

CITY OF WESTMINSTER AND HOLBORN LAW SOCIETY
Revenue Committee

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Dear Mr Swan

UK-REITs: draft legislation

The Society represents a considerable number of private client and property lawyers practising in Central London. Member firms include those undertaking M&A work as well as those specialising in commercial conveyancing as well and leading private client firms dealing (inter alia) with landed estates and leading charitable and similar institutions.

This Committee will confine its observations to the administrative, rather than policy, aspects of the proposals.

1. Presumed objective

It seems that the Government's objective is to provide an improved means for retail investors to obtain a stake in first class property, managed professionally and with a reasonable spread of investment risk.

To this end, it has been thought appropriate to limit:

- (a) the stake a single investor can hold in each REIT;
- (b) the amount of gearing available;
- (c) the size of the largest investment; and
- (d) the scope and extent of related activities permitted.

But, because realised capital gains will end up being taxed at income tax rates, the end product will be most suitable for indirect investment, i.e. through a PEP, ISA or SIPP.

Although this investment medium will also be suitable for use by charities, their needs are already served through specialist unit trusts which are themselves registered charities.

2. **Problem areas**

It is proposed that housing investment trusts be abolished in Finance Bill 2007. This will not cause any concern since, despite a number of attempts to launch such funds, none succeeded. The reason for this was the restrictions on the type of property which it was possible to own, which made impossible the purchase of almost all purpose built blocks of flats (the most desirable form of investment). But, and not least in the light of the Barker Report aspiration that REITs might prove a substitute, the fact that restrictions were responsible for the failure of this form of incentive must lead one to consider very carefully the practicability of the means by which restrictions set out in para 1(a) to (d) above are to be achieved.

3. **Stakeholder restriction to 10%**

This is, of itself, a perfectly reasonable pre-condition and, indeed, one which is likely to be in the interests of the average retail investor. Nonetheless, concern has to be expressed as to the proposed means of achieving this in the following respects:

- (a) All REITs are to be listed companies. It is likely to follow from this that most shareholdings are likely to be held in the names of stockbrokers or other investment managers. It must, therefore, be questioned as to whether the REIT itself is likely to be able to police the 10% limit, especially where overseas holders of record are involved.
- (b) In this connection three further observations must be made:
 - (1) It is by no means unknown for large investors (and especially pension funds) to operate through a number of different investment managers, each of whom has discretion. It must follow from this that the REIT could not be certain that the fact that no single holder of record had more than 10% would mean that Condition 6 would be satisfied.
 - (2) It is by no means clear what is meant by "person" in clause 4(8). Presumably it means beneficial owner, but if it means holder of record (either solely or in addition) then, in the context of the almost universal use of nominees, this would not appear to be a reasonable restriction.
 - (3) Consideration needs to be given to situations in which an existing holder has just less than 10% but inherits more shares unexpectedly either through a relative's Will or by means of a distribution from a family trust. It is suggested that, in these circumstances, a short period to rectify the unintended breach should be provided for specifically (rather than be a matter for administrative discretion).

- (c) If ordinary retail investors are to be protected, it seems inequitable that the consequences of the breach of the threshold should be visited upon the company, and in consequence investors generally pro rata, as opposed to the miscreants.
- (1) If matters were left as drafted, it would be possible for the general public to be “green mailed” in the same way that certain transatlantic speculators appear to have succeeded in achieving on a number of occasions in relation to investment trusts in recent years. Reference should be made in particular to two occasions in which the Board of Scottish Investment Trust plc has been induced to buy back shares from short term investors.
 - (2) Furthermore, were buy-backs to be permitted, it would not be possible for some investors wishing to purchase additional shares to know whether, in doing so, they would breach the threshold.
 - (3) And were they found to have done so innocently, they would face the prospects of having to place their “excess” at a loss in a “fire sale”.
 - (4) It would therefore be appropriate, at the very least, to require each REIT to prohibit the buy-back of its shares as a pre-condition to qualification. Were things to be left as is proposed, it would not be long before a foreign speculator would buy up 9.9% and threaten to purchase more shares unless its holding was bought back at, say, 105% of net asset value.
 - (5) It is also suggested that the proposed sanction (of a proportionate disallowance in exemption) should be replaced by an assessment of an equivalent amount direct upon the shareholder in question. This has been done in the past under legislation long since repealed.
 - (6) It is possible that the FSA may need to be involved formally, in order to permit an apparent miscreant’s shareholding to be frozen pending (and to encourage) ascertainment of the actual facts.
 - (7) Moreover, in order to do achieve the objective in (4) above, it would also be necessary to ensure that non-resident shareholders could be assessed and, in particular, it would be necessary to be certain that they could not call in aid the provisions of any double taxation treaty.
 - (8) This may, therefore, be an appropriate context in which to suggest that, in order to avoid such investors claiming that the “Schedule A status” distributions should be treated in the same way as ordinary dividends, a REIT should have to change its status (albeit without intervening dissolution) to a special form of body corporate under which it would not be possible to claim that a “distribution” should be treated as a dividend.

- (a) This would be fair to UK resident taxpayers because there are no treaties under which rental income is available for reduced-rate treatment.
- (b) It would also get round the problem of capital gains exemption where the relevant treaty did not exclude property transactions. Unless they held their investment through, e.g., an ISA, UK investors would suffer from the disadvantage of suffering income tax (rather than tapered capital gains tax) on realised capital gains.
- (c) In this context it should be mentioned that it seems likely to be desirable for the changes to the PEP and ISA regulations to be formulated in such a way as to treat distributions of chargeable gains as “capital” receipts; so that
- (d) it would become necessary for the REIT to identify this component; and
- (e) this is something which would be required were ordinary trustees not to be debarred from investing in REITs by reason of the “source” being a dividend under long-standing case law.;
- (f) although ordinary trustees will almost certainly need to be supported by a change in general trust law (which could be provided for in the necessary Companies Act amendment legislation) in addition.

4. **Gearing**

Some listed property companies have been restructured in recent years in such a way as to increase the investment risk by taking on very high levels of borrowing, and in some cases either enhanced or “protected” through derivatives. There is no good reason why such entities should be permitted to transmogrify themselves into tax-advantaged vehicles without these operations being brought to an end. Furthermore:

- (a) From an investment point of view, this has equated property investment to that relating to venture capital (alias private equity), in relation to which “targets” on both sides of the Atlantic have a significant insolvency rate, to the considerable detriment of suppliers and ordinary creditors.
- (b) It cannot be desirable for the property market to be imperilled by granting tax-advantaged status to such entities.
- (c) In addition, it cannot be regarded as responsible to allow such vehicles to be held out as suitable for retail investors.

However, the means by which it is proposed to limit geared seems to be unnecessarily complex.

- (1) Back in the days of the minerals boom (i.e. the late 1960s) a repeat of the well-documented – in J K Galbraith’s *The Great Crash - 1929 Wall Street*

debacle was avoided because Australian investment trusts only qualified if ungeared, and it is suggested that, in principle, this would be an appropriate principle to enforce for REITs.

- (2) Nonetheless some allowance would need to be made for (very) short term borrowing to be permitted for property management reasons, i.e. in order (and only in order) to fund repair and maintenance expenditure until recovered from rental income.

5. Investment Size and Problems

It is accepted that it is appropriate to limit REIT status to situations in which a reasonable investment spread is achieved and it is noted, in this context, that

- (a) there is to be a current value limit of 40% for the biggest investment – albeit subject to book value substitution for so long as IAS permit (which may not be long) – giving rise to problems in the event of the portfolio becoming unbalanced through either changes in fashion or by reason of changes in the local or regional plan; but
- (b) a shopping centre is not to be regarded as a single investment, a factor which is likely to make its valuation on a “fragmented” basis an extremely uncertain exercise; while
- (c) the purchase of easily manageable blocks of land (especially if rural) will be hampered by the exclusion [through Schedule 1, Part 2] from exemption of the incidental attributes of such properties, i.e. wayleaves, pipelines, telephone masts and wind turbines – as to which it is suggested that these restrictions should not apply if the receipts are less than 5% of the rental yield from the property in question if similar problems to those which prevented housing investment trusts getting off the ground are to be avoided.
- (d) The draft Guidance mentions compulsory purchase, but does not appear to address the real problems involved with this, i.e.:
 - (1) the enormous period of time taken by the VOA to agree compensation, during which it will not be possible to finalise the consideration to be received for property for which entry has taken place; coupled with
 - (2) the (apparent) need to distributed 95% of the actual profit within a period of months after the accounting date for the period during which that has taken place.
 - (3) Moreover, a situation under which (under clause 29) the capital realised is deemed to be within the ring fence, but (during the relevant period) the interest earned short term is not, seems to be illogical - and, in consequence, indefensible.

6. **Permissible Related Activities**

- (a) It is considered that Part 1 of Schedule 1 is reasonable. Involvement in development not only:
 - (1) increases the risk to retail investors; but also
 - (2) creates valuation problems of its own, especially in relation to the assembling of “jigsaws”,
 - (3) which experience with one particular property bond fund in the mid-1970s suggests is an area from which the retail investor needs to be excluded for his own protection.
- (b) At the time of writing, the proposals with regard to Groups have not been published. It is, however, not immediately apparent why a REIT should be allowed to have subsidiaries, except where this is desirable in relation to foreign property. It is, therefore, suggested that REITs should only be permitted to own shares in other companies where the business of such companies is confined to the ownership of land in the country of incorporation.

7. **Administrative Issues**

- (a) Mention has already been made of the difficulties likely to be faced in identifying large beneficial owners. Clearly the REIT has to have some policing role, but it needs to be reassessed in the light of the realities.
- (b) It is not immediately apparent why it should be thought appropriate for power to be taken to specify types of investor to which distributions may be made gross. This will increase the administrative burdens of the management, to the detriment of ordinary investors. Such shareholders will have experience of obtaining refunds of tax deducted in other contexts and should be expected to go through the same procedures in this context also.
- (c) Retail investors are entitled to certainty. The prospect of clause 14 being applied has, therefore, to be considered from their point of view. In this context, it is considered that the inclusion of clause 14(2)(b) is a step too far and this should be deleted.

Yours sincerely

W J de Souza
Chairman