

Cutting edge trends in foreign real estate investment: use of non-US Reits and other investment vehicles.

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Abstract

Direct investment in real estate is on the wane, so we hear time and again. In the UK, the last decade has seen a significant move away from direct to indirect investment in real estate. Real estate is perceived as illiquid – the time and due diligence involved in a real estate acquisition is perceived as excessive, and accordingly a disposal can equally be time consuming. The process is expensive. Direct ownership of real estate has an all eggs in one basket level of exposure. So, the investor is looking more for schemes which allow a spreading of risks – across different real estate types, geographical spread and indeed different countries. 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 whilst at the same time limiting liability and achieving beneficial tax treatment.

Additionally, in March of this year, the UK Treasury announced a consultation paper (the “Consultation Paper”) on how real estate investment funds (“**UK REITs**”) in the UK should be structured to encourage more efficient investment in commercial and residential real estate. 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, the UK government hopes to redirect the £25 billion or so of UK real estate investment into a properly regulated onshore investment vehicle, thereby protecting UK tax revenues and to promote more flexible investment in real estate.

At Dechert, we saw the Consultation Paper and its requested responses, as a real way to try and achieve reform. Our REIT group, which is a cross disciplined firm wide group consisting of around 30 lawyers, formulated a response. The full response is in your materials. We sent our response to the Government on 15 July and we would hope that the UK Government will introduce the concept of a UK REIT sometime during 2006.

Given the audience here today, I thought we could look at two important issues:

1. Taxation of a UK REIT

As I am standing in front of more taxation lawyers than I have ever stood in front of, it would be remiss of me not to look at this) and in particular how we, in the UK, envisage a UK REIT should be taxed in relation to Income Tax, Withholding Tax and Capital Gains. We can then also briefly take a look at what the appropriate tax for property transfers should be for a UK REIT and investors in a UK REIT.

2. Wider Economic Picture

I then, being a real estate finance lawyer want to leave taxation and finish off with looking at the wider economic picture and consider how would the introduction of UK Reits effect investment in real estate in the UK.

1. Taxation of a UK REIT

The Consultation Paper asked the question:

To ensure no overall cost for the UK Treasury, what is the most appropriate system for taxation at the UK REIT level? Is it appropriate to require a UK REIT to distribute a high proportion of realised capital gains to investors?

Our overall response was governed by a basic premise that:

investment in a UK REIT should not be taxed more than if the investor were to invest:-

- directly in the underlying real estate of the UK REIT; or
- indirectly via existing pooled vehicles.

We believe, guaranteeing an efficient and fair level of tax for investors is an essential element in ensuring the success of UK REITs. In order to succeed, UK REITs must represent a tax efficient investment option to promoters and the investment community at large who will be potential investors in a UK REIT e.g. private individuals, UK corporates, institutions, life companies, tax exempt investors and offshore investors. The attractiveness of a UK REIT to a wide community of investors is in turn vital in promoting a liquid market in the shares and actively minimising any discount to Net Asset Value (NAV) represented by the price at which shares readily deal on an exchange.

Our view is that if the vehicle proves only attractive to a small category of investors this may not create sufficient liquidity in the shares as a listed investment. We expect that a more liquid market in the shares could provide some compensating increase in tax revenues to offset any reductions as a result of beneficial tax treatment.

Income

We believe that a UK REIT should not be subject to tax on its net rental income provided the required proportion of its income is distributed to investors to ensure continuity of UK Treasury receipts. The net rental income distributed should be assessed as rental income in the hands of investors with the result that such investors should be entitled to all the same tax deductions (such as the investors' own pooled deductible expenses and losses) as if they had been a direct owner of the real estate to ensure tax neutrality. Further, the rates of tax applicable to each class of investor in respect of a direct investment would apply in order to ensure the vehicle is no less attractive from a tax perspective. Thus, in relation to this income, individual investors will be taxed at their marginal rate, corporate investors at corporation tax rates, offshore investors at 22 per cent and tax exempt investors such as pension funds and charities will not pay tax.

There may be occasions where substantial non-rental income is received by the UK REIT in the normal course of its operations. For example, pending investment in underlying properties the UK REIT may hold substantial liquid assets in cash deposits, gilts and other forms of money market instruments. In addition, pending distribution of the capital profits of any disposal similar income may arise. We recommend that this income should also not be subject to tax within the UK REIT to the extent that it is distributed, but instead it should be taxed in the hands of investors as if they had received such income directly.

This distribution approach in relation to both rental income and non-rental income may require the UK REIT to make two classes of distribution in respect of income which is not taxed at entity level:-

- a rental income distribution; and
- a non-rental income distribution.

We do not expect that the streaming of distributions will give rise to significant extra complexity for individual taxpayer investors as basic rate taxpayers will have no further tax to pay. The information necessary for higher rate taxpayer investors to complete their tax returns we envisage would be contained in the UK REIT annual statement of returns issued at the end of the investors' tax year in much the same way as occurs with unit trusts.

In the case of both rental and non-rental income distributions, the amount of income distributed would be net income profit for tax purposes. Thus, before the income is distributed it will, in relation to rental income have had the expenses of the UK REIT's rental business (e.g. maintenance and management expenses and interest) deducted and in relation to non-rental income any relevant expenses and interest. Further, any losses of the rental business should also be first deducted on existing tax principles so that the UK REIT is not forced to distribute income when it is in an overall loss position over a period of years. Such a principle as regards distribution of income is in line with the approach taken with REITs here in the US. Our preferred approach is that capital allowances are not deducted in calculating income

for distribution but should instead be made available to investors in the form of a credit against tax withheld by the UK REIT, as set out below.

Non-qualifying income, i.e. income from trading, should be taxed at entity level at corporation tax rates. The untaxed proportion can be distributed to investors as a separate class of distribution which would be subject to tax in the hands of investors as dividend income. While there may be some advantage in attributing losses incurred at the level of the UK REIT to an investor (e.g. equal treatment for investors coming in at different times) we would imagine this would involve extra administrative burdens for investors and instead such losses should be deducted from the proportion of income to be distributed to investors.

As mentioned above, items deductible for tax purposes at the level of the UK REIT (were it to be subject to tax) are available to reduce the amount of income that needs to be distributed. This should not prevent investors setting any allowable expenses or losses of their own against the relevant class of distribution. Thus, for example, a distribution of net income from the UK REIT (after the UK REIT's expenses have been deducted) would not all be subject to tax in an investor's hands if the investor could set off real estate letting expenses from direct real estate investments. This approach will afford consistent treatment with an investment in a pool of properties in which all deductions in the pool are available for set-off against taxable rental income to the extent possible.

Withholding Tax

We recommend a withholding system in relation to rental income distributions and non-rental income distributions. This has two advantages:-

- it ensures security of receipts for the UK Treasury in relation to certain classes of taxpayer upon whom assessments are more difficult to raise. This would assist in fulfilling the government's aims of tax neutrality for the UK REIT project; and
- it ensures basic rate taxpayers have no further tax to pay and need not file a tax return.

The rate of withholding in relation to the respective streams of income should reflect the current rate of withholding tax on similar income streams, e.g. 22 per cent on rental income and 20 per cent on interest. Non-residents should be permitted to apply to receive rental income distribution payments gross under a modified non-resident landlord scheme and to receive non-rental income distributions gross pursuant to a relevant double tax treaty. A similar application could be made by tax exempt investors which we imagine would contain a suitable self-certification.

As mentioned above, capital allowances available to the UK REIT should not be deducted from the amount of income which is required to be distributed, but instead should be made available to UK REIT investors. The reason for this is that tax

exempt investors would not wish the proportion of income distributed to them to be reduced in this way. Instead, investors who have not obtained permission to receive income gross of withholding would receive a tax credit referable to capital allowances that would have been available at entity level. This tax credit would reduce the withholding of tax on income (for which the investor is liable) by the UK REIT.

Capital Gains

In order for the UK REIT to be a successful investment vehicle (and relative to other options for investment in real estate) tax on capital profits within the UK REIT should be kept to a minimum. An important aspect of this is ensuring the minimum discount in share price to NAV. For example, UK investment properties are often held in overseas companies to prevent (subject to anti-avoidance rules) capital gains arising at entity level. Investors within the UK capital gains tax net would not bring their investments onshore into the better regulated structure of the UK REIT unless the entity level capital gains treatment was as beneficial as the overseas real estate holding company. In addition, offshore unit trusts are also not subject to capital gains tax on gains arising.

Our preferred approach is that there should be no entity-level tax on capital profits, irrespective of whether such profits are distributed to investors, and investors should only be taxed at the point of sale of their shares. Such an approach would be consistent with treating real estate as an asset class in exactly the same way as

more liquid forms of investment held within UK regulated investment companies and authorised unit trusts. It is also our view that there should be no compulsory distribution of capital.

As regards a non-distribution approach we note from the Consultation Paper that there is some concern that such an approach would give rise to a loss to the UK Treasury. We believe this need not be the case if a truly liquid market in the shares of the UK REIT is achieved. The alternative approach suggested in the Consultation Paper is that there would be no tax on capital profits to the extent distributed, and such profits as are distributed would be immediately taxed in the hands of the investor. To be practicable, such a regime must be capable of taking into account the capital expenditure of the investor in acquiring shares. This is particularly important as the shares may be priced with reference to the unrealised capital gain. To achieve this, a distribution of capital would need to retain its status as capital in the hands of an investor and should allow the investor's acquisition cost to be taken into account. It should not be deemed real estate rental income as this would unfairly penalise overseas and tax exempt investors and reduce the appeal of UK REITs relative to offshore vehicles and undermine their success.

Our preference (by contrast to the Consultation Paper) is that even if there is no requirement to distribute capital, a distribution should not give rise to an immediate charge to tax in the hands of investors. Instead, upon a distribution of capital investors' base cost in their shares should be reduced increasing the amount of tax payable on sale of their shares. Only if the distribution were to take the base cost

below zero would this give rise to an immediate tax charge at the time of distribution. We believe that an alternative regime providing for a deemed disposal on capital distribution would be difficult if not impossible to administer successfully.

If the government does not favour retention of gains in a UK REIT tax-free, our fall-back approach is that there should be a requirement to distribute a reasonable proportion of gains (we suggest 50 per cent) but that neither the gains distributed nor the gains retained should suffer entity-level tax. Instead, a distribution should affect the investor's tax position as suggested with our first choice of approach. Therefore, upon a distribution of capital, the investors' base cost in their shares should be reduced, increasing the amount of tax payable on the sale of their shares. Only if the distribution were to take the base cost below zero would this give rise to an immediate tax charge at the time of distribution.

Turning now to the wider tax implications for different types of real estate investment, and what the appropriate liability for Stamp Duty Reserve Tax (SDRT) and Stamp Duty Land Tax (SDLT) should be for a UK REIT and investors in a UK REIT.

Real Estate Transfers

In order to prevent avoidance of SDLT the transfer of a real estate into a UK REIT (other than on conversion) would need to be subject to SDLT at real estate rates. It is open to the government whether it wishes to treat the UK REIT as transparent for SDLT purposes or similar to a corporate vehicle. Our preference is treatment similar

to a corporate entity, mainly for the sake of simplicity, so that it is not necessary to apportion between investors the value of real estate transferred in and out of the UK REIT. Applying the corporate model, on acquisition of a real estate by a UK REIT, SDLT would be paid by the UK REIT on the full market value of the real estate, whether the real estate was transferred/contributed by an investor or a third party. However, there should be no SDLT when existing entities convert to UK REIT status by whatever means that conversion is effected.

If, as suggested below, the 0.5 per cent rate is applied to transfers by investors of their UK REIT interests, it might be said that UK REITs could be used for SDLT avoidance. However, we do not see a major risk of this as investors would not wish to incur the initial 4 per cent (maximum) charge on real estate transferred in to the UK REIT. Any relief in relation to the conversion charge would not be used for avoidance as converting entities would not wish to incur the conversion charge (even if reduced by an SDLT conversion relief) merely to avoid SDLT.

Sale of UK REIT Interest

The sale of an interest in a UK REIT should be regarded much like the sale of an interest in a company. UK REIT interests will be designed as a liquid investment which (as is anticipated by the Consultation Paper) would be listed and easily tradable; it seems hard to distinguish such interests from company shares. The lower liquidity of real estate as compared with shares (and thus reduced transaction volume) is often used to justify the increased stamp taxation incurred on real estate

transactions, but such an argument would not apply to sales of indirect interests in real estate via an interest in a UK REIT. Furthermore, the reduction in liquidity caused by the position of a significant charge on the transfer of UK REIT interests could widen the discount of UK REIT share value to NAV. Minimising such a discount is an important goal of the UK REIT, and it would be unfortunate if the position taken on stamp taxes prevented progress on this issue.

Furthermore, to impose a 4 per cent charge on purchase of an interest in a UK REIT could put off overseas investors.

Using this approach we suggest that there would be little difference to the SDLT take from a given sample of real estate over a given time period. As SDLT would be paid in full on transfer to the UK REIT, and a purchaser from the UK REIT would also pay SDLT at full real estate rates, this might be similar to the SDLT take from a direct holding over a similar period, unless UK REITs were said to hold on to real estate longer than other investors. Any consequent loss of tax take by virtue of a longer holding period might well be offset (or even exceeded) by the increased revenues from transfers of interests (chargeable at 0.5 per cent) in UK REITs taking place more often than interests in unlisted entities that currently undertake real estate investment.

2. Now, moving away from taxation and turning to the second of our themes, the wider economic picture.

As stated at the beginning, there is a growing market wanting to invest in real estate, but in a unitised way. The use of capital markets is introducing a transparency into the process and hopefully a consistency of approach to enable a clearer understanding. Real estate investors in every G8 country, other than the UK, have had the advantage of REIT-type vehicles - essentially tax transparent collective real estate investment vehicles - in which investors hold assets which are unitised like shares. The raft of real estate investment vehicles which have been created over the last decade demonstrate the depth of institutional enthusiasm for a UK REIT type structure.

We believe that the introduction of a UK REIT is likely to increase the amount invested in property. Being equity, rather than debt, it is likely to bring greater stability to the market. The diversification offered by a pool of properties in a UK REIT will reduce the risk associated with investment in a single asset.

The UK property market has certain distinctive characteristics. These include the following:-

- a clear division between commercial and residential markets. Institutional investors rarely invest in the residential market and few individuals invest

directly in the commercial market (although, of course, through pension funds and other savings products they may do so indirectly);

- a high level of owner occupation in the residential market - in Europe 70% of real estate is owner occupied;
- a cyclical market often dependent on debt servicing to varying levels (both in the context of commercial and residential property);
- property represents a small part of asset allocation for institutional pension scheme and life assurance investment, but plays an important part in private provision (e.g. through buy-to-let, SIPPs and equity release schemes).

How might UK REITs affect this market?

Buying a property directly is potentially a high risk, high cost investment. Although this is true for both institutional and private investors, the risks are greatest for the latter who do not normally have access to professional investment advice and tend to have least scope for diversification. A UK REIT, by giving access to a pool of properties, spreads the risk so that, for example, when property becomes vacant from time to time and the fund owns other properties which continue to be income producing, then the impact of tenants leaving is less drastic.

For institutional investors the attractions of investing in a UK REIT, rather than directly include:-

- diversification - an investment in a UK REIT is in a pool of properties rather than using funds to buy a single or small number of properties. This immediately spreads the institution's risk. A UK REIT will also offer diversification opportunities in another sense - by investing in a specialist UK REIT an institution could gain exposure to new sectors of the market (e.g. residential) where it may not have in-house management expertise;
- tax status of UK REIT - the UK REIT will offer a tax efficient way in which to pool and manage funds and will encourage a liquid market in the securities of the UK REIT to develop;
- weighting - commentators suggest that property as an asset class is under-represented in institutional portfolios. UK REITs will enable institutional investors to increase their allocation to property as an asset class through allocation to a properly managed property investment portfolio.

For individual and small private investors, the advantages of a UK REIT include:-

- diversification - spreading risk and avoiding some of the high risk prevalent (particularly where single assets are involved) in the current buy-to-let market;

- lower entry cost - particularly on the residential side, this is likely to bring in investors who would not otherwise be able to afford a buy-to-let property. It might reduce the need for high levels of borrowing in order to enter the market, bringing greater stability;
- professional and high quality management at lower expense - the management and maintenance resources of a UK REIT are likely to be greater than those of individual buy-to-let owners and the UK REIT will benefit from economies of scale, thus enhancing the overall standard and attractiveness of let property, to the benefit of both investors in the UK REIT and tenants alike.

UK REITs are likely to provide a new source of equity funding. This would be of particular value in the near future. A credit crunch is predicted for 2006/7: many credit facilities come up for renegotiation, lending is for shorter terms and the effect of Basel II may be to restrict lending on property to the biggest borrowers. The benefit of the new vehicle should bring in new investors - whether institutions increasing their property weighting or retail investors (the 'mums and dads') - who could bridge the gap. The injection of a greater proportion of equity into the property sector should also reduce short termism, as (unlike debt financing) there will not be the pressure to pay down debt quickly.

In the UK, the current institutional preference is for long term leases and upwards only rent reviews in the commercial market, making it an attractive low risk, high

income investment. However, a wider investor base may take a different view and thereby increase the options available to the tenant. New investors attracted to the property market by UK REITs may not have the traditional expectations of upwards only income shared by the property professionals. Such investors have previously been happy to accept products whose income and value can go down as well as up and they may therefore be more open to take the risk of upwards/downwards reviews.

The UK REIT market may well develop two models: those who invest only in longer term leases with upwards only rent reviews, and those who accept the higher volatility which non-institutional leases bring in return for higher rewards. Investors may welcome these choices and we suggest the UK REIT regime should be sufficiently flexible to accommodate them.

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 suggested that it may be appropriate to restrict the market freedom of a UK REIT, but the success of REITs here in the US is the best argument for the UK Treasury to take a minimalist approach to regulating the UK REIT, allowing it maximum adaptability which will translate into larger market capitalisations and liquidity. We urged the Government to take this approach. If such an approach is taken, then the UK REIT may well succeed in aligning the after-tax returns from

holding real estate indirectly with those obtained from holding real estate 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.

Biography of Speaker

Andrew Petersen qualified as a Barrister and was called to the English Bar in 1997. Andrew obtained a first class law degree from the University of Wales and a Bachelor of Civil Law from Somerville College, Oxford. Andrew has extensive experience in advising financial institutions, lenders and borrowers in all aspects of acquisition finance, senior and mezzanine secured finance and general banking, regulatory and finance matters. He also has experience in corporate restructuring, structured finance and receivables financing and has acted for major financiers and banks. He is an author of numerous articles on finance related issues.