
Papers

The major issues facing the successful introduction of the UK REIT

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Abstract

Exciting times are afoot in real estate finance and investment within the UK. This year has already seen the Barker review of housing policy, the Draft Planning Policy Statement 6 reforms to the existing Planning Policy and Guidance Note 6 (PPG 6), new rules on the tax treatment of property derivatives and the continuing review by the Financial Services Authority, through Consultation Paper 185, of Collective Investment Schemes. Moreover, March 2004 saw HM Treasury ('HMT') announce a consultation exercise on how property investment funds ('PIFs', although in this paper they will be referred to as 'UK REITs')¹ in the UK should be structured to encourage more efficient investment in commercial and residential real estate.² The consultation paper reveals that HMT is contemplating a tax-neutral vehicle that will be well regulated (ie low risk), boost liquidity and thus appeal to the small retail investor in providing indirect access to both the residential and commercial property investment markets. The initiative for such a vehicle is driven by a desire, through a government-led review of the taxation of real estate, to stem the flow of investment offshore. Through the introduction of UK REITs, HMT hopes to redirect the £25bn or so of UK real estate investment into a properly regulated onshore investment vehicle, thereby protecting UK tax revenues. This paper will, through examining the successes of the REIT market in the USA, consider the major issues raised and faced by HMT in introducing a vehicle which will succeed and ultimately benefit the UK economy.

Keywords

real estate, property finance, tax, investment and development, trusts

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EXPANDING INVESTMENT OPPORTUNITIES?

The consultation paper has raised a number of important questions. The form that a UK REIT will take is now in the hands of those that respond to the consultation, HMT and the Inland Revenue. Although the country has been down this road before,³ the UK

After-tax returns

Government seems determined to ensure that the consultation exercise is not wasted and to succeed in its desire to align the after-tax returns from holding real estate indirectly with those obtained from holding property directly. Given this incentive, the consultation paper and process are both vital and timely, if the country is to follow the example of the USA and introduce a UK REIT which will succeed and ultimately benefit the UK economy.

Real estate investors in every G8 country, other than the UK, have had the advantage of REIT-type vehicles — essentially tax-transparent collective property investment vehicles — in which investors hold assets which are unitised like shares. The raft of property investment vehicles which have been created over the last decade demonstrates the depth of institutional enthusiasm for a UK REIT-type structure.⁴ Consequently, when UK REITs arrive in the UK, they will be competing in a fierce market and their restrictions and regime will have to be attractive enough for them to become the preferred ownership vehicle for real estate investors. This raises the all important question of whether UK REITs, in reality, will work. To answer this, one should turn to the USA, which has through various reforms to its tax laws cultured a successful US REIT market.⁵

US REITs

The US REIT was created by the US Congress in 1960, with the same UK REIT-stated purpose of making real property an investment option for the small investor. It was not until 1986, however, that, as a result of some dramatic changes in the tax laws, there was a significant increase in REIT investment.

The first hurdle, then, for the UK Government is how to channel the great untapped retail and institutional investment into the real estate market and convince the British public and institutional investors that UK REITs are the investment of choice. The first step must be to deal with the perceived risk of investing in something new. The UK Government seems to have anticipated this in the consultation and, in encouraging individuals to invest in liquid property assets in a tax-transparent way, will encourage the public to invest in a listed UK REIT.

REDUCING RISK

Investor protection

Investor protection will be first and foremost in the mind of the Government. This Government cannot afford to have an HMT-blessed collective property investment scheme scandal which will affect millions of income-seeking savers. Consequently, the consultation paper focuses on a high level of public scrutiny and trust in what will be a listed REIT. By contrast, the USA does not regulate whether a REIT is publicly (ie listed on a recognised exchange) or privately traded. The National Association of Real Estate Investment Trusts ('NAREIT') reports 171 publicly traded REITs at 2003 year-end, and estimates that approximately one-third of all REITs are private.⁶ US institutional investors also favour public REITs because of the quantity and quality of initial and

ongoing disclosure and reporting required under the US securities laws for public companies; more than 50 per cent of REIT shares are owned by institutional investors, about 15 per cent by retail public investors and about 17 per cent by REIT management.⁷ At year-end 2003, the 171 publicly traded REITs had a total market capitalisation of about \$224bn.⁸ Of the estimated total US real property market of \$4.6trn, about \$180bn (or 4 per cent) is held by public REITs.⁹ REIT shares are liquid; about 80 public REITs held investment grade ratings by Moody's, and 70 by Standard & Poor's; daily trading volume in REITs is about 12 million shares.¹⁰

Private REITs

Notwithstanding the success demonstrated by these figures, and the fact that publicly traded UK REITs would carry greater initial and ongoing disclosure and reporting requirements than private UK REITs, it is submitted that the UK should not discourage or indeed prevent the introduction of private UK REITs. Alongside the public REITs, there should also be a private UK REIT market (similar to the private funds market in Luxembourg), for example, where property companies and certain private investors can enter into joint venture arrangements. As the private sector will inevitably be less regulated, a number of restrictions could be added to ensure that only 'sophisticated' expert investors have access to the private market, as has been the case with the qualified investor scheme ('QIS') funds.¹¹ After all, by separating public and private UK REITs, different classes of investor can be regulated to an appropriate level, rather than a 'one size fits all' approach.

Once introduced, the success of a private REIT will depend on the advantages it offers over the public REIT (perhaps more relaxed investment restrictions/investment borrowing). Such a vehicle should be more attractive than other property vehicles in the market, for example, offshore open-/closed-ended funds, Authorised Property Unit Trusts ('APUTS'), EU PUTS, Undertakings for Collective Investment in Transferable Securities ('UCITS'), non-UCITS retail funds and the QIS funds ('CP185 Funds') etc.

The question then becomes, to what extent should the existing listed property sector play a part in delivering both a public listed REIT and a private REIT? After all, the listed property sector has the experience (and, some may argue, the means — see the recent increased attempts to establish market recognition taken by, for example, ING Direct in the marketing of savings products) of delivering a product.

DELIVERING THE PRODUCT?

Critical mass

There is no doubt that when REITs are delivered, there will be a need to establish critical mass. HMT will need the 'assistance' of the listed property sector to achieve this. This approach was taken by the French Government when it introduced French REITs (SIICs) in 2003. There, the French Government and the listed property companies negotiated a deal which accelerated the payment of the tax on capital gains at the expense of future corporate tax revenue.

The listed property sector will have to provide such assistance with a tax-neutral effect. Any entry or exit level conversion charge must serve its purpose and should not prohibit the conversion of existing listed property vehicles which may wish to convert to UK REIT status. A charge set too high could easily discourage conversion and not raise any money for the Inland Revenue. In the USA, there are not many conversions of property companies to REITs, as the transfer of property from a property company to a REIT would give rise to a capital gains charge. Conversion to REIT status can generate tax liability for capital gains realised when property is contributed to a REIT in exchange for cash or shares in the REIT. Consequently, the US REIT market has developed the 'UPREIT' and 'DOWNREIT' structures to minimise and/or defer the tax impact of contributing property to a REIT: assets can be contributed to one or more limited partnerships (controlled by the REIT), in exchange for limited partnership interests that can be traded for REIT shares. The US Internal Revenue Service accepts that use of these structures does not give rise to a capital gains charge on contribution of real estate to a REIT. This is something that the UK could take advantage of.

Conversion charge

So what conversion charges is HMT considering? HMT seems to be considering, one-off stamp duty charges based on a percentage of net asset value; however, exit charges based on a discounted percentage of unrealised capital gains tax ('CGT') liabilities (following SIICs in France and SICAFIs in Belgium) are also proposed. The trouble with CGT exit charges, however, is that most UK companies have low CGT liabilities and so this would not favour the tax-neutral position. It is further submitted that, as modelled elsewhere in Europe, any charge should be payable over a number of years. If a conversion charge has to be imposed, one could suggest the postponement of the charge, such that it would be held over until properties are disposed of by the REIT, and on such an event a lower tax rate would apply. Thought should also be given to whether relief should be available in certain circumstances. As an example, if the Government's purpose is to encourage new housing, any UK REIT which contains a percentage of new housing should be entitled to a reduced rate.

DELIVERING SUCCESS?

Investor return

One of the key features yet to be addressed is the level of return that investors will receive. The consultation raises the question of whether a UK REIT should distribute or reinvest its gains on sales of assets. Typically, net capital gains on sales of REIT assets are subject to income tax at the REIT level if retained. If distributed to shareholders as a capital gain dividend, the gain is not taxed at the REIT level, and is taxed to the shareholder; individual shareholders can take advantage of the lower long-term capital gains tax rates. The ability to retain capital allows for continued maintenance and upgrading of assets, when costs of capital then become an issue.

When REITs were originally introduced in the USA in the 1960s, the requirement was to distribute 90 per cent but this was increased to 95 per cent in the mid-1970s and then, in an effort to be more consistent with certain mutual fund rules, reduced back to 90 per cent in recent years. The 90 per cent test applies after depreciation. There is no requirement to distribute capital, but capital retained in a REIT is taxed. Practically speaking, US REITs will distribute all capital gains to prevent such gains being taxed. A further issue is that some US REITs have been in difficulty as a result of them being required to distribute capital gains to avoid taxation. Retaining only the net proceeds without the gain has made it difficult for them to reinvest in replacement properties.

The consultation has also raised the question of whether such distributions are calculated before depreciation. The 10 per cent leeway goes to the non-deductibility of debt amortisation and the need to reinvest in other properties. Until recently, certain items of income, including 'excess non-cash items', were added to income for the purposes of calculating the 90 per cent test but recent changes have allowed some of such income to be 'backed out' for the purposes of applying the 90 per cent test. An example of excess non-cash income would be certain levelling adjustments in circumstances where rents under a lease rise over a period of years (the levelling adjustments being made in the initial years). It is submitted that it would be wrong not to take depreciation into account, as this would result in a requirement to distribute income which has suffered tax. The relevant depreciation is that for tax purposes, rather than accounting/financial depreciation.

In the UK, accounting depreciation is not deductible for a property investor, but capital allowances (ie tax write-off for real estate) are deductible. How unreasonable it may be to require the distribution of 90 per cent before depreciation in the UK may depend on the meaning of depreciation for the purposes of these proposals; this was not made clear in HMT's consultation document.

Close-ended

A possible UK REIT restriction to ensure their success would be to require all UK REITs to be closed-ended. HMT shows a preference for requiring all UK REITs to be closed-ended as a way of bringing share prices in line with net asset value ('NAV'). To this end, a question raised by the consultation paper concerns the extent to which a listed UK REIT would close the gap with NAV and enable a wide retail investor base. One way of achieving this would be to develop a finite life to the investment trust. In doing so, this would reduce the exposure to interest rate risks. Expected capital distributions would also be factored in to the value of shares and would reduce the gap. The US REIT market has, without mandating closed-end REITs, developed the finite life real estate investment trust ('FREIT') in recognition of the share to net asset value disconnection. The FREIT is a liquidating

REIT, and has a termination date by which it must liquidate all of its assets. FREITs trade at closer to NAV, as investors know they are likely to get their investment back in a shorter period. Their existence reduces exposure to interest rate risk and induces investors to factor in expected capital distributions in valuing share prices.

Should the UK follow this route? UK experience with investment trusts and property companies suggests that these will trade often but not always at a discount to NAV. These discounts can often be narrowed by warrant issues, stock splits and introducing a repurchase programme. It is not usual for investment trusts or property companies to have shares redeemable at net asset value, although this must be possible to a limited extent. The intention that the UK REIT will distribute the majority of income, however, will assist in reducing any discount; this should not cause a difficulty mechanically, as the shares will, either side of a record date, trade cum/ex dividend. The issue of the amount of the adjustment would remain a requirement for distributing capital gains, which, once realised, would be likely to be an effective tool to reduce the discount.

A further way to bridge this gap may be to issue redeemable shares to investors. If all shares were redeemable, there would still be the problems outlined above; however, it is possible to issue only a limited number of redeemable shares which are triggered by defined events (eg if the shares/units were trading at a certain percentage discount).

RESTRICTING GEARING?

The consultation paper suggests that HMT will not restrict a UK REIT from gearing or leveraging itself. For reasons cited as increasing scrutiny and stability, however, HMT favours a low level of borrowing for contingencies, with the main capital raised from investors and equity markets.

This can be seen from the consultation paper at 2.31:

‘High borrowing results in high debt servicing costs, which reduces the available income to investors and moves the balance from an income return to a capital return. The greater the borrowing, the closer the structure may become to that of an ordinary property company, and the less the vehicle benefits from scrutiny in raising finance.’

and at 2.32:

‘Some borrowing may be necessary to meet short term and unforeseen liabilities, and to buy and sell assets, without holding large cash reserves. Thus borrowing will be allowed as a contingency margin. Such a margin might be achieved by a low percentage limit on the nominal share value or asset value. This

Contingency borrowings

would be consistent with a higher level of investor scrutiny, which would be required by requiring a UK REIT to raise capital from the markets, rather than seeking debt financing.'

With debt servicing costs at an all-time low (although recently increasing), the proposal of HMT to turn to the capital markets for funding for each proposed development activity could prove to be a costly way of raising finance. Indeed, if HMT were to limit the borrowing powers of a UK REIT and combine this with a requirement for high income and capital distributions, then a UK REIT's constant visits to the equity markets could prove unattractive to those listed property companies which would be considering converting to a UK REIT. Moreover, with real estate requiring regular servicing, maintenance and refurbishment, there is a real risk that taking away the dynamism of having a suitable credit facility available for the UK REIT to draw upon at will, will hinder the management of UK REITs and the projects they may wish to become involved in. After all, as long as the investor is aware of the debt servicing costs (which largely can remain the same throughout the term of the facility), then those investors can decide the level of risk and costs they are content with. This must be better than not having a choice in the first place. Furthermore, what would be the incentive of managing a passive, ungeared vehicle?

Complementary vehicles

A further disadvantage to artificially restricting the level of borrowings can be seen when one considers complementary vehicles to UK REITs, such as the CP185 Funds, where new tax rules in relation to non-UCITS retail funds allow, in respect of retail investors, 100 per cent of fund assets to be invested in real estate and gearing of up to 10 per cent of net assets, and up to 50 per cent of the fund can be in development; while the new QIS funds can gear up to 100 per cent of net assets. Thus, it is important that UK REITs can compete if they are to be successful, and, although a low level of borrowing is favoured, it is submitted that the success of UK REITs depends on maximum flexibility and allowing the market to refine the product, as the successes in other G8 countries demonstrate. For, while some jurisdictions, for example Belgium, restrict gearing in cases where the REIT is based on a regulated investment vehicle, other major economies, such as the USA and France, prefer a free market approach and do not restrict gearing or leveraging, although in practice the market typically appears to bear up to 50 per cent of asset value.

There may also be a benefit to gearing, which can be seen in the USA. There, for geared REITs, interest on debt is a deductible expense, whereas principal amortisation is not; this imposes a practical limit on gearing. NAREIT estimates that the average REIT gearing is between 40 and 45 per cent.¹² In fact, the presence of leverage at the REIT level makes a REIT a very attractive investment for US tax-exempt investors. US tax-exempt investors who try to directly invest their funds in leveraged real estate may

incur income tax liability notwithstanding their tax-exempt status; by contrast, the existence of leverage in a REIT will generally not cause a US tax-exempt investor's income from the REIT to be taxable (unless the REIT is a closely held entity owned primarily by tax-exempts). This may also be an attraction in the UK and should pass HMT's tax-neutral requirement.

Debt REITs

Restricting the gearing of UK REITs may also be restricting such REITs from entering a potentially lucrative sector. The USA has a concept of the mortgage or hybrid REIT. Since 1997, mortgage and hybrid REITs have participated in the transformation of real estate ownership from private and public hands and the liquification of commercial real estate assets. Mortgage/hybrid REITs, which use debt to buy mortgage products, must distribute substantially all of their income to shareholders and meet other qualifications in order to avoid paying income tax at the corporate level and maintain REIT status. REIT tax status allows these companies to distribute an attractive cash dividend to shareholders and have substantial earnings growth potential. The *quid pro quo* of this tax advantage is that the typical mortgage/hybrid REIT is unable to retain substantial earnings and is subject to other REIT status requirements. The common element of the mortgage/hybrid REITs is a more flexible business plan with a broad range of real estate disciplines that will enable the companies to optimise the creation of value through the financing and/or ownership of commercial real estate. It is submitted that debt REITs are a concept which the UK can take advantage of. Increased stability could come from a greater use of credit derivatives and swap instruments, which protect against burgeoning interest rate cycles.

Market approach

From the analysis of REITs across Europe and in the USA, it is submitted that the UK should not attempt to restrict the gearing on UK REITs, instead allowing a market approach to gearing levels. The US model provides the form of investor scrutiny required by HMT, as the REITs there have to issue capital, after which the analysts decide if it is a good or bad deal. Moreover, having a higher level of borrowing is not necessarily a bad thing. Economies of scale resulting in lower margins for increased borrowings will result in lower debt servicing costs. Increased market scrutiny could come from a disclosure of debt servicing costs. For secured borrowings, there is already a public securities register through which the level of borrowings can be ascertained.

PROPERLY MANAGED PROPERTY?

A UK REIT manager will be fully aware that the success of the UK REIT will, in part, be a result of good property management; poor property managers are likely to be quickly replaced in order to protect the value of the UK REIT. If the UK REIT is internally managed, the trustees or unit holders are likely to have the ability to replace the manager by a majority vote. In addition, property management agreements normally impose a duty of care on the

property manager for the benefit of the property owner; this would add a level of protection for the UK REIT trustees and unit holders. The financial incentive of management fees would also encourage most property managers to keep up standards of management in order to be retained by the UK REIT.

In the USA, REITs were originally required to be passive investors, prohibited from operating or managing assets. Management could only be by independent third parties (whose interests were not fully aligned with those of investors). Today, REITs may 'operate' and provide customary services for most types of real property, and so can be internally managed. REITs may now own taxable REIT subsidiaries (although not more than 20 per cent of total asset value can consist of shares of taxable subsidiaries), which may operate service businesses such as hotel management, day-care centres, golf courses, hospitals and nursing homes as tenants of REIT-owned assets.

Internal or external?

It seems likely that the property management arrangements under a UK REIT will be outsourced to external property managers, since the UK REIT trustees and managers are unlikely to have sufficient expertise to manage a large or complex property, especially where specialist skills are required (eg hotels) or flexible management practices are needed. The only likely exception would be where the UK REIT manager was itself a property company which had sufficient property management skills to carry out these functions internally.

In most cases, therefore, some form of property management agreement would need to be put in place between the UK REIT manager and the property manager. The practice of putting property management agreements in place is common practice in the UK, especially where there is more than one party with an interest in the property-owning company, as is the case with joint venture companies, limited partnerships or where lenders have charges over a property. There is no prescribed form for these types of property management agreements.

In neither the USA nor Hong Kong is there a prescribed form of property management arrangements for REITs. In Hong Kong, there is an obligation on the REIT manager to carry out proper diligence in the selection and ongoing monitoring of the property manager selected, but otherwise any form of property management agreement can be used. In the USA, if external management is used there are criteria imposed on the REIT manager to ensure that the appointment of the property manager is an 'arm's length' contract (eg not participating in profit share) but, again, there is no prescribed form of property management agreement.

In France, Sociétés Civiles de Placement Immobilier (Civil Real Estate Investment Companies; 'SCPIs'), invest directly in real estate and their shares may be purchased by the public, although they are not listed on a stock exchange, as the shares are not negotiable securities. SCPIs are subject to strict regulations regarding the type

of investments they may make, the information they give out to the public, their management and, more particularly, the system of share transfers. As a result, a SCPI is managed by a 'société de gestion' (management company) accredited by the Asset Management Fund,¹³ and overseen by a supervisory board consisting of at least seven shareholders. The SCPI must also appoint a real estate expert who makes a yearly report on the valuation of the company's real estate portfolio. Each real asset must be separately valued at least once every five years.

In summary, in order to maintain the flexibility to manage property to its best potential, it is unnecessary to introduce legislation restricting external or internal management, since the unit holders and UK REIT managers can regulate the property management of the UK REIT themselves. While it may be advisable to introduce legislation to impose a duty on the UK REIT manager to appoint only suitably qualified property managers, UK REITs should not be prohibited from being externally managed. Although the US experience has shown that REITs which are internally managed are the best performers, and that internal management clearly helps to align the interests of management and investors, the simple answer is that prescriptive legislation regarding the property managers is unnecessary.

DELIVERING BETTER PROPERTY?

There is no doubt that one of the main drivers of the consultation process is the Government's desire to improve the housing market in the UK. Its aim in attempting to achieve the reforms highlighted in the *Barker* report is to see if REITs can address the supply side issues which have led to demand exceeding supply and thus unsustainable house price growth, to reform the planning laws and at the same time to introduce institutional and wider investment capital. Similarly, the UK Government is conscious of the property market and the source of destabilising boom and bust cycles. This has led to a desire to reform, so that the net result is a vehicle which creates a safe, tax-efficient environment in which people can invest in commercial and residential real estate, which will be less risky than buying a single piece of residential real estate on a buy-to-let basis. This will reduce volatility in the commercial and residential real estate sector and will appease the UK Government's aim of reducing the sector's exposure to debt and interest rate cycles.

The introduction of a UK REIT market should in itself have associated effects of greater efficiency and activity in the market, and lower cost of capital (resulting from the closing of the gap to NAV), with flow-on effects towards enhanced quality of stock. The transparency of the structure should result in increased competitiveness, which should result in higher standards of management and, ultimately, better quality stock. The indications from US and Australian REIT markets suggest that the economies

Structural reform

Minimum holdings

of scale achievable through large-scale REIT vehicles again have positive effects on management and underlying asset quality. This would be of particular relevance to the UK residential market, where large institutional portfolios are currently rare. To ensure better quality of stock, it is important that the income distribution percentage be set at a realistic level that allows sufficient funds to be allocated to management and refurbishment costs.

The benefit of these advantages, however, should not be outweighed by unnecessary restrictions as to minimum holdings of residential property or even a minimum holding period. In the USA, REITs are not viewed as the main incentive for promoting residential property investment. For example, credit for low income housing, faster rates of depreciation and other measures are more obviously directed to this purpose. There is no requirement in the USA for REITs to hold a proportion of residential property, and any proposal to do so in the UK should be resisted. Residential property requires specialised management. The US market (without this type of regulation) has developed specialised REITs in response to investor appetite for specific property types, managed by specialised managers. Forcing a REIT to require a minimum proportion of residential property in it would inhibit the establishment of REITs by experts in, for example, warehouse or office investment. The US experience indicates that investors want assets managed by suitably specialised managers more than they want portfolios diversified as to property type.

Furthermore, any requirement for a minimum holding period, coupled with a relief mechanism enabling earlier disposal, for example, by general resolution of unit holders (as has been implemented in the Hong Kong REIT market), is likely to be expensive, time consuming and unworkable in practice. The only major REIT structure to include a minimum holding period appears to be Hong Kong, which introduced its REIT in 2003 with a minimum holding period of two years — although with a relief mechanism enabling the earlier disposal of property in cases where unit holders have given consent by way of a special resolution at a general meeting. A restriction on the ability to dispose of property would limit flexibility by preventing the UK REIT from reacting to positive or adverse market conditions, potentially exposing the UK REIT to higher risk and restricting the ability to act in the best interests of investors. The consultation paper recognises that a more flexible market, allowing regular turnover of properties, will result in greater efficiency and productivity in the economy. It is submitted that a more liquid market, with increased flows of equity and turnover of properties, will of itself ensure greater frequency of renewal of the underlying assets.

ENCOURAGING GREATER FLEXIBILITY

The consultation raises the question of how a REIT could be structured to encourage greater flexibility in the commercial sector.

It is submitted that the Government must ensure a level playing field; the scheme will not work if conditions are imposed on UK REIT landlords that are more restrictive than those applying to other landlords. The UK Government should reflect on the failure of Housing Investment Trusts, where restrictive conditions resulted in the industry choosing not to invest in the proposed schemes.

Moreover, any restrictions on the form of lease provisions would result in difficulties in practice. UK REIT landlords could be precluded from acquiring portfolios of existing leases with non-compliant provisions, and the terms of any underlease to be granted by UK REIT landlords may be prescribed by the headlease itself. Monitoring and enforcement of compliance would be likely to be costly and difficult to achieve in practice. Recent surveys suggest that, in the majority of cases, occupiers are unwilling to pay higher rents in return for increased flexibility when given the option. A change in focus from capital gain to income production should result in an increase in the tendency towards shorter lease terms (and flexibility for occupiers) in any event, as shorter leases generally produce higher income returns.

In conclusion, it is submitted that there should be a free market approach to restricting the UK REIT's development activities. Having no restrictions on development would certainly help UK REITs play a role in urban regeneration and assist the Government's much wider post-*Barker* approach to affordable/ social housing. It is notable that the property industry, post-consultation, has highlighted this area as one of the major concerns for the success of UK REITs. Moreover, mirroring a post-*Barker* report aim, recent French legislation¹⁴ offers tax advantages to encourage owners of real property, including SCPIs, to invest in housing projects, whether in older or new constructions, and in particular to lease their property in favour of individuals with low income. The main advantages relate to the granting of a tax depreciation of the investment made in an SCPI and tax deduction of any rental revenues received from the SCPI.

CONCLUSION

Recent years have seen real estate investors across the globe seeking to make indirect real estate investment risk averse and ideally tradable. This has led to a growing market of investors wanting to invest in real estate in a unitised way. The consultation paper suggests that it may be appropriate to restrict the market freedom of a UK REIT, but the success of REITs in the USA provides the best argument for HMT to take a minimalist approach to regulating the UK REIT, allowing it maximum adaptability, which will translate into larger market capitalisations and liquidity. If this approach is taken, the UK REIT may well succeed in aligning the after-tax returns from holding real estate indirectly with those obtained from holding property directly. If the net result of a UK REIT is that it is no less tax efficient for investors investing indirectly in real estate

through a UK REIT than those investing in real estate directly, then UK REITs will be more than half way to succeeding.

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References and Notes

1. The name may change to reflect the financial structure, and the UK Government (in an indication that it may not be happy with 'PIFs' as a name) has welcomed alternative suggestions. After all, it could not have been called a Property Investment Trust (after the Housing Investment Trusts of the 1990s), since one would imagine the take-up of a product called a PIT to be relatively low.
2. See http://www.hm-treasury.gov.uk/budget/budget_04/associated_documents/bud_bud04_adproperty.cfm.
3. During the last housing boom, the government of the day extended the reliefs available in the Business Expansion Scheme, which were originally intended to help small businesses, to include private landlords. Tellingly, the scheme was described in 1993 by the then shadow Chancellor, Gordon Brown, as 'a tax avoidance opportunity for top-rate taxpayers and the banking establishment'. It was shut down soon after. The next attempt to boost private renting, the Housing Investment Trust (HIT) went to the other extreme. HITs were launched in 1995, but had so many limitations and restrictions, that running a HIT was virtually impossible and, accordingly, the market ignored the scheme. Authorised Property Unit Trusts have also had limited success; there are still only a handful of funds over ten years since they were introduced.
4. To accommodate this need, limited partnerships, limited liability partnerships and offshore unit trusts are just a few of the structures which have developed to allow investors to 'pop in' and 'pop out' of real estate while at the same time limiting liability and achieving beneficial tax treatment. Furthermore, Isis Asset Management has recently launched a £240m 'REIT-style' listed property trust (comprising office, retail and industrial sectors) for private investors, which, given that it will pay no corporation tax or capital gains tax, will have gearing of around 40 per cent and will distribute much of its profits to shareholders; it has been billed as the first fund to have a similar structure to a REIT. The fund will be a Guernsey-exempt investment company, with its shares listed on both the London and Channel Islands stock exchanges. It will offer investors a target yield of 6.75 per cent, as well as the potential for income and capital growth. See *Property Week*, 16th April, 2004, 23.
5. Although the US REIT market remains largely successful, it was recently recognised that some REITs may be overpriced; see 'REITS may have fallen, but they still have miles to go before they're cheap', *Wall Street Journal*, 21st April, 2004, 1.
6. *Ibid.*
7. Fass, P., Shaff, M. and Zief, D. (eds) (2004) 'Real Estate Investment Trusts Handbook', Thomson Business, USA, 5.
8. *Ibid.*
9. *Ibid.*
10. *Ibid.*
11. This is a new type of onshore regulated fund; it is only open to institutional and expert private investors.
12. See <http://www.nareit.org/researchandstatistics/>.
13. The management company may be either a *société anonyme* (corporation), whose capital must be at least €225,000, or a *société en nom collectif* (commercial partnership) with the condition that at least one of its partners is a *société anonyme* having a minimal capital of €225,000.
14. Law No. 2003-590 of 2nd July, 2003.