

PROPERTY INVESTMENT TRUSTS

1. INTRODUCTION

- 1.1 In the Pre-Budget Report on 10 December 2003, the Chancellor announced that the Treasury is preparing to consult on a proposal to introduce tax-advantaged property investment trusts to encourage more investment in property. The Chancellor has concluded that a tax-transparent property investment trust would improve liquidity, transparency and scrutiny, as well as expand the private renting sector and provide long-term savers with access to property investment.
- 1.2 The property industry has been arguing for a number of years for the creation of a UK equivalent to real estate investment trusts (or "REITs") originally established in the United States and now widespread throughout Western Europe, and will be watching with interest to see the scope of the concessions proposed. The Chancellor is due to publish a consultation document to consider the most suitable structure for these new trusts at the 2004 Budget.

2. THE PROBLEM

- 2.1 Only a very few major investors can afford to buy entire buildings, and even they may not be able to justify a diversified property portfolio. The use of property funds has been increasingly popular over the last few years to provide property exposure to smaller investors and to allow larger investors to diversify.
- 2.2 The Chancellor will also have been influenced by the current pension fund crisis caused by the loss of billions of pounds from the value of the global stock markets. A tax-friendly property investment trust would encourage institutional investors and pension funds to invest in property, so diversifying their portfolios and reducing exposure to the volatility of equity prices.
- 2.3 An investment fund is unlikely to be attractive unless it is, at the least, tax neutral - in other words, the investor will not suffer tax on his income or gains to any greater extent than if he had made a direct investment in the property concerned. Unfortunately most of the fund structures which are currently available in the UK give rise to the risk of double taxation. For example, if a fund sells a property at a profit, the fund will pay tax on the gain, and this will be taxed again in the hands of the investor when he sells his interest in the fund.
- 2.4 Currently only limited partnerships provide "tax transparency", but broadly speaking they are only suitable for bringing together a small number of investors, and they cannot be marketed to the general public. Furthermore, recent government proposals to charge stamp duty on transactions into and out of limited partnerships will severely limit their attractiveness to investors.
- 2.5 The Treasury has always been suspicious of providing generalised tax breaks for investment funds, since its overall approach is to limit the misuse of such vehicles as components in tax avoidance schemes. What we have at the moment is a series of miscellaneous "targeted" tax breaks which are often hedged round with so many restrictions that they are of limited use. These are:

- (a) Housing Investment Trusts: These are corporate investment vehicles which (as their name suggests) are similar to the traditional investment trusts which invest in securities. They must be listed on the London Stock Exchange and are "closed ended" (ie they have a fixed number of investment units which cannot be redeemed until the fund's maturity). They have a beneficial tax regime (they are not taxed on capital gains realised within the trust, and income is treated beneficially) but they can only invest in low cost housing and are hedged round with various restrictions which limit their liquidity and gearing. Perhaps unsurprisingly they have not been a success, and in the eight years since their inception, not one has been launched successfully.
- (b) Authorised Property Funds: These are unit trusts or open ended investment companies authorised by the Financial Services Authority. They are essentially akin to the retail open ended investment companies and unit trusts investing in securities which are a major part of the investment market. Like "ordinary" unit trusts, they are "open ended" (ie investors are entitled to cash in their investment at any time). This may sound a good idea, but in fact gives rise to problems since it will always be difficult to sell land and buildings quickly to provide cash for investors who wish to redeem. The FSA insists that at least 20 per cent of the assets of such funds must be held in cash or property related securities and the unit trust is not able to take on any debt. This means that, for the professional and institutional investor, the fund is not providing a true replica of investing directly in property. More seriously, the income from authorised property funds is treated for tax purposes like a dividend, and this means that pension funds, which cannot recover the associated tax credit, are worse off than if they invested directly in property. Like housing investment trusts, authorised property funds have not been a success.
- (c) Exempt unauthorised unit trusts: These operate under a very long standing concession which exempts unit trusts from capital gains where all their holders are pension funds or charities. There are a number of established funds of this kind, but the restriction to UK pension funds and charities limits their usefulness to institutional investors.

2.6 The difficulty of raising capital for long-term property projects in the UK has already led UK property companies to consider US REITs as the only viable source of raising the capital required for these projects. Furthermore, there has been an increasing tendency to establish property investment funds offshore, where a better tax regime can be obtained. Even then it is difficult to achieve a vehicle which is both tax efficient and capable of being marketed to the public in the UK.

3. **POTENTIAL SOLUTIONS**

3.1 The property industry has been lobbying the government to introduce REIT style Property Investment Trusts. These would be modelled on the US REIT as tax transparent vehicles and would be required to distribute almost all of their income to investors. In return, it would benefit from exemption at a corporate level from income and capital gains tax. Instead, the dividends and capital growth of the trust would be taxed at the investor level.

3.2 The Chancellor will no doubt pay due regard to Kate Barker's Interim Report in connection with her Review of Housing Supply (Securing our future housing needs) which was published at the same time as the Pre-Budget Report. The Interim Report concluded that the UK is suffering from an increasing shortage of housing and suggests that the promotion of an investment vehicle similar to REITs may lead to greater interaction between institutional investors and the residential housing market.

- 3.3 A number of difficult issues remain to be resolved, and it will be interesting to see how the Chancellor deals with them (if at all):
- (a) There is the question as to whether the fund should be closed ended or open ended. For maximum flexibility it will be desirable to have both options. However, in the Pre-Budget Report the Chancellor indicated that evidence from other countries suggests that these funds have worked well where there are closed-end companies.
 - (b) The now very sharp distinction between the rate of stamp duty land tax (4%) and stamp duty reserve tax (0.5%) makes it increasingly tempting to put land and buildings into corporate or unit trust structures where the lower rate of duty will be payable. Against this background it will be slightly strange if the Chancellor encourages the creation of vehicles which will allow property to be sold indirectly at the lower rate of duty.
 - (c) There has been in the past a concern to avoid creating a vehicle which could be used by property companies which trade in and develop land to obtain a more beneficial tax treatment. It is not entirely easy to distinguish between a property company and a property fund.
 - (d) Previous schemes, such as the housing investment trusts, were aimed almost exclusively at residential property in an attempt to encourage the private rental market and inner city regeneration. Similarly, the Barker Review has focused almost exclusively on housing. However, the property industry has stated that the Chancellor must also include investment in commercial property in his plans to ensure that UK property investments trusts succeed.
- 3.4 Finally, it would be interesting to see how (if at all) the published proposals relate to the FSA suggestion (in its Consultation Paper 185: The CIS sourcebook - A new approach) that the existing authorised fund structure should be extended to allow a range of "non retail funds" which would have more flexibility than the current authorised property funds and might resolve some of the difficulties described above. It appears that the FSA proposals were launched without the prior approval of the Treasury; we must hope that the Treasury will have consulted the FSA as otherwise there is a risk that the two ships may pass one another in the night.

FURTHER INFORMATION

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