Tax Representation

TAXREP 4/06

UK Real Estate Investment Trusts (UK – REITs)

Representation submitted in February 2006 by the Tax Faculty of the Institute of Chartered Accountants in England and Wales in response to the draft legislation on REITs published on 14 December 2005

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INTRODUCTION

1. On 14 December 2005, draft clauses were published by the government in relation to the new scheme for UK-REITs.

2. The government published two earlier consultation papers in 2004 and 2005. We made representations in relation to these earlier consultations in TAXREP 30/04 and TAXREP 25/05 respectively.

3. Details about the Institute of Chartered Accountants in England and Wales and the Tax Faculty are set out in the Annex.

GENERAL COMMENTS

4. We note the policy decisions that the government has taken.

5. We understand the policy reasons behind the interest cover test but are concerned that it will create uncertainty. A limitation based on a combination of rental income and interest, both of which are in many cases variable, will be difficult to apply in advance. The result will be that UK REITs may find themselves with a tax liability because of circumstances wholly outside their control.

6. We support the government's position that it is minded to allow ISAs, PEPs and Child Trust Funds to invest in UK REITs. These are all designed as medium to long-term savings products, and most advisors would want to include a property element in a medium term savings strategy.

7. Some of the key details have been left to Regulations and these should be published as soon as possible.

8. We fully understand the need to ensure that UK REITs are not used as a tax avoidance tool, but the volume of the anti-avoidance rules may create uncertainty and discourage take-up. We would not have thought that UK REITs will provide much opportunity for avoidance, given that they will be listed companies and that no one person (together with his associates) will control more than 10 per cent.

COMMENTS ON DRAFT CLAUSES

Clause 2 – Property rental business

9. Whilst we can see the reason for the exclusions in Schedule 1, Part 2, we think it would be sensible for them not to apply where the income is incidental to the income of the Schedule A business. For example if a UK REIT owns an office block and, in addition to the rent for the offices, also receives rent for allowing a mobile phone mast to be sited on top, we think it unreasonable to expect that small amount of rent to be separated out and

subjected to tax. We suggest that rent should be excluded from Part 2 if it is incidental to the ownership of a building and does not exceed 5 per cent of the rent from the building.

Clause 4– conditions for company
Subsection 1

10. We do not understand why this refers only to conditions 1 to 3 rather than all of conditions 1 to 8.

Subsection 3

11. The restriction of the special treatment to a company that is resident in the UK appears to us likely to conflict with the principle of freedom of establishment under EU law. We would expect, for example, EU law to require a Schedule A business carried on by a French company to be treated in the same way as the same business carried on by a UK company, particularly one listed on the Paris Stock Exchange.

Subsection 7

12. As a UK REIT is permitted to raise long-term non-equity finance by borrowing, we are unclear why it is not permitted to raise such finance by the issue of preference shares, which would have the same economic effect as a borrowing but might attract a lower coupon.

Subsection 10

13. As condition 3 requires the company to be listed condition 8 seems unnecessary as listed companies are required to adopt international accounting standards under EU company law.

Clause 5 – Conditions for tax-exempt business
Subsection 3

14. It seems to us unreasonable that a company which has three properties, sells one and reinvests the proceeds in another should fail the REIT conditions for the accounting period in which the sale takes place merely because there is a short gap between the sale of the old property and the purchase of the new, so that it does not hold three properties "throughout" the accounting period. We suggest that in such circumstances Condition 3 should be treated as continuing to be met if it would have been met had the old property been retained for the entire accounting period and the new one is bought within six months of the sale of the old (or within such longer period as HMRC may in a particular case allow).

Subsection 6(a

15. We are unclear what this condition entails. The explanatory notes seem to suggest that, for example, a UK REIT could own a single property if it is designed to be rented out for multi-occupation by at least three tenants. Is this correct? What about an office building which is intended to be let out to a single tenant but where the ground floor incorporates a coffee shop and a newsagents, both of which are let to separate tenants? That seems akin to the example of a shopping centre being treated as multiple properties.

Subsection 6(e)

16. As a REIT is permitted to have only one class of shares, we are unclear why it is permitted to staple its shares with those of another company. This seems to allow the single class condition to be bypassed.

Subsection 7

17. We think it would be sensible to define profits. In the context of a tax exempt vehicle, most people would assume that it means accounting profits but the Explanatory Notes indicate that it means profits calculated using normal tax rules.

18. We also think that it would be more sensible to apply the test by reference to accounting profits, particularly bearing in mind that a UK REIT is a listed company, subject not only to audit but also to review by the Financial Reporting Review Panel. It seems a waste of time to require a body that is exempt from tax in incur the costs of computing profits using tax principles solely to measure the distribution test, when such a calculation is not needed for corporation tax purposes. In particular, the calculation of capital allowances in a building, and the apportionment of refurbishment costs between repairs and improvements, can be very burdensome.

Clause 6 – Conditions for balance of business
Subsection 2

19. It is particularly burdensome to require a UK REIT to calculate capital allowances on its buildings. Many taxable businesses do not incur the costs of calculating such allowances, which frequently require valuations and protracted negotiations with HMRC, where their net rental income is likely to be insufficient to utilise the allowances. It seems odd to require a tax-exempt business to incur heavy costs that a taxable business might think twice about incurring.

20. The requirement for the 75 per cent test to be met in each individual accounting period seems unduly restrictive. It ought to be sufficient for the test to be met taking one year with another. In the year a UK REIT buys a property, capital allowances will depress its tax exempt profits particularly when it is eligible for first year allowances, in the year a property is sold the loss of rent will depress exempt profit and temporary investment of the proceeds will enhance taxable profits, and in a year in which a refurbishment takes place rents will be temporarily depressed because the building being refurbished is likely to be unlet for a period. It seems wrong for these normal commercial activities to cause a UK REIT to become taxable on its rental income for a single year.

Clause 9 – Effects of entry
Subsection 2

21. The clause should make clear that the deemed sale does not trigger tax. At least we assume that it will not do so, but that the entry charge will be the only tax on conversion to a UK REIT. Even if that is not the case it would seem better for the entire tax charge to be dealt with in section 11 rather than part being in section 9 and part in section 11.

Clause 10 – Ring-fencing of tax-exempt business

22. Can a loss incurred by C (pre-entry) be set against income of C (residual) (subject of course to the normal limitations on the use of losses) or of C (post-cessation)? On the

face of it, as section 9(1) treats the property rental business as ceasing for corporation tax purposes, ICTA 1988, s 391A would prevent any carry forward of a loss of C (pre-entry) unless C (residual) includes an investment business, when it would permit a carry forward. However it would be logical to permit a loss of C (pre-entry) to be carried forward and utilised against a loss of C (post-cessation) where the Schedule A business has in fact continued throughout, albeit that it is deemed to cease under section 9(1). It certainly does not seem logical for the right to carry forward to depend on what the company does outside its exempt business.

23. It is also unclear whether C (tax-exempt) is deemed to claim all loss relief that it is possible for it to claim, so reducing the quantum of the distribution that it is required to make. In particular the Explanatory Notes state that there will be no restriction on the offset of losses and profits between any parts of the tax exempt business, but we cannot see any legislative authority to permit this. We would have expected the property rental business to need to be deemed to be a Schedule A business in order to permit such offset.

Clause 12 – Financing cost – profit ratio

24. We are unclear how this can work in practice, particularly as exchange gains and losses cannot be quantified in advance. The restriction on borrowings and the maximum 10 per cent shareholding are likely to mean that most sophisticated investors will prefer to use other vehicles, such as a limited partnership, rather than a UK REIT for investment in UK properties. Accordingly the main investors are likely to be the general public. It seems unreasonable for an investment vehicle designed to encourage small investors to be subject to unpredictable market fluctuations merely because the market is unable to forecast to what extent the UK REIT might attract tax due to circumstances beyond its control.

25. We are also concerned that the legislation does not contain the details of this tax charge but leaves it to be filled in by Regulations. We do not consider this a proper subject to be left to Regulations.

Clause 14 – Termination by notice: Revenue and Customs

26. We are concerned about HMRC's wide discretion to withdraw the exempt status. As stated above, we cannot see any real scope for a UK REIT to be used as a tax avoidance vehicle (we doubt that even the most avid tax avoider would regard such action as worthwhile if he is forced to give 90% of the resultant tax benefit to other shareholders) and we doubt that it is sensible for the government to encourage small investors to go into a vehicle whose tax status is vulnerable to be adversely changed at any time by HMRC.

Subsection 7

27. In view of the very serious consequences of a notice under section 14 we think that the legislation needs to make clear that on an appeal the Special Commissioners have power to determine whether or not the UK REIT has in fact entered into arrangements designed to obtain a tax advantage. The right of appeal is largely illusory if the Special Commissioners have to decide only if HMRC genuinely "think" that the company has entered into such arrangements. In addition, the Special Commissioners ought to be able to substitute their own view as to whether the notice should be given. Section 14(2) gives a discretion to HMRC as to whether or not to give a notice. Commissioners cannot normally question the exercise of a discretion by HMRC.

Clause 16 – Minor or inadvertent breach

28. The Regulations dealing with minor or inadvertent breaches seem fundamental to the system. Some of our above concerns might well be allayed by them. We accordingly feel that it would be sensible to publish draft Regulations as soon as possible and certainly prior to the enactment of the legislation, as these could have an impact on the extent to which concerns in other areas are justified.

29. We are particularly concerned about the reference to "knowledge or presumed knowledge" in section 16(2)(a), as many of the potential breaches that we can envisage are likely to arise from factors that cannot readily be identified until after the end of the accounting period.

30. We are also concerned by the indication in the Explanatory Notes that a UK REIT will be allowed to suffer only two inadvertent breaches (which we assume includes those arising from factors entirely outside the control of the UK REIT) of the rules in a five-year period. We would stress that the rules seem to us to ensure that a UK REIT is most likely to be a retail investment for small, unsophisticated investors, who are ill-equipped to appreciate the likely effect on the share price of the risk of a loss of the exempt status.

Clause 20 –Distributions: liability to tax
Subsection 2

31. We are unclear what this is intended to do. Deeming a non-UK resident individual to be resident for the purpose of section 20(1) seems to have no effect, as a non-resident is already taxable on the profits of a UK property business. Deeming a non-UK resident company to be resident seems to deem it to have a Schedule A business chargeable to corporation tax rather than a UK property business chargeable to income tax, but we do not understand why such a switch is thought desirable. The Explanatory Notes state that the effect is that a non-resident's liability to tax will be calculated as if he were UK resident, but we cannot derive that from the wording. If that is indeed the intention, is it intended that the deeming should entitle a non-UK resident individual to a personal allowance as if he were UK resident?

Subsection 6

32. We are unclear why a distribution from a UK REIT cannot be included in the profits of an actual UK property business carried on by an individual shareholder (or a Schedule A business of a corporate shareholder). It seems to us cumbersome to deem a person to have two separate property businesses. We can see no logic in treating the income from a direct property investment any different from that in an indirect investment through a UK REIT.

Clause 21 – Distributions: deduction of tax

33. Again, we think it would be sensible to publish draft Regulations so that the proposed exceptions are clear.

Clause 22 – Exemption from corporation tax
Subsection 2

34. We do not think that the words in brackets at the end are helpful. They seem to require reasonableness to be assessed primarily by reference to periods of use, whereas one

would not normally expect what is reasonable to be determined by reference to all relevant factors that exist in a particular case. If the primary determinant is intended to be the periods of use it would be sensible for the legislation to specifically say so, rather than specifying a reasonable attribution subject to such a major caveat.

Clause 23 – Movement of assets out of ring fence
Subsection 6

35. What happens where an established UK REIT wishes to develop and sell a building which it holds as an investment? It is arguable that the development and sale is by its nature a trading transaction, and is thus a transaction of the non-tax exempt business. It seems unreasonable in such circumstances that the entire gain during the tax-exempt period should be subjected to tax. Outside the UK REIT regime there would be a deemed appropriation from investment to trading at the time the development commences. We cannot see why such treatment should not apply equally in this case. Section 23(6) virtually forces the UK REIT to sell the property and allow someone else to develop it.

Clause 24 – Movement of asset into ring fence

36. It is unclear whether the deemed disposal is intended to trigger the normal charge to tax on the resultant capital gain or whether the entry charge will apply on a transfer into the tax-exempt business subsequent to the company joining the UK REIT regime.

Clause 26 – Early exit by notice

37. As indicated earlier we believe that the strict conditions that must be met by a UK REIT preclude it being used as a tax avoidance vehicle. We are therefore disappointed at the inclusion of anti-avoidance rules, for which we can see no obvious necessity.

38. We are particularly concerned why these rules should apply if the UK REIT regime has not applied to the company for at least 10 years rather than the six-year period that normally applies for tax purposes (including for other anti-avoidance rules).

Clause 27 - Early automatic exit
Subsection 3

39. We think this power inappropriate for a listed company, particularly as a direction could significantly adversely affect the share price. Indeed, the directors could trigger a direction in order to pick up the shares of the company cheaply from the innocent private investors, who are likely to disinvest on the drop in the share price generated by HMRC.

Clause 29 – Funds awaiting re-investment

40. We cannot see justification for funds held temporarily between the sale of one property and the purchase of the next being treated as part of the taxable trade. Apart from the fact that it is much cleaner for the assets of a tax-exempt business to remain within that business whilst it subsists, it means that a pure UK REIT (i.e. one with no residual business) will have a residual business, normally with a comparatively small amount of income, for such brief periods and will therefore move in and out of the tax net. The administrative burdens of this, both on HMRC and on the company, could well exceed the modest tax on the interest.

Clause 32 – Housing investment trusts: repeal

41. We are unclear why there should be a five-month gap during which there are no tax incentives to encourage investment in housing.

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ANNEX

ICAEW AND THE TAX FACULTY: WHO WE ARE

The Institute of Chartered Accountants in England and Wales ('ICAEW') is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter 'TAXline' to more than 11,000 members of the ICAEW who pay an additional subscription.

To find our more about the Tax Faculty and ICAEW including how to become a member, please call us on 020 7920 8646 or email us at tdtf@icaew.co.uk or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.