of benefit)	100%	At investors' marginal rate	4%	If investor registered for VAT see Note 1	
AUT	20%	Tax deductible expense (ie only 20% of benefit)	100%	Nil	4%, but not on seeding	Note 1	0.5% SDRT within fund, but not on seeding (Note 2)
OEIC	20%	Tax deductible expense (ie only 20% of benefit)	100%	Nil	4%	Note 1	0.5% SDRT within fund
Exempt UUT	22%, but reclaimed by investors		100%	Nil	4%, but not on seeding	Note 1	0.5% SDRT within fund, but not on seeding (Note 2)
PIT	30%	Tax deductible expense (ie 30% of benefit)	85%	Nil	4%	Note 1	0.5% SD paid by investor on acquisition
Listed property company	30%	Tax deductible expense (i.e. 30% of benefit)	No requirement	30% rate, but in practice minimal tax paid	4%	Note 1	0.5% SD paid by investor on acquisition
<i>New corporate close-ended vehicle</i>	<i>Nil on all income</i>	<i>CAs set against w/hldg rate?</i>	<i>90%</i>	<i>Nil</i>	<i>4%</i>	<i>Note 1</i>	<i>NIL</i>
Offshore property vehicle (Note 3)	NIL	CAs passed to investors (=30 or 40% of benefit)	Subject to trust deed but usually 100%	Nil	4%, but not on seeding (Note 2)	Note 1	NIL

Note 1: VAT position of a property vehicle depends on type and location of the property. For UK property, there are two main possibilities:

- *Commercial property* - If there is a VAT charge on the fund on eg management fees etc, the fund cannot reclaim unless it "opts to tax" its commercial property, in which case the fund must, in turn, charge tenants VAT on rent.
- *Residential property* - If there is a VAT charge on the fund on eg management fees, the fund cannot recover this. (There is no "opt to tax" possibility for residential property.)

With regards to offshore funds, although they do not suffer VAT on management services, they may still suffer VAT on asset specific services in relation to UK land because the service is deemed to take place where the asset is located.

Note 2: This is by operation of law on initial transfers of assets to the trustees of a unit trust in exchange for units.

Note 3: Assumes a structure akin to a Channel Islands PUT set up as a Baker trust (with offshore fund distributing status).

Table 2 - Taxation of income received by investors in different property investment

Vehicle type	Basic Rate Tax Payer	Higher Rate Tax Payer	UK corporate investor	Life funds	Exempt investor	Offshore investor
Direct property investment	22%	40%	30%	Taxed at investors' marginal rate	Nil	22% (or 40%)
AUT/OEIC	Nil (Note 4) <u>but</u> 20% fund level tax	25% <u>and</u> 20% fund level tax (= 40%)	30% on streamed UFII (Note 5)	Taxed at investors' marginal rate	Nil <u>but</u> 20% fund level tax	Nil <u>but</u> 20% fund level tax
Exempt UUT					Nil	
PIT/Listed property company	Nil (Note 4) <u>but</u> 30% vehicle level tax	25% <u>and</u> 30% vehicle level tax (= 47.5%)	Nil <u>but</u> 30% vehicle level tax	Taxed at investors' marginal rate	Nil <u>but</u> 30% vehicle level tax	Nil <u>but</u> 30% vehicle level tax
<i>New corporate, close-ended vehicle</i>	20%	40%	30%	<i>Taxed at investors' marginal rate</i>	<i>Nil</i>	<i>22%</i> (or 40%)
Offshore property fund	22%	40%	30%	Taxed at investors' marginal rate	NIL	

Note 4: Tax liability of 10% met by 10% tax credit

Note 5: UFII = Unfranked Investment Income

Table 3 - Taxation of capital gains received by investors in different property investment vehicles (Note 6)

Vehicle type	Basic Rate Tax Payer	Higher Rate Tax Payer	UK corporate investor	Life funds	Exempt investor	Offshore investor
Direct property investment	20% - on disposal	40% - on disposal	30% - on disposal	At investors' marginal rate on disposal	Nil	Nil
AUT/OEIC	20% - on disposal	40% - on disposal	30% - on disposal	At investors' marginal rate but on deemed disposal	Nil	Nil
Exempt UUT					Nil	
PIT/Listed property company	20% -on disposal	40% - on disposal	30% - on disposal	At investors' marginal rate on disposal	Nil	Nil
<i>New corporate, close-ended vehicle</i>	<i>20%- on disposal</i>	<i>40% - on disposal</i>	<i>30% - on disposal</i>	<i>At investors' marginal rate on disposal</i>	<i>Nil</i>	<i>Nil</i>
Offshore property fund	20% -on disposal	40% - on disposal	30% - on disposal	At investors' marginal rate but on deemed disposal (Note 7)	NIL	

Note 6: After taking into account the annual exemption, taper relief/indexation allowance and capital losses b/fwd etc.

Note 7: The information in the table is for Baker Trusts. However, Life Funds will tend to invest in offshore vehicles which do not give rise to deemed disposals.

Promoting more flexible investment in property

Chapter 1 and the opening section of Chapter 2 of the Consultation Document ("ConDoc") Important Additional Information

Chapter 1 of the ConDoc provides an analysis of REIT markets around the world, and seeks to draw some conclusions / lessons which could apply to the design of a new regime for close-ended corporate vehicles in the UK. It also sets out the Government's policy objectives. The opening of Chapter 2 makes some comments about the relevance and effectiveness of open-ended funds.

This attachment provides additional commentary on property investment vehicles in other markets; responds to the comments made about open-ended funds; and provides a summary of the FSA's revised CIS regulation.

Open-ended Property Funds

In its analysis of property investment markets around the world, the ConDoc does not recognise the existence of open-ended vehicles in other jurisdictions and it appears to assume that being listed is one and the same as being close-ended. Moreover, where the ConDoc mentions UK open-ended funds, it expresses a number of concerns about their liquidity (eg in paragraphs 2.12 to 2.17).

We offer the following facts:

- Open-ended property investment vehicles are common to our certain knowledge in at least 11 European countries (e.g. in Germany since 1959). Some information on these markets has been provided to the Treasury during the consultation meetings.
- On the Continent, open-ended funds are commonly listed in order that their units can be cleared and settled on the same systems as equities and bonds. But their prices are still based on NAV, and are not subject to supply and demand imbalances.
- UK (authorised and unauthorised) and offshore open-ended property investment vehicles have been in existence for many years. In the 1980s, there were some redemption/liquidity issues. But the industry learnt from these and management practices have changed. For the last several years there have been no particular issues.
- The fact that there are now so few UK open-ended property funds is due to the combination of the previous FSA regulations (now updated) and the continuing tax disadvantages (see Attachment 2). Therefore, offshore options have generally been preferred.

- The combination of an unattractive regulatory and tax environment has prevented more UK authorised open-ended property funds from gaining significant mass, to achieve the operational advantages enjoyed by the larger funds on the Continent. For example, at any point in time, a large fund will have properties at various stages of being purchased or sold. If required, this can be controlled to provide additional liquidity, over and above that provided by the ability to borrow.
- The structure of open-ended property funds overcomes the theoretical redemption/liquidity problem:
 - Retail funds can adopt limited redemption, but are required to have a minimum of two redemption dates a year;
 - Funds may borrow temporarily to meet sudden surges in demands for redemptions;
 - Even in recessionary markets, many properties can be sold within a six-month time frame.
- The features of dilution levy, swinging single price and bid/offer spread ensure that where a large investor redeems, the net asset value (NAV) for the remaining investors is not disadvantaged.
- The fact that investors buy and sell at NAV is a clear advantage of the open-ended structure. For close-ended vehicles, the forces of supply and demand determine price and, as a result, in a recessionary market wide price discounts to NAV develop very quickly in close-ended vehicles. This can result in some investors exiting funds significantly below NAV. In contrast, open-ended funds are always valued at NAV and the price of units or shares reflects the value of the underlying properties. Consequently, existing investors are always able to exit at asset value rather than suffering a discount.
- In the event of a major market disruption, the regulations governing open-ended funds enable the suspension of trading in the units/shares, thus ensuring that even in extreme circumstances retail investors are not disadvantaged by being left in the fund after the sophisticated investors have exited.
- Open-ended funds are subject to rules on marketing literature for packaged products and on ongoing disclosure, to protect the retail investors.

The last four facts in particular make CIS ideal for the mass retail market.

The new CIS Regulations – a Summary

From April 2004, the FSA's new regulation of CIS (the COLL Sourcebook) came into force. For the first time in the UK authorised funds may be established which may be sold only to institutional and sophisticated investors, although launches of these new funds are being delayed until aspects of the tax regime are clarified/amended, including for property.

The following provides a brief summary of the new regime.

There are now three types of UK-authorized CIS – UCITS¹, non-UCITS retail (NUR) and Qualifying Investor Schemes (QIS) – each of which can take the form of authorised unit trusts (AUTs) or open-ended investment companies (OEICs). Property is an eligible asset class for NUR and QIS only.

NURs must be open to the public. “Key Facts” must be produced, the fund provider must comply with various disclosure requirements, and the provision of financial advice is regulated.

QIS can be promoted only to “market counterparties” and “intermediate customers”, which basically means institutions and private clients who have “passed” the COBS suitability test.

The governance structures for AUTs and OEICs (whether UCITS, NURs or QIS) are essentially the same. That is, in addition to the management company (ie the unit trust manager or the OEIC’s authorised corporate director) there is a trustee/depositary, which has formal oversight responsibilities as well as being charged with custody of the assets of the fund. All three of the fund, the management company and the trustee/depositary are individually authorised and regulated by the FSA.

Moreover, there is an overriding regulatory requirement on the management company and trustee/depositary always to act in the best interests of all unit/shareholders (ie not of some at the expense of others). For example, if a large redemption would give rise to significant transaction costs for a single-priced fund, impacting the investment of the remaining shareholders, the manager can apply a “dilution levy”. And if there were to be a significant market movement/event that materially affected the certainty/volatility of the price of fund units, then there are powers temporarily to suspend trading in the fund in order to protect all investors, especially retail.

All funds have to submit to the FSA a constitutional document (unit trust deed or instrument of incorporation) and a prospectus. The contents of both are stipulated by regulation. In particular, the prospectus must contain details of the fund’s investment objectives and policy, including what it will invest in and to what limits etc.

Funds may limit issue and/or limit redemption (which needs to be set out in the prospectus). For limited redemption, there is an upper limit for NURs (see table below).

FSA regulation sets down requirements/restrictions on investment limits etc, which are different for NURs and QISs (the latter have far fewer limitations, but must comply with requirements for full disclosure in the prospectus)

In brief, the FSA regulations for property investment are:

¹ UCITS stands for Undertakings in Collective Investment in Transferable Securities. UCITS are the subject of European legislation (the original UCITS Directive was adopted in 1985), which provides a product passport enabling funds in one Member State to be registered for sale in other Member States. At present, UCITS cannot invest in property, but this is one of the issues currently under review by the European Commission, which is due to publish a report by February 2005.

	NUR	QIS
Type of interest	Freehold or leasehold, or equivalent in other jurisdictions	No restriction
Investment limits	Capital: max 15% in any one property at acquisition; may then rise to 25%. Income: max 25% of fund's value in any one accounting period to be from any one grp.	Prudent spread of risk rule, only. Ditto
Mortgaged property	Max 20% of fund, and max 100% on any one property	No restriction
Unoccupied/non-income producing/under development	Max 50%	No restriction
Property derivatives	-	Total premiums on property options must not exceed 10% of fund value
Borrowing	Up to 10% of fund value	Up to 100% of fund value
Limited redemption	Up to max of 6 months between dealing days, but must be " <i>appropriate to its [the scheme's] aims and objectives</i> "	No max stipulated: period will " <i>depend on the reasonable expectations of the target investor group and the particular investment objectives and policy of the scheme</i> "

In addition, there are a series of requirements on proper title, minimum valuation requirements (frequency etc), who qualifies as an independent/approved valuer, valuation of connected or adjacent properties, etc.

Promoting more flexible investment in property

IMA's responses to questions raised in the ConDoc

Chapter 1: The economic context

Paragraph 1.3: The Government would welcome alternative suggestions to the name "PIF".

The label "investment funds" is the generic brand name across Europe (including in the UK) for open-ended funds, and they are understood by countries outside Europe to be the EU equivalent of US mutual funds. We would therefore urge that this term not be misused going forward.

Also, the market at large understands the term REITs to refer to corporate, close-ended property investment vehicles. So, we recommend that the new vehicle be called just that.

Therefore, we recommend that the UK refer to its range of Property Investment Vehicles (PIVs), which will comprise:

- Authorised Unit Trusts investing in property (PUTs)
- Open-ended Investment Companies investing in property (POEICs)
- The new property/real-estate investment trusts (REITs)
- Unauthorised Unit Trusts investing in property (UPUTs)

(And, of course, there will continue to be offshore property investment vehicles.)

A.1 To what extent would a PIF (a) help to promote structural reform in the commercial property market and (b) encourage institutional investment and stimulate new development in the residential sector.

The introduction of a new regime for REITs in the UK is very welcome and should not be delayed, but we would caution against any suggestion that legislating for such a vehicle (however well-crafted that legislation) will of itself guarantee success. Market commentators have noted that the experience of the principal international REIT markets suggests that the key driver behind increased investor interest in a REIT-type structure (and, consequently, increased investment flows into the property markets) has been some sort of significant economic event. For example, it is said that in the USA the new legislation for tax-transparent REITs did not yield immediate growth: it was the recession in the early 1990s that did.

Clearly, what must be avoided are investment restrictions that do not facilitate (or that frustrate) the achievement of the Government's desire for structural reform in both the commercial and residential property markets. And it is imperative that tax distortions are eliminated. But ultimately, the success of REITs will depend upon their performance (ie their attractiveness to investors, of all types), both relative to other property investment vehicles and relative to other types of investment.

Chapter 2: Possible structures for a PIF

A.2 To what extent would a listed PIF close the gap with new asset value and enable a wide retail investor base? How would an unlisted PIF meet these objectives? What additional investor restrictions might be necessary?

We would note that the analysis in Chapter 1 and the opening of Chapter 2 provides a reasonable over-view of REIT markets worldwide, but its summary of their merits tends on the rosy side. And there are a number of assertions about open-ended funds that are not correct. (See Attachment 3 for additional factual information on open-ended property funds.)

In other markets, investors tend to regard REITs as being more akin to fixed income than equities, largely as a result of the relatively strong income component that characterises REIT structures. This view is supported by historic performance data in established REIT markets. But it is recognised that there is still a degree of volatility associated with REITs, although relatively less so than for real estate equities. Indeed, for periods in the US REIT market the ability to raise capital has fallen suddenly, impacting both REIT yields and the direct property market.

That said, we believe that the UK, as a major economy, should have a workable and attractive REIT structure in its range of options for property investment. And one factor in reducing potential discounts to NAV will be eliminating any distortions in their tax treatment vis-à-vis other vehicles.

If the new REITs are to be available to the retail mass market – and they will be if they are listed – then care needs to be taken in setting appropriate levels of investor safeguards, such as governance structure, diversification requirements, limits on gearing, initial and ongoing disclosure requirements etc. Open-ended funds already have these, and can be bought and sold at NAV.

Unlisted REITs are not open to the same degree of market or competent authority scrutiny and, *de facto*, would not be subject to the investment and other requirements in the Listing Rules. We are aware of interest by eg property companies for the ability to convert to unlisted REITs, and it may be a way of enticing some offshore vehicles onshore, but our members have not alerted us to strong demand for unlisted REITs from potential institutional investors. We would also note that Unauthorised Unit Trusts and offshore vehicles already fulfil the need for that sector of the market, and UUTs (both open and close-ended) offer revenue protection.

We therefore suggest that the introduction of unlisted REITs is not as high a priority as the introduction of listed REITs and the amendment of the tax position for CIS. If, however, there is clear investor demand, either immediately or subsequently, then a (separate) regime for unlisted REITs could be drawn up. If unlisted REITs are to be subject to the same tax treatment as listed REITs, then thought will need to be given to provisions in tax legislation covering any disclosure requirements and revenue protection safeguards. Also, we are concerned that any potential loopholes in financial promotion regulation should be considered carefully to ensure that they could not be promoted to unsophisticated retail investors.

For listed REITs, we see no reason for a special/different number of minimum investors than that already required for investment trust companies.

A.3 Should the property management arrangements of a PIF be prescribed through legislation?

There is absolutely no justification for doing so, and the ConDoc gives the reason in the final sentence of paragraph 2.22:

"The Australian model allows for both types of management, although investor sentiment is now [also] tending towards internal management after initially preferring external management"

The clear message from experience in other markets is let the markets decide. Regulatory requirements on the management of potential conflicts of interest can and should be imposed by the Listing Rules. Indeed, the revisions to the Listing Rules in response to the difficulties with split capital investment trusts are already having an impact on market behaviour in that sector.

A.4 Should the minimum gross income distribution requirement be 90 per cent (before depreciation)?

The reference to depreciation may have come from comparison with the US model, to which different accounting standards apply. (See the answer to Question 13 for a discussion of the likely impact of International Accounting Standards.)

We recognise that a minimum income distribution requirement of around 90% is common in other REIT markets, and we believe that figure would be acceptable to the industry and to investors, provided the base is income net of expenses. Any net income not distributed would be subject to corporation tax at 20% (see answer to A10 below), so there would be no tax leakage. (Open-ended funds have to distribute 100% of net income, so the tax position will be equivalent.)

One issue that was raised in discussion at the consultation meetings was the handling of rent-free periods. But we believe that this can be adequately dealt with by the ability to borrow, coupled with good portfolio management to smooth cash flow. The calculation of the distribution should be on an accounts, rather than a cash, basis.

We would also note that the new REIT regime will need to address the position of capital losses within the vehicle. In order to ensure a level playing field with CIS (which do not have to make good capital losses before distribution), we suggest that consideration be given to amending section 266 of the Companies Act. There is already a precedent for this for investment trust companies.

A.5 What level of borrowing should be permitted in order to best deliver increased market scrutiny and stability in the property investment market?

In addition to the information in paragraph 2.31 of the ConDoc on limits on borrowing in other markets, note that for CIS the limit for retail funds is 10% and for QIS it is 100% - see Attachment 3.

It is important to bear in mind that shares in listed REITs will be available to the retail market. We would therefore urge caution in allowing REITs to gear too highly. But it is also clear that a limit of 10% may cause difficulties in a recessionary market when the ability of close-ended vehicles to raise capital is limited. We would therefore recommend:

1. that a limit be included in the Listing Rules, not in tax legislation; and
2. that the UKLA consult on the precise limit (within a range of, say, 10% to 50% of NAV).

A.6 In order to meet the Government's stated objectives, and as a condition for different corporation tax treatment, should there be restrictions on the development and investment activity of a PIF, and the definition of allowable property? How should this be achieved? Any recommendations should provide a clear link to the rationale for its inclusion.

By way of comparison, note the investment restrictions and limits for CIS, as summarised in the Table in Attachment 3. In particular:

- there are no geographical restrictions (only on type of interest/title);
- retail funds have minimum diversification requirements, in terms of both capital and income;
- there are limits on the extent to which property assets may be mortgaged; and
- for retail funds there is a limit of 50% on investment in unoccupied property, non-income producing property or property under development.

And, of course, offshore vehicles are subject to no such restrictions.

Development activity

Given that it is one of the Government's policy objectives to increase the property supply, which is amplified in paragraph 2.35:

"The Government is keen to encourage greater renewal in the property sector, and the development of new commercial and residential buildings"

we find the suggestions in paragraph 2.36 perplexing. There can be no guarantee that enabling the new REITs to undertake property development or invest in properties under development will immediately have a positive impact on property supply. The right economic factors will need to prevail and any unnecessary administrative/planning hurdles will need to be addressed. But it seems obvious that if REITs are not allowed to engage in development, then they will not be able to play a direct part in increasing property supply.

Moreover, we would observe that to encourage increased investment in the property market while at the same time restricting development activity would most likely contribute to an overheating in property prices. With continued demand in the housing market and current levels of house price inflation, it could be argued that the residential market does not need a substantial injection of fresh capital, encouraging further price inflation. And there are similar concerns with regard to the commercial investment market. Market commentators have noted that the UK has seen substantial and sustained levels of inflows into commercial property in recent years, as

other asset classes have produced relatively poor returns and stability. If REITs inject significant levels of fresh capital into the investment market, then there is likely to be a clear impact upon the pricing and performance of property.

There is also the very practical question of how to draw the line between maintaining properties, refurbishing them and developing them. We would seriously question the ability to draft tax legislation or listing rules that are not arbitrary and inoperable.

It may be that a particular structure comes to be favoured, such as a REIT owning a subsidiary, in which all development investment and activity takes place. But we would urge the Government to allow for this rather than require it. Let the market decide.

Trading

When considering the question of development activity, the question arises whether a vehicle is trading rather than investing.

The first, and very important, point to note is that the question of whether a vehicle is trading rather than investing is separate from the discussion of development activity. Development activity should not automatically be regarded as trading; and trading can occur when a vehicle is not engaging in development activity. That said, there is not a specific question on trading in the ConDoc, so we address it here.

First, we would note that in the context of CIS taxation, the Revenue has stated in Tax Bulletin 60 that there is a "general and prevailing" assumption that a fund is set up for investment and not trading purposes. We believe it is necessary for a similar commitment to be given in the context of REITs, otherwise there will be a greater degree of uncertainty about their tax position, which will deter many investors.

In the CIS world, potential cases of trading have been resolved in the vast majority of cases, and to the satisfaction of both the funds and the Revenue, by reference to the "badges of trade" tests. The most important of these is the question of original motive for the acquisition. We appreciate that some existing vehicles (eg property companies) may have found this mechanism laborious and uncertain, but we believe that this mechanism will work well for REITs, which will be required by the Listing Rules to set out similar disclosures on investment policy etc as CIS.

Also, as regards the question of turnover of assets, we recommend that any analysis should be in the context of the REIT's portfolio as a whole, rather than on an individual property basis.

Definition of property

We can find no justification to restrict REITs to UK property investment. (The important points for the Listing Rules are requirements on proper legal title and proper valuations.) Neither is there any reason for restricting REITs to certain property types. In fact, we suggest that to attempt to do so would result in inoperable rules. For example, how would a large complex of shops, other commercial premises, social amenities and housing be categorised/quantified by sector? And the possible exclusion of investment in hospitals and other infrastructure projects would seem counter to the

Government's general aim of increased investment into public/social amenities by the private sector.

We appreciate the Government's concerns about revenue protection as regards REIT owned/occupied or REIT owned/operated properties. But we would urge that the way to deal with this is by rules on conflicts of interest, arm's length agreements etc, and perhaps a cap on the proportion of a REIT's income from service-related activities, rather than by prohibition.

A.7 How could the structure of a PIF be designed to ensure a better quality of stock? Is a minimum holding period appropriate, and if so how long should the period be?

Market forces will ensure that REITs maintain their assets, otherwise the income flow will deteriorate. We would suggest that a more important question for the Government and regulators is how to ensure that property investment vehicles sold to retail investors comply with appropriate diversification requirements. For open-ended funds this is dealt with by the CIS rules. For the new REITs this should be a matter for the Listing Rules.

In paragraph 2.41 of the ConDoc, the Government answers well its own question about the desirability of imposing a minimum holding period. The answer is no.

A.8 How could a PIF deliver high quality residential property for the entire range of rented accommodation, and what features of a PIF would help to achieve this aim, while meeting the objective to ensure no overall cost to the Exchequer?

In the residential property market, the house-building industry has historically been focussed on the construction of owner-occupier properties. If REITs are to play a role in the private rented sector, then any barriers such as limitations on development, rent reviews, VAT position etc will need to be considered further. In particular, there are issues surrounding current planning permissions, as highlighted in the Barker Review.

A.9 How could a PIF be structured to encourage greater flexibility for occupiers in the commercial sector? What conditions could be set for PIF landlords to ensure high standards in both residential and commercial sectors?

The current ODPM consultation on commercial property issues is of direct relevance to this question and will enable a number of issues to be aired. If REITs are primarily financed through equity rather than borrowings, then they may be able to offer greater flexibility on terms of leases. But there is also the question of the degree of control that the REIT will be able to retain over the operation of the properties. Also, if a REIT is subject to tighter requirements than other vehicles, then it will be disadvantaged. If higher standards are needed, then they must be applied consistently and across all forms of investment in order to be effective.

Chapter 3: Tax Implications of a PIF

A.10 To ensure no overall cost for the Exchequer, what is the most appropriate system for taxation at the PIF level? Is it appropriate to require a PIF to distribute a high proportion of realised capital gains to investors?

Paragraph 3.9 of the ConDoc observes, "*this is another area where schemes in other countries show a range of different approaches*". We would caution against comparisons of individual legs of countries' tax regimes, because the relative treatments of capital vs. income, tax incentives, etc vary from country to country.

The tables in Attachment 2 clearly show that the new REIT will be attractive to investors only if tax on income or capital gains is avoided in the vehicle. It is only by avoiding tax at the vehicle level that it will be possible to achieve a genuine choice for investors, unfettered by tax considerations. Moreover, for REITs this would eliminate one of the factors that leads to discounts to NAV.

If there is tax sticking at vehicle level, then there will be minimal (if any) incentive for investors to invest in REITs compared to other vehicles which do not give rise to tax leakage (e.g. offshore funds, unauthorised unit trusts and direct investment).

Taking into account and allowing for future marketing and cross-border selling opportunities, the most effective way to achieve this is to emulate the bond fund regime (s468(L) Taxes Act 1988), whereby the vehicle is subject to tax but effective exemption is achieved by way of a tax deductible distribution, irrespective of the composition of its income. The benefits of such a regime are:

- REITs will be able to invest in overseas markets with the safety net of the access to the various double tax treaties, to minimise/eliminate foreign withholding tax;
- It will enable overseas investors in REITs access to the double tax treaties, thereby encouraging inward investment into the UK property market;
- A blueprint already exists in legislation.

Market forces will encourage REITs to distribute all or nearly all their income. But should any income not be distributed, there is the question of what rate of corporation tax should apply. The ConDoc intimates that "normal rates" would apply, but this would give rise to additional and unnecessary complexity, with any of five rates (from 0% to 32.75%) applying. Again, the CIS regime offers a simpler precedent - corporation tax at the uniform rate of the Lower Rate of income tax (ie 20%).

As regards capital gains, any requirement for REITs to distribute will ensure the death of the product before it begins. Quite apart from the unattractiveness of such a scheme to the vast majority of investors, such a requirement would undoubtedly put an unnecessary strain on the working capital for a REIT, thus severely hampering its ability to maintain the quality of the portfolio and its ability to make sound investment decisions.

It is interesting to note the recent frustration in the US mutual funds market on the question of enforced capital gains distributions. A US Joint Economic Committee study has found that allowing investors to defer payment of capital gains until they sell their fund shares would benefit investors and encourage long-term investment in the US

economy. Legislation was therefore introduced on 6 May 2003 to defer payment of any capital gains tax until investors actually dispose of their shares.

One suggestion that was aired at the Treasury's consultation meetings was giving REITs the option to distribute capital gains. We would note that authorised CIS do not distribute capital gains, they do not have the power to do so and it is Government policy that they should not. And Investment Trust Companies cannot distribute capital gains. Also, there is no capital distribution arising from direct investment or offshore vehicles.

That said, we have no objection in principle to the suggestion that REITs should be able to distribute capital gains, but we believe it would give rise to a number of legal and practical issues. Would it be possible without changes to Company Law? Would it be possible to draft workable provisions on the boundaries between capital distributions, part disposals or share events?

There are also investor protection concerns, particularly for listed REITs held by retail investors. Can it be clearly disclosed upfront what this might mean for their investment? Is there a danger of a parallel with the recent cases of mis-selling of "precipice bonds", where investors were satisfied with the regular distributions they were receiving but were not properly informed/aware of the fact that their capital holdings were being reduced?

If it is thought that these concerns are misplaced or can adequately be addressed, then such capital distributions should be subject to capital gains tax in the hands of the investors, giving them access to annual exemption, taper relief, indexation allowance, loss relief and part disposal calculations where appropriate. Of course, this would bring a number of individual investors within the scope of the self-assessment regime, which begs the question whether such REITs would be attractive to individual investors in the first place. We also doubt that they would be attractive to institutional non-resident investors. So, our conclusion is that this would involve a lot of legislative drafting to no end.

A.11 Given the impact of characterising distributions from a PIF as dividends, would the option to treat distributions from a PIF as income from property, taxed at UK investor's marginal rate, pose any unforeseen problems?

We agree with the proposition that if REITs are effectively tax-exempt vehicles by way of deductible distributions, distributions from REITs cannot be regarded as Schedule F franked dividend income in the hands of investors. Accordingly, it seems equitable to treat distributions from REITs as income from property. Any undistributed income would then be subject to corporation tax at the lower rate of income tax, ie 20% (but see below regarding the treatment of capital allowances).

One problem that must be addressed is keeping Basic Rate investors outside the self-assessment net. This can best be achieved by imposing a withholding tax at source at the applicable rate (see below).

But it is equally important that REITs should be able to distribute gross to qualifying investors. Again, s349B and s468M Taxes Act 1988 provide a useful precedent.

As regards overseas investors, they should be entitled to gross payment if they are willing to participate in the Non-resident Landlord's Scheme.

The tax rates for higher rate tax investors and corporates would seem to be self-explanatory (ie 40% and the relevant corporation tax rate – usually 30%). However, as regards the rate applicable to basic rate investors (and the withholding rate) we recommend that this be set at 20%, because:

- It is the lower rate of income tax imposed on all relevant interest payments and bond fund distributions, where applicable. Accordingly, implementation and reporting will be much cheaper for operators and will be simpler for investors to understand;
- It is the rate of tax applicable to all CIS, subsequent to which basic rate taxpayers have no further liability. Therefore, REITs will have tax parity with CIS;
- The ConDoc proposes a distribution level of at least 90%, whereas under the IMA proposed system of tax-deductible distributions there will be an incentive (in addition to market expectations) for REITs to distribute closer to 100%, thus neutralising the potential impact on the Exchequer.

Capital Allowances

The mechanics of the treatment of capital allowances, as evidenced by discussions within the Treasury consultation meetings, is a difficult practical issue. It is, of course, not relevant to exempt investors, but can be a significant factor for tax-paying investors.

It is clear that if capital allowances cannot be passed on in some way to investors, then direct investment and or investment in offshore vehicles will be more advantageous. One option would be to pass all capital allowances through to investors as a tax credit. This would entail investors receiving an annual distribution split between income (after withholding tax) and a tax credit. On the face of it, this might be appealing to many investors, but could give rise to operational and accounting issues for the REIT, due to delays in agreeing the size of capital allowances with the Revenue. Such discussions, especially if protracted, could result in the wrong investors receiving the benefit, due to interim changes in shareholders.

Another option would be to offset the value of capital allowances against the tax withheld by the REIT. But this would result in higher rate or corporate investors receiving only 20% of the benefit of capital allowances. This would leave the REIT disadvantaged relative to direct investment and many offshore options.

A variation of this option would be to allow the REIT to offset capital allowances against any residual taxable income (that is not distributed or where there is an element of disallowable expenses), with any remainder of capital allowances being offset against withholding tax. We suggest that this option has considerable merit as regards the balance between simplicity of operation for the REIT, fairness for the investor and tax take.

As regards the possible inequity due to timing issues, it might be worth considering a blanket rate (or individual rates for eg different property sectors) of wear and tear allowance. This could significantly reduce the administrative costs for REITs and the Revenue of protracted discussions on the rate of entitlement in particular cases, and would significantly increase the likelihood of the right investors receiving the benefit.

Whatever is the agreed way forward, investors in CIS must be afforded the same treatment.

A.12 In the context of the modernised stamp duty system, and the wider tax implications for different types of property investment, the Government invites views on what the appropriate liability for Stamp Duty Reserve Tax (SDRT) and Stamp Duty Land Tax (SDLT) should be for a PIF and investors in a PIF. This should reflect the objective to ensure no overall cost to the Exchequer.

We would note the IMA's and wider industry's many representations that stamp duty on transactions in financial instruments puts the UK at a disadvantage vis-à-vis other mature markets. Moreover, as evidenced by data from the London Stock Exchange, the stamp take has been steadily decreasing over the last few years, with greater use of eg contracts for difference. We appreciate, however, that this is a question outside the scope of this consultation. The following comments, therefore, assume no general changes to the stamp duty regime.

Consistent with the Government's stated objective of alignment with direct property investment, we support a tapered charge of SDLT up to 4% for REITs investing in UK property. This would put them on parity with existing investment vehicles (the one point on which the field is currently level).

We would question the assumption in paragraph 3.30 of the ConDoc that stamp take will fall. If the introduction of REITs, coupled with the simple amendments expected for CIS, produces the positive outcome we all seek, then it is clear that there will be an increased, and increasing, stamp take. Even in the initial period, there will be an increased stamp take due to adjustments in vehicles' property portfolios, and hence increased turnover in the property market.

There can therefore be no justification for imposing a stamp duty charge higher than 0.5% for REIT shares. To do so, would kill the product.

In fact, we would urge the Government to give serious consideration to abolition of stamp duty on shares in REITs, and in CIS and UUTs investing in property, for the following reasons:

- Investors in offshore vehicles do not suffer stamp duty on the dealings in units/shares. Absent the abolition of stamp duty on shares in onshore vehicles, offshore options will remain more attractive for many investors;
- The SDLT revenues arising from the increased volume of dealings in property will provide the Exchequer with an increased stamp take;
- A stamp tax on the shares of vehicles that have already paid stamp duty on acquiring assets results in a double hit on investors;

- Because of other existing tax distortions for property CIS, there is currently little stamp take from these vehicles, so there would be minimal loss to the Exchequer from this avenue, which would be offset by increased SDLT take;
- As noted in Attachment 2, over the past few years, many UUTs have moved offshore. There is therefore a diminishing stamp take from the few remaining onshore vehicles.

As regards the treatment of conversions, mergers, seedings and in specie transfers, we would urge the Government not to impose stamp duty, so as avoid any barriers to the growth (in terms of number and size) of property investment vehicles. We repeat our belief that the Exchequer will receive ample extra revenues from increased dealings in property, in view of which any decision that serves to promote the proliferation of REITs cannot be regarded as a concession giving rise to loss of stamp tax revenue.

It is also worth pointing out that the Stamp Office has recently published a newsletter setting out its views on the treatment of stamp duty on amalgamations and mergers of CIS. Consequently, the blueprint for a commercial and reasonable approach in many of these cases already exists in the CIS arena and a more draconian approach for REITs would give rise to new tax distortions.

A.13 What implications would International Accounting Standards (IAS) have for a PIF?

UK GAAP is expected to harmonise with IFRS within the next few years. In the meantime:

- adoption of IFRS is mandatory for the consolidated accounts of listed companies as from 1 January 2005 (including property companies with subsidiaries, such companies which convert to a REIT, and *de novo* REITs with subsidiaries);
- other corporates (whether listed or not), including REITs not preparing consolidated accounts, will have a choice of adopting UK GAAP or IFRS; and
- CIS must use UK GAAP during 2005 (ie they are not allowed to use IFRS), but authorised CIS may have to use IFRS from 2006 if the IMA replaces its Statement of Recommended Practice (SORP) with IFRS guidelines.

However, UK GAAP will increasingly converge with IFRS. Therefore, effective convergence is expected within the next three years for all types of entities. In particular, CIS have to follow IMA's SORP, which at present applies UK GAAP. But the industry will be consulted on whether from 2006 it should apply UK GAAP or IFRS, and an IMA working group is already considering recommending that authorised CIS move to IFRS as soon as practically possible.

What is clear, though, is that for a short period there may not be comparability of reporting by different types of property investment vehicles. This is unlikely to be attractive to the market/users of accounts.

The IMA will seek to advance convergence. We already have a project well underway that is looking in detail at the impact of IFRS on funds, from the perspective of preparers of accounts, auditors and investors. Also, we are already providing

assistance to the Revenue in its consideration of the possible implications for various parts of the tax legislation. We can therefore give assurance that for CIS all issues will be well aired, properly consulted on and resolved.

For REITs, whether converted or *de novo*, we suggest that IFRS guidelines be issued by an appropriate body when REITs are introduced into legislation. This means that work will need to start promptly. The IMA would be happy to work closely with that body to secure consistency of approach.

A key area of difference between UK GAAP and IFRS is the valuation of investment property. UK GAAP currently provides guidance in the form of SSAP 19, whereby investment property has to be disclosed in the accounts at fair value with any gain/loss in value taken to a non-distributable revaluation reserve. Under IFRS, investment property is catered for within IAS 40, whereby preparers of accounts have a choice of two methods:

1. a fair value model, "under which an investment property is measured, after initial measurement, at fair value with changes in fair value recognised in profit and loss"; or
2. a cost model, which "requires an investment property to be measured after initial measurement at depreciated cost".

Therefore, prior to IFRS harmonisation, property companies/REITs without subsidiaries will have the choice of three accounting methods, each of which could have differing impacts on the yields, performance and tax treatment of the fund and its investors, and property companies/REITs with subsidiaries will have the choice of two.

We believe it essential from the point of view of investors that the new REITs adopt a common approach, and we suspect that the market at large will prefer the fair value model, which in principle is similar to the SSAP 19 methodology and is likely to deliver more meaningful reports. However, IAS 40 proposes that any unrealised gains/losses are taken to the "profit and loss" account, whereas SSAP 19 takes them to the non-distributable reserve. IAS 40 therefore gives rise to a potential distribution problem. We suggest this be discussed further with preparers of accounts, auditors and users, and be dealt with in the IFRS guidelines.

We believe that four other issues will need to be considered.

1. Leasehold investment property

IAS 40 requires these to be treated as finance leases. As the requirement for finance leases is to gross up the assets and liabilities on the balance sheet by the minimum amount of lease payments, the disclosure as a liability would impact the gearing figure for the vehicle. It may therefore be appropriate to exclude the impact of finance leases in the calculation of compliance with any gearing restriction.

2. Accounting for tenant leases

IAS 17 requires a tenant lease to be considered in two parts for accounting purposes: a lease for the land and a lease for the building. The land lease is an operating lease,

while the building lease may be an operating lease or a finance lease. The rent may, therefore, need to be apportioned between the land and the building elements, and different accounting treatments would apply.

3. Lease incentives

It is frequent practice in the property sector to offer rent-free periods as part of lease incentives. Both UK GAAP and IFRS will require that the rent be spread across the relevant rent period, including the rent-free period. Therefore, for distribution it may be appropriate to track such unrealised income.

4. Property derivatives

There is still uncertainty, Europe-wide, about the potential implications of IAS 39. This standard entails some complex and lengthy provisions on the accounting for financial instruments (ie derivatives). For REITs that do not invest in derivatives, we have not identified an IAS 39 impact. The accounting treatment to be adopted for REITs or CIS that do invest in derivatives should be addressed in the IFRS guidelines/SORP.

Chapter 4: Transitional issues and a conversion charge

A.14 The Government is interested, in the context of ensuring no overall cost to the Exchequer, in the factors it should take into account in setting the scale, nature and timing of the conversion charge to a PIF.

The specific question above is outside IMA's and APUT's remits, as we do not represent companies or other entities that do not have an exemption from tax on capital gains, and no charge can possibly be justified for vehicles with an exemption from capital gains that convert to another vehicle with the same exemption. Neither can there be any justification for a charge on the establishment of *de novo* REITs.

But we would urge that any charge be clear, simple and fair, both as regards its size and its method of calculation, and for both existing and potential shareholders. Moreover, there should be no charge at investor level (eg stamp) should a vehicle in which they are invested convert to a REIT.

Another question is the VAT position on transfer to a REIT of a portfolio of commercial properties that have opted to tax. Under normal circumstances this would be a VATable supply and the recovery of that VAT would very much depend on the recipient's own VAT profile. However, if this transfer is seen as a Transfer of a Going Concern ("TOGC"), there is no VAT chargeable. The issue that arises is if one (or more) of these properties were not tenanted at the time of conversion, then the TOGC provisions may be dis-applied.

[VAT Issues

More generally, the ConDoc does not touch on VAT issues, and it is therefore not clear what the Government's intentions are. We assume that given the corporate nature of a REIT, management services supplied to it will be subject to VAT. This, in turn, raises questions about the attractiveness for this vehicle in investing in residential buy-to-let properties.]

Furthermore, consideration needs to be given to the question of what happens should a REIT breach any requirements under the new Listing Rules or the new REIT tax legislation, or if a REIT decides to relinquish its status. Clearly, any significant breach of the Listing Rules would and should be dealt with by the FSA under its powers as the Listing Authority. As regards the tax position, we suggest that the current precedent in the Bond Fund regime be adopted. That is, for that tax year, the distribution is no longer deductible in arriving at profit chargeable to corporation tax. Again, this would give REITs parity with CIS.

Chapter 5: Wider implications

A.15 With no other changes in taxation, what impact might the introduction of a PIF have on alternative options for property investment? What, if any, are the implications for the distribution rules for authorised investment funds?

The introduction of a workable and attractive REIT regime in the UK will provide investors with an increased choice, and is welcome by our members. There is no sense that our members regard this as a threat. The first part of the question implies that open-ended funds will become less attractive. We question that implicit assumption. In fact, for the mass retail market, the safest investment vehicle is the authorised, open-ended retail fund. Attachment 3 provides some basic facts about the FSA's regulatory regime that support that claim. Moreover, many smaller institutional investors will prefer the greater investor protection safeguards and diversification afforded by CIS. Indeed, it is interesting that in the USA, institutional involvement in the REIT market has been to a large extent via mutual funds (the US equivalent of CIS).

Regarding the second part of the question, if the new REITs are allowed to distribute less than 100% of their net income, then it begs the question why open-ended property funds should be required to distribute in full. That said, since REITs are largely regarded by investors as income plays, there will be an expectation by the market that they, too, will distribute in full (which will, in turn, secure annual tax receipts for the Exchequer). It may be, therefore, that in practice the apparent distortion will not be significant. But we would wish to flag this as an issue on which we may need to seek change should the distortion prove significant.

It is absolutely imperative, however, that for property CIS the following tax neutral change is made, and made immediately:

- Tax income in the hands of the investor under Schedule A (and not at the fund level), by way of deductible distributions akin to the bond fund regime (s468L Taxes Act 1988).
- Basic Rate Tax payers to be taxed at their Lower rate of 20%.
- Income tax at the Lower Basic Rate to be withheld (ensuring Basic Rate Taxpayers fall outside the self-assessment regime), except for investors who are exempt and/or eligible to receive gross income.

The attached numerical example shows the tax positions of different types of investor before and after these changes. It can clearly be seen that the change is tax neutral

for each investor type. Moreover, and very importantly, this simple change will provide pension funds with a regulated, onshore investment option without tax leakage.

Furthermore, a number of our members have indicated that they would give serious consideration to immigrating offshore funds back onshore. This will reduce administrative complexities and costs, and will result in jobs moving back onshore (which will, in turn, lead to a positive tax revenue).

A.16 What role and contribution can Unauthorised Unit Trusts (UUTs) continue to make to the wider objectives of reform set out in this document?

We are interested to understand why the Government believes that property UUTs “might reasonably be expected to convert” to the new REIT. We have no indication from our members or from their investors that this is likely to be a common occurrence. In fact, quite the opposite. Our members are, frankly, exasperated by the lack of progress on a simple, tax neutral change to the authorised funds tax regime. When this change is made, then open-ended offshore and onshore UUTs are more likely to convert to the new QIS than to convert from open to close-ended. Moreover, as noted in answer to question 3, close-ended UUTs are a revenue-protected alternative to unlisted REITs.

Whatever the market decides, we would note that the onshore and offshore property UUT sector is significant (about £15bn and rapidly increasing; in fact, expected to double shortly), and there is at present no indication from the pension funds and charities invested in them that they wish the funds to metamorphose into another vehicle. In any event, given the considerable amount of legislative drafting work that will be involved in introducing the new REIT regime, we would strongly recommend that the Government make no changes to the onshore property UUT regime at this time.

A.17 What are the main reasons for the lack of interest of Investment Trusts participating in housing? Is there any reason why this legislation should not be repealed?

The ConDoc mentions that the threshold value limits have proved to be too restrictive. But we would also point to the analysis in Attachment 3 of the effect of the current tax regimes, which clearly shows that the level of taxation in the vehicle puts it at a disadvantage.

In 1998, (the then) Coopers & Lybrand prepared a report on HITs that examined in detail the reason for the lack of investor interest in this vehicle. We understand from our colleagues in the property industry that the report’s conclusions were sound and are still pertinent (ie insufficient returns, regulatory restrictions and the tax regime).

We therefore recommend that the existing Listing Rules and tax legislation for Housing Investment Trusts be superseded by the new REIT regime.

A.18 If a PIF were introduced, what would be the most appropriate method for evaluation?

In order to assess the impact of the tax changes (both a new REIT regime and the amendment to the tax regime for open-ended funds) on the Government’s policy

objectives, we suggest that the Government will need various data, which will need to be drawn from a range of sources. It will also need to be wary of drawing conclusions during the transitional phase (which will not be short).

As regards the impact on property supply and finance, we suggest that the Government will need to be able to monitor the following:

1. The impact on the supply of finance
 - The overall level of finance to the sector
 - The amount of finance raised by the new REITs, open-ended funds and other investment vehicles
 - Whether this is a substitute for previous finance avenues (if so, is this a desirable outcome or not)
 - Whether it has resulted in finance being transferred from other sectors of the economy
2. Has there been a move to more balanced portfolios from a risk/return perspective? (eg are pension funds better able to invest in liquid property investments)
3. What type of property market is this finance supporting?
 - Socially responsible (eg low cost housing)
 - Brown field sites
 - Housing associations

We would also, emphasise, though, that property supply is equally likely (or in the case of eg residential property, more likely) to be impacted by other measures, such as the lowering of planning hurdles.

The IMA will be able to provide data for authorised open-ended funds (retail and institutional) on numbers of property funds, amount of funds under management, gross/net sales by investor type, and performance. We also conduct an annual asset management survey in which we could ask specific questions about property investment. And APUT can provide figures on the UUT sector. We would be happy to talk through what data could be provided via these mechanisms, and to talk further about the questions that should be posed and about the data the Government might need to seek from other sources.

A.19 The Government would welcome views on whether these proposed changes would significantly increase regulatory burden and compliance costs, and if so how?

The simple change to the tax regime for authorised funds will deliver an immediate benefit at no cost to the industry or the Exchequer. Equally, for UUTs, if the current issues surrounding the FSA's "permitted links" rules are addressed, then this will be an immediate benefit at no cost. And the removal of the cumbersome tax payment then reclaim process for UUTs would reduce administrative costs for pension funds and charities, management companies and the Revenue.

As regards the introduction of REITs, clearly there will be initial costs to the authorities in drawing up the new tax legislation, and consulting on and amending the Listing Rules. These exercises will also involve some costs for the industry (time spent on

consultation feedback), which may be significant for particular individuals, but in the wider scheme of things are forgettable.

As regards on-going costs, we believe that if the Government both leaves any "investment" requirements to the Listing Authority and draws up the tax regime as suggested above, then not only will the drafting of the new regime be relatively straightforward (many of the points to be covered already have a precedent elsewhere in tax legislation), but the ongoing compliance costs to the industry will be readily acceptable.

Clearly, where appropriate investor safeguards are required for the mass retail market, these may give rise to relatively significant costs. But the industry at large recognises that regulation is appropriate here (due to asymmetry of information between these investors and market participants), and is willing to accept justifiable costs. Moreover, many of those safeguards are already in place within the FSA rulebook.

Comparison of tax position for investors

	Basic rate investor	
	Property CIS Existing rules	Property CIS Amended rules
	£	
Net revenue income before tax	1000	1000
Corp Tax	(200)	
Distribution	<u>800</u>	<u>1,000</u>
Corporation tax at 30%		
Income tax		
Inc tax @40%		
Inc tax @25%		
Inc tax @20%		(200)
Net return to investor	<u><u>800</u></u>	<u><u>800</u></u>
Total tax take	<u><u>200</u></u>	<u><u>200</u></u>

	Higher rate tax investor	
	Property CIS Existing rules	Property CIS Amended rules
	£	
Net revenue income before tax	1000	1000
Corp Tax	(200)	
Distribution	<u>800</u>	<u>1,000</u>
Corporation tax at 30%		
Income tax		
Inc tax @40%		(400)
Inc tax @25%	(200)	
Inc tax @20%		
Net return to investor	<u><u>600</u></u>	<u><u>600</u></u>
Total tax take	<u><u>400</u></u>	<u><u>400</u></u>

	Corporate investor	
	Property CIS Existing rules	Property CIS Amended rules
	£	
Net revenue income before tax	1000	1000
Corp Tax	(200)	
Distribution	<u>800</u>	<u>1,000</u>
Corporation tax at 30%		
Note 1	(100)	(300)
Income tax		
Inc tax @40%		
Inc tax @25%		
Inc tax @20%		
Net return to investor	<u><u>700</u></u>	<u><u>700</u></u>
Total tax take	<u><u>300</u></u>	<u><u>300</u></u>

**Note 1
s 468 Q TA 1988**

	£
Net distribution	800
Gross up for 20% income tax	<u>200</u>
Taxable total	<u><u>1,000</u></u>
CT at 30%	(300)
Inc tax offset	<u>200</u>
Net CT due	<u><u>(100)</u></u>