UK Real Estate Investment Trusts

Response to HMT & Inland Revenue Discussion Paper

By the

National Association of Real Estate Investment Trusts®

May 27, 2005

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NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

May 27, 2005
VIA HAND DELIVERY AND E-MAIL

Property Tax Team
HM Treasury
1 Horseguards Road
London SW1A 2HQ
United Kingdom

Re: UK Real Estate Investment Trusts Discussion Paper

Dear Sir or Madam:

The National Association of Real Estate Investment Trusts® ("NAREIT") greatly appreciates the opportunity to provide its comments on the discussion paper (the "Paper") concerning the potential authorization of a UK real estate investment trust ("REIT") that would provide a new vehicle for investing in property to meet the UK Government's objectives to encourage an efficient and flexible property investment market, with fairness for all taxpayers.

NAREIT is the representative voice for United States REITs and publicly traded real estate companies worldwide. Members are REITs and other businesses that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service these businesses.

NAREIT's responses to relevant questions in the Paper are set forth below. Questions from the Paper are marked in bold face throughout these comments. After these initial responses, NAREIT also is providing a number of additional comments.

As an initial point, NAREIT applauds the UK Government for its willingness to commit to the authorization of a UK-REIT structure by 2006. As NAREIT mentioned in its earlier submission to the UK Government, NAREIT believes that adopting a tax-transparent structure that resembles the current United States REIT vehicle would capitalize on 45 years of experience with, and evolution of, REITs in the United States, and should promote a number of the UK government's objectives for reform to the taxation of the property investment market in the UK. Given the increasing global recognition of the acronym "REIT," we believe the UK' s adoption of this term will maximize investor awareness of this new structure.

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Point 1 for discussion

The Government is interested in industry's views and proposed solutions in relation to the taxation of non-UK resident investors within a UK-REIT regime that would deliver the objectives set out in Chapter 1 of this paper. Alongside this the Government is also interested in whether the concept of a ring-fence applied to the property letting business as described in Chapter 3, would work in practice.

Applicable Withholding Tax Rate to UK-REIT Dividends

Background

As we understand it, the Government is considering exempting the UK-REIT from taxation at the company level, and taxing the UK-REIT dividends at the shareholder level either as "property income" or ordinary dividends. The discussion paper states that the Government is considering imposing a withholding tax of 22% (which is the tax rate for "basic rate" UK taxpayers) on dividends to UK resident shareholders that are considered "property income."

However, under applicable double taxation agreement obligations, the Government is concerned about the following two scenarios. First, the UK would not be able to require a non-UK resident company to withhold UK tax on dividend distributions it makes to non-UK resident shareholders. Because the non-resident company would not have paid any tax at the vehicle level, the UK would not be able to collect tax at the shareholder level either. Second, while non-resident landlords must pay UK tax at the highest marginal rate of 22% on UK-sourced rental income, under applicable double taxation agreements, dividends would be subject to a maximum UK withholding tax rate of 15%. Accordingly, the Government is considering applying a 22% company-level tax (reduced from the current highest marginal company-level tax of 30%).

US Experience

While we understand the UK's concerns regarding the potential loss of revenues from adopting a UK-REIT structure, we believe that a number of aspects of the US REIT regime are instructive. First, REITs in the US, unlike most non-real estate companies, pay significant amounts of state and local taxes such as property taxes, sales taxes (which they themselves pay and their retail tenants collect), and property transfer taxes, aside from any corporate-level or shareholder-level taxes. In fact, many of our association's REIT members have told us that their largest expense is state property taxes. The UK should consider these potential revenue sources when evaluating expected revenue gains and losses from the UK-REIT structure.

Second, the residence-based model of REIT income taxation by nearly all US states is instructive as well. Most US states follow the federal model of REIT taxation by allowing a dividends paid deduction at the REIT level. At the same time, these states impose an income tax on REIT dividends earned by their residents who are REIT shareholders regardless of whether the REIT itself derived any income from that state. For example, New York may tax the dividend income earned by New York resident shareholders attributable to rental income earned by a REIT with North Carolina properties and operations. Although North Carolina generally would not tax this

income at the REIT level, it would tax the dividend income of North Carolina resident shareholders attributable to rental income earned by a REIT with North Carolina properties as well as the dividend income earned by North Carolina shareholders from REITs solely attributable to properties outside of North Carolina.

As a result, at the state level, REIT income generally is taxed at one level throughout the US. This model encourages the free flow of capital among the states and increases the overall economic pie. Given the expanded interest in the adoption of REIT structures worldwide, we would hope that the adoption of a similar residence-based model of taxation by the UK and other countries would lead to the same economic result – the free flow of capital among countries with a REIT structure, and the imposition of tax on resident shareholders on REIT dividends regardless of the ultimate source of the property income of such dividends.

Third, the US REIT rules that require US REITs to be widely held in many cases have served to prevent concentrated ownership of US REITs. Specifically, five or fewer individuals may not hold more than 50% of the value of a US REIT, and a US REIT must have at least 100 shareholders.[1] Many REITs incorporate these legal limitations in their organizational documents as a means to insure that these limitations are satisfied. As a result of these rules, US REITs tend to be widely held, and many are publicly listed.

We understand that the Government is concerned about a non-UK entity gaining control of a UK-REIT organized outside the UK and owning UK real estate, thereby avoiding a dividend withholding tax on dividends in the case of certain double taxation tax treaties. One option to prevent such a situation, if consistent with EU and other legal obligations, would be to impose ownership limitations on the UK-REIT similar to, or stricter than, those imposed in the US.

Fourth, US tax rules require that a US REIT must be (but for the REIT provisions) "taxable as a domestic corporation."[2] Thus, a US REIT must be organized under the laws of one of the 50 US states or the District of Columbia. [3] This is one area where we do not recommend the UK adopt the US model. To encourage US REITs to invest in the United Kingdom, we recommend that a UK REIT should be able to be domiciled in any country, or at least in those countries that have similar REIT rules and, perhaps, that have bilateral tax treaties in force with the UK. This flexible domicile rule would allow a US REIT to establish another US REIT that could qualify and operate as a UK-REIT for its UK operations. NAREIT would support a Protocol to the existing US-UK tax treaty under which the UK could withhold a 15% tax on dividends from the UK REIT to the US REIT regardless of how much of the UK-REIT's stock the US REIT owns, paralleling the United States' tax treaty position described below with respect to US REITs.

Fifth, the US experience regarding the taxation of REITs and the applicable withholding tax rate on REIT dividends has been that high withholding tax rates on REIT dividends to non-US shareholders served as a barrier to desirable foreign capital. By way of background, although the

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[1] Sections 856(a)(4) and (a)(5) of the Internal Revenue Code of 1986 (the Code). Unless otherwise provided, all "Section" references within this letter shall be to the Code. A US REIT may own all or part of the outstanding shares of another US REIT, since REIT stock is considered a qualified real estate asset under the US REIT rules.

[2] Section 856(a)(3).

[3] Section 856(a)(3) requires a US REIT to be taxable as a "domestic corporation," and the Internal Revenue Service concluded in Revenue Ruling 89-130, 1989-2 C.B. 117 that a US REIT must be organized as a US entity.

Code has used a 30% withholding rate on all dividends paid to non-US persons for some time, since the end of World War II the US Treasury Department has consistently lowered that rate to 15% or lower in bilateral tax treaties. In 1988, the Treasury Department began renegotiating tax treaties that essentially doubled the withholding rate imposed on REIT dividends to foreign institutional investors, while preserving the 15% rate on other corporate dividends. The stated US concern was that REIT dividends should be treated in a manner that generally is comparable to the treatment of rental income earned on a direct investment in real property.

In 1997, after learning from the REIT industry that the existing policy was hindering the flow of foreign capital into REITs, the US Treasury Department, with the authorization of the US Senate, modified its negotiating position by reducing the withholding tax rate applicable to REIT dividends. The US Treasury Department goal was to maintain treaty policy that properly preserved the US taxing jurisdiction over foreign direct investment in US real property without unnecessarily discouraging desirable foreign capital investment in US REITs. As stated by the Treasury Department's International Tax Counsel: "Our new policy takes into account that portfolio investments in a REIT whether by individuals or institutional investors may be indistinguishable in intent and results from similar investments in other corporate securities and should be afforded similar tax consequences in appropriate circumstances."

Because, unlike non-REIT corporations, US REITs must distribute substantially all of their income, lower withholding taxes applicable to their dividends still attract a significant amount of US withholding tax. Further, by encouraging foreign capital investment in US REITs as portfolio investments, the US Treasury was able to achieve other economic goals, such as providing needed capital for US REITs for expansion and development of real estate, which resulted in the generation of greater property, sales, and transfer taxes, and the potential increase in the number of jobs in the REIT sector. In fact, the equity market capitalization of the US REIT industry has grown from $140.5 billion at the end of 1997 to $296.8 billion at the end of April 2005. We respectfully suggest that the UK consider the positive economic effects of foreign investment in a new UK REIT industry that might be curtailed if it increases tax rates at the REIT level or at the shareholder level.

Under the 1997 Treasury Department policy, REIT dividends paid to a resident of a treaty country are eligible for the reduced rate of withholding tax applicable to portfolio dividends (typically, 15%) in two cases. First, the reduced withholding tax rate applies to REIT dividends if the treaty country resident beneficially holds an interest of 5% or less in each class of a listed REIT. Second, the reduced withholding tax rate applies to REIT dividends if the treaty country resident beneficially holds an interest of 10% or less in the REIT and the REIT's property holdings are diversified,[4] regardless of whether the REIT's stock is publicly traded. In addition, the treaty policy with respect to the application of the reduced withholding tax rate to REIT dividends paid to individuals holding less than a specified interest in the REIT (typically 10%) was unchanged.

Virtually all of the bilateral tax treaties or protocols negotiated by the United States since 1997 have followed the new rules with respect to US REITs. Further, US Treasury Department officials have stated their plan is to incorporate the new policy into the US model treaty.

[4] For purposes of these rules, a REIT is considered diversified if the value of no single interest in real property held by the REIT exceeds 10% of the value of the REIT's total interests in real property.

Recommendations

1. Exempt UK-REIT From Taxation on Property-Related Income

NAREIT believes that an entity-level tax on UK-REITs, particularly on listed UK-REITs, would be counter-productive and would severely impair the creation of a more liquid real estate sector. We suggest that the UK consider applying a 15% withholding tax rate on UK-REIT dividends to non-UK shareholders. While the 15% withholding rate on dividends to non-UK investors may be less than the 22% rate that would apply to these investors if they invested directly in UK rental property, as a practical matter, the difference may not be that significant because we are advised that direct investors use high levels of debt and other expenses to reduce the effective tax on rental income below 22%. Also, as we noted above with respect to the US treaty experience, the US' imposition of higher withholding taxes on US REIT dividends to non-US REIT investors was considered to impede the flow of foreign capital to the US REIT market.

Again, we understand the UK's concern that a foreign entity may attempt to gain control of a UK-REIT so that the UK-REIT's dividends would not be subject to UK dividend withholding tax. In response to this concern, we suggest that the UK consider requiring as a condition of UK-REIT status the ownership of the UK-REIT to be widely held in such a manner so as to limit the likelihood of concentrated foreign ownership solely to achieve tax benefits.

If concentrated ownership in UK-REITs were limited, the UK Government's concern regarding the ability of a foreign entity to acquire control of a UK-REIT and avoid a dividend withholding tax would be reduced. Due to the high level of dividends expected to be paid by UK-REITs, the increase in tax revenues attributable to the withholding tax that would apply to these dividends may be sufficient to offset any tax losses based on the two situations raised as concerns in the Paper.[5]

Finally, if the REIT structure is adopted in jurisdictions other than the UK, the UK may find that the imposition of taxation only on dividends earned by UK resident shareholders, whether attributable to UK or non-UK REITs, along with the 15% withholding tax on dividends to non-UK investors in most cases[6] maintains a sufficient flow of revenue to the UK and contributes to an overall improvement in the UK property sector and the free flow of capital among countries.

We would hope that by adopting some or all of these suggestions, the UK could increase investment in the property sector, thereby achieving some of policy goals such as improving the

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[5] As an aside, we note that with respect to a similar vehicle in Canada, the "income trust" (a business entity that distributes most of its income and whose income is basically taxed only at the unitholder level), the Canadian Association of Income Funds and the Canadian Institute of Public and Private Real Estate Companies jointly retained HLB Economics Inc. to ascertain the effect of income trusts on the Canadian tax revenues. The results were published in March 2004, and can be accessed through the following link: http://www.caif.ca/content/CAIF_RiskAnalysisReport.pdf . In sum, the HLB study concluded that the "statistically best estimate . . . indicates that by comparison to the tax yield associated with enterprises in their previous corporate form, the conversion of income trusts produced a small net gain in governments' tax revenues in each of the years [of the study: 2002-2004] (about $51 million in 2004). If taxes associated with one-time transitional capital gains are excluded [from the conversion of the prior enterprises to income trusts], the statistically best estimate represents a small tax loss to governments' of about $5 million in 2004."

[6] We assume that most UK-REITs would be organized in the UK for administrative ease and to increase familiarity for the UK residents who are the likely majority of investors.

quality and quantity of finance for investment in commercial and residential property; expanding access to a wider range of savings products on a stable and well-regulated basis; and reducing costs and improving flexibility and quality for tenants in the property sector.

2. If Entity-Level Tax is Necessary, Impose Entity-Level Tax Only to the Extent That "Controlling Interests" Are Held By Any Shareholder in the UK REIT

While we recommend against an entity-level tax, particularly for listed UK-REITs, if the UK believes that it is necessary, we would suggest that an entity-level tax be imposed only to the extent that that any shareholder, whether UK or non-UK, owned a "controlling interest" in the UK REIT. A "controlling interest" could be, for example, 50% or more of the vote or value of the UK REIT's securities.

Concept of a "Ring Fence" Applied to the Property Letting Business

We understand that the UK also is considering exempting a UK-REIT's income attributable to activities that fall within a "ring fence" established around the property letting business, while subjecting to regular corporate tax a UK-REIT's income attributable to "ancillary services" associated with the property letting business.

NAREIT respectfully recommends that the UK consider including all real estate-related services in the income exempt from tax at the UK-REIT vehicle level. To do otherwise would be to limit implicitly the types of key services that the UK-REIT might provide, thereby limiting their ability to satisfy tenants' demands for both basic and "cutting-edge" services. Furthermore, limiting exempt -income only to income within the "ring fence" would create very complex calculations as companies attempted to allocate income and losses between the "ring fence" services and the non-"ring-fence" services.

In our prior submission to the UK concerning the UK-REIT proposal, NAREIT provided an extensive list of the many ancillary services that US REITs provide as part of their business of owning and operating income-producing real estate. The provision of these services are what enable REITs to satisfy their tenants' demands for services needed to be competitive and therefore what enable REITs to provide consistent, long-term income distributions to their shareholders, coupled with stable amounts of capital appreciation.

Further, to provide some flexibility to REIT management, the REIT rules allow a small amount of income to not meet the REIT income tests. For example, 95% of a US REIT's income must be from real estate or passive income sources, so that the "5% basket of bad income" can absorb minor investments or activities. We suggest that any ring fence not be an absolute test.

The constraints of the REIT rules (as well as the public market, in the case of publicly traded REITs), rather than different tax rates on qualifying and non-qualifying income, keep US REITs focused on their core business of owning real estate. In this way, the shareholder of a US REIT is taxed comparably (on dividends, for the most part at up to the highest marginal tax rate on

ordinary income)[7] to the direct real estate investor (on ordinary income at the highest marginal tax rate applicable to ordinary income).

Point 2 for discussion

The Government is interested in what solution the industry can offer to ensure that allowing reasonable levels of borrowing within a UK-REIT market would not reduce the tax collected from investors or result in specific manipulation for tax avoidance purposes. Would requiring a UK-REIT to be listed on a recognised stock exchange minimize this risk?

First, as we noted in our prior submission, we agree that market forces tend to reduce the overall level of borrowing by US publicly traded REITs compared to commercial real estate held privately. With that said, the US does not impose significant restrictions on the levels of debt incurred by any taxpayers (whether a REIT or other type of taxpayer) with respect to debt from unrelated parties. Any limitations on borrowing should take into account the special needs of a REIT, which is required to distribute substantially all of its income. Further, no undue restraints should be placed on leverage because a REIT might need to borrow additional funds during a recession when it may be otherwise difficult to obtain equity capital.

We recommend against requiring a REIT to be listed for many of the reasons we stated in our prior submissions. Most importantly, there are valuable reasons to allow REITs to remain private. For example, a REIT's management may need to develop a track record as REIT managers prior to a public listing. Additionally, many sophisticated investors may prefer a private entity to meet their particular investment objectives. As we noted earlier, the private US REIT vehicle has proven to be very popular with pension plans, foundations, public charities, and other institutional investors who are attracted to the corporate governance benefits of a corporate structure as contrasted with a partnership under which a general partner has more discretion.

Furthermore, as in our prior submission, NAREIT recommends that legislation provide the flexibility to meet different market challenges and not limit the level of gearing for UK-REITs. When the UK calculates the foregone tax revenues due to borrowings by the REIT, it should consider that interest earned by UK lenders will be subject to UK tax. If the UK concern is "earnings stripping" by affiliated parties, whereby an affiliated, typically foreign party would make a loan to the REIT that would reduce the REIT's income and the corresponding amounts distributed to investors, but which would not be taxable by the UK, then it should consider adopting a rule against this specific abuse not just for real estate investors, but for all taxpayers.

For example, the US has an "anti-earnings stripping" rule in Section 163(j) that applies to all taxpayers. Under Section 163(j), in general, if the borrower's debt to equity ratio exceeds 1.5: 1, the lender is a "related" person to the borrower, and the interest earned by the lender is not

[7] Note that the highest marginal tax rate on most non-REIT corporate dividends was lowered to 15% in 2003. Certain types of dividends from REITs attributable to income previously taxed at the company level can qualify for this lower rate, but most REIT dividends attributable to the REIT's receipt of rental income are taxed at the shareholder's highest marginal tax rate applicable to "ordinary income."

subject to US tax (for example, due to a treaty obligation), then a portion of the borrower's interest deduction is disallowed. Adoption of a similar rule for all taxpayers might serve to address the UK concern about the use of interest to reduce a UK-REIT's income (and thus, the amount of taxable income distributed to shareholders) without a corresponding increase in the lender's income subject to UK tax.

Point 3 for discussion

The Government would like to discuss how group company structures could fit within a UK-REIT regime in the context of addressing other technical issues outlined in this paper.

Because we are not familiar with group company structures in the UK, we cannot comment on this specific issue. However, the US experience with affiliated companies may be instructive.

To begin with, a US REIT is not permitted to be a member of a US consolidated group of companies. Thus, a US REIT's income may not be offset with losses of another corporation. US REITs are permitted to own 100% of the stock of another corporation, which is either a "taxable REIT subsidiary" (TRS) if a TRS election is made by both companies, or a "qualified REIT subsidiary" (QRS) if no TRS election is made. A QRS is considered a disregarded entity for US tax purposes; its income and assets are considered to belong to its parent REIT. A TRS is a fully taxable entity. A REIT may own less than 100% of a TRS, but it must own 100% of a QRS.

Many US REITs also own properties through flow-through entities (partnerships or limited liability companies), which pass through income and losses to the REIT for tax purposes. Depending on the exact ownership of these partnerships or limited liability companies, these entities also may be disregarded entirely for US tax purposes, in which case their income and assets would be considered part of the parent REIT. The purpose of holding properties through these flow-through entities is typically to isolate particular liabilities from a specific property. In certain cases, lenders require REITs to form special purpose entities as borrowers for loans. Additionally, many REITs have used the "Umbrella Partnership REIT" structure (UPREIT) to facilitate the tax-deferred contribution of appreciated property to a REIT's "operating partnership" in exchange for partnership units ultimately convertible into REIT stock or cash.

Other Issues

In addition to the responses raised above in response to the specific requests by the UK Government, we would like to raise two additional issues. First, the Paper states that the UK will permit the UK-REIT to engage in some amount of development. We would like to suggest respectfully that development or redevelopment of an existing property for the UK-REIT's own account (that is, property it develops for itself to hold for long-term investment) should be permitted without limitation, just as it is in the US. By permitting development for its own account, the UK-REIT would be able to apply its property expertise to improving property that it will hold for long-term investment and is precisely the type of activity that the Government should encourage because a business organization will take maximum care in working on a property that its shareholders will benefit from over a long period.

Second, in determining a UK-REIT's qualifying assets and qualifying income, shares in another REIT (whether foreign or domestic) should constitute qualifying assets that give rise to qualifying income. So long as the relevant REIT is required to comply with similar requirements relating to real estate assets and income as the UK, the investment in such a REIT should be a qualifying investment and should be considered as producing qualifying income.

Thank you again for the opportunity to submit these comments. We would look forward to discussing them in more detail if you believe it appropriate. Please contact me at (202) 739-9408 to discuss in more detail.

Respectfully submitted,

Tony M. Edwards
Senior Vice President and General Counsel